Destructive Creation:
The Unintended Consequences of the rise of finance

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Abstract

The intent of this dissertation is to determine how financial liberalization – specifically, the withdrawal of the state from credit allocation decisions, the removal of restrictions on financial firms' activities, and the introduction of greater competition into financial markets – has affected capital allocations in developed countries.

It follows the cases of Britain and France between 1979 and the present day. It finds that, at first, the two countries followed remarkably similar trajectories: (1) liberalization heightened the competitive pressures facing financial firms, reducing the profitability of traditional financial activities; (2) financial firms adapted by consolidating, expanding, and innovating; (3) these adaptations resulted in a "backwards" allocation of resources, with nonproductive sectors (the household and the financial sectors) borrowing more than the productive (non-financial) sector; (4) the growth which resulted was predicated on consumer spending and asset price appreciation rather than investment; and (5) such growth was unstable, generating both inequality and large macroeconomic imbalances.

After both countries' 1980s-era credit booms gave way to recessions in the early 1990s, the British and French narratives diverged. While Britain restarted the boom-bust progression at the end of the 1990s, the French government took steps to prevent the cycle from repeating. It discouraged household indebtedness and incentivized household savings, aiming to liberalize the country's financial sector without completely deregulating households' financial

activities. As a result, France avoided a return to the "backwards" resource allocations and unstable growth of the 1980s; Britain did not.

Extending this analysis to the developed world reveals a highly generalizable story. The trend toward increased competition, financial adaptation, unproductive resource allocations, and ultimately toward instability, inequality, and external imbalances is evident across a broad cross-section of countries. Even so, these problems are less evident in countries – like France – where increases in household borrowing have been mitigated.

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Table of Contents

List of Tables and Figures

Chapter One

Chapter Three

Chapter Four

Chapter Five

Chapter Six

Chapter Seven

Chapter Eight

Chapter Nine

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One – Introduction

Financial markets and institutions play an essential role in economic life. We rely on them to gather together idle savings and to convert those savings into usable resources. And we depend on financial markets to distribute those resources in a way that fuels growth, puts capital to its most productive use, guides businesses toward sound decisions, and helps us mitigate life's inherent risks. As Robert C. Merton (1990), Nobel Laureate in Economics, put it, "the core function of the financial system is to facilitate the allocation and deployment of economic resources, both spatially and across time, in an uncertain environment." Finance, when it performs this core social function well, is an indispensable tool for improving productivity and material well-being.

Today's financial markets can marshal and distribute financial resources faster – and in greater amounts – than ever before. Even so, the financial crisis of 2007-08 and the economic troubles that followed are a reminder that even the most sophisticated financial markets can malfunction with disastrous consequences. These contemporary markets have emerged out of an extended period of financial liberalization – one characterized by the withdrawal of the state from credit allocation decisions, the elimination of regulatory restrictions on financial activities, and the opening of financial markets to domestic and international competition.

The liberalization of financial markets presents a fascinating empirical puzzle. While there is little doubt that liberalization has enhanced the capacity of financial markets to allocate resources across time and space, it does not necessary follow that the resulting allocations have actually maximized social welfare. It is far from certain that liberalization has produced financial systems which conform to the free-market ideal.

This dissertation makes no *ex ante* assumption concerning the desirability of financial liberalization. Instead, it asks some fundamental questions about the liberalization process: Why did liberalization happen? How did the liberalization process alter the incentives facing economic actors? How did resource allocations change as a result? What broader economic impact did these changes produce? The purpose of this chapter is fourfold: first, to explain why these issues are worthy of a new analysis; second, to boil these questions into a single research question; third, to establish how that question is to be answered; and fourth, to introduce the answers that this dissertation will provide.

I: The Problem

The story of post-1980s financial liberalization begins in the 1970s. Policymakers across the developed world were struggling to deal with a raft of major economic changes: the Bretton-Woods system of fixed exchange rates was collapsing, global financial markets were growing more integrated, oil prices were periodically spiking, and governments were increasingly confronted by the "stagflation" combination of stubbornly high inflation and rising unemployment. The new environment placed severe strain on the idea that governments could continue to take responsibility for stimulating investment, stoking demand, and maintaining full employment.

During this period, developed country financial markets consisted of relatively sheltered national financial systems within a more liberal international framework – part and parcel of the wider postwar regime of "embedded liberalism" (Ruggie 1982). Countries maintained quantitative controls on credit, allowed the existence of financial cartels, imposed stringent legal restrictions on otherwise-profitable financial activities, and controlled international capital movements. This system of financial market controls – useful for maintaining fixed exchange rates under the Bretton-Woods system and for directing credit as the state saw fit – came to be known as "financial repression" for how it inhibited the functioning of financial firms and markets (c.f. in particular McKinnon 1973; Shaw 1973).

Repressive financial regimes relied upon relatively limited international capital flows. If financial institutions could easily move funds in and out of national jurisdictions, it would undermine domestic controls on credit expansion and capital allocations. As the 1970s progressed, however, international capital grew increasingly mobile. Where capital had once served an ancillary function – flowing across borders chiefly in support of trade – it increasingly began to cross borders for purely financial reasons (Helleiner 1993). Growing intermingling of financial markets became a crucial element of a new, interdependent, global dynamic (c.f. Keohane and Milner 1996).

Increased interdependence furthered the cause of those who argued against policies of financial repression. Classically liberal economists in the tradition of Milton Friedman (1953) argued that artificial barriers to capital flows were inefficient. Heterodox economists in the tradition of Joseph Schumpeter (1983) argued that repressed financial systems hindered growth (R. G. King and Levine 1993b). Political pragmatists like Nigel Lawson (2011) simply argued that dismantling repressive financial policies would make domestic markets attractive to international capital.

Taken together, this group of financial liberalizers argued that greater competition in financial markets, fewer barriers to capital flows, and new markets for more diversified financial instruments would improve macroeconomic performance. Financial freedom, they maintained, would allow private markets to better allocate resources, improve firms' hedging opportunities, and make it possible for firms to invest and consumers to sustain themselves without overly burdening the state. In other words, liberalized financial markets could perform Merton's core function better than repressed ones.

In more market-friendly economies – particularly those that already functioned as global financial capitals and therefore had relatively attractive capital markets – the case for liberalization won out early: the United States and Britain were among the earliest reformers in the 1970s. These early movers started a sort of domino effect: capital strained to exit financial systems that remained repressed. This put downward pressure on those countries' exchange rates, making it difficult to remain in fixed exchange rate regimes, and causing domestic capital to grow scarce. This put pressure on states to abandon their policies of financial repression and converge on a more liberalized norm (c.f. Stopford, Strange, and Henley 1991; Cerny 1997).

Governments consequently rewrote rules to eliminate protected uncompetitive niches for certain institutions, opened themselves to international competition, and dismantled obstacles to financial access for firms and individuals. They ensured that firms and individuals could borrow and lend as much as could be profitably justified. By bringing down international barriers to capital flows they expanded the scope for competition from the national to the international level. The trend from the early 1980s onwards was toward freer and more competitive financial markets.

This dissertation takes the view that any attempt to analyze this trend should be based on three foundations: First, a sound analysis must consider both benefits and costs of financial liberalization. Second, it must examine how the liberalizing process affected both the financial sector itself and how liberalization altered the ways in which non-financial actors interact with financial systems. Third, it must examine the end uses to which financial resources are allocated rather than focus on specific financial activities or instruments.

I.1: Acknowledging Costs and Benefits

There has long been a tendency within the mainstream financial literature to simply ignore or downplay the unintended costs of financial activities. Arguably no mainstream view of financial markets has been more influential than the Efficient Market Hypothesis (EMH) – the proposition that financial markets tend toward an informationally efficient equilibrium. At its core, this means that free financial markets will, through the actions of informed buyers and sellers, arrive at the "correct" prices for assets. This is important because it means that any attempt to interfere with free markets will tend to hinder the accuracy of this pricing mechanism.

While the EMH is often criticized for fueling the drive to liberalize financial markets (Nocera 2009; Fox 2011), this blame is somewhat misplaced. As "Chicago School" economist James Heckman points out, the view that markets tend toward efficiency when allowed to flourish is not the same as a desire for blind deregulation. The true problem, Heckman has argued, was that a crude understanding of the EMH and the broader teachings of the Chicago School – their supposed belief that markets are perfect and can be left alone – became entrenched in policymakers' minds as gospel (Fitzgerald 2009). Indeed, the originators of the EMH were not overzealous deregulators; their chief concerns were always a bit more esoteric. Much of their historical debate, for instance, has centered on precisely what information is conveyed by the prices of financial instruments (c.f. Fama 1970; Jensen 1978; Fama and French 2008).

It is nevertheless fair to say that these financial theorists, while not libertarian purists, did tend to focus almost exclusively on the benefits of liberalizing the pricing mechanism. Many like-minded scholars have gone further, explicitly asserting that the benefits of financial liberalization obviate concerns over the cost of financial freedom. “You have to take some of the bad with by far the good,” suggests another University of Chicago economist, Gary Becker, arguing that the past several decades of growth have vindicated the agenda of deregulation and liberalization – a view echoed by others (Beim and Calomiris 2001; Mishkin 2006; Fitzgerald 2009).

Robert Shiller (2012), while hardly not emanating from the same school of thought, nevertheless maintains that freedom to innovate new financial products is necessary for improving the function of financial markets. And Ross Levine, perhaps the most vocal and visible advocate for financial freedom today, puts the point even more starkly:

> 'Information technology eases identity theft. Webcams facilitate child pornography. And, drugs are dangerously abused. But just as we should not conclude that medical research does not promote human health because of drug abuse, we should not conclude that financial innovation does not promote economic growth because of the devastatingly costly crisis through which we are now suffering' (Stiglitz and Levine 2010)

In other words, the benefits of financial liberalization are large enough to justify even relatively large costs.

Yet the quality of existing evidence hardly seems strong enough to justify such confidence. Much of the basis for asserting the positive welfare impact of deregulation relies on a body of econometric literature that does seem to suggest that growth, income, and equality are all associated with financial market liberalization (c.f. King and Levine 1993; Beck, Demirgüç-Kunt, and Levine 2004; Bekaert, Harvey, and Lundblad 2005; Ang 2008;

Demirgüç-Kunt and Levine 2009). If accurate, these studies would at least indicate that the unintended side-effects of liberalization are usually more than balanced by the intended benefits.

There are reasons to question whether this is so obvious: The need for cross-sectional comparability within the fairly strict rules of econometrics compels the use of generic data in these studies, meaning that they effectively regress variables measuring capital market depth and credit creation against economic growth. This provides very little information on, for instance, whether the development of derivative financial products is as beneficial as the development of an active and liquid market for equities or corporate bonds – or whether the relationship is stable over longer time horizons. Moreover, because the studies are typically cross-sectional rather than based on changes within a country over time, they may conflate financial development with wider economic development and macroeconomic stability (Ram 1999; Arestis, Demetriades, and Luintel 2001). Indeed, it is entirely possible that different types of financial deregulation – and deregulation in countries at varying income levels – have quite different impacts on growth and welfare (Demirgüç-Kunt and Detragaiche 1998; Ram 1999; Turner 2012).

In short, while many of these works are extremely rigorous, that rigor comes at a price. They take a very big question – whether financial liberalization is beneficial – and distill it into very specific questions about a handful of metrics. The answers provided may be interesting and insightful, but are too limited in scope to justify the assumption that liberalization always – or even usually – generates benefits that exceed costs. Any analysis of the broad consequences of liberalization is simply incomplete without considering both.

I.2: Considering the Financial System in Context

The debate over whether markets, banks, greed, irresponsible borrowers, ratings agencies, government policy or regulators caused the late-2000s financial crisis continues to rage (c.f. Foster 2009; McNally 2009; Calomiris 2009; Levine 2010; Crotty 2011; Lo 2012; Keen 2012). Heterodox economists and many lay observers tend to blame financial firms. More orthodox economists argue that those firms merely react to incentives created by government policy. Both sides are largely missing the fact that governance structures and markets can not be so easily disentangled; they react with one another to produce both incentive structures and economic outcomes (Underhill 2007). Nor can financial institutions be considered in isolation from the non-financial corporate and household sectors.

The premise behind liberalization was that market-based incentives – i.e., free market competition – better moderated the behavior of financial firms' themselves. For financial firms, however, liberalization was a double-edged sword. More competition meant the removal of government protections that financial firms had come to rely upon. In the past, laws allowed different types of financial firm to thrive on traditional banking activities within assigned niches. Some institutions, for instance, had effective monopolies on mortgage-lending or deposit-taking or stock-broking. Within these relatively closed-off industries, cartelization was often permitted and competitive pressures were generally low.

Liberalization meant the creation of a harsher operating environment. Banks could increasingly compete with each other in the provision of virtually any financial service. Larger banks could acquire smaller banks whose operating costs relative to revenue were simply unsustainable. As competition intensified, the returns produced by traditional business models – such as the deposit-and-lend model of banking or the reliance on equity trading commissions – became less viable. In that way, liberalization greatly increased the pressure on firms to find new ways to remain profitable. In response, financial firms adapted through three strategies: consolidation, expansion, and innovation.

A vibrant body of literature delves into whether these adaptations altered the stability of banks themselves (c.f. Vives 2001): In expansions, for instance, banks may become excessively leveraged or make dubious assumptions about their actual leverage ratios in order to reap greater profits (Minsky 1992; Committee on the Global Financial System 2009; D'Hulster 2009; Triana 2012). Financial institutions sometimes found it lucrative to produce and sell financial products that buyers simply did not understand or to extend loans that they knew were of exceedingly poor quality (Bookstaber 2007; Das 2010; M. Lewis 2011). In short, there is an arguable case for a negative relationship between financial competition and the sector's stability (Allen and Gale 2004; Beck, Demirgüç-Kunt, and Levine 2003; Boyd and De Nicoló 2005).

These studies are important because they all examine how competitive incentives altered the behavior of financial institutions. Yet these analyses often have a large blind spot: they tend to ignore the fact that non-financial firms and households are intimately involved in this process of competitive adaptation within the financial sector. For financial institutions to grow, they need both new savers and new borrowers. In order to sell innovative new products, they require markets for those products. Ultimately, any analysis of the impact of liberalization must consider not only financial firms and their regulatory environments but also the impact of liberalization on the relationships between financial firms on the rest of the broader economy.

II.3: Determining End Use

Even if the financial institutions that emerged from liberalization were more able to perform Merton's "core function" – more capable of mobilizing savings, directing financial resources, and mitigating risks – there was never a guarantee that they would do so in a way that was welfare-maximizing. Deregulation heightened financial firms' alertness to new profit-making activities, yet profitable financial activities are not necessarily the best ones from an allocative perspective. It may, for instance, be more profitable to channel resources into sub-prime credit cards or riskier securitized consumer debt than into business investment that could generate jobs or wage growth (c.f. Crotty and Goldstein 1992; Stockhammer 2004; Froud, Leaver, and Williams 2006; Dallery 2009).

Orthodox and heterodox financial theorists have long jousted over whether certain types of financial transactions – or types of financial instruments – are "good" or "bad." For instance, John Maynard Keynes (1936) saw speculation as unproductive gambling based on future expectations of an asset's value. For the orthodox financial theorist, however, such speculation is a necessary part of the financial ecology (Friedman 1953). Instead of a gambler, the speculator is a "hero:"

> 'When people are desperate to sell their possessions, he appears with cash - the very thing they want most. When they change their minds and clamor to buy those things back from him during good times, he once again graciously accedes to the desires of the majority. The speculator, like any other worker, tries to give his employers what they want. Value is subjective, and the price at which something voluntarily trades hands is exactly what it's worth at the time; the speculator simply gives value for value. If he wasn't there to buy, perhaps no one would be, and sellers would be really in trouble.' (Casey 2005)

In other words, the speculator seeks any opportunity to buy low and sell high, ensuring that there are always buyers in the market. They ensure liquidity and lower the costs of engaging in a financial transaction, helping markets to settle on prices.

The question of whether speculative financial transactions are socially beneficial is fundamentally myopic. While it is important to understand which transactions are encouraged by financial reform, determining how resource allocations are ultimately affected by reform is more important: If financial liberalization results in more capable financial markets that allocate resources to investment, the result would clearly be beneficial. If the post-liberalization allocation of resources favors the pursuit of capital gains or fuels consumption, the benefits are less clear. Any analysis of financial liberalization must consider how the enhanced allocative capacity of liberalized financial markets is ultimately put to work.

The best way to untangle this problem emerges from a critical analysis of a group that is often ignored in mainstream economic discourse: Marxists. One of the key features of heterodox – especially Marxist – accounts of the financial transformation of the past thirty years is the idea that "in an era of finance, finance mostly finances finance" (Toporowski 2010). In Marx's own terminology, money has become increasingly directed into M-M' transactions rather than M-C-M' transactions: that is, money transformed into more money through speculative asset purchases rather than through the productive process. This distinction produces a dichotomy that differentiates between uses of capital that are "real" (i.e., money gets turned into real products) and those which are "financial."

For these heterodox scholars, the major concern with this change was not the effect of speculation on markets, but with the effect of speculation on capitalism itself. John Bellamy Foster, synthesizing the arguments of Minsky and Keynes, argues that since the 1970s,

> 'money capital that could be used for accumulation (*assuming the existence of profitable investment outlets*) within the economic base is frequently diverted into M-M′, i.e., speculation in asset prices.' (Foster 2010) (emphasis added)

Foster goes on to argue that this means that the mode of accumulation in capitalism has changed, shifting from an emphasis on producing physical capital to favoring the accumulation of financial capital. This account is popular within the eclectic "financialization" literature (Arrighi 1994; Krippner 2005; Stockhammer 2008) and is a core part of the story told by both Marxist financial scholars and the French Regulation School (Boyer 2001; Cordonnier 2006). This idea is not wrong; however, the key dichotomy is not between the "real" and "financial" economies, but – following Schumpeter (1983) – between allocations of financial resources that are productive and those that are not.

If an individual or firm borrows for purposes that do not create new productive capacities, the result is spending today at the expense of spending tomorrow. Generally speaking, credit card debt, store credit, home equity loans, government borrowing for social spending, and most mortgages and auto loans are examples of such unproductive borrowing. In contrast, when businesses borrow in order to invest or when students take out student loans, the borrowed funds are used in ways that directly enhance future productivity. That future productivity generates income that the borrower uses to repay their debts. Unlike consumptive credit, productive borrowing therefore does not necessarily require a sacrifice of future purchasing power – though there is no guarantee that the enhancements to productivity will generate sufficient income to pay off the debts incurred.

The distinction between productive and unproductive uses of capital is not entirely cut-and-dry. Home equity loans might be used to finance investment by the self-employed. Or a consumer can use an auto loan to buy a car in order to commute to a better job. Nevertheless, these are problems with classifying the available data, not with the distinction itself. Furthermore, distinguishing between productive and non-productive uses of financial products is ultimately superior to delineating between "real" and "financial" uses of financial capital because it accounts for the growing real-world volume of consumptive credit, which the "real" / "financial" distinction does not.

Several other end uses of financial resources are worth directly addressing. Borrowing in order to speculate on asset prices – or to take positions on derivative instruments that pay out under certain circumstances – are particularly problematic. These tactics do generate income, though only where bets pay off and borrowers realize capital gains. By the same token, poor speculative gambles reduce incomes in the same way. In expansions, credit-fueled asset-price appreciation should result in income-generating capital gains; in contractions and liquidity crises, declining asset prices will be income-destroying. These uses of financial resources can also be zero-sum. The "winner" in a derivative contract is paid by the "loser." For these reasons, the monetary gain from speculation tends to be largely manufactured out of credit growth – or are redistributive rather than resulting from productivity gains (Magdoff and Sweezy 1987; Arrighi 1994).

Purely business-related hedging is the one end use of financial resources that is difficult to fit into the productive/unproductive dichotomy. While hedging does not directly create new productive capacities, its ability to lock in future input costs can provide the certainty needed to undertake investment projects. In that sense, it does facilitate productivity. Again, the problem is distinguishing this sort of hedging behavior from more speculative use of derivative contracts. In aggregate data, separating the two is effectively impossible.

Despite these classification problems, highlighting the distinction between productive and unproductive uses of financial resources rehabilitates one of the Marxists' central arguments about finance capitalism. Marxists maintain that the defining feature of capitalism over the past thirty years has been the creation of massive liabilities on a society that is becoming relatively less productive. Though the literature is sometimes compromised by the Marxist tendency toward overzealous rhetoric, it is nevertheless a sound point. If finance's core function is to allocate resources across time and space, an allocation that generates enormous debts in the present without enhancing future income from which to repay those debts is unlikely to be welfare-maximizing. Distinguishing between productive and unproductive uses of financial resources thus offers the key to understanding whether the new allocations are ultimately sustainable – or will create inherent tensions that at some point compel an adjustment.

II: The Question

Accepting the importance of considering both the costs and benefits of liberalization, examining the financial system in context, and emphasizing how financial resources are ultimately used, it becomes possible to ask one key question:

> *How has financial liberalization transformed how advanced financial markets allocate resources – and has that transformation been welfare improving?*

Put differently, has financial liberalization improved how financial markets perform their essential social task?

There are numerous ways to provide an answer to these questions. The approach taken here is case-study based. It will provide detailed analyses of the liberalization experiences of two countries over two time periods: Britain and France during their initial liberalizing bursts in the 1980s, and as their liberalized systems matured in the 1990s and the

2000s. These four case studies interweave the memoirs of key players, contemporary journalistic and scholarly accounts of events, macroeconomic data, and industry- and firm-level information in order to convey the story of liberalization as it unfolded in both countries. Each case study considers both financial firms in isolation as well as the interactions between those firms and the wider economy. Through comparison between cases that are broadly similar yet differ in key regards, it becomes possible to draw some conclusions regarding the impact of liberalization on resource allocation, whether the changes seen are ultimately welfare-improving, and how domestic policy can alter these causal linkages.

This approach is distinct from most other attempts to answer similar research questions. To begin with, a large proportion of the related literature focuses almost exclusively on developing countries (c.f. Bertero 1997; Beim and Calomiris 2001; Demirgüç-Kunt and Detragaiche 1998; Mishkin 2006; Demir 2009). This development-oriented subset of the literature will not be addressed in any depth; the costs and benefits of financial liberalization are almost certainly very different for countries that already possess highly sophisticated financial systems and those that do not. For the purposes of making an apples-to-apples comparison – and in order to explore the impact of financial liberalization in the most liberalized markets – this dissertation will focus exclusively on post-1970s financial market reform in advanced industrial economies.

Aside from the development sub-literature, most attempts to answer similar questions have been narrow in scope. Most tend to focus on only one section of the economy – or on only one economy. Countless studies have examined how liberalization has affected resource allocation for financial corporations themselves (Demirgüç-Kunt and Detragaiche 1998;

Hardie and Howarth 2009; Pozsar et al. 2012), non-financial firms (Crotty and Goldstein 1992; Laeven 2003; Crotty 2005; Stockhammer 2006; Arikawa 2008; Dallery 2009), governments (Giovannini and de Melo 1990; O'Sullivan 2006; Krippner 2011), and households (Bayoumi 1993; Martin 2002; Aalbers 2008; Langley 2008; Guttmann and Plihon 2010; Trumbull 2012). These works tend to assess how financial deregulation has affected specific types of financial market interactions for specific actors. While these contributions may be informative regarding how finance has affected the typical household or a given financial firm, they say little about how deregulation has altered the distribution of financial resources across sectors or states.

A few scholars have made efforts to better understand how financial liberalization in advanced economies has affected resource allocation more broadly. In recent years, the best-known of these is arguably Raghuram Rajan's (2010) *Fault Lines*, though similar issues have also been raised in *régulationiste*, post-Keynesian, and Marxist circles (Boyer 2001; Lapavitsas 2009; McNally 2011). These works articulate – with varying emphases – how financial liberalization has brought households into financial markets as both creditors and debtors, forced banks' balance sheets to expand by intensifying inter-bank competition, concentrated financial wealth amongst a new class of financial *réntiers*, compelled governments to offer support to their financial sectors, and pushed firms to seek profit through financial markets rather than production. By and large, they address the same question as this dissertation – and some offer similar analyses. Yet there is room to expand on their work: most tend to be either theoretical in nature or highly focused on the United States as a single case, leaving open the question of whether the trends they have identified are empirically valid and are present in other advanced economies.

There have been relatively few attempts to adopt a comparative approach to such an analysis (see Stockhammer 2008 for an exception) – and fewer still that offer contrasting case studies (such as Drees and Pazarbasioglu 1998). More such efforts at comparative analysis are called for. Liberalization does not mean the same thing in all places; it may well be that certain approaches to liberalization yield better or worse results than others. While it is true that financial liberalization has effectively forged a single international financial system, national governments still have a great deal to say about how those financial markets interact with the state, households, and resident firms. National policies in those regards continue to differ, a fact that may be connected to disparate macroeconomic performances across advanced economies.

The United Kingdom and France make for an ideal comparison. Not only is there a distinguished tradition of using Britain and France as foils for one another (Zysman 1984; Hall 1986), the two countries have followed paths that are analytically quite useful. While Britain entered the 1980s with a more developed financial sector than France, both countries pursued similar financial market reforms through the mid-1980s, dismantling barriers between banks, eliminating curbs on credit growth, and opening their markets to new products and new forms of competition. Both countries experienced credit-fueled booms – and both experienced subsequent crises linked to their deregulatory policies. However, whereas Britain under New Labour declined to reimpose restrictions on financial market activities and embraced financial innovation, France became more cautious after the crisis of the late-1980s and early 1990s. While France did choose to continue liberalizing its financial sector, it remained far more assertive than Britain in regulating the relationships between financial institutions and domestic firms and citizens. Partly as a result of this divergence, macroeconomic outcomes in Britain and France have differed – particularly since the onset of the global financial crisis in 2007.

III: The Argument

The drivers of liberalization in Britain and France differed to some extent. In Britain, there was ideological sympathy for the pro-liberalization argument, particularly on the part of Margaret Thatcher's most influential economic advisors, Nigel Lawson and Geoffrey Howe. France lacked the same ideological commitment. Nevertheless, both countries felt pressure to dismantle repressive *dirigiste* financial regimes in order to become more attractive to internationally mobile capital. Britain felt it because of the desire to keep pace with New York as a global financial capital. France felt it because French capital – fleeing the country's relatively backward capital markets and François Mitterrand's heavy-handed nationalization of the financial system – threatened to push the country out of the nascent European Monetary System (EMS).

The changes introduced by both governments forced banks and other financial firms into a new competitive environment. Financial institutions were compelled to adapt, which they did by consolidating, expanding, and innovating. The success of these adaptations was mixed. On one hand, post-liberalization financial sectors were far more capable of mobilizing resources. On the other, they increasingly tended to allocate resources to the household and financial sectors – that is, sectors that are not productive in the traditional sense. This marked a reversal of the historical relationship between households and firms: instead of households saving and businesses borrowing, liberalization pushed both economies to do the reverse.

As both economies transferred more resources to non-income-generating uses, it resulted in a particular form of growth (or "finance-growth nexus") – growth largely predicated on consumer borrowing and asset price speculation. This pattern led to several unintended consequences: debt ratios grew, macroeconomic fragility intensified, inequality widened, and external accounts became imbalanced. Although this trend was in evidence for both Britain and France in the 1980s, France demonstrated during the 1990s and 2000s that such a progression was not inevitable. Indeed, France managed to mitigate each of these negative consequences by encouraging a return to the traditional arrangement of households as savers and businesses as borrowers.

The remainder of this section proceeds to sketch out this causal story as a series of propositions, providing the rationale for each as they are presented:

> *III.1:* Proposition 1: *Financial liberalization heightened the competitive pressures within the financial sector, compressing returns on traditional financial activities and compelling financial institutions to seek new sources of profit.*

Pre-liberalization financial markets were characterized by byzantine rules and regulations that carved out niches for specialized financial institutions, insulating them from competition. Developed economies' financial landscapes were characterized by state-controlled interest rates, quantitative credit restrictions, state-sanctioned cartels, rules prohibiting one type of financial institution from conducting activities assigned to another, fixed commissions and fees, and protection against intrusion by foreign firms and foreign capital.

To varying degrees, liberalization meant the end of these practices. Where financial institutions had once been shielded from one another – and from international markets –

deregulation meant exposing them to market-based incentives. This had a profound effect on the profitability of traditional banking activities: firms no longer could rely on captive markets or state-granted competitive advantages. Financial institutions found themselves unable to fund their activities through low-cost deposits, the interest rate spread between funds borrowed and funds lent narrowed, fees and commissions on traditional capital market transactions declined, and customers increasingly sought more sophisticated financial institutions that could offer more savings options and provide a wider menu of services.

III.2: Proposition 2: *Financial firms adapted in three chief ways: consolidation, expansion, innovation*

Under this new set of incentives – and absent many of the constraints that had characterized the pre-liberalization financial paradigm – financial firms adjusted their strategies. They were forced to adapt, which they did by consolidating, by expanding their businesses and balance sheets, and by innovating.

First, deregulation prompted an explosion of bank mergers and acquisitions. By removing the regulatory barriers between different types of financial institutions, large universal banks could integrate all the various activities previously done by specialty finance houses. This allowed the new mega-banks to offer one-stop-shops for their clients: the same bank could take consumer deposits, use those deposits for either lending or trading, and offer brokerage and advice services. Moreover, they could offer a wider variety of savings products – from mutual funds to money market funds to traditional savings and checking accounts to certificates of deposit. Smaller, more limited financial institutions gradually began to disappear simply because they could not compete, triggering an enormous consolidation of the financial sector.

Financial consolidation also took place for simple cost-cutting reasons. Mergers, it was thought, would help firms reduce costs and achieve economies of scale. The academic support for this contention has wavered somewhat; however, meta-studies of both the United States and Europe have tended to find that horizontal mergers did reduce costs, generate substantial efficiency gains, and generally increase profitability (see DeYoung, Evanoff, and Molyneux 2009 for an extensive review). Two recent studies have further buttressed these findings, concluding that there are indeed increasing returns to scale in the U.S. commercial banking sector (Feng and Serletis 2010; Wheelock and Wilson 2011). Simple rent-seeking also provides a rationale for consolidation: amidst the flood of mergers, it became possible for a banking organization to accumulate such a large pool of assets that its failure would be systemically destabilizing. These "too-big-to-fail" banks consequently won a form of implicit government backing. That is, if they failed, it was more-or-less inevitable that the government would step in to protect the bank's creditors.

Second, as banks got bigger and more aggressive, they expanded their balance sheets. Financial operations can be scaled a great deal without increasing overhead costs. A fund managing $5 million, for instance, would have a harder time making a profit than a fund managing $50 million – even if their rates of return were the same. This is because the overhead costs for the $50 million fund will not nearly be ten times that of its smaller competitor. The competitive impetus was therefore for firms to run larger balance sheets. In effect, banks made up for shrinking margins with volume, transforming deposits, interbank borrowing, and bond issues into new assets on a massive scale.

Lenders were more willing to consider lending to those who might have previously been priced out of credit markets, market-makers were willing to squeeze even the tiniest margins from their arbitrage operations if they could do so in bulk, and proprietary trading operations grew. Of course, it is not possible to expand only one side of a balance sheet: firms borrowed more in order to buy more assets, fueling increases in asset holdings as well as an enormous expansion of financial liabilities.

Third, financial innovation – the creation of a multitude of new sorts of financial assets – helped financial firms to improve their bottom lines in a litany of ways: through securitization, tranching, the invention of "shadow banking" mechanisms like asset-backed commercial paper (ABCP) conduits, the advent of credit derivatives, and the simple generation of new sources of fee-revenue.

Simple securitization was arguably the most important – and common – of these innovations. Securitization facilitates large increases in both leverage and the amount of revenue firms could generate off their balance sheets. It does this in a number of ways, the first being regulatory capital arbitrage – a process whereby securitization reduces banks' regulatory capital requirements through its ratcheting effect on apparent asset quality. Securitization bundles lower-quality assets together into a single debt security. The repayments of the underlying debt (home mortgages, credit cards, auto loans, etc.) are then pooled together and passed on to whoever owns the security. Because repayment streams are comprised of slices of thousands of individual payments, securitization reduces the exposure of the asset-holder to default by individual borrowers. For example, a single default on an unsecuritized loan wipes out the value of the asset entirely; a single default on a similarly-valued asset comprised of parts of 1000 loans wipes out only a tiny proportion of the asset's value. As a result, holding 1000 unrated loans would require banks to hold more capital than the exact same 1000 loans packaged together as a securitized asset (c.f. Ambrose, Lacour-Little, and Sanders 2005).

The second leverage-enhancing use of securitization is known as ratings arbitrage. For example, an A-rated borrower could borrow at AAA-priced interest rates as long as the loans it made could be repackaged in a way that made them AAA-rated debt securities. The belief was that the marketability of the securities was more significant in determining borrowing cost than the risk associated with the borrower. Consequently, even a relatively less credit-worthy entity could obtain low-cost financing in order to originate loans. This cost reduction meant that they could borrow more, generate more assets, sell more into secondary markets, and ultimately hold some of the resulting assets on their own books. Even holding equity constant, firms engaging in this sort of arbitrage could both generate more revenue from the sales of repackaged assets. With the requisite increases in equity, it meant that they could support larger balance sheets without significantly increasing their cost of borrowing (c.f. Kothari 2006).

The "tranching" process amplifies the leverage-enhancing effects of simple securitization. Tranching packages 100-150 securitized assets together and slices them into several pieces, each featuring a different risk-return profile. The junior and mezzanine tranches are subordinated to a senior tranche, meaning that any defaults reduce the value of the subordinated tranches while leaving the senior tranche untouched. As a result, the lower tranches pay a higher interest rate while the top tranche typically receives a debt rating that is higher than much of the underlying debt. Even so, the mezzanine and junior cushioning tranches of a collateralized debt obligation (CDO) are typically much smaller than the senior tranche (nearly 20 times smaller, in many cases). As a result, a relatively small number of defaults can create highly concentrated losses in those lower tranches.

Some of the most exotic "CDO-squareds" were CDOs comprised of slices of *other CDOs*. In other words, a CDO comprised of only mezzanine tranches of CDOs rather than securitized loans. This effectively creates leverage ratios in the thousands on ostensibly AAA-rated instruments (c.f. Tully and Bassett 2010): if even a relatively small number of defaults occur, those losses become concentrated in the mezzanine tranches of CDOs and are passed through to the CDO-squared. Even though the CDO-squared's senior tranche is protected by its own subordinated tranches, the entire asset – including the senior tranche – is still comprised of debt that is subordinated elsewhere. In these situations, the profits generated during market expansions are huge, yet assets could – and ultimately did – go from AAA to worthless overnight as a result of modest increases in default rates.

Banks also developed ways to transfer assets to ostensibly separate "parallel banking" or "shadow banking" entities with lower capital requirements. This shadow banking sector included entities such as Structured Investment Vehicles (SIVs) which free up banks' equity for additional lending while lowering the total amount of required regulatory capital they need to hold. These entities served as conduits through which funding from outside investors could be brought into the market for more exotic debt instruments. Arguably the most significant of these were the ABCP programs operated by major commercial banks. They worked as follows: the SIV would raise funds in short-term bond markets in order to buy securitized products from originating institutions, effectively taking the payments streams from the securitized assets to repay their ABCP investors, pocketing the difference.

ABCP conduits helped banks' boost their leverage ratios by allowing them to shift assets off their own balance sheets and onto the balance sheet of the SIV – allowing them to evade the requisite amount of regulatory capital. Despite selling the assets to an ostensibly independent entity, however, the SIV and its sponsoring institution remained closely intertwined. Sponsoring institutions, in an effort to ensure that the interest rates paid on the SIVs commercial paper were low, often agreed to repurchase the entities' assets in the event of default or provide emergency support if the underlying asset pool underperformed. In other words, the banking system increased its lending capacity by maintaining the thin pretense that those assets had effectively disappeared – without actually reducing their exposure to poor performance by the assets they had moved off their books (c.f. Fitch Ratings 2001).

While there is no question that securitization, CDOs, and SIVs allowed individual institutions to become more leveraged, the development of these innovations had much broader implications. Relatively easily traded securitized debt securities were far more appealing to non-bank investors than simple loans had been. Mortgage-backed securities (MBS), the CDOs based on them, and the commercial paper issued by ABCP conduits appeared to be sound investments: they had top credit ratings, generated good returns, and clearly had the backing of the banks that crafted them. After all, not only had the banks committed to supporting their SIVs, they had signaled their confidence in their products by keeping a large proportion of them on their own balance sheets (Ambrose, Lacour-Little, and Sanders 2005). As a result, non-financial firms, pension funds, mutual funds, central banks, insurance companies, and even central banks were willing to purchase large quantities of the new innovative products (Shin 2009). The effect this had was to boost the leverage of the entire financial sector as a whole (Adrian and Shin 2009). As a result, the sector's returns to equity in an expanding economy were massive – fueling record profits. At the same time, its vulnerability to market downturns increased as well, as became evident in the late-2000s.

Even the proliferation of securitized and structured products represents only part of the new class of innovative financial instruments. On top of traditional exchange-traded derivatives such as options and futures contracts, financial firms developed a host of tailor-made "over-the-counter" (OTC) instruments dealing with interest rates, exchange rates, and default risk. The purpose of such products is ostensibly to alter one's own exposure to potential market fluctuations. In most interest rate or currency swaps, for instance, the present value of the transaction is zero for both parties – they simply swap exposures for hedging purposes. Credit default swaps, by contrast, swap exposure to credit events. In that way, they act like insurance policies on securities: the insurer collects a premium in exchange for its promise to compensate the buyer of the contract if the security suffers losses. By taking out a CDS on its assets, banks could lower the capital they held against those assets.

Credit default swaps remained essentially unregulated until they featured heavily in the global financial collapse in 2007-08. In those cases, insuring entities like AIG had been able to "insure" billions of dollars in assets, collect enormous premiums for the service, yet legally set aside nothing to cushion against losses on their positions. This rapidly became an enormous business: the notional value of all options and swaps worldwide was only $865 billion in 1987. Twenty years later, that number stood at over $500 trillion, $54 trillion of which was in credit default swaps.[1] Though notional values are simply used to calculate payments and are not typically exchanged, the increase in notional values does reflect the growth in the market. Moreover, notional values for credit default swaps *do* change hands if

[1] International Swaps and Derivatives Association (ISDA)

the insured asset is reduced in value to zero. This means that, by 2007, a relatively small number of financial firms had offered insurance-like policies covering a figure roughly equivalent to 70% of annual global output – all without being required to set aside any funds in case they had to pay out.

Nearly all of these innovative new financial instruments offered the financial sector new opportunities to charge fees. As financial firms got into the business of securitizing assets, constructing structured products, and producing bespoke OTC derivatives, they could charge for the service. Firms that wanted to originate and sell loans could charge for managing those loans' repayment streams. Rather than rely on interest income, liberalization encouraged financial institutions to generate revenue in nontraditional ways.

Finally, innovation also enabled financial institutions to profit from transactions without taking on the risk those transactions normally entail. Securitization led to a boom in secondary loan markets, allowing financial institutions to generate loans and then sell the asset produced to a third party. As a result, the incentive became for the original lender to sell as many loans as possible rather than ensure the quality of the loans they made. Eliminating the risks inherent in lending allowed financial firms to make any loan that they believed they could sell on at a profit. As layers of securitization bundle repayment streams together as higher-rated assets, the risks associated with the underlying assets appear to shrink. In large part, the booming trade in financial assets since the 1990s has been predicated on the illusion that innovation could somehow eliminate – rather than reallocate – risk. In some ways, this was more than an illusion: by expanding to the point that they became "too big to fail," many of the world's largest financial institutions did extract the risk from financial markets – by reallocating those risks to governments and taxpayers.

III.3: Proposition 3: *Financial firms' competitive adaptations resulted in an increased allocation of financial resources to the household and financial sectors.*

Firms' competitive adaptations have caused a profound change in how developed countries' financial markets allocate resources. In order to support the enormous expansion and diversification of financial firms' balance sheets under liberalization, someone had to do more borrowing. There can be no systemic creation of new assets without a balancing creation of liabilities elsewhere in the financial system. Following liberalization, those new liabilities were overwhelmingly concentrated in the financial and household sectors. This meant that while there was an enormous global inflation of asset wealth, that wealth was generated from resources flowing to uses that are profitable but not economically "necessary" from the Schumpeterian point of view – i.e., allocations that do not create new productive capacities.

The rapidly expanding size of balance sheets could not be sustained on deposits alone – financial firms had to become more aggressive in raising funds. This meant borrowing on interbank markets, selling bonds, and by using more esoteric means such as ABCP conduits. These tactics meant that the share of financial resources absorbed by the financial sector grew markedly. While banks used some of these funds to engage in proprietary trading, they used most of the funds to create and buy new assets.

Households, which generally had poor access to credit under pre-1980s financial regimes, were also happy to play the role of borrower. Consumer lending had historically been restrained by cost, rules on credit growth, and charter restrictions. Liberalization – by dismantling rules and encouraging innovation – made it much easier for financial systems to channel funds to households *en masse*. Loan issuers no longer had to engage in costly risk assessment or maintain extensive loan collection facilities because they were not obliged to hold their loans on their own books. They could simply lend and securitize (or "originate and distribute"). Moreover, any financial market participant could engage in consumer lending simply by buying a bond-like security on secondary markets. Structured financial products were particularly attractive due to their combination of high credit ratings and good returns. In short, the portion of the loanable funds market available for household lending skyrocketed, directly competing with the large businesses that had formerly dominated borrowing activities.

Just as increased market sophistication allowed financial firms and households to ramp up their borrowing, it also made it far easier for non-financial firms to raise investment capital. Corporate debt markets became more active and diverse, equity markets larger, and firms less reliant on banks to provide them with loans. Yet despite these advantages, the post-1970s financial system has been characterized by generally stagnant or declining investment activity when measured against profits or income – particularly when compared to the relatively high investment rates that prevailed for much of the preceding century. Although financial markets became more capable of funding productive investment, the post-liberalization set of incentives did not encourage growth of investment activity remotely comparable to the growth of wider borrowing activity.

Instead, there is reason to believe that financial liberalization has produced incentives for non-financial businesses to save rather than invest. The growth of new markets in high-return, high-quality financial products created a tempting alternative to investment. In an economy where credit expansion fuels asset-price inflation, where the sophistication and diversity of assets and risk profiles is near-limitless, and where banks or families are willing to pay a higher rate of return than traditional investment would provide, firms may simply choose to save instead of invest. This is not mere conjecture: it is clearly evident in the United States. For instance, General Electric in its 2012 K-10 filing disclosed that it held $115 billion in assets based on household debt, nearly $45 billion more than the on-paper worth of the company's physical assets. Apple likewise held billions of dollars in mortgage-backed securities as part of their “cash” holdings. This demonstrates a rather backwards form of financial relationship whereby large corporations – capitalist society's traditional debtors – elect not to invest in order to lend their savings to capitalism's traditional savers (i.e., households).

The tendency may be reinforced by the growth of capital markets as a relatively short-termist mechanism of corporate governance. Either because firms directly rely on capital markets for funding – or because they rely on banks that, in turn, have increasingly become dependent on capital markets – management became more vulnerable to pressure by a single set of stakeholders (shareholders). Those pressures may lead firms to eschew investment if there are more profitable alternatives – even if those alternatives are less appealing if viewed from the perspective of employment or long-run firm performance.

III.4: <u>Proposition 4:</u> *The resulting growth pattern (or "finance-growth nexus") is fueled by consumer debt and asset price appreciation rather than investment.*

The existence of a relationship between developed financial markets and faster growth (the "finance-growth nexus") is the central claim of a large body of pro-liberalization literature. Rooted in the work of Schumpeter, it holds that financial markets encourage capital to flow to its most productive use, leading to superior resource allocations and faster productivity growth over time. This claim may be valid – particularly for countries that are underbanked or possess poorly developed capital markets.

However, the finance-growth nexus that has emerged since the 1980s in developed economies is very different. Instead of capital flowing to its most productive use, it tends to flow to where returns are highest. So while liberalized financial markets undoubtedly have a greater allocative capacity, they tend to conflate private return with social value when determining where resources should be allocated. Rather than fuel growth through investment, these capital flows instead encourage growth through consumption and asset price appreciation.

The link to consumption is clear: consumers, finding themselves able to borrow in order to increase their present purchasing power, use financial markets to augment consumption and buy assets (particularly homes). Easy credit also encourages borrowers to engage in the leveraged pursuit of capital gains. For instance, borrowers can earn substantial windfalls by contracting debt to buy a home and then "flipping" that home to earn a profit as the housing market rises. During periods of loose credit, the ready availability of finance encourage a seemingly virtuous cycle: mortgage availability boosts demand for housing, demand for housing drives up prices, the capital gains on offer mean the banks are repaid and continue to offer more mortgage credit. This essentially describes the "mania" phase of any credit-fueled expansion (Kindleberger 2005). The tendency to consume more is further reinforced by the appreciation of asset values – as households' on-paper asset values skyrocket, they see less incentive to save their incomes.

Such an abundant-capital system also – somewhat perversely – can disincentivize investment. The sheer diversity and attractiveness of financial markets offers both savers and potential investors a host of alternatives to traditional investment. Schumpeter – writing 100 years ago – lived in a world where both financial capital and the outlets for that capital were relatively scarce. A saver could earn a return either through productive investment, through buying and selling property or stocks, or through participating in the limited bond markets of the day. Today, capital and potential outlets for capital are relatively abundant. Savers can earn returns in a near limitless number of ways – few of which actually generate new productive activities. So while there may be an abundance of capital available, a shrinking share is actually directed toward productive use. It is for this reason that this dissertation emphasizes the end use of financial resources rather than the overall inflation of asset wealth.

III.5: Proposition 5: *This growth pattern is unstable, generates inequality, and is predicated on external imbalances.*

Firstly, increasing the allocation of credit to non-income-generating uses heightens macroeconomic fragility. There is a fundamental balance sheet asymmetry at work when credit is used to engage in leveraged speculation: Liabilities are relatively known and stable; however, the market value of assets tends to fluctuate more wildly. While both sides of the balance sheet expand during a bull market, the increase on the liability side is ultimately more permanent than gains on the asset side. That is, debt is harder to wipe out than mark-to-market asset values. In the example of a homeowner, the liability representing the amount owed on a mortgage is much stickier than the value of a home.

In the short- or medium-run, shifting credit into consumption or speculation may result in seemingly robust and stable growth. In good times, easy credit and appreciating assets make consumers (and firms) feel richer and they borrow and spend more as a result. Over the long run, however, bad times do inevitably return. Wealth that seemed real in an expansion can evaporate in an instant. Worse, even less-than-aggressive borrowing behavior can result in a substantial rise in borrowers' debt-to-income ratios.

Consider a household that has saved up $50,000, earns $100,000 per year and is willing to spend all their savings – plus take out a 50 percent mortgage – to buy a new home every five years. If we assume that their wages rise at 3 percent per year, that they always save 5 percent of their total income, and that the annual rate of home price appreciation as well as the interest rate remains constant at 5 percent, their financial circumstances over the first decade will change as shown in figure one.

	Year 1	Year 6	Year 11
Income	$ 100,000	$ 115,927	$ 134,392
New Home Value	$ 100,000	$ 245,991	$ 546,266
Debt	$ 50,000	$ 122,995	$ 273,133
Debt:Income Ratio	0.50	1.06	2.03

Figure 1: Escalating Debt to Income Ratios

This demonstration combines realistic borrowing behavior with market assumptions drawn from the recent past to show how debt-financed speculation (i.e., flipping the family home) can cause a household ratio of debt to jump fourfold over the course of a single decade. A household under these conditions – or a business, for that matter – becomes increasingly vulnerable to change in conditions that would start a debt-deflationary cycle.

At a fundamental level, debt ratios must rise if financial resources are not put to productive use. Debt will tend to grow as a percentage of income unless what is borrowed is used to fund investments that will increase future income. That is, if firms borrow to finance new production facilities (or students borrow to enhance their own human capital), the income generated by those new facilities (and the higher wage earned by the student) will eventually cause society's debt burden relative to income to decline – at least assuming that the firms (or students) were investing wisely. On the other hand, debt-financed present consumption or speculation does not generate new sources of productivity in the same way. In these cases, debt burdens should continue to rise.

Then, in the event of a macroeconomic shock, the indebted find themselves either seriously challenged to reduce spending in order to pay down debt or insolvent. If defaults occur in numbers, financial markets destabilize. If default is held at bay but deleveraging is widespread, aggregate demand suffers. In this way, economic growth built on widespread consumer borrowing and the pursuit of capital gains is intrinsically built on a boom-bust intertemporal tradeoff: unless asset prices continue to rise, the boom of today must be paid off by a deleveraging bust in the future. Such heightened fragility feeds back into depressed investment: increased long-term uncertainty over aggregate demand introduces new uncertainty into firms' projections of future cash-flows. This has the effect of obliging firms to hold larger stocks of cash and liquid assets to cushion against unforeseen downturns, depressing new investment.

Secondly, a debt-fueled consumption-dependent growth pattern poses problems from the inequality perspective. Traditional business investment tends to have positive effects on workers' incomes as well as returns to capital: shrewd business investment increases both profits and labor productivity, causing both wages and profits to rise. By contrast, there are several reasons to expect that using financial capital to maintain consumption or fuel capital gains will yield more concentrated benefits.

In order to realize capital gains, one has to hold some amount of capital to begin with. The wealthier an individual or firm is, the better that actor can use leverage to seek profits through appreciating asset prices. The biggest winners during a boom are those who hold the most appreciating assets – in other words, those whose existing wealth and market reputation allow them to sustain larger balance sheets. Moreover, even the bursting of a bubble should not reverse this wealth concentration entirely: while the incomes and wealth of all asset-holders as a group will decline as some go bust, the best-hedged financial players will be relatively well-protected. In fact, bursting bubbles could theoretically enhance inequality as those with the best protected wealth would be in a strong position to buy up distressed assets.

Household borrowing for the purposes of supporting consumption also intrinsically stokes inequality. As less-wealthy, lower-income households borrow to consume in the present, their purchasing power today increases. But in exchange, their wealth and future purchasing power falls (i.e., they now have a debt obligation and the interest payments that come with it). For society's creditors, the reverse is true – they surrender some of their purchasing power today (the amount lent) in order to increase their incomes (interest payments) and wealth (the underlying loan asset). In effect, consumptive credit reduces inequality of purchasing power at one point in time by increasing wealth and income inequality in the future. Worse, if the credit expansion stops and borrowers are refused further credit, the initial inequality of purchasing power returns – but will be much larger than before as a result of the debtor's interest burdens. As a result, both income and wealth inequality should expand as long as households continue to borrow in order to consume.

Thirdly, the reallocation of resources to non-income-generating uses has enabled the emergence of large macroeconomic imbalances. In the language of trade theory or the varieties of capitalism literature (Hall and Soskice 2001), national culture and regulatory regimes have endowed different countries with different advantages within the global financial market. Some states have more permissive regulations and resident consumers and financial firms that are not particularly averse to debt. These countries naturally became the system's asset-creation engines, churning out financial products largely predicated on the repayments of their debt-laden consumers and highly leveraged financial institutions. As a result, they will tend to run matching financial account surpluses and current account deficits. Other states possess more restrictive consumer finance regimes – or financially more conservative households – and thus have an excess of savings to dispose of. Those countries will have the opposite and complementary balance of payments imbalance.

The deficit and surplus countries need each other in this arrangement. Asset-exporting countries could not meet the high demand for borrowed funds without international funding. And capital-exporting countries would have less attractive savings options without some other countries doing extensive borrowing. This pattern of interdependence would be ideal if the growth pattern that resulted conformed to the Schumpeterian ideal. In that case saving countries would build productivity in investing countries, boosting the globe's productive powers over time. If instead, as is argued here, the growth pattern is driven by consumption and asset-price appreciation, it means the emergence of an unstable intertemporal tradeoff expanded to the global scale.

> *III.6:* Proposition 6: *Preserving the "traditional" financial relationship between households as savers and firms as borrowers can mitigate this growth pattern and the accompanying negative consequences.*

There is nothing inevitable about the causal sequence presented here. It is true that the liberalization of the financial sector itself has progressed in a similar manner in most developed countries. The incentives that face today's financial institutions are remarkably similar; the international mobility of capital has ensured that states have largely converged on similar sets of regulatory norms. Moreover, that same internationalization of financial markets makes it extremely difficult to envision how nationally based efforts to regulate banks and other financial firms would be sufficient to bring about major changes in those firms' behaviors.

Nevertheless, this does not mean that using national policy to shape the outcomes of financial market liberalization is impossible. Consumers and most non-financial firms remain far more rooted to the nation than financial resources and institutions. While a government would struggle to bar its banks from carrying out a certain type of transaction, it can far more easily influence how its citizens and businesses are permitted to interact with financial markets. States may not be able to stop their financial institutions from seeking capital gains, but they can circumscribe access to credit for the purposes of home price speculation and consumption – or encourage the use of credit for income-generating investment.

Policies that limit consumers' access to credit – a tactic pursued in some measure by France and other continental European economies – reduces households' ability to overcome liquidity constrains, but also appears to restrain household (and economy-wide) indebtedness, limit macroeconomic fragility, reduce pressure on the financial account to move into surplus, and depress wealth and income inequality relative to countries with more permissive consumer lending rules. Subsidizing or otherwise encouraging lending for income-generating uses may yield the same results – though this inevitably puts government into the difficult position of "picking winners."

IV: Value & Limitations

Ultimately, this study provides a framework for understanding how liberalization has altered how financial markets allocate resources, what impact that has had on non-financial actors, and how states can mitigate the negative consequences of liberalization.

This analysis has its limitations. The structure and capacities of financial systems – as well as the process of financial liberalization – vary a great deal from country to country. Only the cases of the United Kingdom and France will be produced here in great depth; the generalizability of their narratives rests largely upon the premise that they are representative of broader trends. Even so, other countries have their own idiosyncrasies that this study does not address. The choice to limit this analysis to only the most advanced of countries is an effort to circumscribe its pretensions of external validity: while chapter nine does maintain that the trends seen in France and Britain are generalizable to the developed world, no claim is made that their stories are generalizable to countries at relatively low levels of financial development.

At an even deeper level, it is somewhat problematic to speak of the actions of a whole "financial system," or of "households," or "non-financial firms." Naturally, the conclusions drawn from the aggregate behavior of a sector may have very little to do with the actions of any individual family, bank, or business. This is the inherent danger in analyses dealing with macroeconomic developments and society-wide change: the story here is unsophisticated in its consideration of individual actors.

Finally, this is an exceedingly wide-ranging analysis. Many of the causal linkages presented in these pages could be – and have been – spun into their own books and theses. But that misses the point: the glaring gap in the literature does not concern any one of the causal propositions at the core of this project – the gap is in the understanding of how they all fit together. And the central argument presented here is that they *do*, in fact, all fit together.

V: Structure of the Argument

After laying out some of the background literature that informs this analysis, part one of the text deals with the initial bursts of deregulation in Britain and France: why they happened, who triggered them, what they changed, and what consequences were felt as a result. Part two then moves to contemporary Britain and France, highlighting why their liberalization paths diverged so sharply in the 1990s and what impact that had on resource allocation, growth, stability, inequality, and external balances in the 2000s and during the global financial crisis of 2007-08.

Chapter two establishes the literatures that this dissertation will draw upon heavily. It begins by asserting the importance of considering ideas, domestic political arrangements, and the international context in driving the liberalization process. It pays particular attention to the competing ideas concerning the value of financial markets, the functions they perform, and ultimately the desirability of liberalization. The chapter concludes by presenting a synthesis approach to the dissertation's central research question, an approach that might be called "problem-centric theoretical eclecticism." This approach demands answers to straightforward empirical questions (e.g., how did liberalization alter resource allocation?) that take into consideration ideas, interests, institutions, and international constraints.

Part one of the text begins with chapters three and four. Chapter three tells the story of early British financial liberalization, describing the pre-1979 state of British financial markets and tracing the Tory reforms agenda through most of Thatcher's tenure in power. Chapter four then moves to France over the same time period, describing Mitterrand's forced conversion to the financial reform as the price of continuing the process of European integration. Chapter five concludes part one, analyzing how resource allocations changed in Britain and France during this early liberalizing period. It identifies the consumption-based finance-growth nexus and evaluates the fifth proposition – that is, that the two countries' growth in this period would be unstable, unequal, and predicated on external imbalances. Indeed, the end of the 1980s and early 1990s were a period of severe economic pain in both countries – in ways clearly connected to their finance-driven boom of the preceding years.

Part two of the text follows both Britain and France from the end of the 1980s through the acute phase of the financial crisis beginning in 2007. Chapter six delves into the rebirth of Labour as a more pro-market, pro-finance party that proceeded to encourage a return to 1980s-style credit expansion. This contrasts sharply with the story of post-1989 France presented in chapter seven. Where Britain chose not to significantly intervene in the financial affairs of its citizens, France reacted strongly to the problems that emerged in the 1980s. While governments from the French left and right continued to encourage liberalization within financial markets, consumer credit was subject to numerous controls. Moreover, the French government maintained influence over the relationships between financial and non-financial firms.

Chapter eight compares the consequences of both the more *laissez-faire* British response to the events of the late-1980s and early 1990s to the somewhat more *dirigiste* approach of the French. It argues that Britain experienced a worsening of the pro-consumption, pro-finance reallocation of financial resources, contributing to a highly unstable, unequal, and externally dependent period of (relatively rapid) growth. France, by contrast, consciously maintained a more traditional financial system based on households saving and businesses borrowing. As a result, there was no reallocation of financial resources and little evidence of the same unintended consequences that came with Britain's finance-driven growth.

The ninth and concluding chapter summarizes the findings of the case studies and attempts to ascertain how generalizable those findings are. Using cross-sectional data, it demonstrates that, while a degree of liberalization is ubiquitous, there is a spectrum between more enthusiastic liberalizers like Britain and more circumspect liberalizers like France. It clearly shows a global tendency to push capital toward unproductive uses, leading to rising indebtedness, heightened macroeconomic fragility, growing greater inequality, and larger macroeconomic imbalances where the reallocation of resources was most severe.

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Two – The Rise of Finance: A Literature Review

In the early 1970s, the international monetary system was in a state of flux. The Bretton Woods regime of fixed exchange rates had collapsed, capital was flowing ever more freely across borders, and national economic policies increasingly carried international consequences. The idea that governments could achieve policy goals through the control of domestic financial systems was called into question by the concurrent emergence of inflation and unemployment (i.e., "stagflation"). At the same time, increased capital mobility meant that governments were pressed to lure international capital into their domestic markets. In this environment, the notion that liberalized and capital-friendly financial systems were preferable to the existing state-dominated regimes gained credibility: advocates of financial liberalization argued that less controlled financial markets would be able to allocate financial more efficiently than "repressed" ones (c.f. McKinnon 1973; Shaw 1973).

The uncertainty of the 1970s – amidst the wider disintegration of the postwar order – provided an opening for this idea catch on. The time was ripe for paradigmatic change: though Keynesian economists had long claimed that uncontrolled financial markets were dangerous, their economic tools had proved inadequate to the task of solving the economic problems of the day. While those who benefited from the parochial privileges of pre-1980 financial systems fought to maintain the status quo, many were ready to try a new approach.

In short, financial liberalization did not occur in a vacuum. It was the product of a changing global environment combined with an insurgent pro-market ideology, mediated by diverse national institutions and interest groups. This chapter serves three purposes in helping to explain this phenomenon: the first is to provide a framework for understanding why liberalization happened – and in particular, why it happened slightly differently in different places. The post-1970s transformation was radical and widespread: government control over financial markets was replaced with *laissez-faire* regimes throughout the developed world. Yet despite the common trend toward liberalization, some national differences endured: idiosyncrasies generated by the particular ideas, interests, and institutions present in each country led to variations in the broader pattern. The second purpose of this chapter is to position this dissertation's narrative relative to the literatures it engages, paying particular attention to the competing ideas concerning the value of competition and regulatory freedom in financial markets.

However, it is not enough to merely catalog the relevant literatures and how they bear on the subject of financial liberalization. This chapter serves a third, more important, purpose: to propose a synthetic approach to the research question at hand. The problem at the heart of this dissertation is an empirical one. What impact did liberalization have on the allocation of financial resources? Answering this question requires an opportunistic approach that considers a mix of causal forces, accommodating both mainstream and heterodox views of financial markets. In short, this chapter makes the case for a holistic and realistic view of a real-world problem – one that draws heavily from several literatures but does not wholly belong to any one discipline or school of thought.

I: Internationalization and Domestic Change

Post-1970s financial liberalization and deregulation must be examined in light of the transformation of the global economic system taking place at the time. The impetus for financial reform came from the collapse of the postwar economic order that John Gerard Ruggie (1982) described as "embedded liberalism." Embedded liberalism operated on the premise that governments could keep their domestic markets relatively isolated within a relatively liberalized global system. Under such a regime, trade and capital flows were permitted but controlled amidst a system of fixed-but-adjustable exchange rates loosely supervised by the International Monetary Fund.

Within countries, national financial markets were internationally closed and tightly managed by the state. Finance, as Eric Helleiner (1993) put it, "was the servant." That is, governments of the era could use financial markets as implements of. Governments could influence the quantity of available credit, the diversity of capital markets and who could participate in them, and which firms or sectors should receive credit. Internationally, governments allowed financial flows across borders chiefly where such flows facilitated the exchange of goods and services. Aside from a certain level of foreign direct investment, capital generally could not cross borders simply in order to earn a higher return.

Yet taming the markets proved difficult. Firms increasingly sought ways to operate across borders, evading state regulations (Gilpin 1975). The policy choices of one country could easily affect others – particularly if the country in question was the United States and the policy in question was how much of the international reserve currency (i.e., the dollar) it would allow to circulate (Calleo and Rowland 1973). Moreover, as international interconnectedness grew through the 1960s, the new connections served to transfer shocks across borders, make it harder for states to respond to those shocks, and intensify international competition (Cooper 1968). In short, states found themselves losing control over their domestic economies (Keohane and Nye 2012). Financial firms, in particular, became increasingly clever at moving across borders, leading to the development of a large extra-jurisdictional collection of financial institutions collectively known as the Eurodollar currency market (Simmons 1999).

These developments gave rise to an academic discipline, International Political Economy (IPE), principally concerned with the reemergence of international interdependence and its impact on states, their domestic policies, and local actors (Cohen 2008). As Geoffrey Underhill (2006) defines it, "international political economy concerns the interaction of a transnational market economy with a system of competitive states." Situating this dissertation within this IPE tradition is important because, on a very basic level, financial liberalization was a competitive response to an increasingly interconnected global system (Cerny 1993).

Nowhere is this insight clearer than where it concerns the two countries to be examined in the chapters to follow. The architects of Britain's financial liberalization and deregulation explicitly connected their pursuit of financial reform to the maintenance of their balance of payments stability and, more importantly, to their desire to make London the world's preeminent financial capital. The instigators of financial change in France likewise blamed the need to maintain external stability with the rest of Europe as the key reason behind Mitterrand's abandonment of his plans to put the French financial sector under direct state control. These stories fit into the tradition of Peter Gourevitch's (1978) "second image reversed" – i.e., the view that the international system has a large impact on domestic policy.

Where other states tried to maintain repressive policies toward their financial systems (such as in France), capital simply fled to jurisdictions that were more liberalized. Capital flight forced states to drop exchange rate pegs, accept inflation, and watch as their firms had to pay increasingly high interest rates in order to secure access to financial markets. As

France discovered in the early 1980s, this mix of economic conditions was unsustainable. To scholars such as Susan Strange (1991) or Philip Cerny (1997a), the need to compete in order to attract financial capital meant that the increasingly unified global financial market could force states to conform on a relatively finance-friendly and *laissez-faire* set of policies.

I.1: Institutions and Variety

The account of financial liberalization as a product of growing international interdependence only offers so much in terms of understanding the real-world process of liberalization. Taking such an analysis at face value implies that all economies are converging on Anglo-American regulatory norms – a so-called "race to the bottom" in which all states default to market-friendly regimes. While some thinkers do advocate variations on this argument – Cerny and Strange included – such a drastic conclusion is not entirely warranted.

Indeed, the tension between cross-national convergence and continued diversity is one of the central themes in the analysis of 21st century globalization. Some see the fairly universal ascendance of the "competition state" in which national governments craft policies in an attempt to attract capital and jobs, producing a convergence on Anglo-American norms and regulations, including financial freedom, consumerism, and pro-capital policies. Others argue that cross-national differences endure due to the diversity of national institutions (c.f. Hülsemeyer 2003).

Peter Katzenstein, for instance, noted that small states have adapted to international pressures in unique ways. He makes the case that the economic successes of countries such as Norway, Denmark, Belgium and the Netherlands – successes that came despite their size and accompanying vulnerability to changes in the global and European economies – are owed to institutional innovations he collectively refers to as "democratic corporatism." These small states have thrived, he argues, because they have centralized and consociational relations between the state, firms, and labor that can adapt quickly to changing external circumstances.

Theorists like David Soskice and Peter Hall (2001) have taken the focus on institutional variety further, examining the "varieties of capitalism" across developed economies. They argue that some institutional frameworks are characterized by coordinated inter-firm dynamics, cooperative industrial relations, and patient financial systems – while others defined by competitive inter-firm dynamics, unregulated labor markets, and risk-taking, arms-length financial systems. For Hall (1999), this means that countries facing international competition will tend to adapt in different ways – following different "adjustment paths." More coordinated economies arguably had a wider range of policy responses to the economic challenges of the 1970s – and have tended to maintain their national diversity (Garrett 1995). More liberalized economies, by contrast, were forced to converge on policies that placated capital-holders in an attempt to maintain international competitiveness and maintain employment (D. King and Wood 1999).

In sum, these scholars maintain that institutions moderate between changing international economic conditions, domestic policy preferences, and political outcomes – leading to a diversity of outcomes rather than convergence on a capital-friendly neoliberal norm (Garrett and Lange 1996). Of course, it is not uncommon for two analysts to look at the same country over the same time period and come to wildly different conclusions as to whether that country is converging on an international template or continuing to maintain its distinctiveness. François Morin (2000) and Vivian Schmidt (2003), for instance, disagree sharply over whether France has converged on Anglo-American norms or has remained a distinctive form a statist capitalism.

I.2: Interests and Variety

Rather than focus on institutions as the source of enduring cross-national variety, some academics have pointed to simple interest-group politics as the reason for enduring cross-national variety. This perspective – not mutually exclusive to the institutionalist account – maintains that internationalization has clear distributional consequences. Internationalization affects domestic actors differently, causing the emergence of new political cleavages: some domestic groups benefit from international financial openness, some do not. This dynamic then manifests itself in national political contests.

Ronald Rogowski (1989), makes the argument as it pertains to trade, noting that domestic political cleavages will divide those who benefit from international openness and those who do not. Jeffry Frieden (1991) extended Rogowski's logic to financial openness. He argued that international capital liberalization – like openness to trade – affected domestic groups differently. Capital-holders, in particular, benefit as they become able to send their funds throughout the global economy. As countries become open to international financial flows, the cleavages will grow between capital-holders and other domestic sectors. For instance, manufacturers will prefer depreciating currencies while international investors favor appreciation. Helen Milner (1988) showed that these differential impacts need not be sectoral: individual firms, differing in their production processes and international relations, may exhibit different preferences toward a country's international economic policies.

In this view, domestic reactions to a changing international economic dynamic are governed by pluralistic competition between domestic interest groups (Rogowski and Frieden 1996). Erik Jones (2008), for instance, offers a sort of pluralistic counterpoint to Katzenstein's take on small states. As Jones notes, institutions are important but not wholly determinative: while institutions may provide a route to adjustment to international pressures, there is no guarantee that firms or workers will agree on or accept a proposed adjustment. This conclusion underscores the exceeding complexity of the interaction between international influences and domestic change.

Another example emerges from Jones' (2002) analysis of the political economy of European economic and monetary union (EMU): he makes the case that various localized interest groups (a) agreed to EMU due to the shared desire to form a bulwark against the pressures of internationalization; (b) disagreed enough to make the establishment of EMU a drawn-out process; and (c) are unlikely to form coherent opposition to EMU because their idiosyncratic problems are unlikely to be compatible. He has produced a wealth of analysis showing how EMU has affected domestic politics (and vice versa) in ways that defy simple analysis, calling for attention to be given to a host of idiosyncratic factors (c.f. Jones 2012a; Jones 2012b). On a basic level, these accounts suggest that pluralistic responses to international influences should foster continued diversity between national economies: as the balance of power between competing domestic interest groups is likely to be different in different places, national policy responses to the same international phenomena will likely diverge.

II: Ideas of Finance

The resurgence of global interconnectedness and the common pressures it placed on all countries go some way toward explaining the environment which gave rise to the liberalizing movement. The cross-national variations in institutions and interest groups provide insight into why liberalization manifested in different ways in different locales. But the liberalization of financial markets after the 1970s cannot be explained through these discussions alone. While the reemergence of international interdependence in the mid-20th century was likely a *sine qua non* for liberalization – and while differing institutions and interests explain some of the variable reactions between states – ideas and individuals play a central causal role in this story.

The collapse of embedded liberalism was not an overnight phenomenon; the system had slowly deteriorated as international capital flows resumed, offshore financial centers developed, and the Bretton Woods regime dissolved. For much of the 1960s and 1970s, there was fundamental uncertainty over how developed countries should respond to the challenge of internationalization, inflation, and unemployment. Mark Blythe (2002) describes this period as one of "Knightian uncertainty" – that is, a period in which uncertainty is so pervasive that meaningful probabilities can not be assigned to potential future events. In these periods, Blyth argues, ideas take on a special significance because ideas can help to restore a degree of predictability to the future.

To Blyth's insight, Matthias Matthijs (2011) adds the importance of narration. While economic ideas can be pulled "off the shelf" (Blyth 2002, 267), Matthijs makes the point that someone within the domestic political system must advocate for those ideas, spinning them into a coherent narrative of an existing crisis. Blyth and Matthijs are joined by a host of other scholars who maintain that ideas – and those who articulate them most forcefully – hold major sway over policy. Peter Hall (1989) described how Keynesianism spread across borders due to the power of Keynes' ideas and his influence over individual economists. Mitchell Orenstein (2008) demonstrated how a small group of advocates successfully waged a transnational campaign to privatize pensions throughout the developed world. Matthijs himself demonstrates the power of ideas and their narration in two periods of British economic reform.

This section details the major economic ideas concerning the importance of financial markets and the value of financial innovation. Some of these ideas – derived from the works of Joseph Schumpeter, John Maynard Keynes, and Karl Marx – existed "on the shelf" in the 1970s. These ideas, how they have evolved since the 1970s, and their relative attractiveness to different countries will ultimately go a long way toward explaining why financial liberalization has happened everywhere – but did not unfold in the same way in all countries.

Whereas the interaction relationship between financial liberalization and domestic institutions or interest groups is best left until the case studies, the discussion of the major ideas behind liberalization belongs here. This is because domestic institutional setups and the relative political influence of different groups are dissimilar enough between countries that it is best to deal with each country's idiosyncrasies individually. On the other hand, the ideas concerning financial markets are relatively transnational: aside from some relatively isolated epistemic communities like the French regulation school, the academic clusters surrounding various schools of thought on finance translate reasonably well across borders. While the adherence to a particular school of thought may vary across countries, the ideas themselves tend to be quite similar.

The ideas explored here are not the only ones that matter. The progress of financial liberalization in Europe has also been closely tied to a different set of ideas regarding the value of European monetary integration. In particular, the notion that economic and monetary union is desirable has played a large part – arguably the largest part – in driving European financial liberalization forward (c.f. Parsons 2003; Abdelal 2007). Again, however, these ideas vary significantly across countries – not least between Britain and France. As a result, these ideas will also be left to a discussion in the case studies.

II.1: Proponents of Free Finance

To reiterate how Nobel Laureate Robert C. Merton put it, "the core function of the financial system is to facilitate the allocation and deployment of economic resources, both spatially and across time, in an uncertain environment" (Merton 1990). The idea that financial development – here, the shift toward relatively free, liquid, and innovative financial markets – is socially beneficial rests on the premise that finance performs this essential function and that liberalization helps financial markets better carry out those tasks. More recent scholars have disaggregated Merton's purpose into as many as five sub-functions: informing capital allocation decisions, exerting corporate governance, managing risk, mobilizing savings, and easing the exchange of goods and services (Levine 2005). This dissertation will borrow heavily from this functionalist approach to finance; this section explains the most important of these functions at some length.

This approach is important because focusing on function rather than structure downplays some of the more established but less informative debates within financial theory. In particular, it de-emphasizes the distinction between bank-based and capital market-based financial systems that is particularly common in institutionalist literature (c.f. Allen and Gale 2001; Hall and Soskice 2001) since both types of financial system ultimately perform the same functions (Crane 1995a; Merton and Bodie 1995; Levine 1997). More recent institutionalist scholarship concedes that the divide between the two ideal-type systems has been rendered obsolete by the advent of "market-based banking:" banks themselves now largely raise their own funds through arms-length capital markets (Hardie and Howarth 2012).

II.1.a: Resource Allocation

In his 1911 *Theory of Economic Development,* Joseph A. Schumpeter laid out the basic case for finance as a driver of economic growth through promoting innovative and productive investment. Entrepreneurs, whether individuals or large corporations, require advances of purchasing power in order to innovate new products and production methods. A well-functioning financial system takes unused savings, evaluates entrepreneurial proposals, and allocates credit to those with the best ideas for developing new production processes. Schumpeter even went so far as to suggest that this was the only *necessary* function of finance:

> '[N]o one other than the entrepreneur needs credit... in the sense of a temporary transfer to him of purchasing power, in order to produce at all, to be able to carry out his new combinations, to *become* an entrepreneur... He can only become an entrepreneur by previously becoming a debtor. He becomes a debtor in consequence of the logic of the process of development... What he wants is credit. Before he requires any goods whatsoever, he requires purchasing power. He is the typical debtor in capitalist society' (Schumpeter 1983, 102). (Emphasis in original)

This Schumpeterian notion of finance has been profoundly influential, setting a generation of scholars about the task of developing and attempting to empirically demonstrate this positive growth-finance relationship (Goldsmith 1969; McKinnon 1973; Shaw 1973; R. G. King and Levine 1993b; R. G. King and Levine 1993a; Levine 2005). Schumpeter's view has endured because it captures the beneficial aspect of finance that virtually all observers acknowledge – its capacity to turn idle savings into productivity-enhancing investment.

In order to be effective in performing this function, financial markets must be able to do two things: (1) mobilize savings and (2) gather information that suggests the highest-return use of those savings. Most individual savers cannot perform either of these tasks on their own – they lack both the funds to pay for large investments (Sirri and Tufano 1995) and the resources to gather information about which alternatives are the most promising (Schumpeter 1989; Diamond 1984; Boyd and Prescott 1985; Greenwood and Jovanovic 1990). This is where financial intermediaries and capital markets step in.

Financial actors pool savings or support the pooling of savings in different ways. Retail and commercial banks accumulate individual and corporate deposits, pensions manage large numbers of employees' retirement savings, mutual funds attract clients wishing to purchase securities, and various forms of private equity combine the wealth of a smaller number of higher-wealth individuals and institutions. Investment banks aid in this process by helping firms issue easily traded small-denomination securities. They then act as matchmaker in decentralized securities markets, seeking out institutional and individual savers to put together with capital-seeking firms (Carosso, Sears, and Katz 1973).

In this way, banks and other financial institutions act as middlemen, transforming smaller amounts of savings into capital available for firms to borrow. But, as Schumpeter noted, their role is bigger: not only do financial institutions pool society's savings and transform them into usable sources of credit, they also decide how to best use them (Schumpeter 1983; Levine 1997). This is essentially a task in information-gathering – determining the risks and potential rewards of alternative resource allocations. Traditional banks assess borrowers in order to decide who is credit-worthy; investment banks and professional money managers provide information about which firms are the most deserving of capital, and private equity firms seek out profitable uses for their own resources.

Decentralized capital markets may also perform the same information-gathering task, though the case there is more arguable. The efficient markets hypothesis holds that, in an efficient market, asset prices "'fully reflect' all available information" on how those assets are valued (Fama 1970). The strongest version of the hypothesis only plausibly holds if all information was freely available to all – which paradoxically makes it unlikely that anyone would choose to spend money to assess alternative investments in the first place (Grossman and Stiglitz 1980). Nevertheless, proponents of the efficient markets hypothesis maintained that markets may be generally considered efficient if "sufficient numbers" of rational market participants had access to all available information and acted to drive asset prices toward their true value, earning some private benefit in the process (Fama 1970; Jensen 1978).

In theory, ending policies of financial repression – that is, policies of quantitative and allocative controls on financial firms – enhances the capacity of a financial system to carry out these mobilization and allocation functions. Innovations like the advent of mutual funds assist financial markets in mobilizing savings; credit ratings agencies disseminate information. Dismantling interregional or international barriers to transferring financial resources expands resource allocation options and provides more areas with access to a more unified pool of savings. Innovations like securitization help this process along (Crane 1995b).

Deregulation and the introduction of market-based incentives into financial markets – accomplished through the removal of interest rate controls and abolition of credit rationing – should also improve both the quantity of available savings and the quality of savings allocation (McKinnon 1973; Shaw 1973; Gmech 2006). Allowing freer competition between financial institutions in this more credit-rich environment should produce larger and more liquid financial markets, lowering transaction costs and improving the efficiency of price discovery through the introduction of additional market participants. Liquidity should also reduce uncertainty over whether assets can be transformed into cash on short notice. This tends to increase the availability of financial resources, easing the credit constraints of firms wishing to invest in productive long-term research and development (Banerjee and Aghion 2007; Aghion et al. 2010). In short, deeper, more liquid, more innovative financial markets theoretically should allow for better resource allocation and ultimately generate faster economic growth.

II.1.b: Intertemporal Resource Allocation

Schumpeter paid little attention to households' use of finance to smooth consumption, nor to firms that use financial markets to survive temporary downturns. This is because there is no obvious connection between these short-term financial transactions and long-term growth. From a welfare perspective, however, these functions are important.

For firms, the value of being able to allocate resources across time is simple. A firm might not be able to cover its operating costs during a cyclical downturn. However, if the poor business climate is expected to be only temporary, it might be inefficient – and certainly unfortunate for workers – to shut the firm down in the short term. Financial markets offer two potential ways around this: first, firms can accumulate assets by saving during the boom times and then drawing down their savings during bad times (a tactic that also qualifies as intertemporal risk management). Second, if the firm had not accumulated sufficient savings, it can borrow in the present against their future earnings. Both of these strategies represent trades of spending in one period for spending in another – and both would be far more difficult in the absence of financial markets.

Households derive utility from financial markets in the same way: they can save in the present to fund future consumption or borrow against future earnings to fund present consumption. This can be motivated, as above, by temporarily hard times. More importantly, it can also be motivated by the desire to spread consumption over one's entire life in a way that maximizes that individual's utility. This is known as "consumption smoothing" or the "life cycle model of consumption" and it has produced an exceedingly large body of literature (c.f. Attanasio and Weber 2010). The model generally holds that access to financial markets allows households to borrow against their “permanent income” – their total lifetime earnings – in order to consume in the present. This results in a superior distribution of consumption over consumers' entire lives – instead of consuming less in youth and more in later life when they are wealthier (Friedman 1957; Modigliani and Brumberg 1980).

Ending quantitative credit restrictions, abolishing qualitative lending guidelines, and loosening restrictions on certain financial activities extends intertemporal trade opportunities to a wider group of economic actors. Allowing more widespread household lending, for instance, should improve households' capacity to spread spending over time. Financial innovation can also augment access to credit – for instance, securitization has made consumer lending to even the riskiest borrowers more possible on a massive scale. In theory all of these changes should produce more optimal spending patterns.

II.1.c: Risk Management

Financial markets offer an enormous array of strategies determining how much risk – and what types of risk – they take on. As a result, individuals and businesses – each possessing their own tolerance for risk – use financial markets to execute transactions that bring them closer to their ideal exposure profile. In this way, finance offers opportunity for everyone to be made better off (Mason 1995).

It is neither possible nor necessary to explore each and every way in which financial markets make this possible – and, in any case, the speed of innovation in the arena of risk management would render such a catalog obsolete in short order. The focus here is on risks that arise from – and can be managed through – securities markets and financial intermediaries. Theory suggests that more robust, competitive, and innovative financial markets should improve social welfare in three ways: cross-sectional risk diversification, intertemporal risk sharing, and liquidity risk reduction (Levine 2005).

First, cross-sectional risk management simply describes not putting all your eggs in one basket. If a saver allocates all their funds to one investment opportunity, they become highly exposed to that one investment not providing the expected level of return. The financial market, by dividing securities and other financial instruments into small denominations, allow savers to diversify their portfolios. This is intrinsically beneficial in terms of risk reduction; however, it is even more valuable if it allows savers to fund higher-risk, higher-return investment opportunities. As long as the risks attached to those opportunities are uncorrelated, savers can devote a portion of their diversified portfolio to more productive investments without significantly increasing their overall level of risk (c.f. Obstfeld 1994).

Liberalization improves opportunities for cross-sectional management in a host of ways. The simple growth of financial markets, lowering barriers to international capital mobility, and improved access to financial markets each allow savers more diversification options. Perhaps more importantly, innovative financial instruments and institutions provide new methods of diversifying. Instruments like "spiders," which mimic the market performance of entire exchanges do this, as do "funds of funds" in which one investment fund holds shares in other funds rather than buying securities directly. Securitization has almost certainly been the most significant innovation in cross-sectional risk management over the past few decades. The securitization process entails chopping up and repackaging hundreds or thousands of individual lender-borrower transactions into securities. The idea is that the idiosyncratic risk attached to each underlying transaction is rendered effectively meaningless: a default on one underlying transaction has a near-negligible effect on the overall value of the instrument – so long as not all of the borrowers default at the same time (i.e., the losses are uncorrelated) (Hu 2011).

Other risks are not so easily managed. Some events impact large numbers of firms and individuals in the same way; this second type of risk is often called "non-diversifiable risk" because it cannot be eliminated by cross-sectional diversification alone. In this case, even a diversified portfolio can be endangered because the performances of the assets within the portfolio are correlated. This sort of risk must be mitigated by what Franklin Allen and

Douglas Gale call "intertemporal smoothing," a concept similar in many respects to the smoothing in spending patterns addressed previously.

> 'Risks which cannot be diversified at a given point in time can nevertheless be averaged over time in a way that reduces their impact on individual welfare. One hedging strategy for non-diversifiable risks is intergenerational risk sharing which spreads the risks associated with a given stock of assets across generations with heterogeneous experiences. Another strategy involves asset accumulation in order to reduce fluctuations in consumption over time.' (Allen and Gale 1995)

Over the very long run, if intermediaries exist which pay low returns during economically good times and higher returns during bad times, it should be possible to hedge against macroeconomic shocks that create otherwise non-diversifiable risk. Markets could theoretically produce similar opportunities (Levine 2005). Short-selling and certain derivatives transactions such as in futures also perform this function in limited ways.

Third, liquidity risk stems from the fact that savers want the power to cheaply convert their holdings into more easily exchanged assets like cash. Borrowers, on the other hand, need to feel that they have stable access to capital markets in order to make longer-term decisions. If savers are forced to hold their assets for longer periods of time, they will tend to choose lower-risk alternatives. Likewise, if borrowers are uncertain of their ability to raise capital, they will tend not to make longer-term investments. Both are generally undesirable as they limit the return paid to savers and restrains the sort of risk-taking that accompanies major leaps in innovation and productivity (Hicks 1969; Bencivenga, Smith, and Starr 1995; Aghion et al. 2010).

More developed financial systems mitigate this risk in two ways: first, through robust and active secondary markets for securities and through banks. With sound secondary markets in place, firms gain permanent access to the funds originally provided by the sale of equity or debt even though the initial provider of those funds does not need to hold on to their original claim. Savers can lend to a firm – or buy a piece of it – then sell the resulting security to others in secondary markets. As a result, savers can take greater risk knowing that, if their circumstances change and they need immediate access to their funds, they can quickly convert their holdings into something more liquid. At the same time, firms get a stable means of raising capital from savers who need not feel excessively bound to the firm receiving their initial investment (Diamond and Dybvig 1983; Levine 1991).

The second – and arguably second-best – mechanism by which financial systems ameliorate liquidity risk is through banks. Banks' balance sheets are traditionally comprised of very liquid liabilities (deposits) and a large proportion of highly illiquid assets (loans). This is made possible by the fact that depositors do not typically demand all of their deposits all at once. Thus, banks only need to hold a very small proportion of their total capital in liquid form. This vulnerability should condition bankers to be shrewd managers of liquidity risk (Diamond and Rajan 2001). If so, banks can roughly approximate the equilibrium created by highly accessible and liquid secondary securities markets. However, the resulting arrangement concentrates the system's liquidity risk within a small number of intermediaries. This concentration is theoretically unnecessary if securities markets were costless and completely accessible (Jacklin 1987; Diamond 1991).

Less repressed financial markets enhance the systemic capacity to reduce this sort of risk. The more participants and assets are involved in secondary markets, the cheaper and easier it gets to liquidate a portfolio. Consequently, heightened financial market competition with fewer limits on secondary markets – and on which institutions can participate in them – should reduce liquidity risk. Innovations like securitization may also play a role in reducing liquidity risk by ostensibly reducing the fragility of banks' balance sheets: if banks can securitize their loan book, they can more easily sell portions of it into secondary markets. This should increase overall market liquidity though – following Douglas Diamond and Raghuram Rajan's (2001) analysis – it may actually lower the general quality of bankers' decisions by reducing the pressure on them to act carefully.

II.1.d: Corporate Control

In early capitalism, the industrial capitalist both owned and directed the firm and was wholly bound to the fate of his enterprise. With the development of capital markets, however, the roles of owner and manager become separable. Shareholder-owners transformed into more distant figures, each owning a small piece of the firm and claiming – in the case of dividends – a share of its profits. In this transformation, owners gained the freedom to buy and sell their pieces of a firm through increasingly liquid financial markets but lost direct control over firms' day-to-day decision-making. Conversely, managers and employees obtained more power over operations (Berle and Means 1933).

This division of firm ownership into smaller denominations has – as established in the preceding sections – a great many benefits. Because savers can buy a small part of a firm rather than the entire firm outright, it becomes easier to mobilize smaller pools of resources for productive use. Small-denomination equities also make it possible to diversify even low-value portfolios, mitigate liquidity risk, reduce the transaction costs that arise from buying or selling ownership of an enterprise, and thus generally make it easier for businesses to raise capital.

Benefits aside, however, this transformation also created a problem – the so-called "principal-agent problem." In effect, with owners no longer physically present, the managers appointed to run the firm on the capital-providers' behalf may pursue their own agenda instead of what is best for a firm's owners. For instance, managers might choose to build a vast but unprofitable empire rather than focus on putting shareholder capital to use in a way which earns the highest return to capital possible (c.f. Stiglitz and Weiss 1983; Jensen 1993; Dallery 2009).

Well-functioning capital markets present a potential solution to the principal-agent problem. One solution is found in the labor market for managers. A firm's share price in relatively efficient markets reflects the past performance of a manager's ability to maximize shareholder value. When hiring new managers, shareholders will assess potential hires based on this track record. As a result, managers should be incentivized to maximize shareholder returns (Fama 1980). Second, capital markets allow for the hostile takeover of firms with misbehaving managers. This can, for instance, allow for outside private equity to shut down firms whose managers refuse to shut themselves down (Jensen 1993).

Third, the simplest and most common method of aligning manager incentives with shareholder interests is to make managers into shareholders themselves. This can be achieved through the use of stock options and issuance of restricted stock. Options grow in value as a firm’s share price appreciates and restricted stock is issued to managers but cannot be sold for a fixed period of time. Both provide managers with the incentive to enhance shareholder value and boost the firm’s stock prices. As they become bound to the firm’s performance in financial markets, they are less prone to pursue other goals (Palley 2007; Stockhammer 2004).

Mechanisms for corporate control through financial markets grow stronger as markets become less regulated and more innovative. The development of incentive-based pay, particularly through the issuance of options, has allowed widespread alteration of manager incentives (Abowd and Kaplan 1998; Murphy 1999). The removal of barriers to leveraged buyouts likewise improved the capacity of outside private equity to tame misbehaving managers (Jensen 1993). Finally, any development that allows equities to better transmit information regarding manager performance – such as the reduction of transaction costs, improved liquidity, greater market competition – should theoretically augment financial markets' performance as a signal for managerial labor markets.

Whether this sort of corporate governance is beneficial from a broader social standpoint is contentious (Levine 2005). Indeed, of finance's major social functions, this is the most arguable. There is a distinct element of distributive conflict in this discussion: often, what is best for shareholders will not necessarily be best for other stakeholders in the firm – especially over the short-to-medium turn. The belief that maximizing shareholder returns will yield superior growth and better job prospects over the long term can seem abstract to workers without jobs or cities without industry (Ireland 2001).

It is to these counterarguments that this survey now turns. Based on the theories laid out in the preceding pages, financial liberalization *should* lead to socially beneficial change in financial markets. Indeed, it is all-but-impossible to argue that a certain level of financial sophistication is required in order to reach an advanced level of economic development. This point is not necessarily disputed by those scholars with more critical perspectives on finance – even Marxists would concede that functioning financial markets are a necessary ingredient in capitalist progress (though they might argue that the end result of such progress should be communism).

However, finance-skeptical theory maintains that financial development – particularly the sort of deregulated development that has occurred over the last thirty years of deregulation and liberalization – also creates serious problems. There is a large and diverse literature examining this period of so-called "financialization." The roots of these contemporary critiques of finance can be found in two well-established economic dissents against orthodox financial theory: the decidedly anti-market stance of Marxists and the less ardently anti-market positions adopted by thinkers like Keynes. Before turning to the interdisciplinary financialization literature itself, the next two sections present the two most important finance-critical strains of thought in heterodox economics.

II.2: The Liberal "Anti-Liberal" Dissent

The most prominent objection to orthodox pro-finance thinking derives from a handful of prominent liberal scholars – Tawney, Keynes, Adolf Berle, Gardiner Means, Hyman Minsky, and Charles Kindleberger – and their intellectual descendants. These thinkers have not rejected markets outright as Marxists have, yet they are decidedly more communitarian in their orientation – growing concerned that the gains from financial development would be uncertain and unequally distributed. They present the view that financial markets tend to destabilize as they become more liquid, more sophisticated, and more accessible. They also maintain that the sort of corporate governance exercised through financial markets could be counterproductive. Particularly in arms-length financial systems, they see financial stakeholders placing demands on business that ran counter to the interests of workers, communities, and society as a whole.

II.2.a: Financial Instability

Keynes (1936) was an informed skeptic of financial markets, famously advocating the "euthanasia of the *réntier*" while also making, losing, and then re-making a small fortune in financial trading (Skidelsky 2002). In his *General Theory*, he drew a distinction between speculation – buying and selling assets based on forecasts of their future market value – and enterprise – buying and selling assets based on forecasts of their prospective yields. In Keynes' view, the pursuit of capital gains was essentially a form of gambling in which traders placed bets other market participants' future behavior.

Moreover, he believed that the more active a market became, the more prone it was to such volatile behavior:

> 'As the organisation of investment markets improves, the risk of the predominance of speculation does, however, increase. In one of the greatest investment markets in the world, namely, New York, the influence of speculation (in the above sense) is enormous… It is rare, one is told, for an American to invest, as many Englishmen still do, "for income"; and he will not readily purchase an investment except in the hope of capital appreciation. This is only another way of saying that, when he purchases an investment, the American is attaching his hopes, not so much to its prospective yield, as to a favourable change in the conventional basis of valuation' (Keynes 1936, chap. 26)

Orthodox financial theorists are in agreement with Keynes up to a point. What Keynes called speculation, Friedman and Fama called arbitrage – and both perspectives agreed that this behavior increased as markets developed. The great dispute between the two camps, however, concerned whether such market behavior is positive or negative. Keynes believed that speculation turned financial markets into casinos; pro-finance theory responded that arbitrage was a stabilizing process by which large numbers of traders effectively arrived at accurate prices.

Keynes' logic reappeared in the works of thinkers like Susan Strange (1986) but was arguably most fleshed out by Minsky (1986; 1992) and Kindleberger (2005). In a developed financial system, Minsky (1992) argued, three models of finance exist: hedge, speculative, and Ponzi. Under hedge finance, firms can repay all their debts out of current cash flow if so required. In speculative finance, firms can make interest payments on previous borrowing but cannot repay the principal without further borrowing (i.e., "rolling over" their debt). Ponzi finance implies that firms must either borrow or sell assets to meet their interest responsibilities – either of which increases the ratio of liabilities to assets. Ponzi finance is thus only stable when assets are appreciating: debtors can only meet their responsibilities by borrowing against rising asset values or realizing capital gains. The problem, as Minsky and Kindleberger describe it, is that there is a pro-cyclical tendency for firms to move into speculative or Ponzi positions as funds flow into financial markets and credit expands. This inexorably triggers a violent boom-bust cycle.

This progression was captured by the title of Kindleberger's (2005) book on the subject: "manias, panics, and crashes." Good times breed optimism, overly ambitious projections of asset prices, and reduced risk aversion. Lenders offer large amounts of credit on lenient terms, allowing borrowers to feel justified in aggressive leveraging in pursuit of capital gains. Taken together, easy credit and growing leverage bring more money into the financial system, pushing asset prices higher. Rising asset prices seemingly justify the market's optimism, further intensifying lending and borrowing. Financial units consequently tend toward speculative or Ponzi positions as their debt burden rises.

This continues until some event, the so-called "Minsky moment," causes financial market participants to question their own optimism (Lahart 2007). Some begin to liquefy their asset holdings in order to repay debt, causing asset prices to fall. Ponzi units quickly find themselves "under water" – a situation in which their assets at market prices are worth less than their liabilities. Moreover, both Ponzi and speculative units find it harder to meet their repayment responsibilities through additional borrowing because once-abundant credit becomes more cautious. In the ensuing collapse of asset prices (i.e., "debt deflation"), market participants are forced to de-leverage, seek safer financial instruments, or potentially go bankrupt.

From this perspective, financial liberalization adds speculative fuel to the fire by allowing more credit into the financial system, removing regulatory brakes that might short-circuit the boom-bust cycle and encouraging the creation of instruments that result in illusory reductions in risk. Falling barriers to competition, abolition of quantitative credit controls, and broader access to financial markets generally increases the flow of funds into financial markets and creates destabilizing asset price inflation (Toporowski 2000). This effect is only magnified by the internationalization of financial markets, which radically increases the funds available for any given domestic market.

II.2.b: Shareholder Control

The idea that financial markets can and should play a role in corporate governance was troublesome to early 20th century communitarian scholars. They saw a natural tension between the interests of a firm's financial stakeholders and all other groups that held a stake in an enterprise (Tawney 2004; Berle and Means 1933; Keynes 1936). Shareholders in a modern corporation are able to quickly and cheaply associate or disassociate themselves with firms by buying and selling their stakes in those firms. Employees and managers, by contrast, are bound much more closely to a single firm and could not so easily disentangle their own fates from the fate of the enterprise for which they work. Keynes described this as an inherent problem with the idea of liquidity:

> ‘Of the maxims of orthodox finance none, surely, is more anti-social than the fetish of liquidity, the doctrine that it is a positive virtue on the part of investment institutions to concentrate their resources on the holding of “liquid” securities. It forgets that there is no such thing as liquidity of investment for the community as a whole.’ (Keynes 1936, 155)

The inherent problem is that shareholders can afford to take risks that other stakeholders cannot. In taking risks, shareholders’ downside is limited because they can sell their holdings if things do not work out as planned. That is, if a firm's gamble goes wrong, shareholders can sell their stake in the firm. Society, by contrast, is stuck with firms whether they succeed or fail: it is collectively exposed to all firms. This directly contradicts the idea that shareholders, having put up the capital behind an enterprise, have the strongest incentive to ensure that their funds are used efficiently.

However, efficiency in this sense has a very particular meaning: it refers to profit maximization. As a concept, it may be biased towards the interests of wealthy capital-holders at the expense of others (Ireland 2001). Shareholders may seek short term returns that fit poorly with other stakeholders' interests (Berle and Means 1933; Lipton and Rosenblum 2003; Aspen Institute 2007). In particular, workers may suffer. William Lazonick and Mary O’Sullivan (2001) have called one such outcome the “downsize and distribute” strategy: effectively, if firms can boost profits through layoffs, they will do so – even if profits are already strong and the benefits appear transitory (Widmer 2011; Morin 2000; Froud et al. 2000).

Advocates of shareholder control do not necessarily dispute this, conceding that the pursuit of efficiency can result in employment volatility. However, they counter that by shedding labor to improve profitability, firms improve the productivity of their remaining workers and allow displaced workers to pursue work in new fields (Wasserstein 2009). This premise is implicitly or explicitly at the core of many arguments in favor of labor market flexibility (c.f. Klau and Mittelstädt 1986).

There are, however, additional objections to shareholder control. Shareholders may have an incentive to seek short-term profit at the expense of long-run growth because they can liquidate their positions in the firm before the ultimate consequences of myopic decisions are felt (Berle and Means 1933; Boyer 2001; Stockhammer 2008). Moreover, executive compensation in stock options engenders the same "short-termism" in managers. This could potentially result in under-investment (Stockhammer 2004), excessive use of dividends and share repurchases (Bagwell and Shoven 1989), or socially costly “rent-seeking” (Krueger 1974). These choices depresses productivity and wages over longer time horizons, leading to what one group of French scholars – the French Regulation School – call *le profit sans l’accumulation* (Coriat 2008).

II.3: The Marxist Dissent

The Marxist perspective on finance is similar to the liberal collectivists' in many respects. Like Keynes and his followers, Marx himself saw financial assets – or "fictitious capital" – as objects of destabilizing speculation. Furthermore, both schools tend to view corporate governance through financial markets with suspicion – though the Marxists are more strident in their assertion that financial development concentrates power in the hands of *réntiers.* The anti-capitalists also distinguish themselves with the distinctively Marxist claim that financial development is both an inevitable product of capitalist progress and an instrument of capitalism's demise.

The Marxist portrait of globalized and liberalized financial markets is ultimately one of capitalist decay. Wealthy asset-holders send their money around the world in search of returns well in excess of what they could get from accumulating productive capital. They buy and sell with little regard for the intrinsic value of the underlying asset involved. Crashes invariably occur as a stagnating society is no longer worth the claims made upon it. In the resulting collapse of asset values, those few with the best protected wealth find themselves able to buy low, accumulating even more assets, and leading to ever-widening inequality between the asset-holding ruling class and the rest of society. The process occurs everywhere as a stage of capitalist development, propelled by history and economic structure: Decay worsens and the cycle will continue until capitalism finally gives way to a new economic system.

II.3.a: Speculation and Instability

Marx was among the first to see that financial assets could easily be analyzed as product in their own right. Securities, he argued, were "commodities, whose price has its own characteristic movements and is established in its own way" (Marx 1967, vol. 3, chap 29, p...) While Marx's thoughts on what these movements looked like – and on finance in general – were rather nebulous, Rudolf Hilferding's (1910) *Das Finanzkapital* offered a more systematic account:

> '[S]peculation increases, with the aim of exploiting the rise in security prices, and the demand for shares grows, with the result that prices are driven still higher... It is in this period that promotional activity is most vigorous, and the profits made by the banks from their own issues are greatest. Money liquidity favours speculation, which is dependent upon the availability of credit for its operations…[E]ventually a point must be reached at which the effort of speculators to force up prices comes to a halt. This point is reached all the more quickly if some of the credit which was previously available is withdrawn from speculation… Speculation, therefore, has to contract, and this means a decline in the demand for securities and a fall in stock exchange prices. Since the prevailing level of security prices was the basis

> of the credit made available for speculative purposes, it now becomes necessary to provide additional funds to support the paper which has served as collateral, or in some other way, as a basis of credit; funds which many of the speculators, and particularly their fellow travellers among the public, cannot supply. So there ensue forced sales of pledged shares, a sudden increase in the supply of shares, and a rapid fall in stock exchange prices. This fall in prices is exacerbated by the manoeuvres of the professional speculators who, having recognized the critical state of the market, now rush into 'bearish' operations. The fall in prices leads to a further restriction of credit and new forced sales; the decline becomes a crash, and a stock exchange crisis and financial panic develops.' (Hilferding 1981, chap. 18)

This is extremely similar to the Minsky-Kindleberger conception of a cycle of manic expansions and panicked crashes. Indeed, Marxists and Keynesians have largely the same view of financial market instability – arguing that market activity and liquidity ultimately fuel instability rather than efficiency. It is noteworthy that Hilferding wrote this passage more than half a century before either Minsky or Kindleberger addressed the topic (though the text was not widely available in English until the 1980s). Although now over 100 years old, Hilferding's work remains the foundation of Marxist financial analysis.

II.3.b: Concentration of Power

Marx took note of the changing nature of ownership in the 3rd volume of *Capital*, pointing out that stock markets had the effect of transforming "the actually functioning capitalist into a mere manager, administrator of other people's capital, and of the owner of capital into a mere owner, a mere money-capitalist" (Marx 1967, vol. 3, chap. 27). Hilferding took this thinking further, focusing on the money-capitalists – bankers and financiers – as a new class of *über*-capitalist. He argued that the division between money capitalists and industrial capitalists constituted a new phase of capitalism, one in which finance held increasing power:

> 'Finance capital now appears as a unitary power which exercises sovereign sway over the life process of a society, a power which arises directly from ownership of the means of production.' (Hilferding 1981, 235)

Ownership of the means of production in this context meant that bankers and financiers generally controlled the whole of society's savings. Because financial capitalists allocate the accumulated resources of every individual saver, they effectively have power over society's entire stock of wealth. For Hilferding and later, in particular, for Vladimir Lenin (2002), this would inevitably lead to "the highest stage of the concentration of economic and political power in the hands of the capitalist oligarchy" (Hilferding 1981, chap. 25).

Recently, even non-Marxists have begun to echo the Marxist refrain that government is little more than the executive committee of the ruling class – in this case, finance capitalists. In less incendiary terms, this would be considered "regulatory capture" (c.f. Dal Bo 2006) and appears in popular narratives of governments' role in promoting the global financial crisis (c.f. Johnson and Kwak 2010).

The economic system thus conforms to a standard assumption of Marxist thought: it greatly benefits the owners of the means of production (Duménil and Lévy 2005). Whereas Hilferding' ruling class was composed of actual financiers, present-day Marxists identify the new ruling class as any individual or firm who own financial assets – whether longtime members of the landed elite, nonfinancial firms, or entrepreneurial upstarts. Inequality inexorably grows between the ruling class – those who hold liquid financial assets – and those whose wealth is concentrated in a far more illiquid assets: workers, whose most valuable asset is their own labor power (Bryan, Martin, and Rafferty 2009).

II.3.c: Contradictions and the End of Capitalism

For more contemporary Marxists, freeing financial markets leads to far more than instability and the concentration of power – it is the logical outcome of the decline of capitalism. Harry

Magdoff and Paul Sweezy (1987), coining the term "financialization," argued that market saturation has drastically reduced the return on productive investment. As a result, capital-holders have been searching for new ways to earn a return on their savings in financial markets. They have thus pressed for deregulation and liberalization of financial markets, hoping to create new ways of extracting returns for themselves.

As this evolution has taken place, it has become more profitable for capital-holders to buy financial products than to invest in firm-building. This destroys the central mechanism for accumulating productive capital: rather than reinvest profits in expansion, firms instead divert them into unproductive speculation, arbitrage, and increasingly complicated derivative financial contracts. This is seen as indicative that capitalism has entered an end stage in which capital holders engage in zero-sum gambling of existing resources instead of fostering growth (Foster 2009; Foster 2007; Foster 2010; Freeman 2010; McNally 2009; Arrighi 1994; Pollin 2004).

This account identifies an inherently destructive contradiction: financial innovation allows the market value of one primary transaction asset to be multiplied many times over through the creation of multiple layers of derivative assets based on that transaction. This creates new nominal wealth based on a relatively small pool of underlying lender-borrower interactions. As savers buy these assets, they increase the nominal value of financial claims while reducing the amount of funds actually used to support productive investment. Society thus effectively borrows against future productivity without making the necessary investment to ensure that productivity in the future will be any higher than it is today. As a result, the returns on the original borrowing transactions will be lower or more uncertain than expected.

This inevitably leads to a mismatch between expected and real asset values, triggering enormous asset price corrections (Foster 2009).

There are several problems with the purest form of this account. Different scholars give contradictory theoretical accounts of post-1970 stagnation and profit decline (Krippner 2005): Some argue that oligopolistic concentration of market power has generated a crisis of "excess productive capacity" (Foster 2007; Baran and Sweezy 1968). Others maintain the opposite: that competition, not abuse of monopoly power, are responsible for stagnating profits (Arrighi 1994). Additionally, Marxists have a tendency to look to the falling rate of profits for explanations of capitalist change because Marx, as a good believer in the theoretical ideal of "perfect competition," saw diminishing profits as the single most important rule of political economy (Christiansen 1976). This is problematic. For one thing, the profitability of firms since the mid-to-late 1980s has been quite strong. For another, this emphasis leads Marxists to overlook the fact that profits do not need to fall in absolute terms for their account to have some explanatory value: potential investors will divert their resources into financial maneuvers so long as the expected return from doing so is higher than it would be from investing. This does not require profits to decline at all.

Of course, all of the typical critiques of Marxism apply: their account is hardly even-handed, prone to endowing history itself with a sense of agency, and overly loyal to Marx's original arguments. Nevertheless, the core of their argument – that financial development creates instability, concentrates economic and political power, and diverts resources away from productive enterprise – is plausible. In keeping with their tradition of radical but difficult-to-ignore polemic, Marxists coherently portray all financial development as a selfdestructive product of capitalist greed that has very little to do with improving the capacity of financial markets to carry out socially beneficial functions.

II.4: The Financialization Literature

The body of recent finance-skeptical theory, though firmly rooted in longstanding liberal and Marxist critiques of financial markets, is now so diverse and eclectic that it cannot be confined to a single school of thought or even a single discipline. Marxist and heterodox liberal economists have much to say about the relationship between financial markets and production; however, they are relatively quiet on the relationships between financial markets and households or financial markets and the state. Indeed, sociologists, cultural economists, and political economists have a great deal to contribute to the discussion. Some have tried to collect these perspectives together with the more classical positions outlined in the two previous sections under the term "financialization" (most notably, Epstein 2005). Yet it is hard to group this literature together in anything but the broadest sense (Engelen 2008).

Nevertheless, the scholars who self-consciously use the term – as well as those from the French Regulation School who refer to the phenomenon slightly differently – tend to share one common trait. All claim that capitalism has undergone a fundamental transformation starting in the late 1970s and early 1980s, transitioning away from manufacturing and the accumulation of physical capital. Where finance once performed only a support role for industry and provided few services to the ordinary consumer, post-1980s neoliberalism has been characterized by financial interests penetrating households, guiding government policy, and dominating firm decision-making.

II.4.a: The Eroding Position of the State Vis a Vis Financial Markets

Functionalist advocates of financial development like Levine and Merton maintain that post-1970s deregulation and liberalization was the product of governments' desire to reap the benefits of better functioning financial markets. The incentives at work in this view were straightforward: allowing financial markets to develop promised better resource allocation, improved risk amelioration, and more responsive corporate governance. For others, however, states' decisions to loosen financial sector controls were compelled by circumstance and should not necessarily be expected to yield positive outcomes.

As the 1970s and early 1980s progressed, stagflation convinced many governments that their traditional toolbox for managing output and employment were no longer functioning. This left them with expensive welfare state commitments and few policy options minimizing those costs. Political realities limited the viability of cutbacks: despite many rhetorical calls for welfare state reform, there has been little tangible reduction in the size of advanced economies' welfare states (J. D. Stephens, Huber, and Ray 1999; Pierson 1996; Garrett 1995). Higher taxes were also politically toxic for obvious reasons. Financial markets offered governments a third option.

Not only could governments simply borrow more to meet their obligations, they could also allow financial markets to perform tasks the state had become less capable of: the maintenance of living standards. In her analysis of financial deregulation in the United States, Greta Krippner (2011) argues that the Reagan administration dodged difficult distributional questions by allowing the decentralized financial system to provide for households. Instead of the government forcibly redistributing money from the wealthy to the poor through taxes and transfers, financial markets performed the same basic function.

Because such a strategy required a mass access to credit, the system of restraints on credit creation and financial market competition had to be dismantled. Raghuram Rajan (2010) describes much the same process as the "let them eat credit" phenomenon.

This new reliance on finance meant that governments had a strong incentive to make their domestic financial systems attractive to internationally mobile capital. Not only do financial inflows increase the supply of loanable funds within domestic markets, they create high-income jobs in the financial industry. The result has been states playing the role of suitors to international capital: every country wants to be an importer of capital and, ideally, to assume the role of financial center. This dynamic allows capital-holders to play governments against one another in order to drive policy toward an accommodating laissez-faire stance (c.f. Stopford, Strange, and Henley 1991; Cerny 1997; Cerny, Menz, and Soederberg 2005; Simmons 1999; Keohane and Milner 1996; Strange 1992). Such "regulatory arbitrage" can include demands for more lenient tax policy, less transparent accounting rules, fewer restrictions on financial activities, or outright government subsidies (Partnoy 1996). Thus, governments – once the masters of their financial systems – have begun to surrender control in order to make themselves attractive to internationally mobile resources.

II.4.b: The Financial Penetration of the Household

Households in the post-1970s era have more incentive to interact with financial markets than ever before – moreover, they have been allowed the freedom to do it, both as borrowers and as savers. As real wages have begun to stagnate and governments have allowed households to maintain living standards through access to credit, households have turned to borrowing in order to maintain their living standards (Stockhammer 2008; Guttmann and Plihon 2010; Rajan 2010; Krippner 2011). Randy Martin (2002) describes this as a tectonic cultural shift: in order to have material security, households are required to exercise sound debt management. Consumers must successfully juggle revolving credit (credit cards), store credit, and finance options for large purchases like cars. In particular, they are encouraged to view the household itself as an asset to be used for collateral for borrowing or even speculative investment. The end result is the transformation of debt management from a relatively minor consideration into the primary means of achieving the economic wellbeing.

Financial innovation greatly accelerated this process. Securitization, in particular, allows the efficient transfer of massive amounts of wealth into consumer debt (Hyman 2013). The process creates a bond-like asset from multiple individuals' repayments on debt such as home loans, meaning that the buyer of securitized debt he owns a composite of repayments on multiple loans. This theoretically makes risk easier to assess because it is ostensibly easier to predict the default rate for a thousand borrowers than it is to predict the likelihood of individual default. Risk for large numbers of borrowers is assumed to be based on Gaussian distributions that can be adjusted based on simple coding criteria such as credit scores (c.f. Dick and Lehnert 2010; Dore 2008). This creates assets that were ostensibly internally diversified – again assuming no correlation between borrowers' capacities to repay their debts.

This could be further compounded through the creation of structured financial products such as collateralized debt obligations (CDOs), which package securitized assets together in a way that permitted buyers to effectively choose what combination of risk and return they were willing to accept. This allowed savers to buy consumption-based assets from banks as a sort of income-bearing product, choosing from a menu of interest rates and associated risk. The practice potentially works for any stream of regular payments – from home mortgages to student loans to credit card payments and car financing (Leyshon and Thrift 2007). Almost any household lending could be repackaged and sold on in this way, extending the "originate-and-distribute" model throughout consumer finance (Lapavitsas 2009).

Just as financial concerns have increasingly penetrated the home, the household has become more central to the functioning of financial markets. Multiple layers of financial assets are underpinned by consumer borrowing. The mortgage, the mortgage-backed security, the credit default swap insuring the mortgage-backed security, the commercial paper issued by lending institutions to raise funds for mortgage lending, and all other related derivative contracts are fundamentally based on consumer borrowing. Schumpeter, otherwise a great advocate of finance, would likely take a dim view of this.

> '[T]he point is that the granting of credit does not then appear as an essential element of the economic process. This holds good first of all for consumptive credit... it is not an element in the fundamental forms and necessities of industrial life.' (Schumpeter 1983, 103).

In the end, the financial penetration of the home increasingly means that the entrepreneur is no longer receiving resources as "the typical debtor in capitalist society" – that role is instead played by homeowners and consumers. This is problematic because it allows household borrowing to substitute for the sort of corporate borrowing that Schumpeter and his intellectual descendants saw as forming the crucial link between finance and growth.

Households have increased their interaction with financial markets not only as borrowers, but also as lenders. Consumers have increasingly gained the power to engage in financial trading through brokers or directly through the internet. Pension schemes have also been a major boost to their asset holdings. This aspect of the financial penetration of the home has both its supporters and detractors. Proponents argue that household lending makes consumers into owners, with a full stake in financial markets and many of the privileges extended to shareholders. The French Regulation School goes so far as to suggest that this sort of consumer involvement in finance is necessary for the functioning of an economic system based on financial activity (Boyer 2001). Furthermore, growing asset holdings provide some balance to consumers' growing liabilities. Opponents, however, note that this sort of ownership will only introduce more uncertainty into the household. Consumers may prove less than adept at navigating financial markets and end up – again – disadvantaged in comparison to better-informed wealthy capital-owners (Langley 2004; Dore 2008).

III: Conclusion: A Synthesis

Despite the lengthy discussion of ideas concerning financial markets and financial market development here, this dissertation does not assign any particular primacy to the causal force to the power of ideas and those that narrate them. Nor does it see international economic change, pluralistic competition, or institutional path dependence as playing a particularly special role. Instead, it adopts an opportunistic attitude: all of these forces matter; it is impossible to provide a realistic account of financial liberalization without accepting that complex events emerge from an equally complex intermingling of forces. The main thrust of this project is empirical, not theoretical: it aims to understand why financial liberalization happened, how liberalization affected the functioning of financial markets, and whether the "new" financial systems that emerged from liberalization actually achieved the results orthodox financial theorists hoped for.

The method employed is a simple comparative analysis of the political and economic history of Britain and France, subsequently checked against a wider cross-section of countries in order to determine whether the findings derived from the paired comparison can be generalized. It is an exercise in theoretically informed historical and economic analysis that *may* point toward a generalizable set of conclusions. It consciously follows the guidance of Katzenstein (1995) when he advocates the "blurring of distinctions" between disciplines as well as Theda Skocpol's (1995) admonition that comparative political analysis should "*compare* – a startling idea!" This is a work in the tradition of Calleo, Strange, Jones or Matthijs: each of these scholars seeks to describe and analyze empirical realities without imposing upon themselves the theoretical blinders that accompany devotion to a single discipline or theoretical perspective.

It is also important to make clear that this is neither a diatribe against nor a justification of "neoliberalism." Orthodox financial theory is *not* neoliberalism; it is a set of discrete ideas about the role that financial markets play and why they are valuable. Indeed, contemporary financial orthodoxy owes as much to the relatively heterodox Schumpeter as it does to more classically liberal thinkers like Friedman. This distinction is crucially important: by focusing on a relatively specific set of ideas rather than the whole sweep of "neoliberalism," the merits and shortcomings of orthodox financial theory can be evaluated on their own terms.

Different schools of thought have each made their predictions about what financial liberalization would accomplish. Orthodox thinkers argued that the result will be superior resource allocations and faster growth (the ultimately "intended" consequences); liberal communitarians envision unstable resource allocations and fragile growth; Marxists fear that the well-off will gather wealth and power to themselves as capitalism crumbles around them; finally, financialization scholars argue that financial markets will come to dominate the daily lives of businesses and individuals (these would be the "unintended" consequences of liberalization). The various claims are not mutually exclusive – in all likelihood, each strand of thinking contains elements of truth.

In short, this is not an account of the homogenizing force of a single pernicious idea and its self-serving adherents along the lines of Naomi Klein's (2008) *Shock Doctrine*. It is an assessment of where several major competing ideas were right – and where they were not. Moreover, it accepts that these findings will vary by country as local interest groups, institutions, and adherence to ideas differ. Put simply, there is sufficient data to evaluate the whole of the post-1970s process of financial liberalization. This work is an attempt to perform such an evaluation for Britain and France, with an eye to how those two countries may represent the rest of the developed world.

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Part One:
The Beginning

Three –
The Radical Liberalizer: The Thatcher Boom

'The City serves not only the City, but the nation as a whole'
–Margaret Thatcher, November 10, 1986

Few of Margaret Thatcher's reforms were as fundamental as her governments' overhaul of the British financial system. When Thatcher was first elected in May 1979, British finance was best described as cliquish, internationally closed-off, and very tightly controlled by the state. Within a decade, Tory policies had successfully forged a dynamic, internationally competitive, and thoroughly liberalized system. This transformation has proven remarkably durable: even after Labour returned to power in 1997, the Thatcherite approach toward financial markets established during the 1980s remained the British status quo. Britain, perhaps more than any other advanced economy, has adhered to the conventional wisdom that competitive, liquid, and deep financial markets – largely unhindered by state intervention – greatly benefit society.

From Thatcher herself came the simple conviction that this was true: that free market competition would serve the interests of the country at large. That vision as it applied to financial markets was given form by others – above all by Geoffrey Howe and Nigel Lawson, her first two Chancellors of the Exchequer. Their reforms during the 1980s brought a wide array of new lenders and borrowers into financial markets, fostering stiffer competition and allowing more borrowers better access to financial resources. Capital flow bottlenecks for non-financial firms were broken and Britain's position as an international financial capital strengthened. As a result, financial markets moved from the periphery to the core of the British economy. According to the OECD, the financial sector now employs more than a million workers and accounts for nearly 40 percent of all corporate profits. An assessment in 2010 found that financial firms pay more corporate taxes than any other sector of the economy (PricewaterhouseCoopers 2010).

The aim of this chapter is twofold. The first objective is to tell the story of the Thatcher-era liberalization and deregulation of British finance, highlighting how and why the country's financial system was so radically altered. The second is to identify who benefited most – and least – from the financial reform process. Before getting to those tasks, however, it is necessary to begin at the beginning: by describing how British finance worked prior to the Tories' victory in 1979.

I: The Pre-1979 Regime

For anyone who didn't experience it firsthand, financial activity in pre-1980s Britain might appear quite alien. Today's transnational and universal financial supermarkets were completely absent from the economic landscape: instead of using one institution to manage savings, transact on capital markets, take out loans, and provide revolving credit, customers in the 1970s confronted far more specialized financial institutions. Electronic payment systems were unsophisticated; 90 percent of all transactions were conducted with cash at the start of the 1980s and most non-cash payments processed by paper check through a slow paper-based clearing process (Mullineux 2012). British residents' transactions in and out of Sterling were subject to arguably the most extensive capital controls in the developed world, with most large transactions requiring explicit government approval (Lawson 2011).

On a systemic level, financial institutions were isolated from competitive pressures, with many segments of the market grouped into government-sanctioned cartels that dealt with only a few financial activities. Moreover, exchange controls meant that domestic markets for financial products and activities were closed off from international competition. Despite the fact that London was – then as now – one of the largest financial centers in the world, consumer lending, the banking system, and the stock market were heavily influenced by the government and dominated by small elite groups.

I.1: Ad-Hoc State Control

Britain's rather peculiar legal legacy meant that "regulation" in the pre-1979 era was generally ad hoc and based on accumulated custom. Banking law referred to traditions dating to the 19th century; what few statutes existed on equities markets came from the 1938 and 1959 Prevention of Fraud Acts (Pimlott 1985). The first contemporarily recognizable attempt to impose statutory financial regulation didn't occur until the Banking Act of 1979, which delineated exactly what institutions were permitted to take customer deposits. Yet even this was not a product of internal forces – the European Economic Community (EEC) had issued a directive that all member states must pass regulations that permitted the licensing of depository institutions (K. Watson 2004).

While there is no question that the British financial system was subject to a significant degree of state control, that control was exercised in a uniquely British way – through elite networks, extralegislative direction, and ad hoc custom that evolved over time. Policies were crafted with two overriding goals in mind: first, to restrict credit formation by limiting lending; second, to avoid politically dangerous interest rate hikes. The first goal flowed from the desire to curtail inflation, rein in current account imbalances, and maintain the position of Sterling *vis à vis* the Dollar. The latter concern was a product of Britain's demand management regime: the elected Chancellor of the Exchequer ensured that interest rates did not rise high enough to choke off industrial credit and stoke unemployment. Of course, these two goals are mutually exclusive in a free market: restraining the supply of loanable funds will generally cause the cost of borrowing existing funds to rise.

Hitting these two contradictory policy targets meant that all aspects of British finance had to be largely insulated from international markets. UK citizens' access to foreign finance was sharply constrained, as was foreign financial institutions' access to the UK. Foreign firms and investment banks were barred from membership in the London Stock Exchange and capital controls limited the scope of cross-border banking. Although the investment banks did have overseas portfolios and certain international financial connections had continued to grow – off-balance sheet transactions and Eurodollar holdings allowed the banks some scope to evade regulatory roadblocks – the restrictions were nevertheless limiting. The importance of the closed nature of British finance prior to 1979 cannot be overstated: without it, the collusive nature of the domestic system would have been impossible to maintain (R. Michie 2001; Britton 1991; Howson 2004). Indeed, the opening of the British financial system was among the first and most potent drivers of change brought on by Thatcher's rise to power.

It is worth explicitly noting that the Bank of England was not independent until the late 1990s. Consequently, the Bank had to adjust its rules based on the dictates of the more politically minded Treasury, creating a great deal of tension between the two. In order to maintain below-demand levels of lending at below-market interest rates, the Bank established an official price at which it would lend. As a tool, the Bank Rate was accompanied by a proliferation of rules, including liquidity targets, lending ceilings and so-called “special deposits,” briefly summarized below (c.f. Tew 1978; Saunders and Ward 1976; Holden, Matthews, and Thompson 1995; Howson 2004; Watson 2004; Capie 2010):

- Liquidity targets were a direct means of controlling overall liquidity in financial markets – banks were typically required to hold around 30 percent of their overall holdings in liquid instruments (mainly government debt). Analogous restrictions still exist today in one form or another: reserve requirements and the management of value-adjusted leverage ratios effectively achieve the same result.

- Lending ceilings operated as straightforward quantitative restrictions on the amount of lending that a bank could undertake. These were periodically removed or readjusted. For instance, between May 1965 and April 1967 banks could not increase lending by more than 5 percent compared to a March 1965 benchmark; the ceiling was then removed in April 1967 only to be reimposed (at a higher level) later that year. Ceilings became increasingly unpopular within the Bank of England for several reasons. For one thing, they were seen as ineffective. Ceilings could not stop firms from raising bank capital via commercial paper, nor could they control lending from banks' foreign-currency accounts or prevent banks from routing transactions through foreign subsidiaries – Ireland was particularly popular for that purpose.

- A second objection to quantitative restrictions on lending arose because they were traditionally paired with qualitative lending directives issued at the behest of the Treasury to the country's clearing banks. These directives served as an indicator of where the government thought credit should be allocated – a relatively crude analogue to France's *encadrement du crédit*. In practice, this meant that the Bank got drawn into minutia – for instance, getting involved in lending decisions for tomato growers and hoteliers on the island of Guernsey. Even lukewarm supporters of ceilings like onetime Chief Cashier John Fforde bemoaned qualitative restrictions, noting that it was absurd to believe the government could effectively determine which firms and industries would receive credit.

- Special deposits effectively penalized banks for accumulating large liabilities (i.e., deposits) by forcing them to hold a certain proportion of their total deposits with the Bank of England at a punitive interest rate. This removed a portion of banks' capital from their books, preventing them from loaning it out and helping to control credit growth. These deposits took on several forms in the pre-1979 era: initially deployed in 1960, they remained in use until just after the Conservatives' 1979 rise to power in the form of the Supplementary Special Deposits Scheme – better known as the "corset."

- The government's ministries also maintained hire-purchase controls as a supplementary mechanism for limiting credit growth. Through regulation implemented in 1938, revised and updated throughout the 1950s and 60s, and ultimately consolidated with the Consumer Credit Act of 1974, the government held a great deal of control over consumer financing arrangements. This included, for example, the power to set minimum down payments, maximum repayment periods, and even the language of financiers' advertisements.

There had been efforts to reform this system prior to 1979. With the election of Edward Heath in 1970, reformers within the Bank of England gained support to remove quantitative controls and press ahead with a partial liberalization. They were led by then-Governor of the Bank, Leslie O'Brien, who had antagonized the first Labour government of Harold Wilson by openly disagreeing over economic policy. The initiative, known as Competition and Credit Control (CCC), sought to replace direct control over lending and liquidity with a regime that influenced lending through the open-market manipulation of interest rates. The Bank Rate – the centrally administered price at which the Bank of England would lend – was replaced by the Minimum Lending Rate (MLR), an ostensibly market-based calculation. Liquidity targets and special deposits were retained, though theoretically as a tool for fine-tuning interest rates. A set of revised liquidity targets also served to level the playing field between the clearing houses and non-clearing banks by extending liquidity targets to most non-clearing financial firms (Mullineux 2012).

The experiment was short-lived. Not only did the Bank of England fail to completely surrender its non-market-based tools of interest rate manipulation, but both the Bank and the government were caught off-guard by the lending explosion that followed the lifting of quantitative restrictions. Funds which had been hidden or moved abroad suddenly appeared on banks' official sterling books, greatly expanding the money supply. Despite rising interest rates, the intense demand for credit meant that lending continued to increase (Capie 2010;

Dennis 1980). In many ways, the immediate result was very similar to what would happen under Thatcher a decade later.

Yet while the appropriate policy response to such an inflationary mix should have been to allow interest rates to rise even further – something Thatcher *did* have the political audacity to do – Heath blinked. In the face of increasing interest rates and rising unemployment, the government began to express reservations over continuing with CCC. O'Brien's relationship with Heath and his Chancellor, Anthony Barber, became increasingly frayed as the government pressed him to reassert the bank's direct control over credit markets. O'Brien resigned in 1973 at the height of tensions. Heath and Barber then continued to press his replacement, Gordon Richardson, to control credit growth while maintaining lower interest rates. With few other options available, the Bank reintroduced quantitative controls at the end of 1973 and maintained them for most of the ensuing decade. CCC had been a resounding defeat for the liberalizers (Capie 2010).

The failure of CCC neatly illustrates the central challenge of 1970s for British policymakers trying to use the tools of the state to manage the economy: how could it control inflation without creating capital bottlenecks that could rob industry of needed funds for investment? From 1974 to 1979, a series of weak Labour and coalition governments struggled to meet that challenge. Wilson, returning to 10 Downing Street in 1974, used a slim three-seat majority to push for an expansion of social spending and increased taxes on top earners and investment income. While inflation and unemployment largely abated until his resignation in 1976, his successor was less fortunate. James Callaghan first inherited Wilson's slim majority from 1976-77, then governed in coalition with the Liberal party following by-election losses from 1977-78, then led a minority government which lasted from 1978-79.

As the position of Callaghan's government deteriorated, so too did Britain's economic prospects: both inflation and unemployment began to rise again despite the implementation of anti-inflationary wage controls. The deteriorating balance of payments compelled Callaghan's first government to devalue the pound. Enormous public finance shortfalls further forced it to request support from the IMF. Increasingly under siege, Callaghan delayed calling a new election hoping that economic conditions would improve. His gamble backfired dramatically: trade unions rebelled against wage controls and brought much of the country to a halt during the 1978-79 "winter of discontent." In March, 1979, a vote of no-confidence compelled Callaghan to call an election with Labour in disarray.

I.2: The Fragmented Financial Space

The pre-1979 banking system was also extremely segmented, populated by the large clearing banks, non-clearing retail banks, building societies, merchant banks, and discount houses – each of which had their own special preserves within the county's financial space. Two divisions are of chief importance: first, between building societies and the clearing banks; second, between the entities that operated extensively on capital markets (merchant banks and discount houses) and those that did not (the clearing banks and other retail operations).

In the retail lending market, state rules and regulation maintained a near-monopoly in the mortgage market for building societies, a subset of mutually owned bank-like entities restrained by law to act as simple intermediaries. In effect, they had only one job: taking in household savings and using those funds to make mortgage loans. These laws also ensured that building societies were at a distinct advantage in the mortgage business. In particular, the tax treatment of income generated by the building societies' mortgage lending was extremely favorable. Additionally, building societies were specifically exempted from the liability limits imposed by the corset and from certain capital requirements, allowing them to accumulate relatively cheap deposits and lend them more aggressively. As a result, building societies dominated the mortgage market, reaching the point where they accounted for 96 percent of all mortgages issued in 1977 (Merrett and Gray 1982).

The tradeoff was that building societies were expected to fund themselves *entirely* through deposits and make profits *entirely* through mortgages – wholesale markets and the market for interbank deposits were generally restricted to the large clearing banks (such as Barclays and Lloyds) and smaller "fringe" banks. These other commercial banks, in turn, had more access to wholesale markets but were penalized by discriminatory tax treatment and by the corset. Ultimately, this variable treatment resulted in two partially overlapping industries in which each avoided competition from the other (c.f. Merrett and Gray 1982; Stephens 1993; Stephens 2007).

In this rather staid environment, institutions within the parallel banking systems were free to collude amongst themselves in order to enhance their profits. The Building Societies colluded under the auspices of their official cartel, the Building Societies Association (BSA), while the clearing banks maintained the Committee of London Clearing Banks (CLCB) to assist themselves in coordinating. Both bodies actively encouraged the harmonizing of interest rates among their members – both what they paid depositors and what they charged lenders.

For the building societies, demand for loans easily outstripped supply at the lower interest rates favored by the state. This meant that mortgages had to be rationed, often leading to discriminatory lending practices (M. Stephens 2007). Such coordination was calibrated to “allow the least efficient societies to survive and, at the same time, to give generous margins to the more efficient societies” (Gough and Taylor 1979, 13). Moreover, the coordination was officially sanctioned by the government, which specifically exempted building societies and the BSA from investigations for restrictive practices (Gough and Taylor 1979).

Collusion was similarly rife at the CLCB. Throughout much of the pre-1979 period, the major British banks agreed to a coordinated schedule of lending rates for different types of borrowers, a practice that was also explicitly tolerated by the government until 1971. The collusive inter-firm dynamic added a second anti-competitive layer to government restraints, further limiting the growth in British credit markets (Bank of England 1968).

The fragmentation of Britain's financial space becomes even more apparent when capital markets are considered. Neither the clearing banks nor the building societies could freely participate in the UK's equity markets – a significant restriction given the historic importance of equity markets to the British economy.

Since the late seventeenth century, ownership of a firm was often a financial affair rather than a family one. This long-standing tradition, combined with the evolutionary nature of Britain’s common law system, ensured that the UK had some of the most robust investor protections in the world. Precedent had been established for a raft of investor rights – for instance, to a firm’s assets in the case of bankruptcy. Under such a system, there was little incentive for individuals or institutional investors to build up controlling stakes in firms:

rather than expend the cost to run a business directly, investors were content to leave the day-to-day management to others with the knowledge that their rights were secure. This ultimately created an equity market characterized by widely dispersed ownership in which no one individual or institution had a dominant stake in firms (Porta, Lopez-De-Silanes, and Shleifer 1999; Goergen and Renneboog 2003).

The group of merchant banks and brokers that populated these established equity markets was every bit as cliquish and closed-off from competition as the rest of the country's financial sector. While only building societies were explicitly barred from investment activities, the closed membership of the London Stock Exchange (LSE) effectively prevented competition to the established group of investment bankers and brokers. During the pre-1979 or even pre-1986 era, London's capital markets were dominated by a tight-knight club of elites famously noted for their leisurely and boozy lunches (c.f. Augar 2008; Guthrie 2013). Commissions were fixed among the major traders who still bought and sold from each other face-to-face. Functionally, firms could not act as both a "broker" – individuals executing trades on behalf of a client – and a "jobber" – market makers holding large portfolios from which to buy and sell. This uniquely British distinction, known as the "single capacity" system, prevented conflicts of interest between brokers both trading on behalf of clients and themselves (i.e., there was no proprietary trading) (R. Michie 2001).

II: The Impetus for Change

During the second half of 1970s, opposition to the Wilson-Callaghan governments coalesced under Thatcher, who had ascended to leadership of the Conservatives in 1975 after narrowly deposing Heath. Thatcher saw her task as leader as joining an epic battle of ideas – a "political and moral challenge," as she put it at her first Party Conference as leader. On one side of this struggle stood Labour ("the socialists") which she saw as anti-property and anti-enterprise, so eager to redistribute and centrally command the economy that they would penalize the industrious, starve businesses of capital, and supplant the private economy with a public one.

On the other side stood the Tories, champions of the individual and of the power of free enterprise. The economic recipe outlined by Thatcher, Howe, and Lawson featured three major ingredients: tax cuts, public spending reductions, and inflation reduction. With a smaller government, leaner taxes, and stable prices, the Conservatives argued that government borrowing would cease squeezing private borrowing out of financial markets and create a less uncertain environment for investment. Productive investment would therefore rise – and those who fled abroad to pursue greater fortunes and smaller tax liability would return. Finally, curtailing the increase in prices would prevent the debasement of the pound, allowing households to save with peace of mind that their savings would not evaporate.

Thatcher's critique of Labour was devastatingly simple, encompassed in the Tories' 1979 election slogan: "Labour isn't working." Inflation and unemployment continued to rise to postwar heights, investment was plummeting, and Callaghan had been revealed as strikingly tone-deaf to the darkening mood of the country. Labour had very little with which it could fight back against Thatcher's core criticism: that the country had tried Labour's economic prescriptions and that they simply weren't getting the job done.

Explicit mention of financial deregulation was rarely to be found in Thatcher's sometimes-Manichean rhetoric. Her emphasis was broader, casting socialism as morally corrupt and ineffective. Where she entered into explicit policy debates, she usually emphasized fiscal policy and inflation. Introducing more freedom and competition into financial markets was consistent with Thatcher's grand economic vision but not a central part of it. In fact, financial liberalization stemmed in large part from one major policy initiative spearheaded by Lawson, then the Financial Secretary to the Treasury: the abolition of foreign exchange controls. In Lawson's own (1992) retrospective view, the genesis of the entire deregulatory agenda of the 1980s lay in the 1979 decision to allow the free movement of capital in and out of the country.

Lawson had pushed for an abolition of capital controls since his first speech as a spokesman for the shadow cabinet in 1977. He saw it as a necessity in light of the huge impact that North Sea oil deposits were having on the British balance of payments: with oil exports surging, capital controls would tend to harm other British exporters. That is, the demand for oil would fuel an appreciation in Sterling that would harm the competitiveness of the rest of the British exporting sector. He hoped that a relaxation of controls would allow the funds brought in by oil exports to instead be exported abroad, maintaining the balance of payments and providing Britain with a larger foreign capital base from which it could generate foreign exchange in the future (Lawson 2011).

While Lawson (2011, 65) was enthusiastic, he described Howe as "apprehensive but fundamentally sympathetic." Indeed, Howe (1995) would later speak of the choice to lower exchange controls as the most difficult economic decision of his life. Thatcher herself was not necessarily sold on the idea, allowing it to go ahead but warning Howe (1995, 142): "'on your own head be it, Geoffrey, if anything goes wrong.'" The great concern was over where British capital would go – and what it would do – once restrictions were lifted. Labour had maintained the controls to prevent capital flight that might undermine their powers of Keynesian reflation and, as Lawson put it, saw the lifting of controls as a dangerous example of Tory radicalism. They were not the only opponents of the move: Michael Heseltine, a cabinet minister from the Tory left who would later mount a leadership challenge to Thatcher, objected that potentially productive credit might flee the country to buy frivolous luxuries on the beaches of the Mediterranean (Campbell 2011)

But that sort of objection ultimately carried little weight with Thatcher. Her ideological attachment to notions of economic freedom meant she was more inclined to agree with Lawson and Howe. After Howe convinced her to come on board, she embraced the project with typical color, describing exchange controls as a "prison," to which she was throwing the doors open as part of a "Herculean" pilgrimage (Thatcher 1979). With her and Howe fully on board, the way was paved. Howe announced the move publicly on October 23, 1979 and controls were rapidly dismantled thereafter. It was an abrupt end to forty uninterrupted years of strict control over Sterling's international mobility – and it had a profound knock-on effect. As Lawson saw it,

> '[I]t is hardly possible to overstate the critical importance of our decision. Politically it was the first significant increase of market liberalisation undertaken by the Thatcher Government. It marked the start of a process of deregulation which has embraced the world in general and the European Union in particular. Industrially, by enabling UK firms to invest where they liked, it ensured that investment in the UK would yield a worthwhile return – the economy had to compete. Without it the City would have been hard put to remain a world-class financial centre. ' (Lawson 2011, 69)

At its core, the suspension of all exchange controls undermined the state-dominated and cliquish nature of the banking system. By allowing unrestricted international capital movement, the government rendered its system of lending restrictions obsolete: banks could move an unlimited amount of their business off their Sterling balance sheets and into overseas markets, thus evading the any sort of quantitative restrictions. Banks that were barred from an activity in Britain could simply conduct it elsewhere. In sum, much of the financial liberalization of the 1980s was necessitated by this first step in Thatcher's first months in office.

III: A Ten-Year "Bang"

Following capital account liberalization, the changes to the financial sector came fast and frequently, culminating in 1986 with the passage of the Building Societies and Financial Services Acts of 1986 and the so-called “Big Bang” reform of the London Stock Exchange (c.f. Lawson 1992), Looking back at the whole history of British financial deregulation, the years between 1979 and 1986 were clearly the most intense period of formal systemic change, establishing the legal and regulatory framework that has guided the country’s financial and economic development ever since. The developments can largely be clustered into two categories: first, the deregulation of banking; second, the deregulation of capital markets.

III.1: Banking: A Leveled Playing Field

Banking deregulation came swiftly on the heels of capital account liberalization. The government formally announced the end of the corset in June 1980, indicating that there would be no further effort to control lending through quantitative restrictions. Instead, the new government planned to return – at least in part – to CCC's envisioned method of monetary control: the use of open market operations to control interest rates. Unlike Heath and Barber a decade earlier, Thatcher, Howe, and Lawson were willing to back their deregulatory moves with the draconian interest rate hikes needed to forestall inflation. Rates consequently rose to 17 percent in the early months of their mandate.[2]

The move was arguably no more popular than it would have been under Heath, but was made markedly easier by the fact that Labour at the time was in complete disarray. The party was riven by internal dissent: Tony Benn, among the most leftist senior Labour ministers, contested the party leadership in 1980, rallying the left wing of the party against Callaghan's more moderate stances. Despite losing to Michael Foot's compromise candidacy, the right wing of the party became so concerned with Labour's leftward lurch that several high-profile members split away to form a new centrist Social Democratic Party. Labour's share of the seats in the House of Commons dropped from 41 percent to 32 percent in 1983, as the party under Foot stumbled to less than 30 percent of the popular vote. The Social Democrats only mustered six victories, with the vast majority of Labour's lost seats going over to the Tories. The Tories were left to pursue their policies unencumbered by an effective opposition.

Following on the heels of the abolition of the corset came a host of other deregulatory moves over the course of the first and second Thatcher governments. Liquidity targets (the so-called Reserve Assets Ratio) were eliminated in 1981 and hire-purchase controls ended in 1982. These changes – particularly combined with the end of quantitative controls – profoundly affected the UK's banks and bank-like entities. By eliminating the corset, a major obstacle to the clearing banks entering the mortgage market was gone – they could now hold large amounts of deposits without penalty. This, coupled with the repeal of the existing reserve requirements, allowed the clearing banks to dramatically widen their retail deposit

[2] Bank of England (BoE)

and lending activities. When hire-purchase restrictions were abolished less than a year later it further widened the potential range of consumer credit products.

The radical expansion of banking activities necessitated a reevaluation of the role of building societies altogether. Without the protection of the corset, building societies now faced intense competition for the lifeblood of their one core activity – low-cost household deposits. A contemporary issue of trade magazine *The Banker* summed up the changed environment succinctly:

> '[T]he big UK banks, which for years have been losing out to the building societies in the battle for deposit funds, have started to fight back. They have introduced a bewildering variety of new savings and deposit schemes … and they have vigorously promoted their own mortgage loans (The Banker 1981b).'

Furthermore, the favorable tax treatment that had given the building societies a comparative advantage in mortgage markets was phased out, disappearing completely by 1985 (M. Stephens 2007). In effect, the new competitive forces compelled the building societies to compete rather than collude. The BSA, which had allowed building societies to ration household lending at below-market rates, collapsed as the societies began to undercut one another.

For a time, this left the banks with distinct advantages over the building societies. Banks were allowed to raise funds from wholesale markets (which, with the higher market-determined interest rate for mortgages, was now more profitable) while building societies were obliged to rely on increasingly scarce deposits, limiting their expansion possibilities. The scope of building societies' business activities remained restricted – they could not, for instance, participate in the booming consumer credit market by offering products such as unsecured personal loans, credit cards, or investment accounts. In effect, the increase in competition had been one sided: the large clearing banks could invade the building societies' turf but the reverse was not the case. As a result, the building societies pushed hard to be allowed to diversify their activities (Stow 1979; The Banker 1983).

In general, the building societies' case for freer competition found a receptive audience in Thatcher's pro-enterprise government. From 1983 to 1986, the BSA, individual societies, and the government worked together on a succession of bills that culminated in the Building Societies Act of 1986. That Act removed most restrictions on the building societies' business model. On the asset side, the societies were permitted to move into mainstream banking, insurance, and unsecured lending. In fact, where previous rules had specified exactly what limited activities building societies *could* do, the Act specified only a handful of activities that the societies *could not* do. On the liabilities side, building societies were permitted to raise 20 percent of their funds on wholesale markets, a figure that rose to 40 percent by the end of 1987 (Boddy 1989; M. Stephens 1993; M. Stephens 2007). Although still required to keep the bulk of their business in mortgage lending, the societies were permitted to demutualize and convert themselves entirely to banks if they found the lingering requirements too onerous. In effect, the old division between bank and building society was mostly wiped away, leaving a more homogenous and competitive banking system largely free from government interference.

The introduction of market-driven interest rates and the fostering of a more competitive marketplace compelled both the banks and the building societies to adapt. Small institutions became increasingly unviable: overhead for a lender running a relatively small balance sheet made up a much larger percentage of costs than it did for one of the larger banks with their greater resources. The overall number of UK banks rose slightly as foreign banks were permitted to enter the country, with foreign banks accounting for 27 percent of all

British bank lending in 1982 – 45 percent of which came from American banks (Heath 1982). Yet there was intense pressure on smaller and medium-sized firms to consolidate rather than continue to eat into each others' market shares (The Banker 1981b).

In order to survive, the lenders also had to grow their balance sheets. Fortunately, all of the ingredients for the desired lending boom were present: The demand for credit was provided by a credit-starved public. All major obstacles to meeting that demand had been eliminated through the abolition of exchange and hire-purchase controls, the end of the corset, the breaking of the building society cartel, and the invitation of banks into mortgage lending. Furthermore, as interest rates fell from the historic highs that had prevailed between 1978 and 1982, the market-based barriers to borrowing declined as well. In effect, all British banking institutions were increasingly at liberty to borrow as much as they could profitably lend – and that turned out to be a lot.

At the margins, the expansion of credit was aided – toward the end of the decade – by innovative new financial products. Mortgage-backed securities (MBS) had been popularized in the United States in the late 1970s and early 1980s. Though there were some difficulties in technically adapting them for the UK market, they made their first appearance in London in 1985 (Karley and Whitehead 2002). The size of the MBS market in America continued to dwarf that found in the UK, yet the British MBS market grew quickly, with gross issuances jumping over 300 percent between 1987 and 1989. At the time, Britain was by far the largest MBS market outside of the United States (Pryke and Freeman 1994). The credit card also became widely adopted during this period, with the UK joining the American MasterCard and Visa systems soon after the lowering of exchange controls. Marks & Spencer became the first UK store to issue its own store credit card in 1985 (UK Cards Association 2010; Marks and Spencer 2012).

Figure one demonstrates the remarkable nature of the credit explosion that resulted from the birth of a new consolidating, innovating, and expanding banking sector. After more than two decades of highly stable bank lending (relative to the size of the British economy), the amount of credit provided by banks grew from 47 percent of GDP in 1983 – when banks finally entered the mortgage market in force – to 115 percent by the end of the decade.

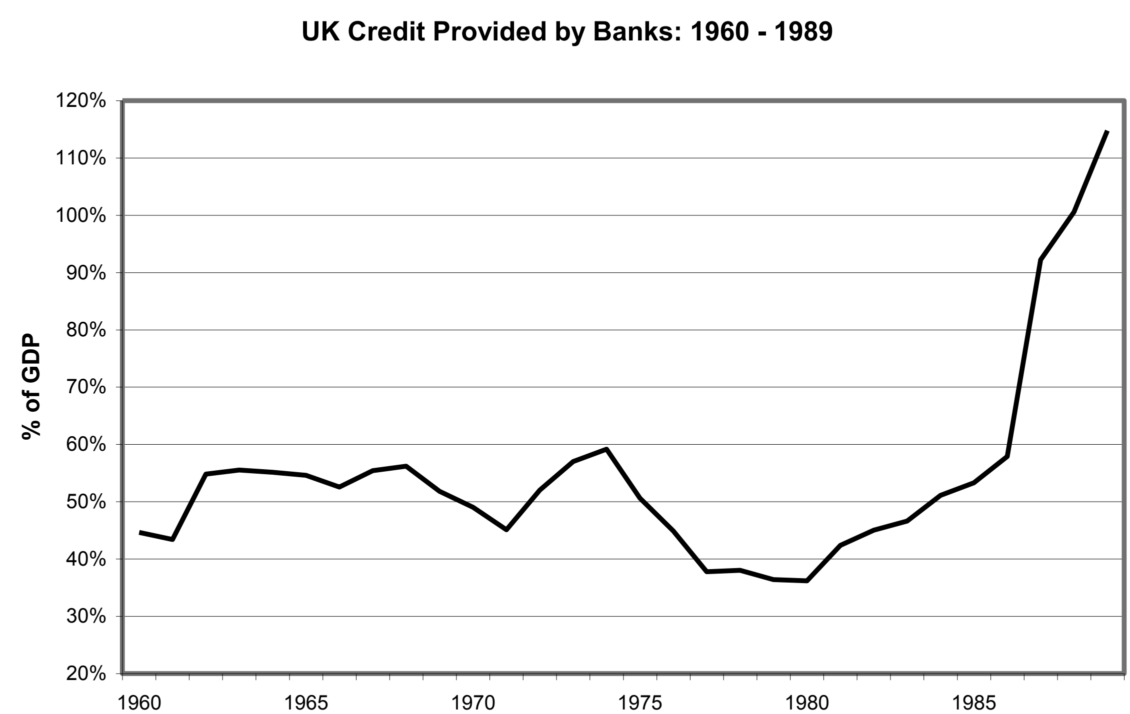

Figure 1

This expansion of bank credit was initially interpreted as a sign that using the interest rate to control the money supply had failed: intense demand for credit caused the money supply to expand well beyond the Tories' early targets (Congdon 1982). Comments by the architects of deregulation, notably Lawson, indicated some surprise at the scope of expansion. Yet the concerns were largely assuaged by the fact that the British economy, by the mid-1980s was booming. There was a palpable sense of optimism, one enthusiastically endorsed by the government sensing that their economic plans had been vindicated (c.f. Lawson 1992; Howe 1995).

The credit boom also squeezed the margins on traditional banking activities. At the height of the boom in the late-1980s, it took a 69 percent increase in loans to earn a 64 percent boost in interest income. When factoring in the cost of borrowing, that yielded only a 30 percent increase in net interest income.[3] Yet between the increase in volume and cost-cutting measures, profits for British financial firms leapt from an average of around 2 percent of the total British operating surplus during the 1970s to roughly 8 percent during the 1980s (Turner et al. 2010). At least over the shorter term, this seemed to indicate that the banks' adaptations to their competitive environment were working.

III.3: Change in the City

"The Big Bang," as it was popularly referred to, was the overnight transformation of Britain's equity markets. One contemporary market participant, looking ahead to the October 27 implementation of the new rules, summarized it as "deregulation; competition; and globalization with 24-hour trading activities" (Ash 1986). Four changes were of chief importance: (1) The schedule of fixed commissions was abolished in favor of market-determined commissions; (2) proprietary trading became permissible with the elimination of the long-standing distinction between brokers and jobbers; (3) LSE membership (and the takeover of LSE members) was opened to foreign firms; (4) the low-tech and low-volume face-to-face trading system was replaced by screen-based trading operated by computer (Clemons and Weber 1989).

[3] Office of National Statistics

Like British banking reform, the story of how the Bang came to be is less the product of a single deregulatory vision than a sort of domino effect facilitated by the government's pro-market tendencies. The first domino has already been mentioned – the lowering of exchange controls. Then-chairman of the LSE, Nicholas Goodison, placed the impetus for the Big Bang squarely on the 1979 elimination of capital controls, arguing that they had forced the city to adapt to the new internationally competitive environment and leave behind some of its parochialism (Vogel 1998; BBC News 2006).

Though London had a long tradition as a global financial capital, the City of the early 1980s lacked in competitive dynamism. Capital controls limited the quantity of Sterling leaving the country, meaning that British capital market players were relatively unsophisticated in their understanding of and access to foreign markets. For potential inward investors, the single-capacity system, fixed commissions, and an undercapitalized network of brokers collectively made British capital markets less attractive (Mullineux 2012). Amidst these shortcomings, the semi-independent Office of Fair Trading (OFT) had for years been assembling a restrictive practices case against the LSE, alleging that its system of fixed commissions, single-capacity trading, and restricted exchange membership was illegal under competition law. Though the case was opened when Labour had been in power, it was supported by the Tories' Secretary of State for Trade and Industry, Cecil Parkinson. The government took the position that the LSE's restrictive practices were not consistent with their embrace of free enterprise (Feder 1983).

Many members of the London Stock Exchange saw the OFT's criticisms as a threat to their business models. Deregulating commissions, ending the single-capacity system, and permitting international competition would likely mean the end for many of the smaller, lesscapitalized, and less efficient trading firms. The lowering of capital controls and a modest increase in the stake foreign firms could purchase in British LSE members (up to 30 percent) had already caused several venerable traders to go bust (New York Times 1982). The LSE and Goodison spent years trying to fight off the OFT's case.

An out-of-court accord between Parkinson in Goodison – brokered by Bank of England Director David Walker – was reached in July 1983. The OFT agreed to drop its legal challenge; in return, Goodison promised the abolition of minimum commissions. In assessing how to implement that one change, however, it immediately became clear that reform would have to go further. The end of guaranteed brokerage commissions meant that brokers would demand more of the 'jobbers' (market-makers), who were already struggling. More competition between brokers might also mean a greater willingness to move outside the exchange altogether. It became clear to Goodison and other market analysts that the fight to maintain the City as it was had been lost (New York Times 1982; Mullineux 2012). Rather than phase in changes over time, they decided to move ahead with a single liberalizing burst on October 27, 1986.

The most significant of the Big Bang changes was arguably the opening of the LSE to foreign firms, a natural bookend to the process begun with capital account liberalization seven years earlier. Foreign ownership of UK stocks jumped from 3.6 percent of total British equity in 1981 to 12.8 percent by 1989.[4] Figure two shows how foreign acquisitions of UK firms tripled in the first years after the Bang. Though other European firms were the largest group of buyers, American purchases made up more than 30 percent of the total spending on British acquisitions.[5] The financial sector was particularly appealing to US buyers: American

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[4] Office of National Statistics
[5] ONS

investment banks came to plant their flags in a finance-friendly country within the European common market. Moreover, American retail banks could gain the freedom denied to them at home by the Glass-Steagall act (Group of Ten 2001).

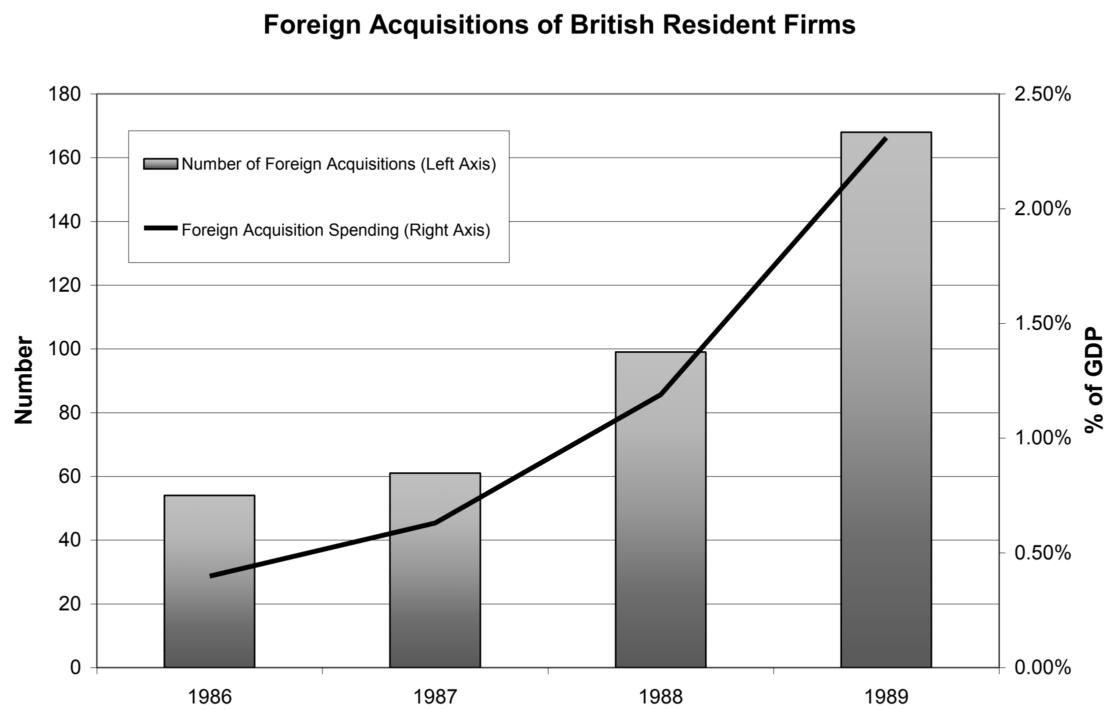

Figure 2 *Source: UK Office of National Statistics*

Indeed, the new British financial system began to take on a distinctly American flavor as major US firms relocated to London and brought many of their business practices with them. The newly deregulated City of London became increasingly populated with Americans and those employed by American firms: in the first three years following the Big Bang, American investment banks Salomon Brothers, Merrill Lynch, Morgan Stanley, and Goldman Sachs collectively more than doubled the size of their staffs in London (Roberts 2008). In contrast to the idealized British stockbroker of long liquid lunches and a complacency toward profit-making, the new generation of British finance was shaped by people like Dick Fuld – the eventual villain of the Lehman Brothers collapse who arrived in London during the Big Bang to supervise Lehman's takeover of L Messel, a City broker. As one City veteran recalled:

> 'On the plus side, the Americans brought a more meritocratic culture. But they also brought the idea that, instead of being client-based, it was a transaction-based business. You change from long-termism to short-termism, from looking after the long-term interests of your client to making the biggest buck out of today's deal (Stewart and Goodley 2011).'

On a more tangible level, the Americans also imported financial practices that had become common in New York. In the United States, investment banks participated in a multitude of activities – advising corporations, helping them raise capital, and trading on the secondary markets for the securities they created. This was novel in the British experience, where City firms had traditionally specialized in either specialist banking, corporate finance, or asset management – but not in all three (Roberts 2008). Likewise, British firms embraced the Americans' "hands-on" approach to venture capital, with a threefold increase in the number of venture capital firms between 1979 and the mid-1980s (Craig 1984).

With the entry of foreigners and the diversification of clearing banks and building societies' activities, the number of players in British capital markets grew by leaps and bounds. For individual institutions, this meant a great deal more cross-selling and a general shift toward a model of universal banking akin to Germany's (Mullineux 2012). As exchange members had feared when attempting to fend off the OFT's complaints prior to 1983, this effectively meant the death of the small-to-medium sized discount house. Most had entered the period undercapitalized and specialized in very narrow activities; survival therefore meant merging (or being purchased) into larger, more diversified entities (Riley 1982). As happened with retail banking, the forces of competition compelled Britain's capital market participants to consolidate, grow, and innovate (or adopt American innovations) in order to remain viable.

Changes in the Square Mile were also driven by the Financial Services Act of 1986. The Act's content was entirely regulatory – albeit in a way which enshrined the principle of "light touch" self-regulation (White 1984). It had been prompted by dissatisfaction with the existing ad hoc regulatory structures that had previously prevailed. Scandals had repeatedly engulfed firms' top managers throughout the 1970s and early 1980s leading, in 1981, to the government appointing Professor LCB Gower to report on how the British regulatory infrastructure could be improved.

Gower found that the informal British regulatory structure needed to be rationalized and put into legal language. He criticized the blind spots in existing rules that allowed certain "fringe and elite" market participants such as stockbrokers to effectively run their own affairs. In general, he argued, the regulatory system as it stood was only intended to catch people whose practices were dishonest enough to constitute fraud. A new system was needed to encourage sound professional behavior. Yet Gower, whose intellectual leanings were compatible with the government's, argued that government regulation was not the solution to these problems. Instead, the solution was self-regulating bodies made up from industry itself (Gower 1985).

His recommendations were largely adopted in the final text of the Act, which established the Securities and Investment Board (SIB) as an umbrella organization tasked with overseeing the self-regulating organizations (SROs) that populated the financial landscape. Regulatory enforcement was largely left to the SROs themselves; the government continued to involve itself only where criminal laws were breached. So while the Financial

Services Act of 1986 did impose significant regulatory changes on the British financial system, it must be noted that the bulk of the actual regulating was meant to be carried out by financial institutions and financial market participants themselves (White 1984; Pimlott 1985).

One final key point on the Act was that it formally established the legality of derivatives trading in Britain. Some had argued that derivatives trading could be subject to judicial oversight on the grounds that such trading fell under the Gaming Act of 1845, which regulated gambling. In response, section 86 of the Financial Services Act specifically exempts derivatives contracts from the purview of the courts, stating that no agreement shall be voided on the grounds that it constituted betting. In short, this legislative move legitimized the explosion of the derivatives-trading system that emerged over subsequent years.

IV: Short-Term Winners and Losers

So with all the changes in British financial markets, who benefited the most? The least? These are key questions to answer, not simply to form a complete picture of this period, but in order to understand why Britain continued to embrace financial liberalization even after the boom of the 1980s gave away to the economic implosion of the early-1990s. It is also important to consider these questions in more than simply materialistic terms: Certainly, some groups experienced more monetary gain than others during the 1980s. But some groups' ideas also gained more credence than others.

One of the most striking things about the British expansion of the 1980s was that the group of winners was far bigger – at least over the shorter term. Of course, some won more than others. The biggest beneficiaries of financial deregulation were capital-starved businesses, holders of financial and physical assets, *réntiers*, and the Tories. The biggest losers, by contrast, were the political left and that part of the financial world that lost the privileges that the pre-1979 regime had afforded them: the cartels and smaller, less efficient, financial firms that had relied on anti-competitive measures to stay afloat.

IV.1: The Material Winners: Business, Capital-holders, and Homeowners

For the greater part of the 1980s, the group of those who benefited from financial liberalization was unquestionably larger than the group of those who lost out. Economy-wide growth was robust. After years of trailing the other major European powers, Britain grew faster than Germany, France, and Italy between 1982 and 1988.[6] Of course, not all of this can be attributed to financial liberalization: Thatcher's taxation and fiscal policies, privatizations, and the stabilization of the interest rate certainly had major affects as well. Nevertheless, there is good reason to highlight businesses, *réntiers*, and homeowners as groups that directly gained from financial liberalization.

Even accounting for the downturn at the start of the decade, the 1980s were very good for businesses: they were borrowing more, investing more, and ultimately making more. Industry was no longer forced to deal with credit rationing and increasingly gained access to international capital – particularly after the Big Bang. Business borrowing grew sharply, hitting a high point at the end of the 1980s. This facilitated a concurrent investment boom, reflected in figure three: the low-investment 1960s under rationing preceded the higher-investment 1970s under CCC and partial liberalization, which gave way to an enormous jump in investment in the later-1980s. This increase in investment coincided with a period of

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[6] World Bank World Development Indicators

improved profits when compared to the 1960s or 1970s.[7] The financial sector did particularly well: financial firms' profits – which nearly doubled as a percentage of GDP during Thatcher's first decade in office – grew far faster than non-financial sector profits.

Figure 3 *Source: AMECO*

Aside from businesses more generally, the *réntier* class – those who earn incomes from their financial holdings – was among the biggest winners of 1980s deregulation. This should not be entirely surprising: the influx of foreign funds would be expected to drive the price of British capital up. Moreover, the increased freedom to use financial resources in whichever way appeared most lucrative would tend to create profit-making opportunities for those wealthy in financial assets. This intuition is consistent with the breakdown of income in 1980s Britain. As figure four shows, households' income derived from financial market

[7] AMECO, Epstein and Power 2003

activities (dividends, realized capital gains, annuities, pension payments) rose significantly faster than wage income or total income. Between 1979 and 1989, nominal incomes for the average British home rose 153 percent – relatively close to the 129 percent increase in wages. Income derived from financial market activities, however, jumped more than 300 percent.[8]

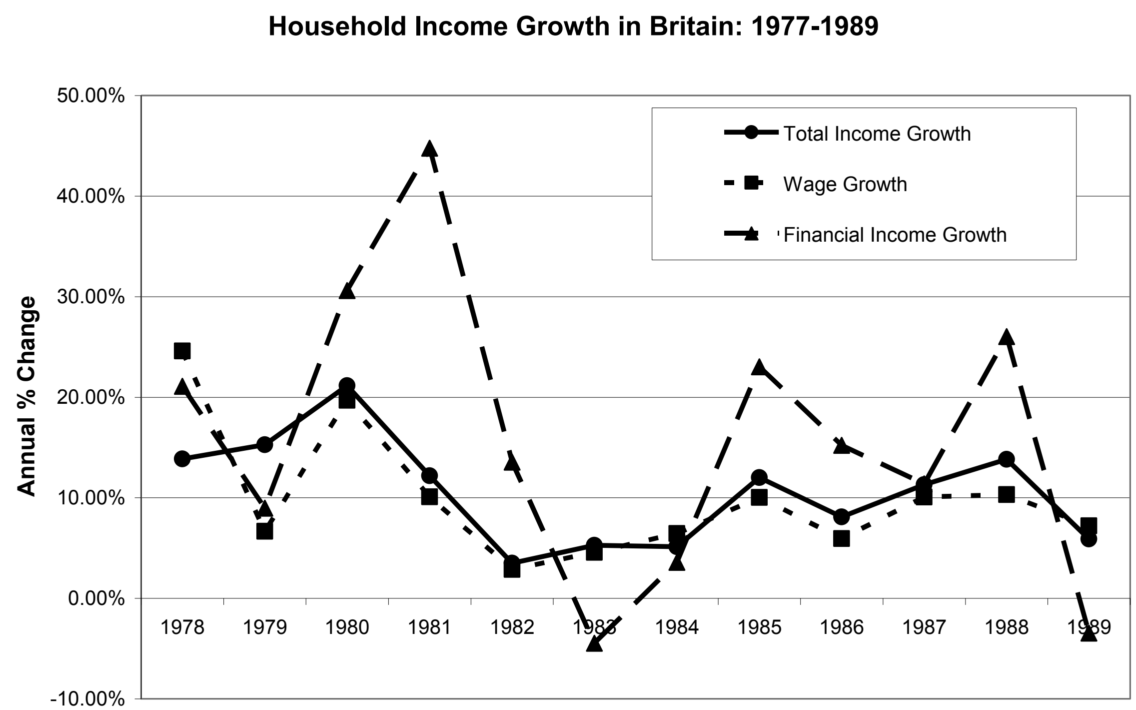

Figure 4

Source: UK Office of National Statistics

This increase was particularly relevant for the top decile of income earners. While the average British household earned less than five percent of their total income in financial markets, the top decile earned over seven percent. Indeed, since wealthier households tend to bring in more income from financial activities – and those incomes rose faster than wages – the group that benefited the most from the relatively fast expansion of investment income was Britain's very wealthy. This pattern is readily apparent in figure five: the wealthier the group, the faster their incomes rose during Thatcher's first decade in power.

[8] UK Office of National Statistics, excluding retired households

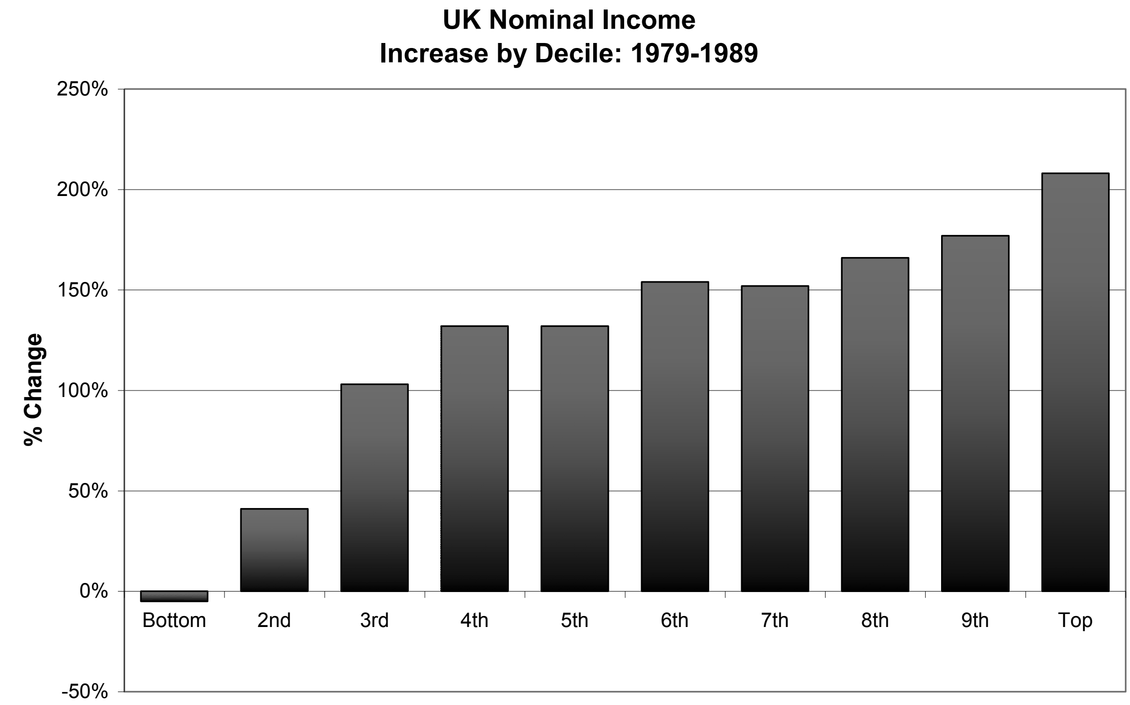

Figure 5 *Source: UK Office of National Statistics*

Another significant group of material beneficiaries from financial liberalization were homeowners. The expansion of mortgage credit that resulted from the intensified competition between building societies and the clearing banks – together with the generally growing economy – had the effect of driving up British housing prices. So like those rich in financial assets, those who held physical assets tended to gain from financial deregulation. Figure six depicts the Nationwide home price index from the first quarter of 1975 through the peak of the market in Q3 1989. These are inflation-adjusted prices, reflecting a very real increase in the mark-to-market wealth of homeowners.

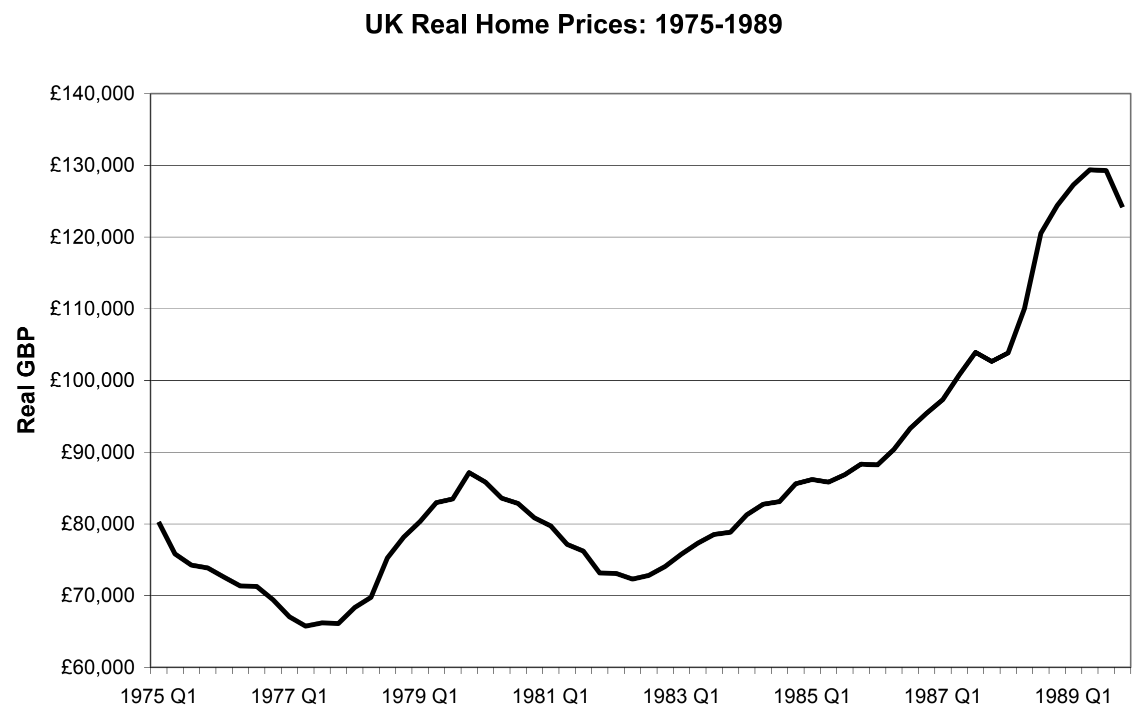

Figure 6 *Source: Nationwide Home Price Index*

It is worth noting that the proportion of the British population to own their own home (either outright or with a mortgage) also grew markedly during the Thatcher years, not least because of the right-to-buy scheme that encouraged those living in state or "council" housing to finance the purchase of their homes. As Thatcher put it:

> 'Our policies encourage people to provide for their own security, to buy their own home and to look after their own families. What our people have struggled and saved for, what our Party has bent every political muscle to give them, far transcends mere bricks and mortar. It is the security and independence of home ownership which we seek. So brick by brick, month by month, as home ownership continues to spread, freedom is being entrenched in Britain. (Thatcher 1985)'

Between 1983 and the peak of the housing market in 1989, the number of outstanding mortgages increased by 2.6 million, increasing the share of owner-occupiers from 54 percent in 1981-2 to 67 percent ten years later.[9]

[9] UK Office of National Statistics

IV.2: The Material Losers: The Poor and Formerly-Privileged

The preceding discussion of those who emerged as winners should, in part, make it clear who the losers were: the poor. The bottom decile of wage-earners saw their *nominal* incomes decrease during the 1980s. And the second and third deciles saw their below-average gains compromised by inflation. The 1980s also saw an enormous leap in the ranks of the jobless: the unemployment rate in every year of the 1980s was higher than in the worst of the preceding 20 years.[10] In absolute terms, the worst-off suffered mightily during this period.

Whether or not that *absolute* suffering can be directly connected to financial liberalization is not clear. Many of Thatcher's other initiatives – cutbacks on benefits and state spending, privatization, the breaking of the labor unions – almost certainly had a greater impact on the poor than the freeing of the banks and the internationalization of capital flows. Whatever link may exist is tangential: for instance, the flurry of mergers and acquisitions encouraged by financial account liberalization and the Big Bang may have led to cost-cutting job losses. What is far more certain is that the *relative* losses of the income- and asset-poor are very deeply connected to liberalization. It was largely the enhanced availability of credit that caused home prices to rise, leaving renters relatively worse off; likewise, the increased freedom of capital allowed *réntiers* to earn higher returns without benefiting those who held few financial assets. Moreover, the absolute losses incurred by the poor strongly suggest that there was little trickle-down benefit from the winners.

A final group that clearly lost out as a result of financial liberalization were those individuals and institutions that held positions of privilege in the pre-1979 financial regime or were sheltered by that system's lack of competitiveness. This group includes institutions

[10] AMECO

no longer needed – such as the BSA – as well as firms that were too small or too inefficient to survive in the more competitive environment created by liberalization. Numerous discount houses, building societies, and banks did not survive. The increased professionalization of the survivors also generated job losses. Financial institutions began demanding that their workers hold university degrees, effectively forcing long-tenured but less-educated workers into unemployment.

IV.3: Ideational Winners and Losers

Finally, there can be no doubt that the British Conservative Party itself benefited immensely from the short-term consequences of financial deregulation. Partly, this can be defined in terms of political success. They initiated a series of radical reforms that served a wide cross-section of the electorate very well. And they were rewarded for their service, being returned to office in 1983, 1987, and eventually in 1992 despite the economic deterioration of the 1990s (to be discussed in chapter five).

The Tories' victory runs deeper than that, however. When the Conservatives contested the 1979 election, they were cast as radicals and reactionaries espousing an extremist economic vision (c.f. Thatcher 1977; Howe 1995; Lawson 2011). By the late 1980s, they could justifiably point to their record and argue that history had vindicated their ideas rather than Labour's. The Tories had argued that socialism was a failure, that trusting to free enterprise was the way to restore robust growth, and that international financial openness was a necessary piece of the puzzle. Then they seemed to largely prove their case.

The mark this left on the British political class cannot be understated: the Labour party of Wilson, Benn and Callaghan was dead. When New Labour emerged under Tony

Blair and Gordon Brown, it was a very different party: one which had wholeheartedly adopted many of Thatcher's basic ideas. Between the early 1980s and the onset of the global financial crisis in 2007, no major political force in Britain questioned that large, liquid, innovative, and diversified financial markets largely free from government intrusion were in the best interest of the country as a whole.

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Four –
The Ambivalent Liberalizer: Mitterrand's First *Septennat*

'Frankly, after the London Big Bang, we had no choice'
– Thierry Tuffier, French Stockbroker, 1987[11]

In contrast to the full-steam-ahead approach taken by their rivals across the English Channel, the French approach to financial liberalization was both hesitant and halting. Thatcher's counterpart, François Mitterrand, was no free-marketeer. The 110 Propositions that formed the core of the Parti Socialiste (PS) 1981 platform were steeped in the belief that the state had a responsibility to manage the economy. Far from being a liberalizer, Mitterrand began his presidency as a nationalizer, bringing the French banking sector almost entirely under state control, hoping to insert the already activist French state even further into credit allocation decisions. Yet despite these origins, Mitterrand would eventually preside over a radical modernization – and liberalization – of the French financial system.

Mitterrand's famed "U-turn" – his reversal from a conventionally leftist approach to financial markets and economic management to a more market-friendly one – was not the product of some ideological conversion. Where Britain's reforms emanated from a core set of convictions given voice by Thatcher, Mitterrand's reforms were grudgingly conceded as a necessary evil if the country was to remain a full participant in the process of European integration: in order to remain within the European Monetary System (EMS), the country had to somehow prevent capital from fleeing the country. The socialist experiment from 1981-1983 demonstrated that capital controls were not sufficient. Instead, exchange rate stability

[11] (P. Lewis 1987).

demanded both fiscal restraint (which is frequently noted in the literature on Mitterrand's reversal) and financial modernization (which is not).

Despite the ambivalent origins of France's financial deregulation, the reform process – once begun – was marked. Mitterrand's first term from 1981-1988 saw a substantial and successful reorganization of France's tightly controlled financial sector. Almost from scratch, France established some of what would become Europe's most popular capital markets, dismantled the formal tools for state-led administration of credit, and ultimately fostered the creation of a cutting-edge financial sector. Banks alone accounted for 6 percent of value added in the French economy by the end of the 1980s, up from 4 percent during the 1970s.[12]

This chapter is the French analogue to chapter three, telling that country's story of financial reform as it unfolded under an ambivalent Mitterrand. It begins with a characterization of France's pre-1981 financial regime before examining precisely how and why that regime was changed, again concluding with an assessment of who won and lost – over the short term – from the process of financial change.

I: The Ancien Régime

Much more so than in the United Kingdom, the French financial system has evolved in symbiosis with the French state. Whereas British finance had, from a very early date, served the decentralized fundraising needs of enterprise (e.g., through joint-stock companies), early French finance houses existed largely to support state spending. This gave rise to an almost exclusively bank-based system in which raising capital usually meant taking on bank loans. The pattern of dependency was oriented in favor of the banks: the government was reliant on

[12] OECD

them for external financing. In the immediate postwar period, the reformed French political class consciously sought to reverse this relationship.

I.1: Explicit State Control

Where British governments maintained ad hoc influence over how the country's financial system allocated credit, France took a far more direct approach. Postwar French leaders saw the French financial sector as an invaluable tool for carrying out the economic modernization envisioned by the economic plan. Rather than draw funds from banks through state coffers and into spending, they simply put the banks under direct state control. At the close of 1945, the state nationalized a sizable chunk of the banking sector, most notably the largest of the country's lenders to non-financial businesses (the *banques d'affaires*): what would later become the Banque Nationale de Paris (BNP), Crédit Lyonnais, and Société Générale (SocGen). The postwar government also officially brought the Bank of France under state control as central bank.

Either through outright state ownership or parapublic arrangements, the state consequently held more-or-less direct control over the vast majority of French credit. In addition to the *banques d'affaires* under state control, the three largest credit-providing institutions (Crédit National, Crédit Agricole, and Crédit Hotelier) were partially state-run. On top of maintaining indirect control over the funds controlled by these institutions, the government directly managed the Caisse des Dépôts et Consignations (usually abbreviated to Caisse des Dépôts), a unique state-run agency that aggregates the deposits of smaller regional savings banks and manages them in a way consistent with the general interest of French.

John Zysman (1984), in his seminal description of the postwar French finance, described the system as consisting of a set of concentric circles. At the very center, the Finance Ministry (the Trésor) and Conseil National du Crédit made policy decisions regarding which sectors and firms received credit and at what prices. In the first concentric circle around this core stood the largest credit-providing institutions under either direct or indirect state control: Crédit National, Crédit Agricole, and Crédit Hotelier, as well as the Caisse des Dépôts. The second circle was then comprised of the banques d'affaires. On the outside sat the French businesses and households that relied on bank lending.

The Zysman heuristic of concentric circles is useful, though it does not fully reflect the variety of French banking institutions and the special status attached to many. French banking laws prior to 1984 distinguished between deposit banks, investment banks, medium-and-long term lending banks, and other financing institutions. Each faced different restrictions on the duration of loans and the types of deposits they could accept (Commission Bancaire 2003). Many savings banks, for instance, were not permitted to offer checking accounts, nor could they make loans. Instead, they offered only savings accounts. Customers' savings were then transferred to the Caisse des Dépôts for lending (Muldur and Sassenou 1993). Another special case was Crédit Agricole, which did not directly take its own deposits but instead aggregated and managed the deposits of smaller agricultural collectives (Zysman 1984).

Within this system, credit growth was restricted for much the same reason it had been in Britain: excessive lending tended to create inflationary pressures that threatened to force a devaluation of the franc. Many of the tools used to achieve restrained credit growth were the same as in Britain: rules determined which institutions could lend, exchange controls prevented access to foreign capital, and quantitative lending caps governed precisely how much lending could take place. Yet where Britain simply set the rules and largely allowed the banks – or banking cartels – to function as they wished within those rules, the French state explicitly ran a large share of the banking industry. Moreover, the indirect influence over lending was much stronger in France than in the UK.

This system of indirect influence was known as the *encadrement du crédit*, which functioned as a set of quantitative lending caps and exemptions. The important thing about the *encadrement* is not when it was applied, but when it wasn't. In practice, lending ceilings were ignored where the Trésor deemed it necessary. This meant that the state could control the overall growth of credit while maintaining the option of overriding those limits in order to lend to targeted industries or firms. The Trésor thus influenced the direction of even those limited financial resources held outside of the explicitly state-owned financial entities. As Zysman summarized it:

> 'In essence, the French financial system is a credit-based system with administered pricing. In many of the markets the system of matching supply and demand is controlled by quantitative management rather than by freely moving market prices (Zysman 1984, 130).'

As in Britain, the key to maintaining this system was to restrict access to foreign capital. The overriding French priorities were first, to ensure that firms had access to relatively inexpensive borrowed funds; and second, to maintain exchange rate stability (Drumetz 2002). If borrowers had access to foreign sources of funding, credit growth would have gone unchecked, creating pressure on the franc to depreciate relative to other benchmark currencies. Repeated attempts to create London-style eurocurrency markets in France throughout the 1970s foundered over fears over the impact of such a market on the capacity of the state to manage both credit growth and the franc's exchange rate (The Banker 1983).

If anything, the need to prevent excessive credit growth was a bigger problem in France than in Britain. France continued to seek participation in fixed exchange regimes after the Bretton Woods system – and the European Economic Community's (EEC) first attempt at a successor, the so-called "snake" – collapsed in the early 1970s. In 1979, the same year Britain decided to fully liberalize its regime of capital controls, France re-entered a fixed exchange rate regime between EEC members under the guise of the EMS. As a result, maintaining a fixed exchange rate has remained a major policy priority in a way which it has not in Britain.

I.2: A Strained Bank-Based System

The importance of the state's influence over credit allocation decisions was amplified by the fact that non-financial firms had few alternatives to the state-run banking sector – and households essentially had none. Outside of the banks, the French financial system was extremely underdeveloped. Equity markets were small, with stock market capitalization of listed French firms at less than 10 percent of GDP by 1980 – roughly a quarter the share accounted for by contemporary British or American equity markets (Rajan and Zingales 2002). This situation is sometimes described as an "overdraft" system, in which firms self-finance insofar as it is possible, then rely on bank loans to compensate for any shortfalls (Bertero 1994; Schmidt 2003). While some dispute this characterization, there is little doubt that French firms relied extensively on bank loans and internal financing until at least the mid-1980s (Cobham and Serre 2000). As late as the end of the 1970s, the French intermediation rate (a measure of the prominence of banks in providing funds to enterprises) stood between 70 and 80 percent.[13] Put another way, non-financial corporations raised about 12 times more funds from banks than they did from bond markets.[14]

The problem with such reliance on banks constrained by the *encadrement* was a simple lack of financial resources available to French businesses. As was the case in Britain, demand for credit always exceeded supply. This placed pressure on interest rates to rise, compelling the Trésor to direct credit at concessionary interest rates. This became more problematic over time: at the start of the 1970s, less than 15 percent of total credit offered was subsidized; by the start of the 1980s – amidst rising global interest rates – that figure had reached more than 50 percent (Loriaux 1991; O'Sullivan 2006) The lack of alternatives and the credit-starved nature of the system only concentrated more power in the hands of the Trésor, tasked with choosing the best end-uses of the scarce amount of credit the country would permit itself.

Households were similarly constrained by the limitations of the state-run bank-based system. Among the most popular French savings options were – and remain – the state-backed *livret* schemes. These savings "passbooks" promise a state-guaranteed rate of return free of all taxes. Each citizen is only permitted one of these accounts – and historically they were only available through a handful of providers (including the French postal service). The funds deposited in the *livret* were then allocated to the Caisse des Dépôts for management. Also important were the deferred credit *épargne-logement* plans in which customers saved for a contractually agreed period of time in order to be guaranteed a loan in the future (Taffin 1998).

[13] Banque de France
[14] National Institute of Statistics and Economic Studies (INSEE)

Consequently, households interacted with financial markets primarily as relatively unsophisticated bank-based savers. The French savings rate was relatively high – around 19 percent annually for most of the 1970s. Moreover, over 60 percent of French household savings was held as simple demand deposits or in one of a variety of savings plans (Fougère 1992). Borrowing options were limited, further encouraging households to save heavily. Long-term mortgages along the lines of those in the United States or Britain remained unavailable in France until 1966. Even afterwards, however, the growth of French debt remained relatively slow until the mid-1980s. Lending restrictions on numerous classes of banks, together with the *encadrement*, meant that consumer credit was not possible or appealing for many French banks. Instead, consumer finance was largely left to a group of smaller specialized firms. This was particularly true for non-mortgage debt, which amounted to only three percent of French households' disposable income at the start of the 1980s – compared with between 15 and 20 percent in the United States. (Guttmann and Plihon 2010; Trumbull 2012).

I.3: Early Reforms

As had occurred in Britain with the early-1970s with Competition and Credit Control (CCC), France did experiment with liberalization prior to the 1980s. During Charles de Gaulle's final years in power at the end of the 1960s, Finance Minister Michel Debré promoted the *déspecialisation* of financial institutions. This made it easier for domestic banks to open new branches and allowed foreign banks greater access to the French marketplace. During the same period, exchange controls were briefly weakened – before being reimposed in 1968.

The effects were significant but still limited. Fewer than 10 percent of banks operating in France in 1970 were foreign – a figure that rose to 15 percent by 1980.[15]

The entry of foreign banks offset the competitive consolidation of domestic banks. The most significant merger during the period was between Banque Nationale pour le Commerce et l'Industrie and the Comptoir National de Paris, which gave rise to BNP. This period of aggressive branching expansion contributed to one of the enduring traits of the French banking system: the highly saturated retail banking space. To this day, France has maintained one of the highest ratios of bank branches to population in the entire world.[16] Despite these limited liberalizing moves, the French financial sector remained highly compartmentalized. The non-bank financial sector, moreover, remained extremely small (Drumetz 2002; Commission Bancaire 2003).

II: Mitterrand and the Franc

Mitterrand did not actively seek to liberalize this financial space when he campaigned for office. Far from it, the 110 Propositions explicitly promised to nationalize the country's credit system – which he did almost immediately after entering office. Nor was the decision to liberalize foisted upon him by his biggest political opponent on the right, Jacques Chirac and his Rassemblement pour la République (RPR). Instead, financial reform became necessary after the victory of the anti-devaluation faction within his own PS – a victory rooted in France's desire to remain within the EMS and the European common market. Mitterrand's decision to side with the *franc fort* supporters and adhere to a fixed-but-adjustable exchange

[15] Commission Bancaire
[16] European Central Bank

rate regime constrained and guided the rest of his economic policies, including the modernization of French financial markets (Cameron 1996).

II.1: Before Mitterrand

The story of financial deregulation under Mitterrand begins in earnest with the presidency his predecessor, Valéry Giscard d'Estaing and particularly Giscard's second Prime Minister, Raymond Barre. France in the 1970s was, much like Britain, struggling with high inflation. Moreover, due to its heavy dependence on petroleum imports, it was highly susceptible to the sort of external shock posed by the 1973 oil shock. The spike in oil prices meant that France imported rampant inflation as industries requiring petroleum products were compelled to raise prices. As Georges Pompidou prepared to leave office at the start of 1974, France was pushed to the bottom of its permitted fluctuation band within the European joint-floating arrangement known as the "snake." The de facto operation of the snake called for all participants to shadow the movements of the habitually strong German deutschemark – a serious challenge for inflation-ridden France (Loriaux 1991).

The first French defection from the arrangement occurred several months before Giscard's election in 1974. Giscard, who believed strongly in maintaining the value of the franc, then sought to quickly reverse that decision on entering office. By 1975, an austerity program had allowed France to rejoin the snake at its previous value. Yet the structurally higher inflation in France vis à vis Germany rapidly pushed the franc back to the bottom of its fluctuation band. This put Giscard in a politically awkward position: his first Prime Minister, Chirac, had resigned in order to begin positioning himself as an alternative Gaullist power center on the right. Moreover, Mitterrand's PS had made strides in local elections and

– together with the Parti Communiste Française (PCF) – looked to be the early favorites in the 1978 parliamentary elections. Confronted with an anti-austerity party in the ascendancy and a less-than-reliable ally who was suspicious of imposing domestic pain to maintain external stability, Giscard reluctantly chose the politically palatable route by exiting the snake again in 1976 (Ludlow 1982).

Despite this setback, Giscard and Chirac's replacement, Barre, did not give up on the idea of a stronger franc and eventual return to a European system of fixed exchange rates. Indeed, it could be argued that the Giscard-Barre pairing was the most pro-integration French government seen during the fifth republic (Loriaux 1991). Domestically, Barre pressed ahead with a robust austerity plan, freezing wages, consumer prices, and boosting income taxes and duties on alcohol and gasoline (PerspectiveMonde 2011). Externally, Barre and Giscard launched negotiations with the Germans to create a new, better snake. Learning the lessons of 1974 and 1976, Giscard maintained that:

> 'The same snake cannot be reborn twice! The experiment had shown conclusively that we could never make a European monetary system work as long as the weakest currencies had to bear the full brunt of responsibility for maintaining the fixed differential while the strong currencies continued to forge ahead, heedless of whether the others were able to follow. A different formula had to be envisaged.' (Giscard d'Estaing 2004)

The result was the launch of the EMS in 1979 – the origins of which are explored in great detail in Peter Ludlow's (1982) history of those events. For the purposes of this analysis, it is merely important to note that Giscard and Barre were successful at forging a successor to the snake that was more France-friendly: for one thing, it allowed currency fluctuations around a notional currency unit, the ecu, which was comprised of a weighted basket of European currencies – somewhat mitigating the pressure on all currencies to follow the deutschemark. For another, it ostensibly spread the burden of exchange rate realignment between strong and weak currencies. The EMS as envisioned also provided for aid to states needing to adjust and strongly discouraged unilateral defections (Loriaux 1991).

Giscard saw the formation of the EMS as a victory for France. Not only did it promise reestablished of currency stability built upon a strong franc, but it provided a means of diminishing the German power to determine what stability would ultimately look like. This view of the EMS is best encapsulated by an anecdote Giscard tells in his memoirs: at the July 1978 European Council meeting, he had suggested the use of the word ecu as the name for the EMS' unit of account. To the others, this stood for "European Currency Unit." For Giscard (2004), ecu harkened back to the écu – the highest value note during the French Valois dynasty.

The true importance of the EMS achievement to France is somewhat more complex. While it did achieve Giscard and Barre's fundamental aims, it did so at the cost of imposing a relatively strict external constraint on the French economy. As Europeanists, they had effectively converted their pro-integration predilections into an institutional restriction on future French leaders. Of course, the EMS was not unbreakable; states could (and did) leave the arrangement. Yet maintaining the arrangement became a cause to which many on both the left and right were fervently committed – either out of a desire for further European integration or a fundamental belief in the value of a hard currency.

II.2: The Socialists' Pyrrhic Victory

By the early 1980s, the French economy was in severe difficulty. While austerity may have restored France's external stability, the domestic situation was deteriorating rapidly: inflation, despite a mild dip in 1978, had skyrocketed following the second oil shock in 1979. The rapid inflation in France as compared to Germany, combined with Barre and Giscard's complete unwillingness to contemplate a devaluation in their new EMS construct, meant a secular deterioration in France's current account balance. Surveying the situation, currency markets had decided that a devaluation was imminent and international sales of the franc forced Barre to raise interest rates to compensate. With the help of an unfavorable global environment, Giscard and Barre had succeeded in achieving a politically toxic combination of high interest rates, rising inflation, increased unemployment, and slow growth (Cameron 1995).

Nevertheless, Mitterrand's election in 1981 was far from certain. Infighting between the PCF and PS had already cost the left what appeared to be a good chance to seize the National Assembly in the 1978 elections. Burned once, the two parties' pre-election entente in 1981 was tenuous (Friend 1997). Mitterrand had to play a delicate balancing act, conceding enough to the communists to consolidate his hold on the left without conceding so much that it scared off the rest of the French electorate: The 110 Propositions called for extensive investment in public works, state-directed research and development programs, price controls, higher minimum wages, and steeper taxes on the wealthy (Parti Socialiste 1981). His only explicit policy toward the financial sector was a promise to "nationalize the credit system in full" – hardly the sentiment of a future liberalizer. Market observers were unquestionably worried by the prospect of the leadership of someone who once wrote (1973) that, "nationalization is not socialism but the instrument for breaking the exploitation of man by man "(The Banker 1981a).

Working in Mitterrand's favor was the fact that right was arguably more divided than the left. Relations between Giscard's center-right Union pour la Démocratie Française (UDF) and Chirac's Gaullist (and highly personalized) RPR had become increasingly acrimonious, leading to a longstanding rivalry between the two (Bell and Gaffney 2013). After finishing third in the first round of the 1981, Chirac offered Giscard only a lukewarm endorsement, saying "considering the circumstances, I cannot but vote for Mr. Giscard d'Estaing" (Montreal Gazette 1981).

The second round was a close-run affair, with Mitterrand eking out a 51.8 to 48.2 percent victory. But when Mitterrand then called for immediate elections to the National Assembly, the result was far clearer: the left secured 333 seats in the 491-seat assembly, giving them a clear mandate to govern. The unanticipated definitiveness of the socialist victory gave Mitterrand and the PS the confidence to embark on their socialist experiment.

The market tension created by Mitterrand's agenda was immediately clear. The 110 Propositions as translated into policy meant greater public spending, more generous social transfers, and higher taxes on the wealthy. At the same time, Mitterrand seized most of the banking system not already under direct state control – adding 36 deposit-taking banks to the state's portfolio. Despite the limited impact of nationalization on the day-to-day management of French finance houses (V. Lewis 1981), the Mitterrand policy mix was highly unattractive to financiers. Almost immediately after Mitterrand's victory, the Paris Bourse declined sharply and the government had to rely on heavy Banque de France intervention to keep the franc within its EMS. Private capital was fleeing the country: between March and September 1981, French foreign reserves fell by more than 40 percent in attempts to fend off speculation against the franc band (P. Lewis 1981).

Within only months of assuming the reins of power, Mitterrand was thus confronted with the fundamental incompatibility of Keynesian reflation, fixed exchange rates, and even a limited degree of capital mobility. This is the celebrated macroeconomic dilemma of the "impossible trinity:" he could not have complete macroeconomic independence, fixed exchange rates, and capital mobility – he had to choose to surrender one (c.f. Obstfeld, Taylor, and Shambaugh 2005).

The government did make an effort to solve the dilemma by cutting off capital movements. Firms were prohibited from imposing leads and lags on payments for goods in an attempt to stamp out stealthy use of the current account to hide currency speculation. Even the allowed amount of currency that travelers could take out of the country was restricted. Capital controls in 1982-83 were stricter than ever before or since (Drumetz 2002) yet they failed to stem the downward pressure on the franc. This left two other options. The story of the 1981-83 period is essentially one of two competing factions, each advocating for one of those two remaining choices.

II.3: One Key Decision

To one side stood the more moderate bloc: Jacques Delors and eventually Pierre Mauroy, the finance and prime ministers, who favored a stable franc inside the EMS. This, they acknowledged, must come at the cost of reining in the expansive vision of the 110 Propositions, cutting back on spending and allowing interest rates to rise. To the other side stood those in favor of the "other policy" – sometimes referred to as the "Albanian" solution. This bloc, led by ministers Jean-Pierre Chevènnement, Laurent Fabius, Michel Jobert as well as Mitterrand's chief of staff, Pierre Bérégovoy, advocated abandoning the EMS altogether, imposing tariffs, and allowing a depreciation of the franc in order to gain the freedom to fully carry out the government's original agenda. Mitterrand's main rivals both within the PS

(Michel Rocard) as well as outside (Chirac), struck more ambiguous stances (c.f. Friend 1997; Parsons 2003).

It took the better part of three years of equivocating before Mitterrand would ultimately settle on a course of action. By late 1981, Delors had succeeded in negotiating a devaluation of the franc to be paired with a revaluation of the deutschemark. However, the size of the adjustment was insufficient to fully solve France's external problems. Moreover, internal divisions within the finance ministry between Delors and Fabius – a man technically Delors' junior but favored by Mitterrand – led to an incoherent response to the devaluation. On one hand, Delors succeeded in pressing Mitterrand to announce a pause in reforms and a tightening of the *encadrement*. On the other, Delors had little support from the rest of the cabinet, leading his austerity measures to be undermined by Fabius' expansionary 1982 budget (Cameron 1995).

The pattern of negotiated revaluations and contractionary policies repeated itself in 1982 and 1983, with Delors gaining ground each time. Crucially, he was able to win Mauroy over to his side despite the prime minister's genuine preference for leftist policy stances (Friend 1997). Delors achieved the 1982 and 1983 devaluations only at the cost of making promises to the Germans in order to secure their cooperation: first they agreed to remain in the EMS, then to make specific austerity-minded concessions (Cameron 1995).

Mitterrand oscillated back and forth throughout, agreeing to progressively more austerity-minded budgets but continuing to flirt with EMS exit. The decisive moment came in March 1983, when Mitterrand was briefly won over to the "other policy" – causing Mauroy to announce his resignation – only to balk and reverse course days later (Bauchard 1986; Friend 1997). In the end, he committed the government to Delors and Mauroy's *tournant de la rigueur* – notably opting for the word rigueur rather than the tainted Barre-era term, *austérité* (Favier 2010). The new plan entailed significant tax hikes, wage freezes, and spending cuts, definitively putting an end to the socialist dreams of 1981.

Mitterrand's decision is a theoretically rich one: while forced to make a decision based on institutional constraints, he ultimately had to choose between two competing ideas. Both ideas had their virtues, though the Delors-Mauroy position was arguably better fleshed-out than the "other" position. Delors and Mauroy could deal in relative certainties – but certainties that meant the end of the 1981 agenda. Fabius, Chevènnement, and Bérégovoy offered to keep the socialist dream alive – but were vague on specifics aside from EMS and perhaps EEC exit. In the end, Mitterrand opted against the "leap in the dark" (Friend 1997, 43). Craig Parsons (2003) has argued compellingly that Mitterrand's final decision was driven by the fundamental worry that, by pursuing the "other" solution, he would somehow be betraying the trust the French people had placed in him by debasing their money.

II.4: The Enduring Impact of a Policy Choice

By choosing to allow the EMS to constrain macroeconomic policymaking, Mitterrand had committed France to seeking competitiveness through piecemeal revisions of its exchange rate combined with market-friendly liberalization at home. Without recourse to competitive devaluation and protectionism, France had to find another way to compete. In part, that meant modernizing French industry. But to accomplish even that, France had to modernize its financial markets.

Not only was France's financial sector a hindrance to its non-financial businesses, but it made it difficult for French governments to keep capital inside the country. A major part of

France's problem from 1981-83 had been the existence of alternative homes for capital in the liberalized financial markets of Britain and the United States. Financiers simply would not tolerate keeping their funds within a France administered by a radical government and saddled by a relatively backwards financial sector. Compared to the Anglo-American alternatives, the French financial system was too dominated by banks, rates of return were too low, credit allocation was too politicized, and the *encadrement* was too intrusive (Cerny 1989; Drumetz 2002). The fully dirigiste financial model was simply not compatible with a regime that allowed external considerations to drive monetary policy and relied on the attractiveness of financial markets to offset current account deficits.

Consequently, both the Mitterrand-Fabius government of 1984-86 and the Mitterrand-Chirac *cohabitation* between 1986-88 were characterized by a steady process of financial modernization. Despite the alternation of governments, overall economic policy remained strongly grounded in Mitterand's March 1983 "U-Turn:" economic competitiveness was fostered through negotiated devaluations of the franc (in 1986 and 1987), restrained fiscal and monetary policy, and progress toward creation of a financial space that could compete in an interdependent European economy. Though there were some sharper discontinuities brought about by the right's victory in the 1986 parliamentary elections – such as the repeal of the 1981-era wealth tax and re-privatizations – an impetus for financial liberalization had been established that was respected by both the left and right.

III: French Financial Reform

Considering that the Mitterrand government began by seizing control of virtually the entire French financial sector, the scope of the reforms pursued between 1984 and the end of

Mitterrand's first *septennat* were particularly remarkable. Beginning in the second year of the new rigueur socialism, the government embarked on its program of modernizing the country's financial system with an eye to making it more internationally competitive – hence more compatible with the European common market. In short order, the state created new markets, deregulated old ones, liberalized the country's financial account, and put an end to the *encadrement*.

III.1: The Modernization of French Capital Markets

The years between 1984 and 1987, spanning Mitterrand's reversal and his first two years of *cohabitation* marked the largest turning point in the French liberalization experience. Many of these liberalizing steps entailed the creation of entirely new markets and financial market instruments. A summary of these is presented below (c.f. Melitz 1990; Bertero 1994; Drumetz 2002; Commission Bancaire 2003; Bertrand, Schoar, and Thesmar 2007):

- A "new" money market was created, on which firms would be able to raise money through the issuance of short-term debt instruments (*titres de créance négociable*). Whereas the previous statutory minimum maturity length for debt instruments had been seven years, the new products were shorter-term, creating something akin to a market for commercial paper.

- The "old" money market was converted into a more traditional market for interbank deposits. This meant closing the market to non-financial firms, such as Eléctricité de

France and the National Railways, which had previously had access to interbank funds – and with it, significant capital-raising advantages.

- The *marché à terme d'instruments financiers* (MATIF) was created in 1986. This brought a large, contemporary futures market to France for the first time, allowing for the trading of commodity and interest rate futures and options.

- MATIF was supplemented in 1987 by the *marché des options négociable de Paris* (MONEP). Where MATIF was meant for trading interest rate and commodities derivatives, OPEP created markets for equity and index futures and options.

These new markets were developed with a more liberalized rulebook: upon opening, the MATIF only reserved half of its seats for registered brokers. While commissions in some areas remained fixed, the commissions for large bond issuances became freely negotiable in 1985 (Cerny 1989). The new rules were ultimately expanded to all French capital markets. In March 1987, Chirac's Finance Minister, Edouard Balladur, announced France would pursue its own version of Britain's "big bang" liberalization. This "petit bang" allowed all French and foreign financial institutions to purchase stockbrokers and trade directly on the Paris Bourse. This was extremely significant for the France's non-bank financial institutions – particularly its relatively small community of 60 state-sanctioned stock-brokers and investment firms (P. Lewis 1987).

In practice, by allowing banks to absorb brokers, brokerage activities gained better access to international and domestic capital. This greatly improved market-making: the relatively small balance sheets of the old-style brokers meant that it was necessary to immediately match buyers and sellers in order to execute a trade. Allowing bigger institutions to step into the market meant that they would be able to hold a larger inventory of equities themselves, greatly facilitating market completeness.

The overall effect of these changes was to make France's financial sector more dynamic. As the French stockbroker put it at the start of this chapter, these steps were necessary if Paris was not to be left behind as an international financial backwater. That also meant dismantling exchange controls, which the government – armed with more attractive markets and a President striking a less investor-unfriendly pose – was willing to undertake. The heightened restrictions on trade-related exchange of currency that the government had imposed in 1983 were eliminated, restoring a degree of freedom to international capital flows. Between 1984 and 1989, the government progressively dropped the rest of its restrictive measures, ultimately transposing the June 1988 European Union directive calling for free capital mobility into national law. The results were as hoped-for: while a great deal of capital did leave the country, it was largely balanced by growing investment into France.[17]

This renaissance of French capital markets had a profound impact on France's financial institutions. On one hand, it meant that non-financial firms could raise money without taking on bank loans, cutting banks out of the capital-raising equation. On the other, it meant that banks could diversify into new markets and purchase finance houses that specialized in capital market activities. Indeed, one of the largest consequences of the petit bang was the immediate rush to acquire venture capital firms, investment banks, and stockbrokers (P. Lewis 1987; Bertero 1994) This also meant there was a marked transition away from holding loans and toward holding debt securities. Figure two shows the transition

[17] INSEE

from loans to debt and equities as a percentage of all financial institutions' asset holdings: while the levels of debt security and equity ownership remain relatively low, the direction of change is unmistakable, particularly after 1985.[18] In total, banks acquired new bonds nearly three times faster than they did new loans.

Composition of French Financial Firms' Balance Sheets: 1977-1989

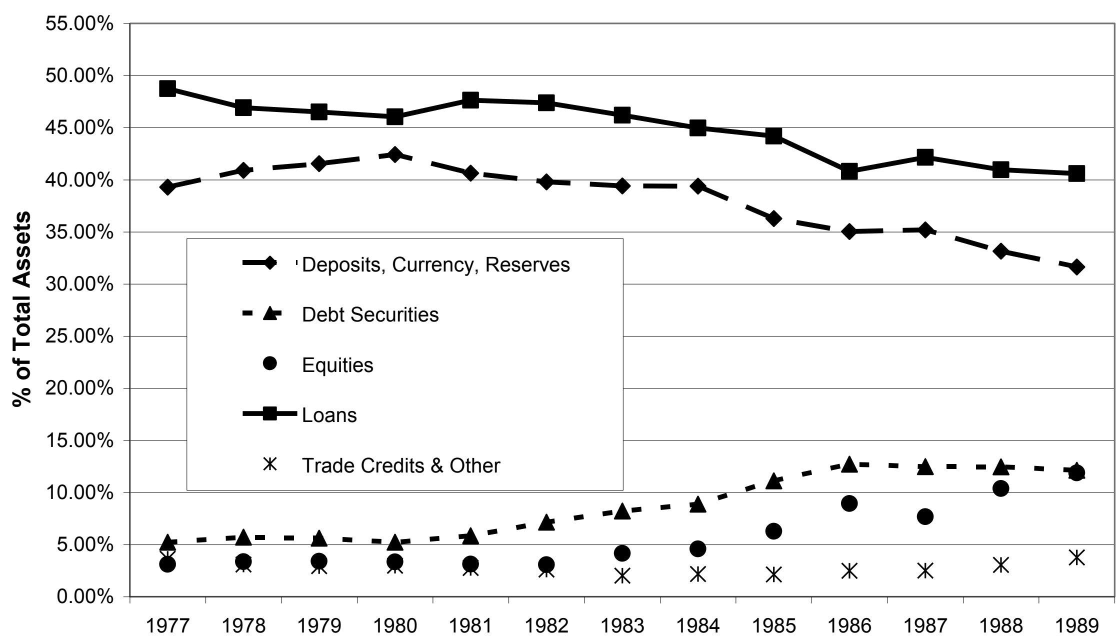

Figure 1 *Source: Banque de France*

On the whole, the French transformation away from a purely bank-based system was remarkable. Between 1980 and 1989, the intermediation rate in France fell from over 70 percent to just over 60 percent as firms sought out new ways of raising capital.[19] The ratio of firms' loan finance to bond finance fell from over 12:1 in 1980 to less than 6:1 by the end of the decade.[20] This had a profound effect on the balance of power between traditional

[18] INSEE, Author's Calculations
[19] *Banque de France*
[20] INSEE

intermediating financial firms (i.e., banks as usually conceived) and non-bank financial institutions such as investment funds, collective investment schemes, and venture capital firms. The value of assets under bank management rose 157 percent during the 1980s – but the value of assets managed by non-bank financial institutions soared 400 percent.[21] The largest discontinuity was in 1985 and 1986, coinciding with the creation of the MATIF and the "new" money market for short-term debt.[22]

Despite this impressive growth of new markets for debt instruments, the expansion of debt markets was small when compared to what happened in the French stock markets. Between new offerings and a general increase in the accessibility and appeal of holding stocks on the Paris bourse, the market capitalization of firms exploded following financial reform – from nine percent of GDP to over 36 percent by 1989 (Rajan and Zingales 2002).[23] Some of this growth in French equities can be directly attributed to the shrinking of the state. Privatizations of state enterprises made up a significant portion of the new equities issued by the end of the decade. In 1986 and 1987, in particular, the proceeds of public offerings linked to privatizations equaled or exceeded the proceeds from all other public offerings – between 0.8 and 1.2 percent of GDP (O'Sullivan 2006).

This boom in French equities markets was also fueled from demand outside of France: as capital controls were loosened, foreign investors surged into French markets. Portfolio investment in French assets was 29 billion francs in 1980. By 1989, that figure was well over 1 trillion francs. The largest single increase came the year of the final loosening of France's exchange controls – from 1988 to 1989 – when portfolio inflows nearly doubled.[24]

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[21] INSEE
[22] INSEE
[23] World Bank
[24] BDF

Amidst greater international interest in French stocks, the CAC 40 index was established at the end of 1987 and eventually would establish itself as the European index in which the most shares were held by non-residents (Morin 2000; Chirac 2006).

III.2: Banking Reform

Alongside this modernization of French capital markets came a major reform of the French banking sector. The process began in earnest with the Banking Act of 1984. That act built on Debré's *déspecialisation* efforts of the 1960s, eliminating the distinctions between banking entities that had kept the banking sector compartmentalized. It streamlined the mélange of French bank-like entities into a single category of "credit institutions," and put them under the authority of the same regulators – if not entirely the same regulations. This came close to introducing universal banking in France, with few bank-specific prohibitions on activities (Bertero 1994). Nevertheless, several distinctions between bank types remained. Notably, the financial wing of le Poste as well as the Caisse des Dépôts retained their special positions. Furthermore, specific savings options like the Livret remained limited to special savings banks, the Post Office and Crédit Mutuel (Commission Bancaire 2003).

Two other developments in 1984 are worth noting for the impact on French banking. First, the government began encouraging banks to devise equity instruments that would reintroduce partial private ownership in French banks. 10 percent of publicly owned banks, accounting for 20 percent of France's banking assets, were subsequently re-privatized (The Banker 1984). Second, it was announced in November 1984 that the *encadrement* – together with the provision of certain forms of subsidized credit – would cease at the start of the following year. In its place, the government announced that credit was to be controlled through interest rates and reserve ratios rather than quantitative controls (Melitz 1990). In keeping with this, the Bank of France stopped announcing a single price at which it would lend for the day, removing a large source of price rigidity. Moreover, with the progressive dismantling of capital controls, French residents were permitted to keep foreign-currency accounts in France and franc-denominated accounts abroad. Caps on foreign currency borrowing and lending for institutions were eliminated (Drumetz 2002).

These changes began a revolution in the day-to-day behavior of banks, tremendously expanded households' and firms' access to credit, and generally brought the French financial system more in line with emerging international norms. But the advent of near-universal banking and the abolition of quantitative credit controls and the *encadrement* also put pressure on financial firms' traditional activities. Banks competed intensely for cheap deposits, forcing more institutions to look to alternatives. As figure two shows, banks' reliance on deposits to fund their activities fell off markedly, particularly at the end of the decade. While the new capital markets meant that banks did have alternatives, those alternatives were generally more expensive. In the latter half of the 1980s, the cost of acquiring funds rose 116 basis points (Commission Bancaire 2003).

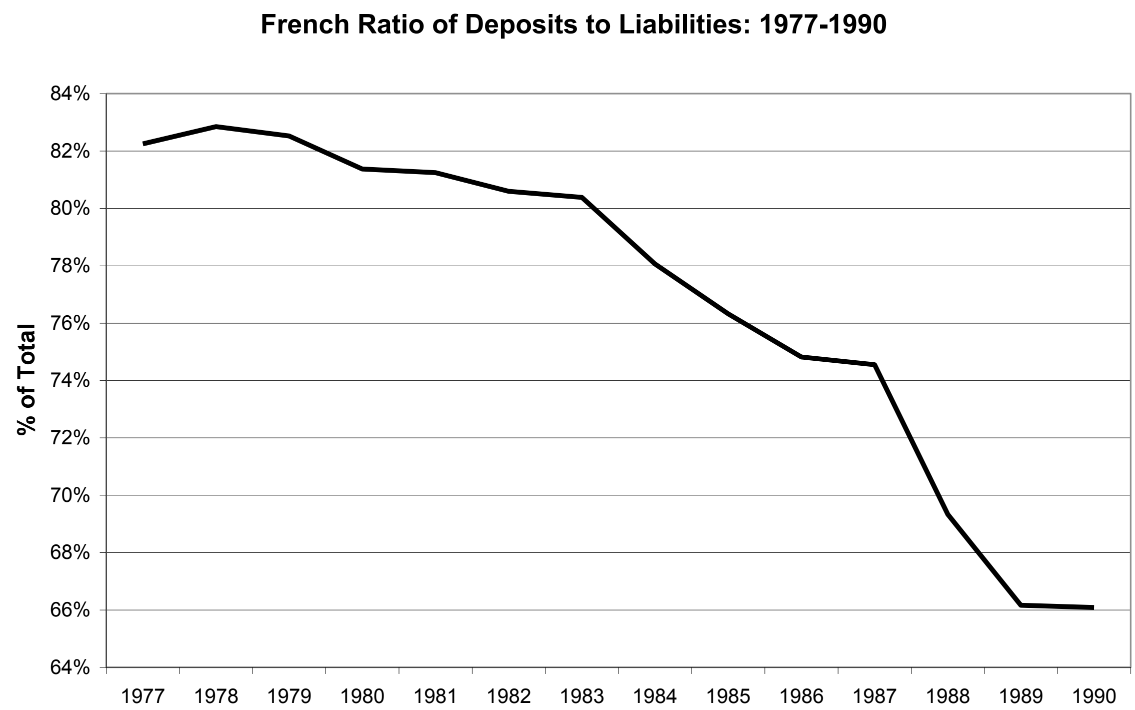

Figure 2 *Source: Banque de France*

At the same time, banks' rush to expand meant more competitive lending practices. Banks balance sheets grew by 200 percent in real terms during Mitterrand's first *septennat* – compared to a less than 20 percent real expansion of the economy as a whole over the same time period.[25] This heightened competition down the interest rates on banks' assets by an average of 41 basis points.[26] Investigating the impact this competition had on the profitability of French banks is difficult simply because the stated profits of state-owned banks were not market-determined but negotiated between the firm and the state (V. Lewis 1984b).

Surveying the new competitive environment in 1985, The Banker's France specialist, Vivian Lewis noted:

> 'French banks, seeking greater freedom from regulation, better leverage for their limited capital and higher profits, have developed an enthusiasm for alternatives to 'plain vanilla' banking.' (V. Lewis 1985, 48)

[25] Banque de France; OECD
[26] Commission Bancaire

Still, many institutions options for diversifying away from "vanilla" banking were limited. French banks at the end of the 1970s and start of the 1980s were widely considered to have among the weakest capital bases in Europe (V. Lewis 1984a; Commission Bancaire 2003). As such, despite declining margins, it was not feasible for French financial firms to simply lever up in an attempt to increase profits. Moreover, most institutions were already expanding balance sheets as aggressively as they could manage.

The best option left to the banks was to consolidate and innovate through diversification. In some cases, smaller geographically specialized entities like the *livret*-offering savings banks were ripe for simple cost-cutting rationalization. These considerations were given increased weight as the 1980s progressed. In 1986, for instance, there were 421 different local savings banks, with the regional reach of each bank often limited to merely one small village. The government administrator of the savings bank system was willing to bluntly state that this was simply too many, pushing for restructuring (V. Lewis 1986; Bertrand, Schoar, and Thesmar 2007). Ultimately, the rush to consolidate overwhelmed the entry of new foreign competitors by the late-1980s: an uninterrupted 20-year decline in the number of French banks began in 1987.[27]

For larger banks, consolidation and diversification took place through targeted acquisitions. As noted previously, this often meant buying specialized finance houses with expertise in France's booming capital markets. Likewise, bidding wars regularly broke out over the purchase of specialists in the rapidly expanding and innovating field of consumer finance (V. Lewis 1985). Interestingly, the state's large footprint in the financial sector did little to quell the competitive scramble:

[27] Direction des établissements de crédit et entreprises d'investissement (DECEI)

The enthusiastic entry of banks into the consumer finance field is particularly illustrative. Crédit Lyonnais, Assurances Générales de France, and Cie Financière de Suez competed sharply to acquire consumer finance specialist Banque Sofinco, which eventually saw the Suez group win out. What was interesting was that all three bidders were owned by the state and managed by Mitterrand appointees. In other cases, state-owned banks directly competed with private groups and lost – such as happened with SocGen's failed takeover of mortgage and leasing specialist Banque Hypothécaire Européene (V. Lewis 1985).

The structural changes in the French banking sector had an important effect on precisely whom the banks were lending to. Here again, the data is telling: 69 percent of all outstanding loan balances in 1977 were owed by the non-financial private sector. By 1987, only 55 percent of outstanding loan balances were owed by non-financial businesses.[28] The difference is largely attributable to the rise in household borrowing. In short, a growing share of traditional bank credit was allocated to consumers.

Ultimately, the modernization of bank regulations and capital markets fundamentally altered the shape of the French financial sector. Capital markets, once relatively insignificant, became more central to the functioning of the French economy. Banks, once largely restricted to specified activities, found themselves with much larger scope to expand into new areas. The result was enhanced competition on two fronts: first, increased capital market sophistication meant that banks lending had to compete with bond markets as a source of funds; second, the banks competed more intensely with one another – both in their traditional areas of expertise and in the rush to expand into new fields such as consumer lending and trading on capital markets. Complicating the process of competitive adaptation was the fact that most of the financial sector throughout this period remained under state ownership.

[28] Banque de France

IV: Short-Term Winners and Losers

Compared to how the British liberalization experience generated clear short-term winners and losers, the impact of the liberalization program in France was far more ambiguous. In the end, the reform process – grudgingly accepted rather than enthusiastically embraced – had a mixed impact on most parties. Caveats abound: the business community became more profitable but investment remained flat. The financial services industry boomed but remained largely under state ownership. The wealthy saw incomes rise slightly faster than the poor but this was mostly offset by Mitterrand's progressive social and tax policies. Consumers gained better access to financial markets but high interest rates and an aversion to buying and selling family property tamped down the property boom.

Many of the champions of the period's victorious ideas – such as Mauroy or Mitterrand himself – struggled to square their adopted positions with their idealism. Likewise, many of the champions of losing ideas (such as Chevènnement, Fabius, and Bérégovoy) were nevertheless rehabilitated in France's cliquish political space. Perhaps the clearest winners of Mitterrand's first term in office were the advocates of European integration and using the integration process to force domestic change on France.

IV.1: Material Ambiguity

The clearest material beneficiary of liberalization was France's large business community, which saw a marked jump in profits as new financial options were opened to them. Figure three shows both the decline in profits during the Giscard-Barre years, the nadir at the start of Mitterrand's term, and the upswing that followed the *tournant de la rigueur*. The upturn was particularly robust after 1985 as the market reform program gained steam. This broader increase was paralleled within the financial sector, which saw nominal profits jump nearly 200% between 1981 and 1988.[29] Again, the largest jumps occurred in 1986 as the reform program hit full swing.

Figure three also illustrates the fall and recovery of French business investment There are two possible explanations for this pattern. First, it could reflect a lagged reaction to profitability: as profits declined, investment fell; when profits recovered, investment rose once again. Second, it could reflect that French industry has a tendency to invest about ten percent of GDP annually but that businesses held back during the uncertainty of Mitterrand's first two years in office. The first explanation suggests that financial liberalization helped restore investment by boosting profits; the second suggests that it was Mitterrand's firm policy commitment in 1983 restored normal activity.

[29] INSEE

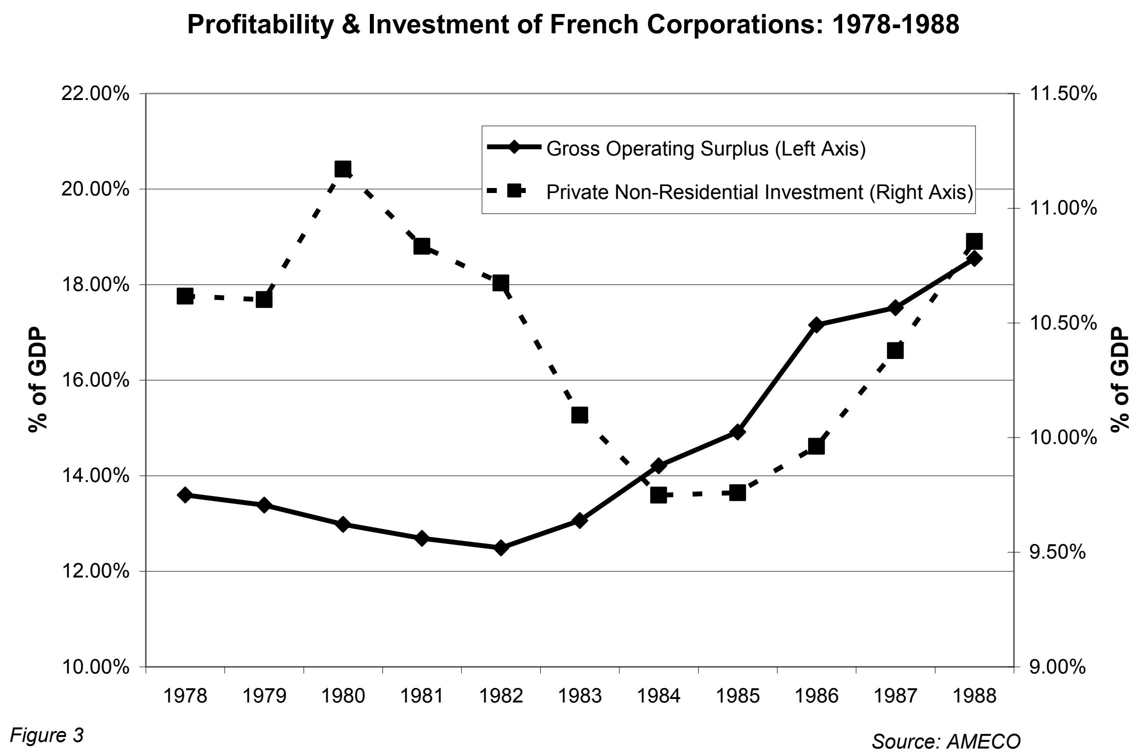

Figure 3

Any discussion of profitability among French financial institutions must remain particularly conscious of the fact that the fast majority of the French financial sector in 1988 was still state-owned. While contemporary observers noted that this did not seem to significantly impact the large banks' behaviors, their stated profits were negotiated with the state and their senior leaders were often political appointees. Yet the fact that the gains in the financial sector were not simply accruing to a small group of *réntiers* may go some way toward explaining the minimal increase in inequality under Mitterrand. Of course, any increase in inequality during Mitterrand's first *septennat* should be noteworthy, considering that many other socialist policies – such as the increased minimum wage and increased taxes on the extremely wealthy – would have mitigated any such rise. Indeed, the wage share accruing to the top decile of French earners did drop briefly during the socialist interlude from 1981-82. Once rigueur took hold and social reforms paused, however, a very modest increase in inequality did take place. This is at least partially due to the fact that the investment income accruing to *réntiers* grew more between 1981 and 1988 (75 percent) than wages did (62 percent). This was a far less severe reflection of what took place in Britain, where the gap between *réntiers* and wage-earners was much wider and the increase in inequality far larger.[30]

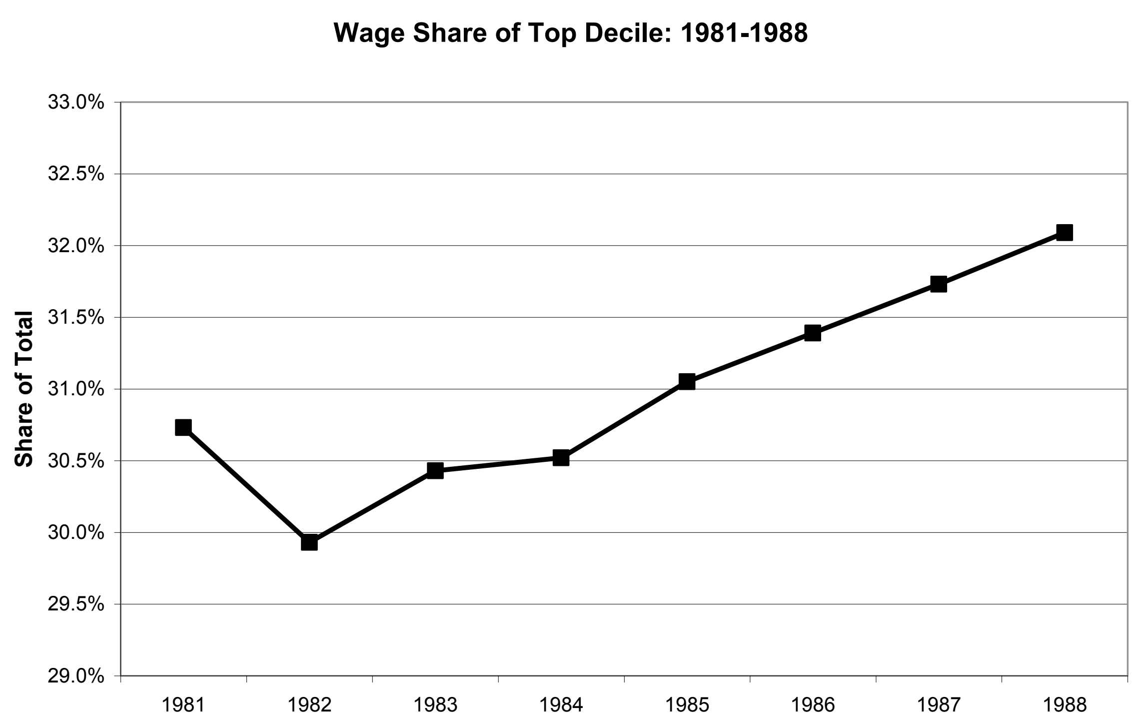

Figure 4 *Source: Pikkety 2007*

Finally, while French homeowners did see some appreciation in the value of their homes, the increase was negligible when measured against the increase in disposable income. The mortgage market did expand during the 1980s – despite interest rates in excess of 15 percent at times – meaning that one might expect to see an increase in housing values.[31] Part of the reason this did not occur may rest on a major difference between French homeowners and their American or British counterparts. In France, there was no assumption, implicit or

[30] INSEE
[31] *Conseil Générale de l'Environnement et du Développement Durable* (CGEDD)

explicit, that home prices would rise. Indeed, as one French Sénat report attests, the French tend to assume the opposite, seeing homes as more akin to durable goods than as an asset:

> 'New housing becomes old once a family enters. Instantly, it loses some of its value…If one remains in place, this is not a problem. But if one is forced to leave his home due to divorce, unemployment, a move, or change in family life, then the unrealized capital loss becomes real' (Hyest and Loridant 1997, I.B.2.B) (translated by the author)

In short, the tendency to buy and sell the family home in order to reap a capital gain – a major feature of Anglo-American housing bubbles, was not present in 1980s France.

IV.2: Ideational Ambivalence

French financial liberalization was an incidental thing. In contrast to Britain, liberalization in France was accepted but never embraced by all sides of the political spectrum. Those who chose to pursue reform were deeply conflicted: for Mitterrand, it meant the essential failure of his vision of a dirigiste financial system. For Chirac, it meant accepting a serious external constraint on France's domestic freedom – something he would chafe at when he became president in 1995. Yet despite this lack of ideological commitment, the financial reform program rolled on whether stewarded by reluctant supporters (such as Mauroy) or those who had opposed it from the start: indeed, both Fabius and Bérégovoy presided over crucial deregulatory moves during their tenures as prime minister.

In the end, financial liberalization happened in France because it was a means to an end. Those ends – and the people committed to achieving them – were the big beneficiaries of the 1983 U-Turn. Liberalization was a victory for European institution-building, for deeper economic integration as a means of dealing with interdependence, and for those who saw the need for such integration to be based on market-friendly principles. It was the

Giscards, Barres, and Delors who "won" as a result of financial reform: their vision of an institutionalized Europe built on monetary coordination with Germany guided the development of the EMS, the euro, and remains the dominant paradigm in continental Europe. None of that would have been possible with the underdeveloped and thoroughly state-dominated financial system of 1981.

The ambivalence toward financial liberalization in France – particularly in contrast to the gusto with which the Tories pursued their own agenda – will ultimately prove crucial: Britain sought to deregulate for its own sake; France did it in order to satisfy other policy preferences. This led to highly divergent reactions to the emergence of liberalization's unintended long-term consequences in the late 1980s and early 1990s.

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Five –
A Tale of Two Downturns

'Any radical reform, even if it achieves its objectives, is likely to bring about unforeseen side effects. This has proved particularly true of financial deregulation.'
–Nigel Lawson, January 27, 1992

Toward the end of the 1980s, the economic outlooks in both Britain and France were positive. Britain had recovered from the economic malaise of the late 1970s and recession of the early Thatcher years and was in the midst of a major economic boom, with investment, consumption, and debt reaching new heights. France, too, had recovered from the economic nadir of the latter Giscard-Barre days and the uncertainty of Mitterrand's first two years in office. Businesses' profits were up sharply and real consumption growth had surged above the EEC average.[32] In retrospect, 1988 was a high water mark for both countries. Growth slowed somewhat in 1989 then declined in earnest during the early 1990s. The British economy contracted in 1991 and France followed suit in 1992.

Part of the reason for the downturn was global: the American savings and loan crisis, US interest rate hikes, and an oil price spike resulting from the Iraqi invasion of Kuwait all conspired to reduce global growth. But the recessions of the early 1990s were complicated by the unintended consequences of the two countries' liberalization programs. French and British growth during the 1980s had been fueled in large part by consumer borrowing. As the 1980s came to a close, a historically large proportion of those debts were being defaulted upon. Savings rates rose as households deleveraged, creating more economic drag.

[32] AMECO

Particularly in Britain, the problem was amplified by the collapse of the enormous housing bubble that had emerged over the course of the preceding decade. At the same time the global economy slowed, the engine of domestic growth in both countries stalled.

This chapter tells the stories of the early 1990s period in both Britain and France, highlighting how both countries relied on debt-fueled consumption to fuel growth – then paid a price for that reliance. It starts by detailing how financial liberalization allowed the emergence of a peculiar growth pattern: for a time at the end of the 1980s, households in both countries borrowed while businesses saved. This represented a fundamental reallocation of resources away from investors and toward spenders. That reallocation led to a host of subsidiary consequences, including balance sheet fragility, greater inequality, and reliance on external sources of finance.

I. A Particular Finance-Growth Nexus

Chapters three and four suggested that financial liberalization contributed to increased investment in Britain and France during the 1980s. This was undoubtedly an intended consequence of financial liberalization. Yet there is also a direct line of causation between financial liberalization, increased consumer indebtedness, and faster growth. The corset and the *encadrement* both restrained the quantity of credit that could be extended by the domestic financial system. The abolition of these schemes – together with the elimination of statutory barriers between different types of lenders – meant that financial institutions could increasingly lend as much they wanted to whomever they chose. In both countries, this largely meant an expansion of consumer credit.

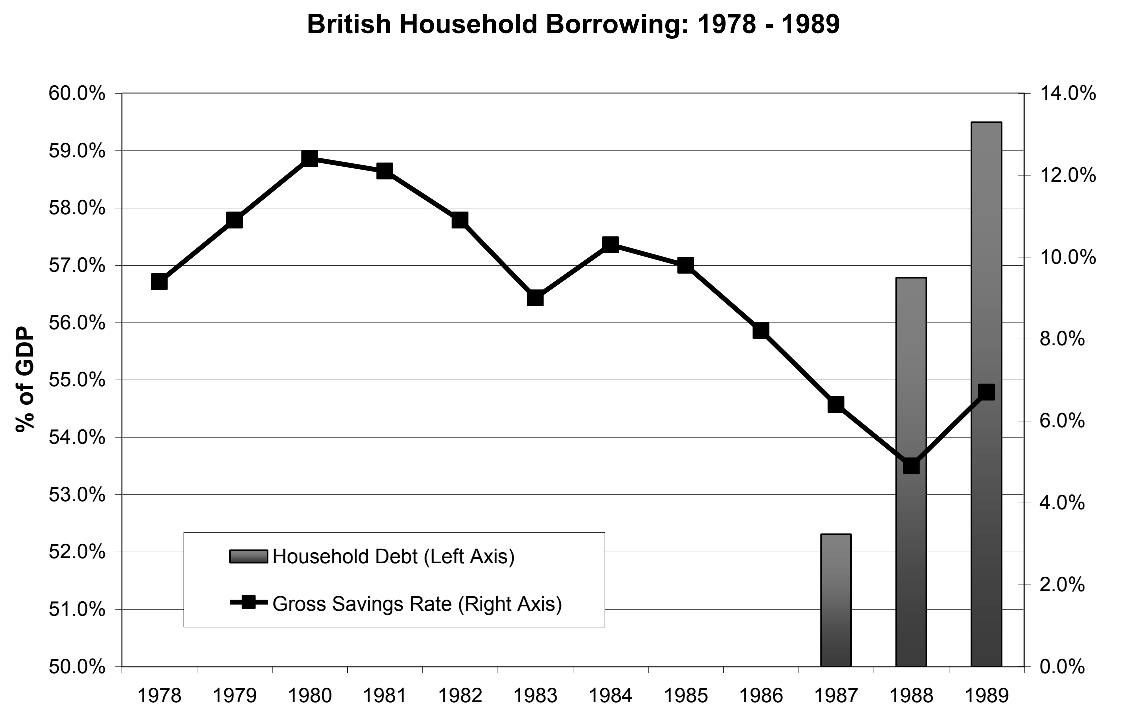

Figure 1

In France, banks jousted with each other to buy consumer finance firms in order to expand their household lending operations. In Britain, the rush to expand consumer lending led to the collapse of the building societies' cartel and the rapid expansion of the clearing banks' retail operations – particularly in mortgage lending. While liberalization certainly did facilitate easier financing for business, the transformation of the consumer financial space was particularly dramatic. By the mid-1980s, households in both Britain and France had more access to financial markets than ever before. And they used that access – to borrow. Figures one and two show the concurrent declines in household savings and increases in household indebtedness for the two countries.

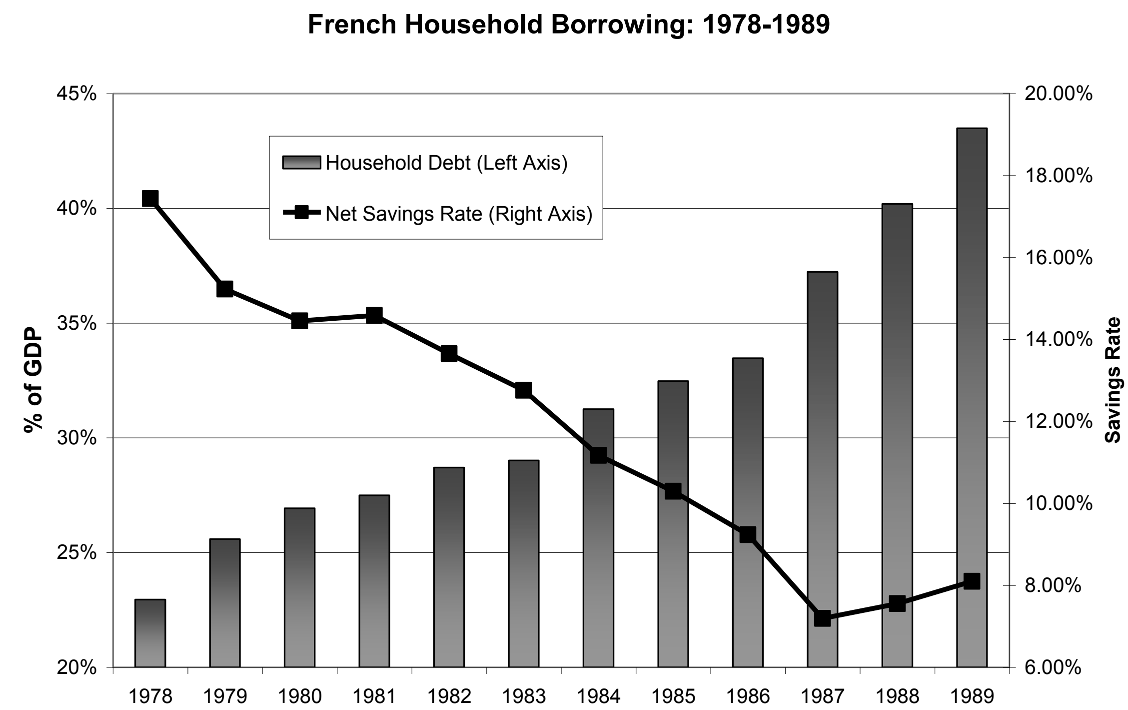

Figure 2

Source: INSEE

I.1: The First Hints of Backwards Finance

The expansion of lending to households led to a novel phenomenon: by the end of the decade, households had become larger net debtors than corporations in both countries. In 1987 and 1988, net household lending in both Britain and France had reached historic lows. Indeed, the entire British household sector was borrowing more than it was saving (i.e., net saving was negative). At the same time, the expansion of the financial services industry and the increased savings opportunities offered by the end of exchange controls – together with expanding domestic and international financial markets – meant that businesses had a greater diversity of savings options than ever before.

Figure three offers a graphical representation of this dynamic.[33] What it shows is that, during that 1987-88 period, households displaced businesses as society's principal net debtors. This is, in a sense, backwards: the economy's traditional savers (households) and its traditional borrowers (investing businesses) had switched places. Such a reversal is significant. It suggests that the British and French liberalization processes of the 1980s led to a greater relative *share* of society's financial resources – not simply a larger absolute *amount* of resources – being allocated to non-productive use.

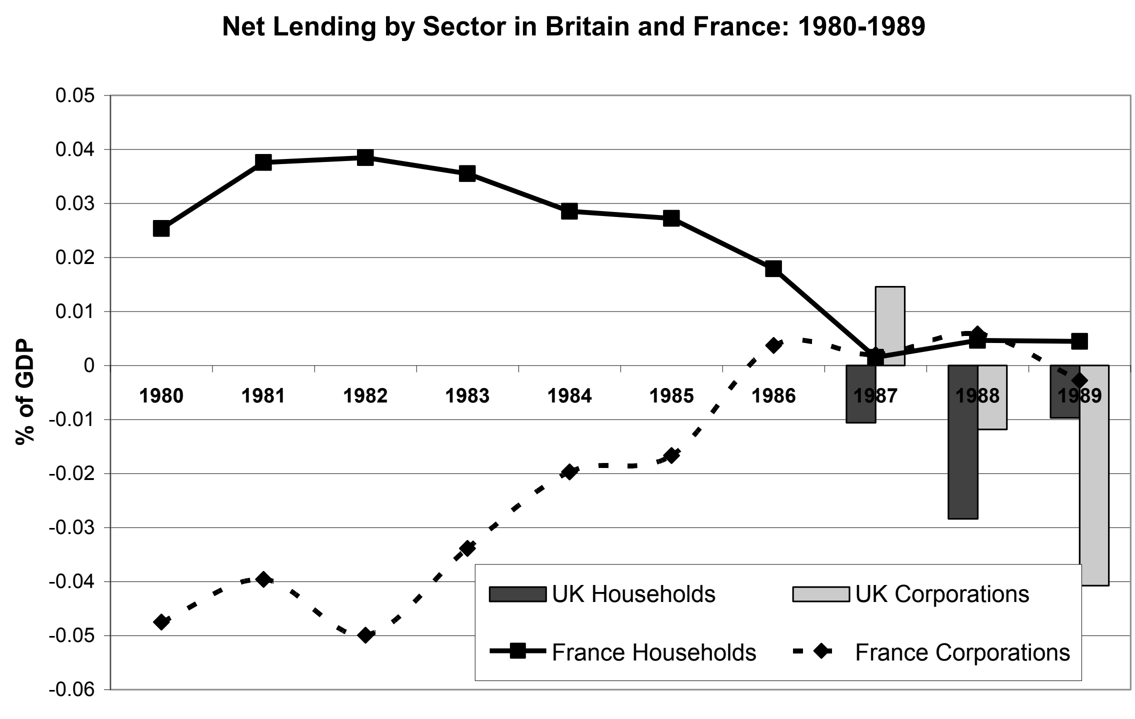

Figure 3 *Source: AMECO*

I.2: A Consumption-Fueled Boom

While a great deal of the increase in household debt went toward buying homes, households also used a large proportion of their borrowed wealth to support consumption. This took the

[33] Sectoral financial balance sheets were not kept by the UK Office of National Statistics until 1987

form of store credit, credit cards, personal loans, and home equity withdrawals. Indeed, some estimate that British actually withdrew more equity from their homes – cumulatively, over 150 percent of household value between 1980 and 1989 [34] – than the total sum of GDP growth over the same time period (Engelen et al. 2011). One thing is abundantly clear: households in Britain and France increased consumption more than can be accounted for with income growth during the 1980s. As figure four shows, nominal incomes in both countries grew by roughly the same rate – just under 110% -- during the decade, yet per-capita consumption spiked by over 113 percent in France and by 140 percent in Britain. This means that households borrowed in order to spend more.

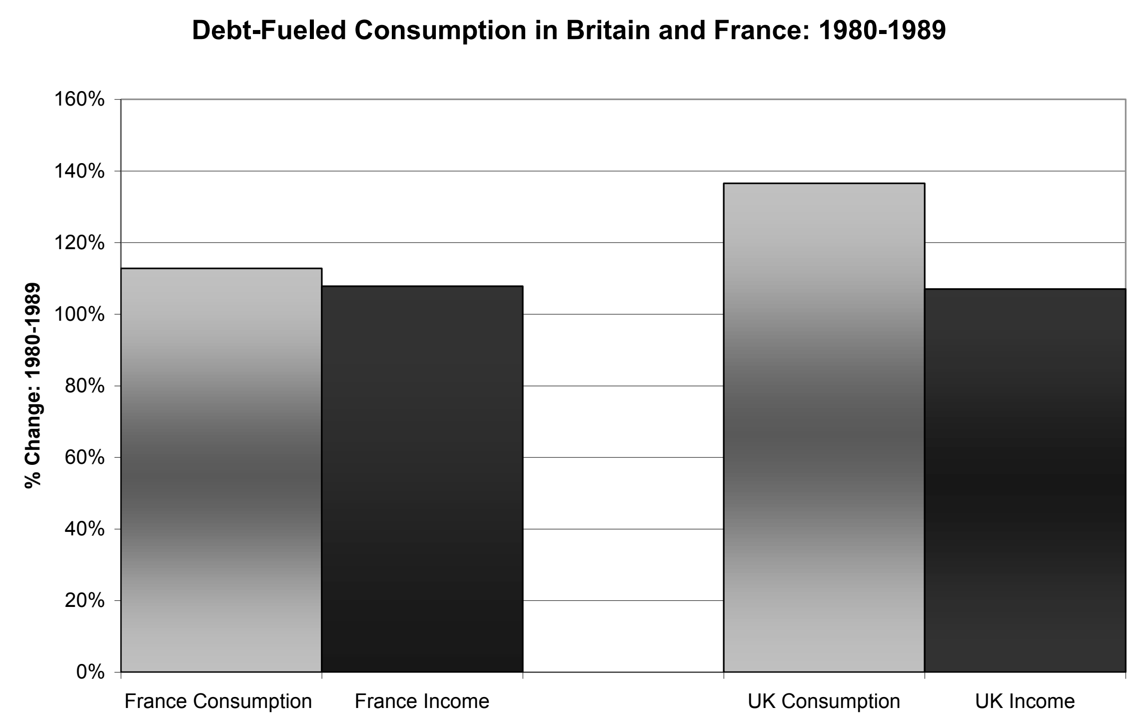

Figure 4 Source: INSEE, ONS, and AMECO

Not only were consumers borrowing in order to spend, they were spending a larger proportion of their income (as figures one and two showed). Increased access to on-demand

[34] Bank of England

funds – as well as asset-price appreciation in Britain in particular – meant that households were willing to operate with smaller savings-based safety nets. Any link between liberalization and consumption is particularly important because of the significance of consumption to both countries' economies. Figure five demonstrates how, during the 1980s, household spending was by far the largest contributor to GDP growth in both countries.

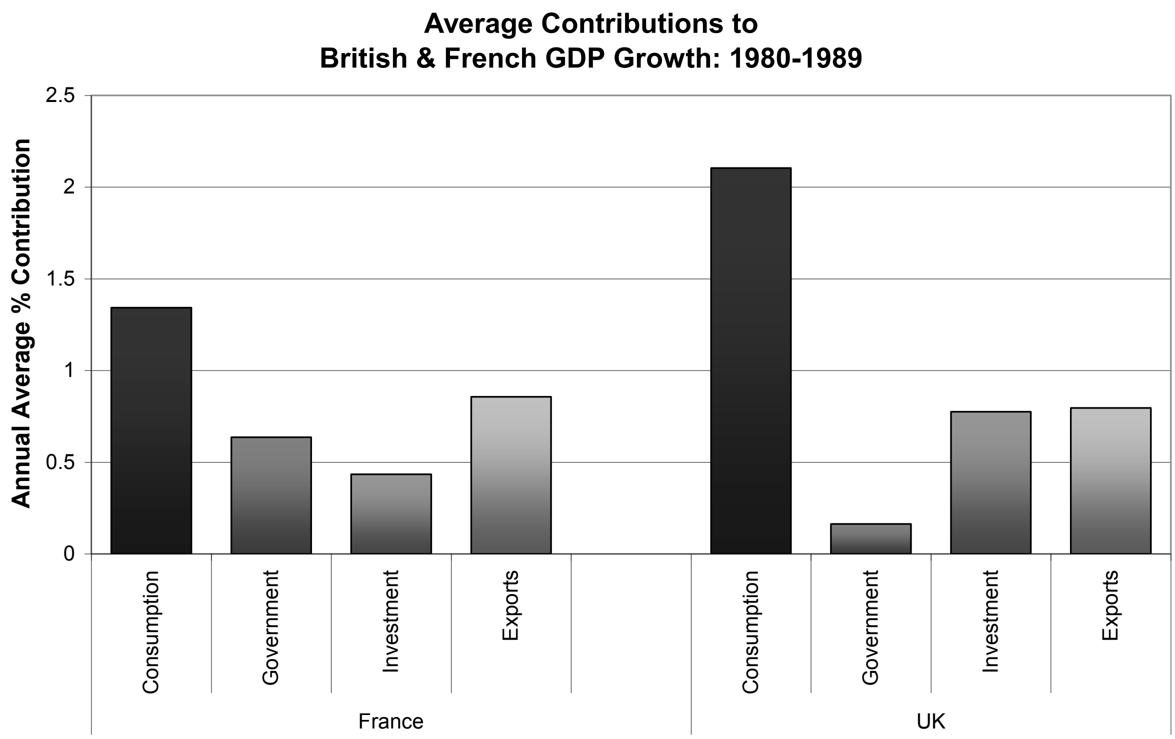

Figure 5 Source: AMECO

So why should it matter that liberalization led to growth through boosting consumption? Two answers to that question suggest themselves. First, debt- and consumption-driven growth leads to expansion of particular industries. During this period, the general trend among developed countries was toward smaller manufacturing sectors and larger business service sectors. While this phenomenon is more appropriately linked with technological change and increased Asian competition, both countries also experienced relative growth in low-value added sectors that are particularly reliant on consumption and the housing market: the retail and hospitality sectors in both countries as well as construction in Britain. Moreover, the size of the financial sector itself – in terms of employment and value added – grew sharply in both countries.[35]

The second answer is more straightforward: if growth in one period is heavily helped along by the contracting of new household debt, growth will slow in any subsequent period of deleveraging or default. That is, debt-fueled consumption is an intertemporal tradeoff: consumers spend today and the economy grows faster – but at the expense of growth-slowing belt-tightening (or destabilizing defaults) in the future. This is, in a large sense, what happened in the early 1990s.

II. Unintended Consequences

The preceding section concurs with a key claim made by the advocates of liberalization: there clearly is a finance-growth nexus at work. Financial liberalization stoked consumption, pushing growth higher; yet this type of growth hid more pernicious long-term consequences. The emergence of the debt-fueled growth model led to a reallocation of society's financial resources toward sectors that do not intrinsically generate productivity growth. This reallocation increased vulnerability to external shocks, stoked greater inequality, and compelled both Britain and France to import capital.

II.1: Vulnerability to Shocks

While the global crisis of the early 1990s had many root causes, the widespread decline in savings, combined with an increase in debt, made households in both countries vulnerable to any economic crisis. This was particularly marked in Britain, where debt burdens were

[35] OECD Structural Analysis Statistics

higher and many households counted on their physical assets as a buffer against downturns. Individuals who lost their jobs under these circumstances faced a daunting combination of income loss, high debt service costs, a low savings cushion, and less asset wealth to draw on. Under these circumstances, debtors would be forced into either austerity or default, both of which have pro-cyclical impacts.

In the United Kingdom, the big bang and the big boom were followed by a big bust. Inflation, stoked by years of credit expansion and the development of North Sea oil, had crept back up to over 7 percent by the end of the 1980s. This, in turn, placed downward pressure on sterling. The government, particularly during their brief and ill-fated attempt to enter the EMS, had to raise interest rates to counteract the currency's weakness.[36] The interest rate hikes, combined with the reduction of a popular provision that allowed couples with mortgages to reduce their tax burden, severely damaged the housing market. Home prices and the market for new mortgages all collapsed, with home prices falling over 22 percent in the 18 months between mid-1989 and the end of 1990.[37]

The recession caused British unemployment to rise sharply, to 10.2 percent from 6.9 percent between 1990 and 1993.[38] The shock to employment quickly forced a relatively large number of households into insolvency. Unlike previous recessions, the recession of the early 1990s was characterized by default on an unprecedented scale. While repossession is always a rare event, figure six shows that more homes were taken into possession during the first three years of the 1990s than had been seized for the 1970s and 1980s combined. A further 3 percent of borrowers – a historically high number – had fallen at least 6 month into arrears by

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[36] Bank of England
[37] Nationwide Housing Price Index
[38] AMECO

1993, leading to millions of county court judgments against individuals for non-payment of debts (Munro et al. 2005).

Figure 6 *Source: UK Council of Mortgage Lenders*

The situation in France was little better. French unemployment rose from 8.8 to 11.6 percent between 1989 and 1994. Even before the crisis became acute, the government of Laurent Fabius had grown concerned over the rapid expansion of consumer credit. A government commission recommended the reimposition of statutory minimum down payments and, in 1985, banned US- and UK-style private debt settlement companies. While such entities reduce bankruptcy by allowing debtors to refinance their debt burdens, the government saw their actions as predatory (Kilborn 2005). The removal of this private route to debt settlement caused problems. Rising debt burdens in a society with relatively little experience with credit instruments began to place a weighty burden on the country's legal system as more and more individuals went into default. While France did have a bankruptcy code, it didn't apply to individuals. All that existed were some restrictions on wage garnishing and asset seizure, as well as very limited provisions for short-term debt payment deferrals. By 1989, three quarters of *tribunaux d'instance* (small claims) cases concerned non-payment of consumer debt (Morin 1992; Kilborn 2005).

In this environment, consumers' demand for borrowing and lenders' appetites for risk fell dramatically. Household savings in both countries shot back up. By 1992-93, savings rates in both countries had returned to their 1970s levels and debt growth plateaued.[39] After a decade of record-high consumption growth, real consumption declined from 1990-93 in Britain and remained flat in France from 1992-93.[40] Due in part to the fact that British households had borrowed more heavily over the 1980s (and grew faster), the crash there saw deeper cuts to both consumer spending and growth. Defaults and a lack of good lending outlets also took their toll on the financial sector: profits for financial firms in both Britain and France declined between 1989 and 1995, reversing nearly a decade of steady increases.[41]

In short, the early-1990s were a difficult time for consumers, for financial firms, and for the British and French economies as a whole. Financial liberalization sat at the heart of the downturns in both countries. In short, liberalization was a *sine qua non* for the 1980s credit expansion and the resulting increase in household indebtedness was a key ingredient in British and French macroeconomic instability. Such a causal connection is supported by the fact that the British credit expansion – and its economic downturn – were more intense than those seen in France. Indeed, this finding is supported by a study by Mervyn King in his days before taking over the Bank of England. In a cross-sectional study, King (1994) found that

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[39] ONS and AMECO
[40] AMECO
[41] INSEE, OECD, Epstein and Power 2003

the countries where households had borrowed the most during the credit expansion tended to have sharper downturns.

II.2: Heightened Inequality

This point follows from the discussions of winners and losers at the close of both chapters three and four. In both Britain and France, the asset-wealthy and those who earned their incomes from financial markets benefited more from the liberalization process. Furthermore, as posited in proposition five, there is reason to expect that inequality expansion should be higher where consumers have borrowed more. Household debt typically means that poorer debtors sacrifice future income and wealth in exchange for greater purchasing power in the present.

All of this suggests that inequality should have expanded in both Britain and France during the 1980s – and that the increase should be more evident in more heavily-indebted Britain. As figure seven shows, this is indeed the case. The share of income accruing to the top decile of wage-earners in both countries grew and – despite starting from almost the same point in 1981 – France soon began to lag behind. Of course, there are other factors at work here: Britain was governed by a right-wing party with a particular hostility toward organized labor; France was led by a committed socialist who managed to implement progressive measures despite the wider *tournant de la rigueur*. Nevertheless, the consistency between the empirical record and the theoretical rationale for a liberalization-inequality link is striking. It stands to reason that a significant part of the increased inequality in both countries did stem from their financial reform programs.

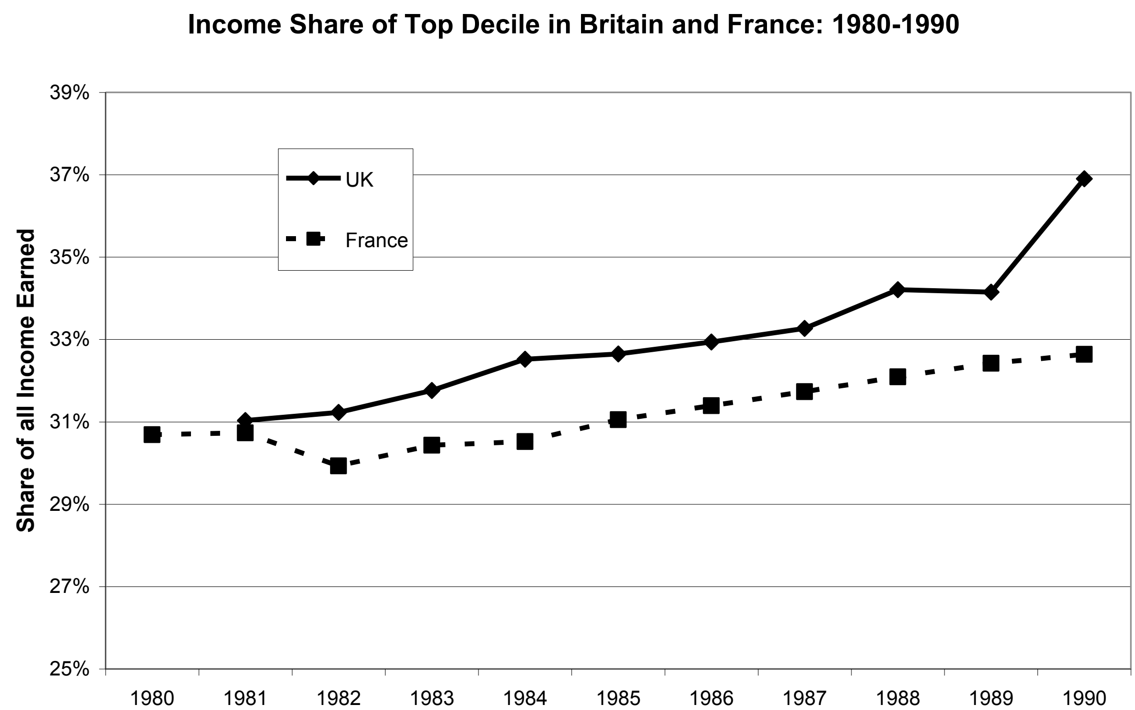

Figure 7 *Sources: Pikkety 2007 and Atkinson 2007*

II.2: Greater External Imbalances

As the rationale for proposition five also argues, there is a natural complementarity between domestic borrowing and external deficits. The world's heaviest borrowers – and most heavily indebted consumers – are likely to be heavy spenders on imported goods. At the same time, borrowing creates new assets that can be exported abroad, facilitating a financial account surplus. The more adept a domestic financial system becomes at generating assets for international sale, the more structural such a deficit is likely to become. In short, international capital will tend to seek out the deepest and most modern of financial systems and facilitate domestic consumption within those systems (Cooper 2008).

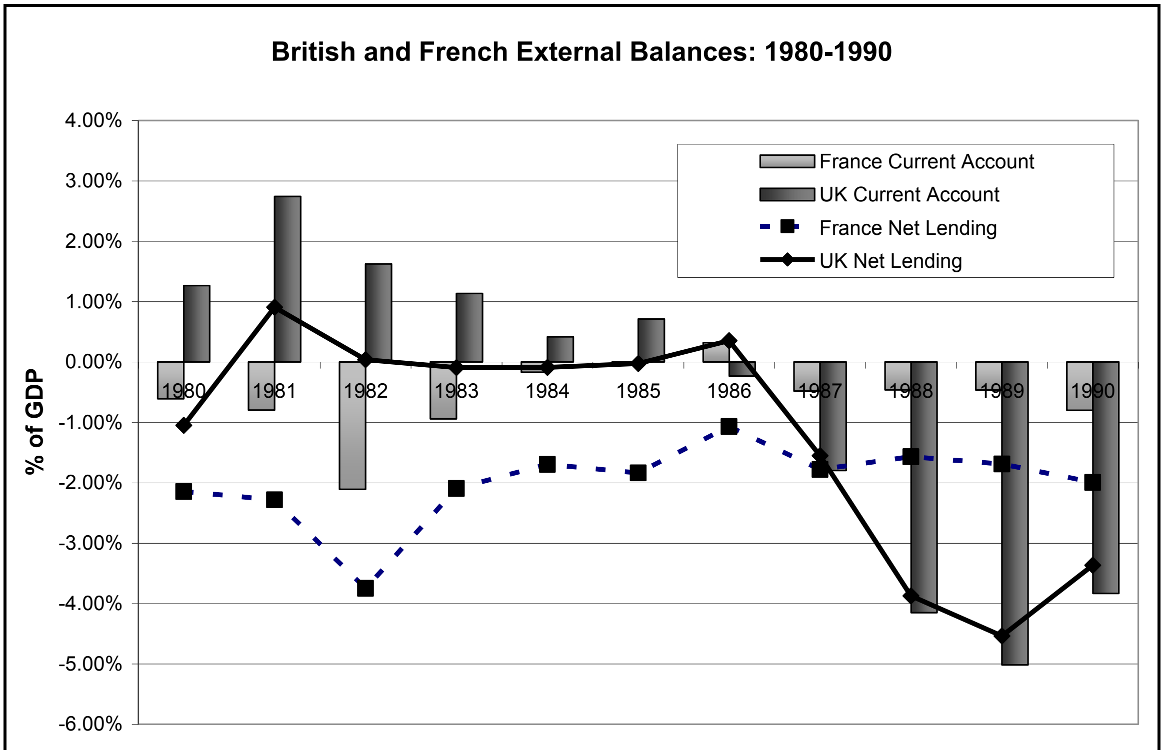

Figure 8

Figure eight again shows that this intuition also pans out. Britain began the 1980s with current account surpluses and a relatively balanced net financial position. In the year of the Big Bang, the current account deteriorated rapidly as a financial resources flooded into the country. The French case was less clear-cut. Heavy government borrowing and overvaluation of the franc in the early 1980s meant that the country began the 1980s with a current account problem and was importing capital to compensate. Both accounts initially swung toward balanced during the *rigueur* years; however, France returned to exporting financial assets (i.e. borrowing) by the end of the decade. The major difference between the beginning and the end of the 1980s was the decline in government borrowing. Whereas state spending was responsible for the need for external finance during the early 1980s, the collapse in household saving – coupled with France's increasing financial attractiveness – was responsible for the external imbalances at the end of the decade.

III. Conclusion to Part One

As Nigel Lawson admits, financial liberalization did indeed have some unintended consequences. Lawson himself (1992) was up front that the scope of the consumer credit expansion and the accompanying irresponsibility on the part of the financial sector had surprised him. In France, by comparison, there was no shock that the reform program entailed costs. After all, many of those charged with implementing the program had been convinced that the way to solve the country's problems was – in Pierre Mauroy's words – to seize control of the *puissances d'argent*. These differing attitudes toward both the boom and bust explain two key facts:

First, Britain's relative embrace of liberalization – particularly by households – meant that its credit boom was bigger, its growth faster, and the unintended consequences harsher. The size of the credit expansion, the involvement of a housing bubble, and the attractiveness of British capital markets meant that the story of boom and bust emerges more strongly from the British case. France was always more hesitant – and had fewer groups with an explicit stake in pushing for liberalization. This ambivalence became manifest in policies that encouraged savings, abolished private refinance corporations, and eventually strengthened the country's usury laws (to be discussed further in chapter seven) – laws that never appeared to the same extent in Britain. Ultimately, France was less committed to liberalization, reaping fewer of the consequences – both intended and not.

Second, Britain's relatively enthusiastic embrace of liberalization would come to mean that, by the late-1990s, the country was ready to repeat the events of the 1980s. Credit expanded, leverage rose, housing prices boomed, and the debt started to mount. Lawson, despite his admission of surprise over the events of the 1980s, maintained that history could not repeat itself. Future Prime Minister Gordon Brown would exude supreme confidence that innovative financial wizardry had abolished the cycle of boom and bust. The French, never ideologically wedded to liberalization and lacking some of the same incentives to move ahead with further deregulation, chose not to repeat their 1980s experience. While the financial sector was allowed to liberalize, the state acted to prevent the emergence of a second credit boom – and bust.

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Part Two:
The Rise of Finance

Six – New Labour's Britain: The Wrong Lesson Learned

'And I say to Conference and the country,
we will never return to the days of Tory boom-bust.'
–Gordon Brown, September 27, 1999

Britain's 1980s boom and subsequent bust gave way to a period of relative calm. The credit expansion halted – as did the widening of British inequality and the growth of the country's external deficits. Financial institutions, stung by the scale of default and restrained by a lack of qualified borrowers, became more circumspect. Borrowers, more aware of their precarious finances, saved more and borrowed less. For a time, there was a sense of caution toward financial markets that had largely been lacking during the previous decade.

The end of the boom also presaged the end of Thatcher's tenure at 10 Downing Street. Internal challenges to Thatcher's polarizing leadership of the Tories had grown, leading to her ouster prior to the 1992 elections. Labour, for the first time since the 1970s, found itself within striking distance of electoral victory. While Neil Kinnock failed to win back the Commons, Labour's resurgence launched the political careers of its two key leaders to-be, Gordon Brown and Tony Blair. They began to forge a new Labour identity, carefully steering clear of the party's legacy of hostility toward business in general – and the financiers of the City in particular.

It is Brown, not Blair, who was the most important figure in shaping Britain's post-Thatcher relationship with financial markets. Nearly a decade before entering government, Brown wrote a book (1989) critical of the Thatcher boom entitled *Where There's Greed.*

Twenty years later – and after holding the reins of power himself – Brown (2010) penned another treatise that argued that the late-2000s financial collapse was caused by "reckless and irresponsibility all too often caused by greed." This begs an interesting question: If greed had been problematic before he had entered government, why would he embrace liberalized markets – even go so far as to say that sound regulation is predicated on "trust in the responsible company" – when it was his turn to govern?

This chapter sheds light on that question through the telling of two concurrent stories. The first is the tale of Brown and Blair's rise to power – and their belief that a second financial boom-bust would not recur. The second is the story of a financial sector trying to re-find its footing after the early 1990s downturn. The two narratives come together in 1997 with New Labour's victory. That victory married a financial sector hoping to innovate its way back to profitability with a new government that believed in the benefits of financial liberalization, particularly in the powers of innovation. The resulting combination put the country on course for a new financial expansion (and bust) that would ultimately dwarf the "Tory boom-bust."

I: Picking up the Pieces

Britain would spend a full half-decade recovering from the economic boom of the 1980s. Politically, the government's realization that the credit boom had stoked inflationary pressure triggered a series of unpopular policies and drove fault lines between ministers that helped to bring down Lawson, Howe, and ultimately Thatcher herself. Economically, higher interest rates and rising unemployment created the conditions for a prolonged standstill in credit expansion, putting a temporary stop to the pattern of debt-fueled growth.

I.1: Political Fallout: The Tories' Long Fall

Returning for a moment to the peak of the boom, it is instructive to note what government ministers saw as the biggest problem implied by the country's credit-fueled boom: inflation. The credit expansion and loose fiscal policy, Lawson admitted, had allowed the country "just a bit too much of a good thing" (D. Smith 1988). Howe (1995, 606) concurred, noting that "we had all been carried away by our own success story." Annual inflation had grown from what Lawson initially termed a "blip" into something approaching 7.5 percent annually. The government responded in much the same way it had on entering office in 1979: by raising interest rates to over 14 percent between 1989 and 1990,[42] helping push the country into a recession.

It is to both Howe and Lawson's credit that they acknowledged that their policies had contributed to overheated lending. Nevertheless, their emphasis on inflation pushed them toward a solution that succeeded only at intensifying divisions within the government. There was no effort to influence lending or borrowing directly; instead, the government sought to make borrowing unappealing by making it too expensive. The immediate impact of this policy choice was discussed in chapter five: it effectively ended the boom. The medium-term impact was to commit Britain to closer monetary integration with Europe – with Germany in particular.

Lawson and Howe's suspicion of inflation made shadowing Germany an attractive option. If sterling was held constant relative to the deutschemark, Britain could effectively import Germany's traditional price stability. This was particularly important after 1986 and the big bang: Britain relied on capital inflows to fuel their economy and sustain the country's

[42] Bank of England

current account deficit. Exchange rate stability was seen as crucial for protecting the international attractiveness of the City (Andrews 1991). It was for this reason that both men argued in support of Britain entering the EMS in 1985, only to be overruled by Thatcher. The divergence between Thatcher on one side and Howe and Lawson on the other was fundamental: Howe and Lawson saw entering EMS as a way of stabilizing external financial relations while making a credible commitment to low inflation. Thatcher saw European monetary integration as skirting dangerously close to a cession British sovereignty to Germany, arguing that the pound was the country's "greatest expression of sovereignty" (Thatcher 1990; Howe 1995).

The differences were papered over in the years after 1985. For much of the late-1980s, Lawson directed the Bank of England to informally shadow the deutschemark at a rate of 3.2 marks to the pound. But as inflation continued to worsen, the topic reemerged in 1989-90. Lawson, who favored entering the EMS' exchange rate mechanism (ERM), repeatedly clashed with Thatcher's economic advisor, Alan Walters, who described the scheme as "half-baked" (Hughes 2009; Pierce 2009). Lawson, who also differed with Walters on the topic of the flat-rate "poll tax" to fund local government, demanded that Walters quit. Thatcher refused, leading Lawson to resign on October 26, 1989. Howe (1995, 606) was discouraged by this turn of events, noting that "the only useful by-product of losing a Chancellor was the near-simultaneous resignation of Alan Walters himself."

Lawson was replaced by John Major, who was every bit as committed to ERM membership as Lawson had been. He attempted to chart a course that would allow Britain to import German price stability without committing to eventual membership in a common currency, floating the idea of turning the EMS unit of account, the ecu, into a "hard" paper currency that could circulate alongside national currencies for use by businesses and tourists. With this in mind as an alternative to surrendering the pound, Major finally convinced Thatcher to sign off on ERM membership in October 1990 (BBC News 1990; Major 1999).

Even entry into the ERM failed to cool tensions between Thatcher and Howe, who believed that Thatcher's open hostility toward the process of European integration risked Britain being "left behind" on economic and monetary union (EMU) In his resignation letter, he wrote that rejecting leadership in the European integration process would be a "tragedy" for the country's financial institutions and businesses – relegating Britain to the position of powerless junior partner (1995, 649–50).

Howe's resignation speech in the Commons triggered Thatcher's final downward spiral. Sensing weakness, Michael Heseltine launched a leadership contest in November 1990. Abandoned by some of her closest allies and confronted by a back-bench insurgency, Thatcher was besieged on all sides. She failed to win back the leadership on the first ballot, with many in the party considering her to be a liability in the upcoming elections (Storey 2013). These forces compelled her to resign on November 28, 1990, producing an immediate recovery in the Tories' polling figures: Labour led by 16 percent in Thatcher's final days in office but trailed by two percent just after her departure. [43] In the end, it was not the economic bust that brought down Thatcher (indeed, the country had by then slipped into recession), but divisions over how to deal with the inflationary fallout of the country's boom.

The irony was that ERM membership turned out badly after all. Germany's own inflation problems stemming from reunification meant drastic interest rate hikes by the Bundesbank. The still-wounded British economy was compelled to shadow those contractionary policies, raising interest rates themselves. This raised the cost of the public's

[43] Guardian/ICM Polls

adjustable-rate mortgages and caused severe declines in aggregate demand, worsening the British recession. Currency markets became increasingly skeptical of the government's willingness and ability to maintain such high interest rates and began to sell their sterling. This ultimately forced the pound out of its ERM fluctuation band on "Black Wednesday" – September 16, 1992.

The embarrassing reversal forced on Major was a watershed in British politics. Already weighed down by Britain's lagging economic prospects and steep interest rates, it seemed as if the Major government – despite being led by a relatively well-regarded former Chancellor – did not know what it was doing with the economy. Figure one demonstrates how the voting public decisively turned on Major: after leading in every poll following his election in early 1992, only one poll after Black Wednesday put the Tories in the lead. The Black Wednesday debacle was, in retrospect, the final nail in the Tory coffin. They had held on to power in 1992 by popularly recalling the economic difficulties of the late-1970s, only to watch their signature economic policy fail.

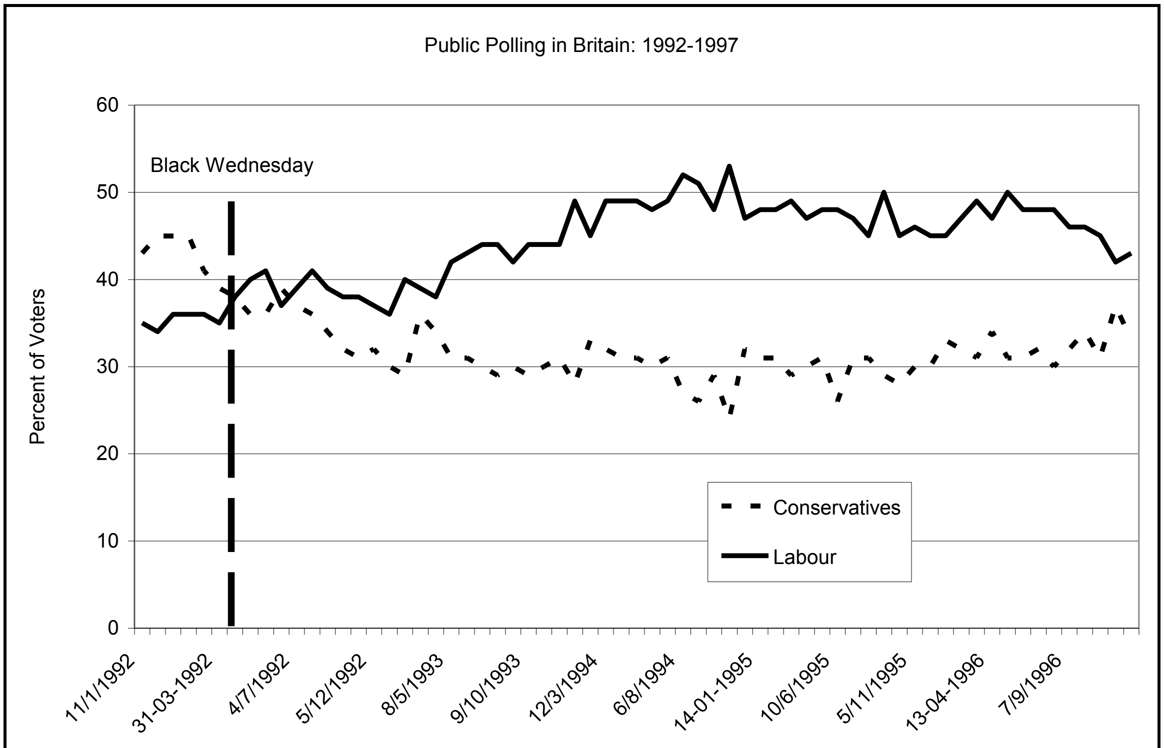

Figure 1 *Source: Guardian/ICM Polls*

After taking the lead in polling in 1992, Labour would hold that advantage for nearly 15 years. Indeed, the campaign in 1997 was largely fought over the perceived failure of Major's economic policies. Labour's slogan in the run-up to elections that year was "things can only get better." The Tories went with the tellingly defensive "yes it hurt, yes it worked."

In the end, the Conservative party misdiagnosed the problem. It saw the 1980s boom as problematic only insofar as it led to increased inflation, then it disintegrated over whether the solution to that problem was monetary integration with Germany. The pro-Europe side won out – only to watch the policy it had fought for explode in its face. At no point did the Tories consider that the problem with the 1980s boom might have been the operation of financial markets themselves. Like Heath and Barber in the 1970s, Major was unable to maintain the interest rates needed to satisfy inflation targets. Unlike Heath and Barber, Major never considered reimposing direct controls on financial activity. The only attempt to directly intervene in the lender-borrower relationship was the advent of the tax-exempt special savings account (TESSA) – now known as the Individual Savings Account (ISA) – a far less ambitious version of France's *Livret* accounts. Despite the fact that credit expansion sat at the heart of the inflationary pressure – and while heavy borrowing was a key driver of the country's need to remain attractive to international capital – the government was singularly focused on only one symptom of the wider problem.

I.2: The Economic Fallout

In the absence of new controls on lending, the only thing restraining financial institutions from a new credit expansion in the late-1990s was wariness – their own and that of their potential borrowers – of repeating the 1980s boom-bust cycle. The competitive adaptations that financial firms had undertaken in response to the changing environments of the 1980s had reached a sort of limit: balance sheet expansion was difficult amidst widespread default and an economic downturn, the easy pickings in the M&A market had been bought, and the market for innovative products that first appeared in the late-1980s had dried up.

As would be expected, the result was less impressive profits for financial firms (see figure 2). While financial firms' nominal operating surpluses grew over 2000 percent during the debt-fueled expansion of the 1980s (and would grow over 424 percent during the next debt expansion in the 2000s), they only rose by 17 percent during the relatively low-debt 1990s. Given that the British economy grew at a nominal rate of 87 percent over the same period, times for financial firms were indeed rough.[44] There were reasons on both the supply and demand side that explain the slowdown.

[44] Office for National Statistics

Figure 2 *Source: UK Office of National Statistics*

On the supply side, lenders simply began to run short of consumers who were qualified to borrow at the rates banks were willing to offer them. Prior to deregulation, many relatively credit-worthy households had been barred from credit markets due to quantitative restrictions. As the 1980s boom progressed, more and more of these borrowers were brought into financial markets. (Kempson and Whyley 1999). However, when the boom ended in expensive defaults, most major financial institutions became shy about returning to such aggressive lending practices. What's more, the ranks of those with questionable credit swelled during the crash – the Royal Bank of Scotland estimated that roughly 25 percent of the adult British population in the early 1990s qualified as subprime, many due to the judgments rendered against them during the downturn (Munro et al. 2005). Ultimately, the potential for lenders to expand their portfolios was much smaller than it had been during the

1980s: growth in the number of mortgages outstanding fell nearly 40 percent in the 1990s.[45] In terms of overall debt, the value of all outstanding loans stood at 140 percent of GDP in both 1990 and 1996, signaling virtually no market expansion.[46]

It was not until 1995 that larger firms began to reenter the market for marginal borrowers. Even then, John Maltby, the CEO of specialty sub-prime lender Kensington Finance, noted that they had the field largely to themselves (Maltby 2003). The subprime market was held back until the late-1990s largely because one of the major channels for fueling money into higher-risk consumer credit – the market for securitized consumer debt – had virtually disappeared during the first half of the 1990s. After playing a peripheral role in the buildup to the crash of 1989, the small British market in MBS instruments became confined to a small group of specialty houses. In 1992, the market had shrunk to the same size that it had been in its infancy in 1987.

This decline was largely due to the scarcity of buyers. Because interest rates on British mortgages were reevaluated far more frequently than on American mortgages, prospective buyers tended to prefer US-based assets (Pryke and Freeman 1994). Net sales of any kind of securitized debt by all banks and building societies – which would amount to over 7 percent of GDP by 2008 – didn't account for more than a quarter of one percent of GDP until the end of the decade. Figure three shows the lull in the market prior to 1998, in which new issuances of securitized debt rarely exceeded their 1988 peak.[47]

[45] Council of Mortgage Lenders
[46] Eurostat
[47] SIFMA

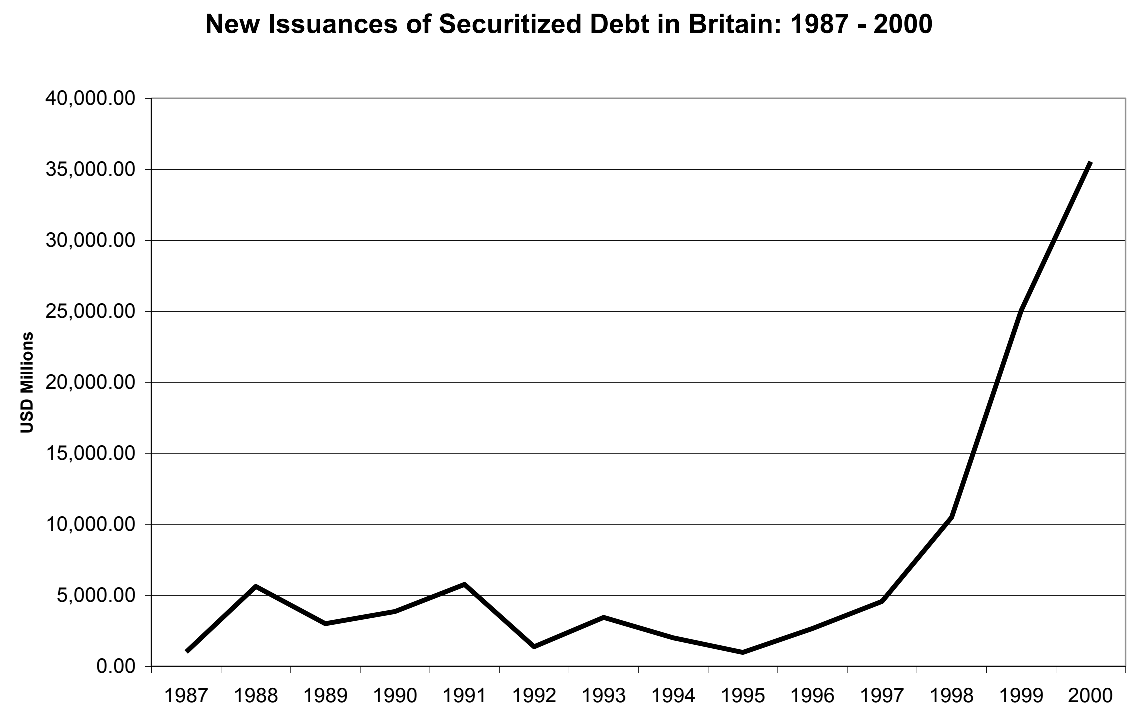

Figure 3 *Source: SIFMA*

The relative calm in credit markets was also due to hesitance on the part of consumers (i.e., the demand side). British borrowers – particularly households – made a major effort to wean themselves off debt during the early 1990s (see figure 4). There was an enormous decline in the appetite for withdrawing equity from homes; indeed, households stopped borrowing against their homes altogether by 1995. These trends are also reflected in the data on British credit card debt, overall household sector debt, and private sector debt: in each of these categories, borrowing either declined or rose in line with GDP growth for much of the 1990s.[48]

[48] Home equity withdrawal data from Bank of England, Credit Card data from the British Bankers' Association; household debt from Eurostat; private sector debt from World Bank.

Figure 4 *Source: AMECO*

II: The Prawn Cocktail Offensive

The Labour of the 1970s had been thoroughly discredited by the events of the 1980s. A succession of stinging defeats and the defection of the party's centrist wing into a new party made it clear that, in order to win, Labour had to change. The process began under Neil Kinnock and continued under his shadow chancellor and brief successor, John Smith. The strategy finally came to fruition under Blair and Brown, who presided over a Labour party transformed. Before Kinnock, Labour had been euro-skeptic, principally concerned with policies of redistribution, and had argued that the state should play a large role in the economy. By 1997, Labour was inclined toward closer European integration, paid little mind to redistribution, and championed the powers of individuals and firms to make decisions for themselves. Nationalizations, Keynesian reflations, and planning all fell out of favor. In their place, Labour adopted much of Thatcher's basic faith in the power of free markets (c.f. Driver and Martell 1998).

In opposition during the early 1990s, Smith had launched a charm offensive to reassure the City's businesspeople that his party had abandoned its hostility to business, profits, and markets. Senior Labour leaders wined and dined business leaders in an attempt to convince them that they could safely support the new Labour party (J. Smith 2012). The effort led to a memorable moment on the Commons' floor: Heseltine, questioning whether Labour's many lunches and dinners in the City actually meant the party had fundamentally become more pro-business, mocked Kinnock: "All those prawn cocktails for nothing," he lamented. "Never have so many crustaceans died in vain" (House of Commons 1992). Heseltine's laugh-line foreshadowed the successful line of attack that the Tories would deploy against Labour later in 1992: the Conservative campaign deftly tied Labour to the bad-old-days of stagflation and financial repression and used that line of attack to overturn their deficit in the polls.

The 1992 defeat signaled that Labour was still not sufficiently trusted with the economy – a sign the party's reformers took to mean that they had to try harder with the City. After the election and Smith's premature death of a heart attack after only two years as Labour leader, the mantle of reform was seized by Brown and Blair. "Labour is not against wealth, nor will we seek to penalise it," Brown announced in 1993 (Anderson 1993). Blair repeatedly referred to Labour as "the party of business" (Kampfner 2008; BBC News 2011) and sought to recast the party as one that celebrated the power of the individual rather than the state (Driver and Martell 1998). Labour's aim was, in part, explicitly political. Blair in particular had come to believe that the party could not win when saddled with the albatross of being hostile to business.

For a time the recipe was remarkably successful. Labour would hold a polling edge over the Conservatives for nearly 15 consecutive years – and Blair managed over a decade at 10 Downing Street before departing to make way for Brown. But the Labour that returned to government in 1997 after nearly 20 years was unquestionably a product of the Thatcher era. Despite the ignominious end to the Thatcher boom, New Labour never demonstrated an interest in rolling back the Conservatives' financial reforms. Indeed, after Labour's majority finally eroded with the election of the Tory-Liberal Democrat coalition in 2010, Blair re-emerged to point to a drift away from the New Labour recipe as the cause. He argued that new-leader Ed Milliband's demonization of bankers and "predatory" capitalists was bad politics, saying that the party could not afford to go into the 2015 elections without the support of business (Ross 2012).

II.1: The Ideological Transformation of Gordon Brown

Whether Brown and Blair's New Labour represented a break with Thatcher, a humanization of Thatcherism, or an utter betrayal of the Labour movement largely depends on the observer. Brown loyalist Robert Peston (2005) saw Brown's politics as fundamentally different from Thatcher's but argued that Blair had merely softened Thatcherism's rougher edges – an idea that Blair (2011) himself rejects. Leftist socialists tend to see both men as betraying the cause of the left, defecting to the Thatcherite camp of neoliberals (Newsinger 2007).

Dispute aside, their can be no doubt that Brown – in particular – underwent a significant ideological conversion. The Brown who wrote the 1989 *Where There's Greed: Margaret Thatcher and the Betrayal of Britain's Future* was a dyed-in-the-wool leftist concerned with the massive increase in inequality during Thatcher's tenure. By the time he arrived in office, he had become a different man. Two decades after decrying the greed of the executives of newly-privatized companies who awarded themselves lucrative pay packages in the 1980s, he would say in a speech that regulation must be based on:

> '[T]rust in the responsible company, the educated consumer and the informed employee... the goal should be a fraction of forms, a fraction of information requirements and a fraction of inspections needed.' (Brown 2005)

In the process of forging New Labour, Brown apparently came to believe that the government that regulates best regulates least.

Nowhere was this shift in mentality clearer than on the issue of financial markets – and financial innovation in particular. Brown came to think that financial innovation really had solved the problems of financial instability. Legal and psychological scholars have noted that Brown and Greenspan stood at the "vanguard" of articulating the conclusion that innovative risk dispersion, combined with light-tough regulation, had banished financial booms for good (Flood 2009; Bénabou 2009). In Greenspan's language:

> '[C]omplex financial instruments have contributed to the development of a far more flexible, efficient, and hence resilient financial system than the one that existed just a quarter-century ago. After the bursting of the stock market bubble in 2000, unlike previous periods following large financial shocks, no major financial institution defaulted, and the economy held up far better than many had anticipated (Greenspan 2005).

Brown was avowedly in support of this view and of Greenspan personally. He invited Greenspan to give the 2005 Adam Smith Memorial Lecture in Smith's hometown – and Brown's constituency – of Kirkcaldy, Scotland. Brown repeatedly stated that the City of

London under Labour's stewardship had abolished boom and bust and helped usher in a "new Golden Age" brought about by the "unique innovative skills… courage, and steadfastness" of the City's financial services workers (Brown 2007). Addressing the City, he exhorted them to press further, announcing "I want us to do even more to encourage the risk-takers" (Brown 2004).

While Blair's conversion might have been prompted by political realities (Newsinger 2007), Brown's appeared to go deeper. By all appearances, Brown changed his mind about fundamental economic issues, increasingly seeing liberalized financial markets as a solution to economic problems. The same man who had resented growing inequality during the 1980s pushed for an inequality-stoking decrease in Britain's capital gains tax on the grounds that it would improve capital allocation (Blair 2011). The same man who decried capitalist greed at the end of the 1980s articulated a vision of regulation that trusted businesses to check their own ambitions. Confusingly, the same man who watched and criticized the Tory boom-bust cycle became convinced that he could pursue similar policies without suffering the same fate.

II.2: The Rise of the Shareholder

Brown's transformation was helped along by structural changes in British financial markets. Labour's rise – and its embrace of financial markets – coincided with a significant democratization of capital markets. While New Labour's view of corporate governance tended to favor the German stakeholder model (where business decisions are governed by all who hold a stake: management, owners, workers, and the community), they also preferred to emphasize the power of individuals rather than collectives. Britain's highly sophisticated capital markets enabled an odd form of stakeholder capitalism. That is, it ostensibly made the public at large stakeholders through shareholding: if everyone has a financial stake in a firm by owning equity, then all the firm's stakeholders will be represented through financial markets. This made liberalizing financial market moves (such as the cutting of capital gains taxes) more palatable for socially minded Labour politicians.

Between 1990 and 1999, the value of households' equity holdings more than doubled relative to the size of the economy as a whole – from 37 to 78 percent of GDP.[49] There is a tendency to exaggerate this trend to a certain extent – particularly in the United States where Bill Clinton – in part, the inspiration for New Labour's centrist strategy – explicitly spoke about the phenomenon as a democratization of financial markets (Gross 2000). Indeed, the vast majority of shareholder wealth remains concentrated among British society's most wealthy. Nevertheless, the importance of financial markets to the returns on pensions – which form the second-largest part of Briton's wealth (after property) has meant an increased public stake in the performance of the country's equity markets.[50] During the 1990s, “maximizing shareholder value” becoming a mantra of sorts for the business and investing community. The phrase “shareholder value” appeared in the Financial Times an average of once a week in 1989; by 1996 it appeared more than once per daily issue.[51]

Shareholders did exert this power to an extent during the 1990s. Anger was particularly directed against the sorts of stock-based executive compensation schemes that had become in vogue during the 1980s (Conyon and Murphy 2000). Furthermore, there was significant public outcry over a series of high-profile corporate scandals. The early 1990s saw the collapse of Coloroll, the Polly Peck Consortium, the Bank of Credit and Commerce

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[49] Eurostat
[50] Office for National Statistics
[51] Based on Lexis Nexus searches

International (BCCI) and the publishing empire of Robert Maxwell amidst accusations that they had hidden aspects of their business in order to appear financially sound.

The response to these incidents was a private sector committee under the chairmanship of Adrian Cadbury. The Cadbury committee and its successor, the 1995 Greenbury committee, formed the backbone of what would become Britain’s code of corporate governance. While generally calling for a more transparent implementation of the existing status quo, the committees did express concern over corporate mismanagement and compensation schemes that created perverse incentives to boost short-term stock prices (Committee on the Financial Aspects of Corporate Governance 1992; Study Group on Directors’ Remuneration 1995). The material impact of the reports was limited; nevertheless, the prevalence of stock-based compensation among top-level directors did fall markedly after the Cadbury report was published, dropping from nearly 100 percent of firms to roughly 70 percent by 1997 (Conyon and Murphy 2000).

III: A Risky "Risk-Based Approach"

New Labour's rise to power came together with an ideological and political shift toward the Thatcherite status quo – buttressed, in part, by the seeming erosion of capital markets as a refuge of the privileged. Labour continued to support and promote the benefits of deep, liquid, and attractive financial markets featuring competition between increasingly consolidated and diversified financial supermarkets. Indeed, it is fair to say that between 1979 and 2008, every legislative initiative pertaining to finance, whether initiated by Conservative or Labour governments, was predicated on the belief that the market-directed growth of financial markets was good for the country.

There remains some dispute over precisely who was in the driving seat when it came to New Labour's economic policies. The purported "Granita Agreement" between Blair and Brown supposedly entailed Brown ceding Labour's leadership to Blair in 1994. In exchange, Blair promised Brown a large degree of control over economic policy (Naughtie 2002). Whether this meeting did, in fact, take place, there was a widespread belief throughout Blair's tenure that Brown was effectively in charge of economic decision-making – a belief acknowledged but rejected by Blair in his memoirs. Nevertheless, the public face on Labour's approach to financial markets was most certainly Gordon Brown's.

Brown's institutional reforms continued down the path established by previous Conservative governments – toward freer financial market competition. The Building Societies Act of 1997 built on the 1986 Act of the same name, removing many of the remaining restrictions on societies. Additionally, it gave government discretionary power to further weaken the few lingering rules – in particular, to further reduce the proportion of societies' assets that were required to be comprised of mortgages (Building Societies Commission 1999). The Bank of England Act of 1998 eliminated one of the last vestiges of direct government control over the economy by leaving monetary policy to a committee of nine technocrats and limiting political participants to a non-voting role. This, for the first time, formally freed the Bank of England from political considerations (Bank of England Act 1998).

The most significant piece of Labour legislative policy toward financial markets was the passage of the Financial Services and Markets Act of 2000, which established the Financial Services Authority (FSA). The FSA was created to address the increasingly outdated nature of the 1986 Financial Services Act. Legislators in 1986 had been reforming the British financial system of another era – one in which equities markets, wholesale banking, consumer lending, and other financial services were handled by different specialized firms. The supervision provided by the 1986 Act was based on this understanding of finance, creating numerous self-regulating organizations each dealing with their own aspect of the financial universe. Since 1986, however, firms had expanded their activities into multiple realms of finance. The barriers between mortgage lenders, retail banks, wholesale banks, and investment banks had blurred or disappeared after a decade of open competition. By the time the 2000 Act came into effect, eight firms performed all five of the major regulated financial activities (deposit-taking, insurance, securities and corporate finance, fund management, and investment banking). A further 13 firms took part in four of the activities, with more than 50 in three (M. Taylor 1997).

Reacting to this new competitive and diversified reality by unifying the regulatory hodgepodge under a single roof was the primary rationale – indeed, the *only* officially stated rationale – for the creation of the FSA (M. Taylor 1997; Briault 1999). From the outside, however, there was a second widely perceived failing of the 1986 Act: its reliance on self-regulation (K. Watson 2004). While the 2000 Act endowed the FSA with more direct power than was allotted the SIB, it did not eschew the principle of self-regulation. Indeed, the government took great pains to assert that the FSA was born of a need for efficiency, not a desire to re-regulate. The FSA's seven founding regulatory principles are largely a repackaged version of the ethos that had dominated since 1979 (Financial Services Authority 2012):

- The need to use resources in the most efficient and economic way.

- The responsibilities of management include ensuring that its business complies with regulatory requirements.
- The burdens or restrictions imposed on the industry should be proportionate to the benefits that are expected to result from those burdens or restrictions.
- The desirability of facilitating innovation in connection with regulated activities.
- The international character of financial services and markets and the desirability of maintaining the competitive position of the UK.
- The need to minimize the adverse effects on competition that may arise from regulatory activities.
- The desirability of enhancing the understanding and knowledge of members of the public of financial matters (including the UK financial system).

The fourth of these principles is perhaps the most important. The new FSA went to great lengths to avoid trampling on financial innovation. It was built upon the idea of "principles-based" regulations in which no specific behavior was proscribed – instead, these rather vague guiding principles were offered. In this way, the FSA hoped that the spirit of regulation could persist despite constant and hoped-for innovation:

> Financial markets are constantly changing. Continuous innovation and new product development are important ways in which the financial services industry generates benefits for consumers and markets. It is important that regulation can respond rapidly to the pace of change in markets and so allow them to continue to develop for the benefit of their users. *We believe regulation that focuses on outcomes rather than prescription is more likely to support this development and innovation*. Any set of prescriptive rules is unable to address changing market circumstances and practices at all times, and it inevitably delays, and in some instances prevents, innovation. In a quickly changing marketplace, principles are far more durable (Financial Services Authority 2007, emphasis added).

Brown described this approach to financial liberalization as a "modern risk-based approach" – one in which financial regulators largely let financial institutions act without the need for "outdated" 100 percent supervision (Brown 2005).

In short, it is clear that there was no effort by Labour to turn back the clock. The new government was not hoping for the reined-in financial sector of the 1970s but for the same benefits of competitive financial liberation that the Conservatives of the 1980s had sought. As Ed Balls – later to be Shadow Chancellor – announced to the British Bankers' Association in 2006:

> We do not view bank profits as undesirable. Profits are essential for any industry to survive let alone invest, grow and innovate. And in banking, profits, which are generally strongest at an advanced stage of the cycle, are an essential part of keeping the sector sound and stable over the whole of the cycle. Some have suggested that given their central role in the economy, it would be appropriate to treat banks just like utilities – to subject them to price-setting and onerous rules on how they interact with their customers. The alternative approach – and the one I favor – is to rely on market forces and competition policy to promote efficiency through open and competitive markets (Balls 2006).

New Labour's regulatory policies did make some minor shifts in emphasis away from the old Conservative regime. In particular, they put more effort into protecting individual borrowers, especially by improving the quality of information offered by lenders. This culminated, in 2006, with a major update to the existing Consumer Credit Act of 1974 (Consumer Credit Act 2006). The corporate governance suggestions provided by the Cadbury committee and subsequent committees on governance and executive compensation were also incorporated into a single Combined Code on corporate governance – though it continued to rely on the "comply or explain" mode of governance (Committee on Corporate Governance 1998). Nevertheless, these shifts in emphasis were meant to encourage participation in financial markets – by borrower and by investors – not restrain it.

IV: The Great Financial Boom

Nigel Lawson believed that the period of excess during the 1980s was one-time event – something that happened to financial systems as they adjusted to their new operating environment. Brown believed much the same thing, repeatedly asserting that the powers of financial innovation – the powers initially unleashed by Lawson's deregulations of the 1980s and encouraged by Brown's own stewardship of the economy – had relegated booms and busts to history. Yet, as stated in the first section of this chapter, nothing fundamental about financial regulation in Britain had changed after the 1980s bubble burst. There was no Heath-ian reimposition of financial controls. Nor was there much of an effort to directly control households' net borrowing as there was in France. The market lull in the 1990s was produced by market forces alone: as soon as financial institutions could find a way to adapt to their new circumstances – and wider economic conditions improved – there was nothing to prevent the reemergence of the 1980s credit boom.

The pro-finance, pro-innovation bent of the New Labour government was thus well-suited to a financial sector that had begun to recover its confidence. Financial institutions, still under pressure to boost profitability amidst a more competitive environment, increasingly turned to innovation as a way of breaking through the barriers to expanding their balance sheets. New products – particularly securitized lending – began to make finance more available to a wider range of borrowers. At the same time, falling interest rates and the slow economic recovery seemed to indicate that households had weathered the worst of the downturn.

IV.1: The Innovation Revolution

Arguably the most important competitive evolution of financial markets after the mid-1990s was the embrace of innovative financial instruments. Capturing the mood of the day concisely, Chairman of the Federal Reserve Alan Greenspan came to London in 2002 and likened financial innovation to the industrial revolution, outlining the causes and consequences of financial innovation:

> All participants in competitive markets seek innovations that yield above-normal returns. In generally efficient markets, few find such profits. But those that do exploit such discoveries earn an abnormal return for doing so. In the process, they improve market efficiency by providing services not previously available…Most financial innovations in over-the-counter derivatives involve new ways to disperse risk (Greenspan 2002).

This statement merely reflected the growing belief that risk could be profoundly reduced through the development of new financial products (c.f. Shiller 2003). Additionally, there was a compatible realization among financiers that such innovation could be enormously profitable (Das 2010; Das 2012).

The perception that new financial products could limit risk – and the reality that new financial products could generate a lot of money – gave financial firms the tools they needed to restart the economy's credit engine. Four late-1990s developments were key: first, the spread of securitization beyond the residential mortgage market; second, the popularization of structured financial products like collateralized debt obligations (CDOs) starting in 1997; third, the increased size of so-called "shadow banking;" and fourth, the standardization of the market for credit default swaps (CDSs) in 1999. As chapter one noted, each of these developments helped to boost leverage, facilitate expanding balance sheets, and ultimately generate revenue for the financial sector. Moreover, each of these innovations helped fuel consumer borrowing in particular.

The early market in asset-backed securities (ABS) was highly concentrated in high-quality residential mortgages: 96 percent of all issuances during the early phase of British securitization (1987-1995) were based on lending secured by real estate – 89 percent of which were prime first or second mortgages on residential homes (P. Taylor 1996). The widespread expansion of the market beyond residential property really started in 1996 and 1998, when the first European issuances of more than $1 billion in auto loans, store credit, credit cards, and CDOs took place.[52] Significantly, the first British issuance of securitized sub-prime debt came in the first quarter of 1996, with the sale of "B&C"-rated debt by City Mortgage Receivables (P. Taylor 1996). Residential mortgages continued to a plurality of all debt securitized but other securitized instruments became gradually more important.

Figure five reflects the exponential rate at which the market for securitized debt changed from being niche to mainstream after 1998. Mainstream banks, particularly Northern Rock, Abbey National, and Halifax, became the largest issuers of securitized debt based on prime lending (Karley and Whitehead 2002; R. Watson and Carter 2006). While subprime operations remained relatively small, the apparent risk reductions that come with securitization made subprime mortgage lenders into the fastest-growing part of the mortgage market by the early 2000s. Firms like IGroup and the pseudo-independent financing wing of General Motors, the General Motors Acceptance Corporation (GMAC) joined Kensington in the market in the latter half of the 1990s (Munro et al. 2005). Unsecured securitized lending – such as on credit card debt – was a smaller and more volatile share of the market for securitized debt, but annual issuances roughly doubled in size after 1998.[53]

[52] SIFMA
[53] BoE

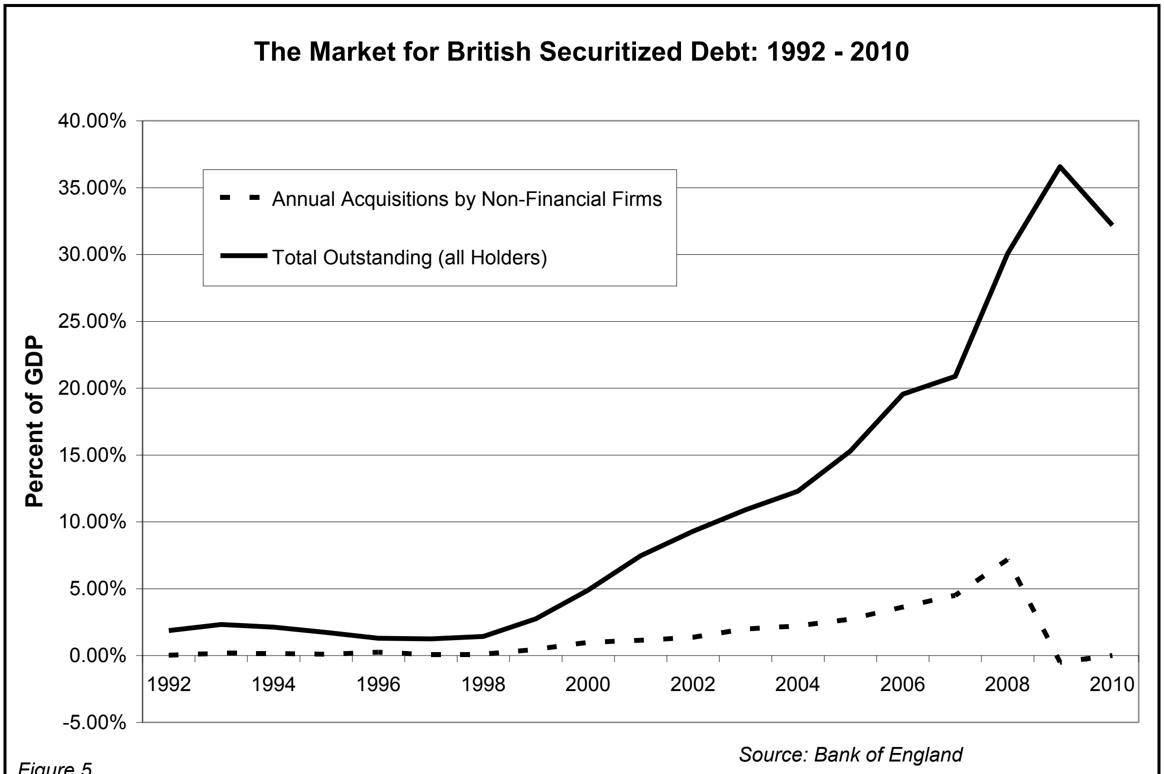

Figure 5

The market was further aided by the popularization of CDOs and CDSs. CDOs are of particular importance because of their appeal as marketable securities. Of all asset backed securities sold in created in Europe, CDOs are the most likely to be sold on rather than kept on the issuing institution's own balance sheets – 80 percent of all outstanding CDO debt was "placed" with an outside buyer as of 2012. By comparison, only 35 percent of residential mortgage-backed securities were placed – although the total outstanding amount placed ($500 billion, as opposed to $186 billion), was much larger for residential mortgages.[54] In all, figure five demonstrates that the financial sector's *net* sales of securitized debt – i.e., securitized debt sold to non-financial institutions – followed the same expansion path as the overall market, but at lower levels. The growth pattern in the global market for CDS – approximately 40 percent of which was located in London – is similar, with the notional

[54] SIFMA

value of outstanding swaps increasing nearly over 11,000 percent between 1996 and 2006 (Barrett and Ewan 2006).

IV.3: Demand-Side Rocket Fuel

While innovation might have helped overcome the supply side obstacles to credit expansion, innovations alone could not solve the demand side of the problem. In order to generate such enormous expansion in the market for securitized assets, new borrowers were needed. Households' demand for additional credit had plummeted in the 1990s (at least relative to the 1980s); what could change that? Part of the answer is directly tied to financial innovation: subprime lending and credit card securitization brought previously un-creditworthy borrowers into the market. After stagnating at 1.5 percent of GDP, outstanding British credit card debt began to rise by an average of £4.4 billion annually following the first issuances of securitized debt underpinned by credit card borrowing. This was not simply increased borrowing by those with credit cards: between the end of 1994 and the start of 2001, the number of British credit cards in circulation doubled from 25 to 50 million.[55]

A second ingredient in rising demand for consumer credit was simply that the recession ended and households were willing to take on market exposure once again. The unemployment rate peaked in early 1993 and dropped precipitously thereafter, triggering an almost immediate increase in household borrowing activity. Household savings peaked in 1993 before beginning a speedy decline in 1997-98 as the new markets for consumer debt came online. Once again, expanding credit possibilities and a return of rising household wealth caused savings to plummet: gross household savings fell from over 10 percent to less than 4 percent, once again turning households into net debtors by 1999. Aside from a very

[55] British Bankers' Association (BBA)

slightly positive net savings rate in 2001, British households would continue to borrow more than they saved until 2009 – bottoming out just before the global financial crisis began.[56]

A third reason behind households' renewed willingness to serve as Britain's principal borrowers was the decline in interest rates. After paying extremely high rates in the early 1990s, the average rate on the typical British variable rate mortgage began to decline – first briefly in 1995-96 and then more permanently between 1998 and 2003. Rates in excess of 8 percent, the norm for most Britons' memories, disappeared for good in 1998. Between 1995 and 2003, for instance, the rate fell from 8.35 percent to 5.3 percent. [57]

With households' willingness to borrow restored and tools for encouraging new lending available, the credit-fueled boom was on again. In less than ten years, home equity withdrawals returned to their late-1980s heights; credit card debt tripled relative to income, real home prices leapt 160 percent, and real consumption rose 40 percent.[58] Behind it all was a mind-boggling increase in indebtedness and associated leverage: between 1995 and 2008, Britain went from having society-wide liabilities worth over 800 percent of national income to between 1300 percent and 2000 percent of GDP (depending on the accounting for derivatives).

* * *

As much as Brown promised that the era of "Tory" booms and busts had come to an end, the state of Britain's financial system in the mid-2000s looked like a more extreme version of 1987-88. Credit was being reallocated to households on an enormous scale, prompting

[56] AMECO
[57] BoE
[58] Nationwide, AMECO

heavily credit-fueled and consumption-based growth. The result, as before, was large external deficits, widening inequality, skyrocketing debt levels, collapsing consumer savings, and the a vulnerability to macroeconomic shocks. Chapter eight will return to a discussion of these unintended – though no longer unforeseeable –consequences. First, however, it is necessary to return to France, which responded to the lessons of the late-1980s and early 1990s very differently.

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Seven – France's *Puissances d'Argent*: A Certain Idea of Finance

'Mon véritable adversaire n'a pas de nom, pas de visage, pas de parti, il ne présentera jamais sa candidature, et pourtant il gouvern..., c'est le monde de la finance.'
–François Hollande, January 22, 2011

The British financial lull of the mid-1990s was an interregnum – one caused by temporary hesitation on the part of both lenders and borrowers. That hesitance was overcome by the recovery of the economy at large and the advent of innovative new financial practices. In France, the story was quite different. While the country continued to aggressively reform its financial sector, it also tended toward the *re*regulation of consumer finance. Re-privatization of the banking system and continued liberalization continued to push the French financial sector to innovate and expand – indeed, French banks were some of the most active traders in derivatives and securitized assets at various points during the 1990s and 2000s. Nevertheless, the French never gained the British comfort with letting unfettered market forces penetrate the whole of their society.

While the conservative governments under the presidencies of Jacques Chirac and Nicolas Sarkozy were more market-minded than Mitterrand's, both countenanced far more intrusive financial market activities than would be tolerated in Anglo-American economies – even under Britain's ostensible party of the left. And François Hollande, the first Socialist to wield power since Mitterrand, made no secret of his antagonism toward financial markets. The quote at the outset of this chapter, uttered during Hollande's successful presidential campaign, means "my true enemy has no name, no face, no political party, it will never run for office, and yet it governs. It is the world of finance." In France, such hostility is crucially important: the French government was never enamored with pro-market ideologies or liberalization for its own sake. The French liberalized financial markets insofar as that satisfied other policy goals (like successful participation in European monetary integration) – yet maintained their suspicion of the *puissances d'argent*.

Consequently, the interactions between the French financial sector and the rest of the French economy remained under closer scrutiny than elsewhere. Particularly after the 1980s boom and bust in consumer finance, the state placed restrictions on households' financial activities. Moreover, the popular *livret* has consistently been expanded since the 1980s. The maintenance of barriers to borrowing – together with the encouragement of savings – helped French households return to their pre-1980s net lending activity.

The state's approach to the non-financial sector has also limited the influence of financial markets over non-financial firms. French governments continue to demonstrate a penchant for industrial policy, providing subsidized loans to favored or troubled French industries. Moreover, as the state privatized much of its large portfolio of nationalized enterprises, it left in place a large network of cross-shareholdings between systemically important firms. These networks were meant to immobilize large amounts of equity in the hands of strategic alliances, preventing activist shareholders – particularly foreign ones – from exerting too much influence over management. In situations where foreign influence grew despite their efforts, governments of both the right and left have demonstrated their willingness to intervene in less market-friendly ways.

In sum, the French made a very different choice from Britain when it came to financial markets: they did want bigger, better, more innovative financial markets and the benefits that came with them. And they wanted firms to have better access to capital markets in which their banking sector did not control the only sources of external funds. At the same time, they remained more willing to use heavy-handed government interference in an effort to tamp down the social costs associated with financial liberalization. They saw shareholder control as dangerous, so they built large cross-shareholding blocks. They saw financial markets as driving too much capital toward consumer credit, so they imposed restrictions on borrowing and incentivized saving. French financial markets of today are more complete than they were in the 1970s – and in many ways are as freewheeling as Anglo-American systems. Yet the connections between the French financial sector and the wider French economy are far less dense than in Britain. In short, the French tried to liberalize their financial sector without allowing that liberalization to impact the rest of French society.

I: Continuity

Much like in Britain – where Thatcher's governments established the pattern of relations with financial markets that would ultimately carried on by New Labour – successive French governments tended to continue Mitterrand's policies of ambivalent acceptance toward financial market liberalization. There are several major reasons for this continuity. First, France did not experience such a dramatic downturn in the early 1990s: it suffered a brief contraction and had large problems with defaults, but nothing like what happened in Britain. This generated relatively little pressure for change, as reflected by the fact that Mitterrand held on to power while Thatcher lost it. Second, both the left and right were largely of the same mind when it came to financial markets: they were interested in liberalizing the financial system only insofar as was necessary to ensure French competitiveness in the increasingly integrated European economic space. The sense of national possession is important here: the state actively worked to ensure that liberalization did not mean foreign takeovers.

Such continuity was maintained despite – or perhaps because of – the relative balance between the major parties in France. Power alternation occurred relatively frequently in France during the 1990s and early 2000s. Mitterrand himself remained in government until 1995, presiding over a socialist National Assembly from 1988-93 before returning to *cohabitation* with Chirac's former finance minister, Edouard Balladur, between 1993 and Chirac's election as President. Chirac then followed much the same pattern, holding office with a government of the right from 1995-97 but working with a *cohabitation* government led by Lionel Jospin from 1997-2002. After Jospin's embarrassing third-place finish in the first round of 2002's presidential elections, the PS did suffer through a decade out of power. Even then, however, successive right-wing governments continued programs of cautious liberalization coupled with a fairly active role for the state.

Chirac, in particular, struggled with many of the same questions Mitterrand had. He too had to grapple with whether France might be better served by breaking out of the then-nascent European Economic and Monetary Union (EMU). And, like Mitterrand, he ultimately decided against it – largely due to heavy pressure from his UDF coalition partners, including the still-active and still pro-integration Valéry Giscard D'Estaing (Parsons 2003). There is no question that the single biggest economic undertaking of the first Chirac presidency was the formation of and accession to the eurozone – and Chirac's ambivalence toward the change closely echoed Mitterrand's own.

Yet where the major policy choice in 1983 implied a need for financial reform, much of the work needed to ensure that French financial markets could cope in an integrated international financial system was finished by 1995. France's capital markets were already internationally competitive: inward FDI consistently ranked among the highest in the world and it had one of the highest rates of foreign equity ownership in Europe – facts Chirac was quite proud of (Chirac 2006). The only major liberalizing step left was to complete the privatization of the banking sector, a process that continued under governments formed by both the left and right.

While there was pressure to ensure that France's financial system could remain internationally competitive and out of direct state control, there was relatively little impetus for allowing the liberalization of household or – to a lesser extent – industrial finance. Again, this was an area of agreement between left and right: in the run-up to the 2012 election, Hollande's party called for the abolition of credit cards – a seemingly radical step (Morley 2010). But Hollande's opponent, Sarkozy, had tabled the *Loi Lagarde* in 2010*,* which went nearly as far as the socialists' plan: it banned store loyalty cards that worked like credit cards, mandating that stores offer simple layaway-style installment plans as an alternative (French Finance Ministry 2011).

Likewise, governments of both the left and right have been chastised by outsiders for their protectionist instincts. Sarkozy got into trouble for bailing out the French car industry, Hollande for trying to force ArcelorMittal to keep loss-making steel foundries open, and Chirac was constantly under fire for trying to orchestrate takeovers that would keep major corporations in French hands, including the (successful) Gaz de France-Suez merger and the (overruled) Lagardère acquisition of Vivendi's publishing arm. There can be no question that the French government continues to see a role for itself in mediating between French firms and capital markets.

In short, the French political relationship with finance has largely been stable since 1988 despite the alternation of power. That relationship has an "on the one hand" – "on the other hand" dynamic to it. On one hand, it has been characterized by steady liberalization of financial markets – including a process of privatization – which has pushed the French financial sector to adapt in ways consistent with what happened in Britain. On the other, the state has maintained a key role in mediating the financial relationships of firms and particularly households, marking a clear departure from the British approach.

II: On One Hand: Continued Deregulation & Competitive Change

In terms of formal rules and regulations, the deregulation of the French financial sector was largely complete by the end of the 1980s. What remained, however, was for the French state to divest itself of its still-enormous stake in the financial sector. The rules of the game had been made clear by the banking reform of 1984, the creation of new capital markets in 1986-87, and the dismantling of capital controls at the end of the decade. Financial firms were permitted to diversify into virtually any financial activity – and reach into any country – in an attempt to earn a profit in their competitive environment. Contributing to this dynamic, re-privatizations added to the rolls of free-market competitors throughout the 1990s.

II.1: Reducing the State's Footprint

The re-privatization of financial firms in France had actually begun as part of the original deregulation program in the 1980s. Among the Chirac's *cohabitation* government's largest privatizations had been Société Générale (SocGen) and Banque de Paris et des Pays-Bas (Paribas) in 1987. Mitterrand's reelection in 1988 and the PS victory in the ensuing parliamentary elections slowed – but did not stop – this initial momentum: during their five-year mandate, the PS government approved the sale of just over half of Crédit Locale de France, which later became known as the French stake in the Dexia group. The elections of 1993, held amidst a sharp economic downturn, saw the PS suffer an enormously lopsided loss. The return of a conservative coalition with a Balladur-led government brought about an intensification of privatizations, with Banque Nationale de Paris (BNP) privatized in late-1993. The privatization program continued during Chirac's presidency, with Crédit Industriel et Commercial (CIC), Société Marseillais de Crédit, Crédit Lyonnais, and Crédit Agricole all privatized in the late 1990s and early 2000s.

While the state certainly shrank its footprint in the French financial sector, it did not disappear entirely. The French Post Office, which provides retail financial services, has remained under state control. So too has the Caisse des Dépôts, which continues to manage over €200 billion in *livret* savings deposits.[59] The closely interconnected of the French elite – including the boardroom presence of Ecole Nationale d'Administration (ENA) graduates as well as veterans of the Ministry of Finance – further ensures that the state continues to play a role in the management of French financial resources (Lecaussin 2011; Jabko and Massoc 2012; Clift 2012).

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[59] *Caisse des Dépôts*

II.2: Competitive Forces

The competitive forces unleashed by deregulation in the 1980s and reinforced by privatization in the 1980s and 1990s meant the extension of two key trends for French banks: first, banks' stranglehold on the allocation of financial resources continued to weaken as the country's new capital markets matured. The trend for bank credit to shrink relative to other sources of disintermediated fundraising intensified as the 1990s and 2000s progressed. Second, competition further compressed the returns on traditional banking, pushing French financial institutions to seek profits in other ways.

The simplest reflection of the heightened competition in French financial space is the growth of non-credit financial markets. Figure one shows the real value of annual transactions for a variety of asset types in France: while the growth of securities and derivatives markets in the 1980s was significant, the expansion of securities and equities trading in the 1990s and particularly the 2000s was far larger. As this data makes clear, France had developed increasingly active and innovative capital markets throughout the mid-1980s, with those markets became a more defining feature of the French financial landscape over time.

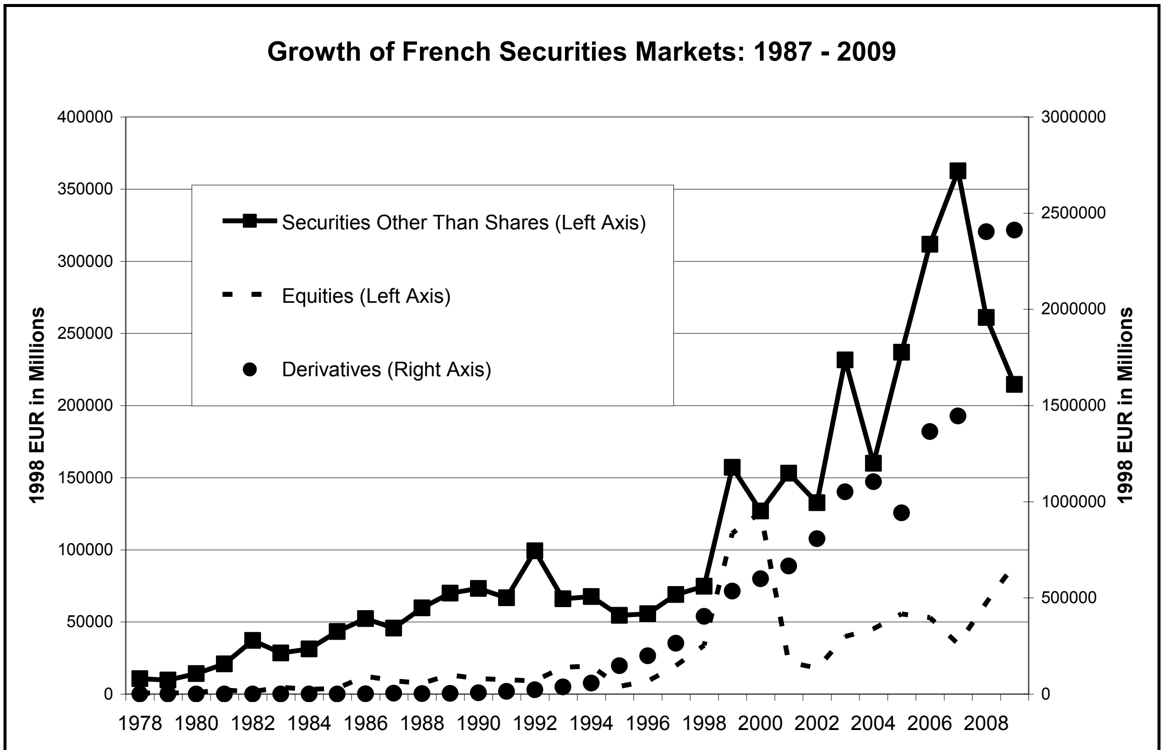

Figure 1 *Source: Banque de France*

The growth of capital markets directly translated into a decline in the intermediation rate in the French financial system. The sharpest fall in such traditional borrow-and-lend banking came in the 1990s and 2000s: the *Banque de France*'s strict measure of intermediation declined from over 60 percent at the close of the 1980s to just over 40 percent by the mid-2000s. Loans, while continuing to make up a large portion of banks' balance sheets, continued to shrink relative to holdings of various types of securities.[60] Much of this change can be attributed to the shrinking profit margins on traditional bank intermediation. Data from the *Banque de France*'s regulatory wing, the *Commission Bancaire*, reveals that the margin on bank lending declined markedly in the 1990s and 2000s. The profit margin on overall banking activities was more than halved between the early 1990s and 2008, despite the shrinking cost of raising funds. In other words, the competition for lending outlets drove

[60] OECD Bank Profitability Database

down returns faster than competitive adaptations could drive down banks' borrowing costs (Commission Bancaire 2003; Commission Bancaire 2008).

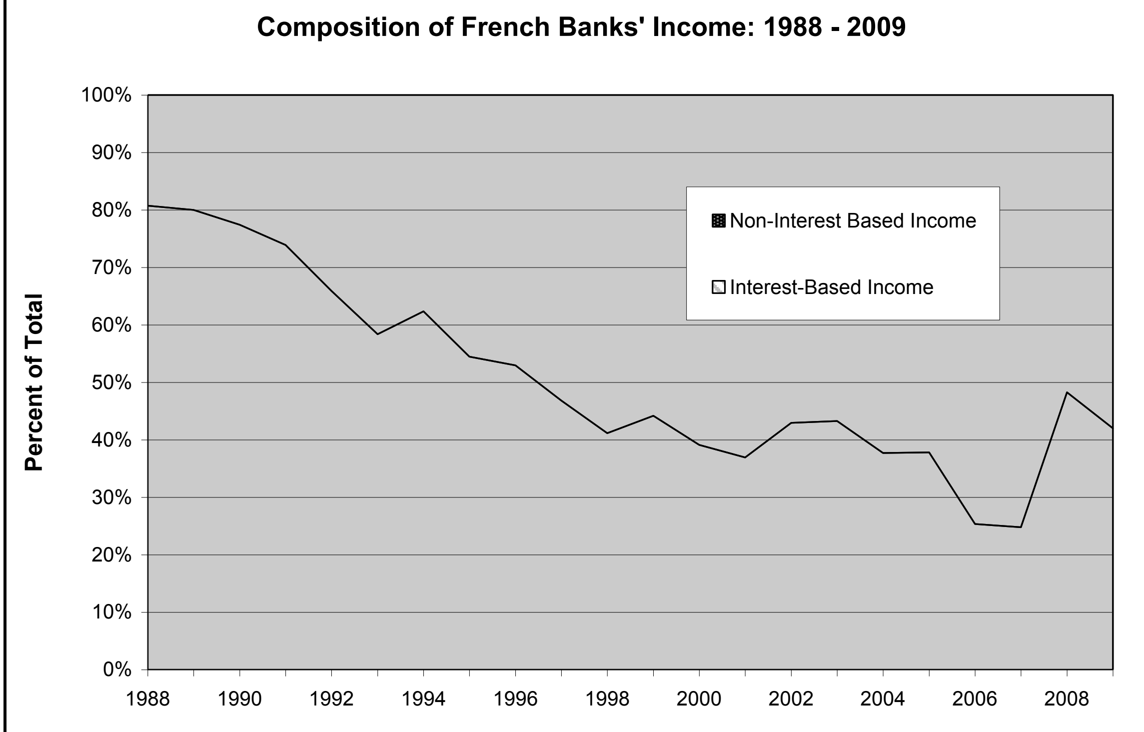

Figure 2

This meant a fundamental strain on banks' traditional sources of income. In retrospect, the French banking system at the end of the 1980s still looked relatively traditional: figure two shows that, as late as 1988, banks earned over 80 percent of their net income from interest payments. That figure fell throughout the subsequent twenty years, bottoming out at 25 percent in 2006 and 2007, just before the financial crisis struck. By that time, the vast majority of banks' income was generated by commissions, trading gains, and other off-balance sheet operations.[61]

[61] OECD

II.3: More Financial Adaptation

The consolidation drive among major French banks that began in the 1980s accelerated in the 1990s and early 2000s. The scale of the decline in the number of financial institutions is striking: the number of French banks declined from a peak of over 2000 in the late 1980s to under 350 by 2007.[62] During that time, virtually all small family-owned banks disappeared and the vast majority of specialty houses became absorbed by large banking groups (Commission Bancaire 2003). The biggest of these was arguably BNP's 1998 acquisition of Cetelem – the largest specialist provider of consumer financing in Continental Europe. Crédit Agricole, for its part, acquired the Cetelem competitor Banque Sofinco in 1999 to expand its own consumer lending business.

The end of the 1990s and beginning of the 2000s were particularly dramatic in terms of M&A activity. In 1999, SocGen launched a takeover bid for Paribas, which prompted BNP to respond by attempting a takeover both SocGen *and* Paribas. In the ensuing battle, SocGen remained independent but failed in its takeover, which allowed BNP to take over Pariabas and form the new BNP-Paribas group – immediately the third largest bank in Europe in terms of its market capitalization. During the same period, Crédit Agricole took over Indosuez (1996) and the troubled Crédit Lyonnais (2003), while Crédit Mutuel purchased CIC (1998).

While the resulting financial environment was not as concentrated as those of smaller countries like Sweden, Denmark, Belgium, or the Netherlands, it was far more concentrated than the banking systems of Germany, the US, Britain, and Italy (Santillán-Salgado 2011). Indeed, while the number of banks contracted almost everywhere in the OECD between the

[62] OECD

1980s and late-2000s, France had the largest decline among large countries. By 2009, the OECD estimated that 61 percent of all deposits were held by the five largest French banks – as compared to 37 percent in the United States. By the *Commission Bancaire*'s calculation, the top ten French banking groups had managed to capture 85 percent of the retail banking business in France by the start of the 2000s.

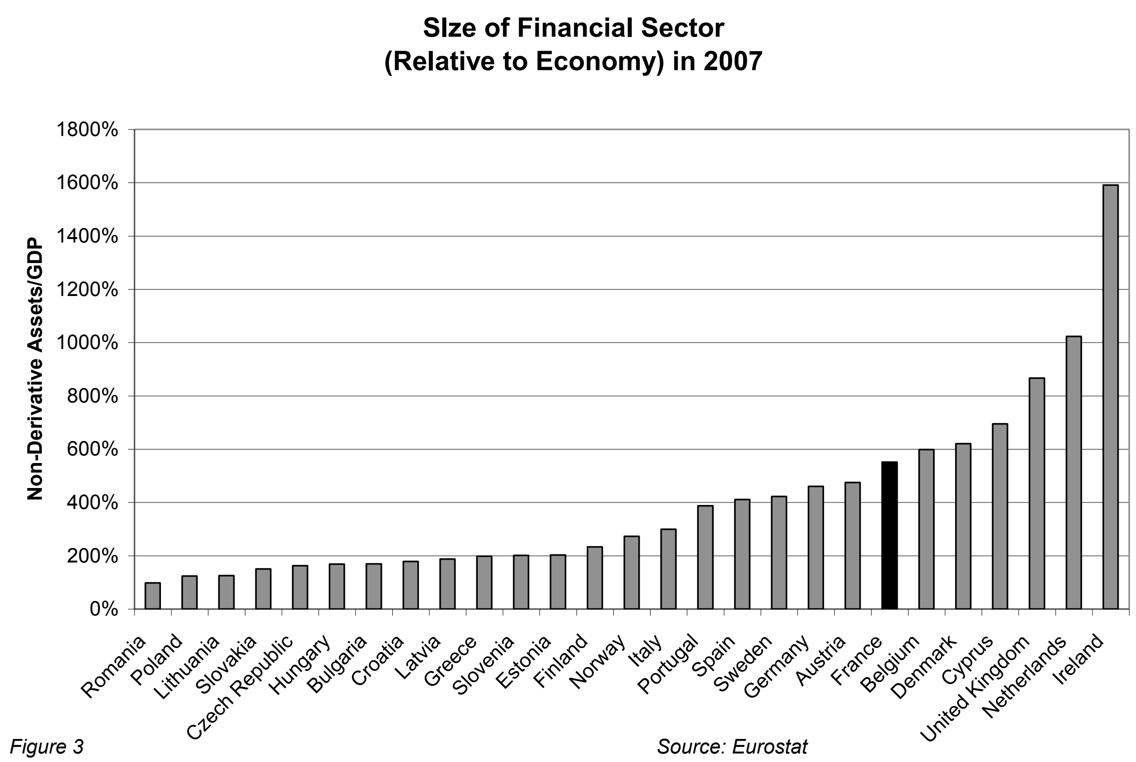

Figure 3 *Source: Eurostat*

As banks consolidated – and coped with shrinking margins on their lending – they expanded their balance sheets, branching out into non-loan products. Overall, the value of the assets held by French financial firms grew from 310 percent of GDP in 1995 to 575 percent by 2007. Figure four shows that, while this was a mere pittance next to the UK and smaller countries with relatively large banking sectors (e.g., Iceland, Ireland, Cyprus, Luxembourg), it was significantly larger than that of Germany, Italy, and most of the rest of the eurozone. As of 2011, the French financial system had passed Germany's to become the second-largest in Europe, holding assets worth over €12 trillion – an impressive figure, if far behind the UK's €26 trillion.

It is important to note that much of the balance sheet expansion in France took place abroad – particularly toward the end of the 2000s. As late as 2002, French banks held less than $700 billion in foreign assets; by the start of 2008, that number had reached over $3 trillion.[63] This made French banks particularly important from an international perspective: of the 29 global banks the Financial Stability Board initially identified as "systemically important financial institutions" (i.e., "too big to fail") in 2011, five were based at least partly in France (Crédit Agricole, BNP-Paribas, SocGen, Banque Populaire, and Dexia). That was more than in any country outside the United States (eight) – including Britain (four). On that list, BNP-Paribas held the third-largest stock of foreign assets in the world, trailing only Deutsche Bank and HSBC; Crédit Agricole was 6th and Banque Populaire was 11th. BNP-Paribas was also considered the most interconnected bank in the world – that is, the bank with the most intra-financial sector exposure across borders (Credit Suisse 2012).

French banks also branched out into more innovative markets, moving away from the simple deposit-and-loan operations they had relied upon prior to reform. In addition to moving into markets for debt securities and equities, the large French banks embraced derivative markets as enthusiastically as their American or British contemporaries. While French institutions generally eschewed the credit derivatives that ultimately became central to the global financial crisis in 2007-2008, they were nevertheless at the cutting edge of financial innovation and development. France, SocGen in particular, accounted for roughly 25 percent of the global trade in equity derivatives (Howarth 2012). After the United

[63] BIS

Kingdom, French financial institutions owned more derivative products than the financial sector of any other European country.[64]

Change has also been evident on the liability side of French banks' balance sheets. In the late 1970s and early 1980s, French banks relied extensively on deposits in order to fund their operations – 81 percent of banks' liabilities in 1980 were accounted for by consumer and interbank deposits. That number declined throughout the 1980s as banks began to turn to new debt instruments and the interbank market for capital, dropping to just under 60 percent by the start of the financial crisis – half of which was provided by other banks.[65]

While the transformation of French financial firms during the 1990s and the 2000s was extensive, it was not immediately successful. Profits largely remained stagnant during the 1990s, during which time the financial sector was forced to unburden itself from a spike in defaults triggered by the early-1990s recession. Much of this unwinding was focused on ill-advised commercial property loans that the government had extended through the banks during the nationalization era (European Banker 1998; Commission Bancaire 2003; Lecaussin 2011).[66] After the last big wave of privatizations and firm consolidation in the late-1990s, however, profits began to rise. Figure four reveals that the increase is not evident from gross operating surplus figures (as it is, for instance, in the United States over the same period). However, the evidence of increased financial sector profits does emerge from data on financial firms' distributed income (i.e., dividends), which skyrocketed once the banks were privatized and began paying to non-state shareholders.[67]

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[64] Eurostat
[65] OECD
[66] INSEE
[67] INSEE

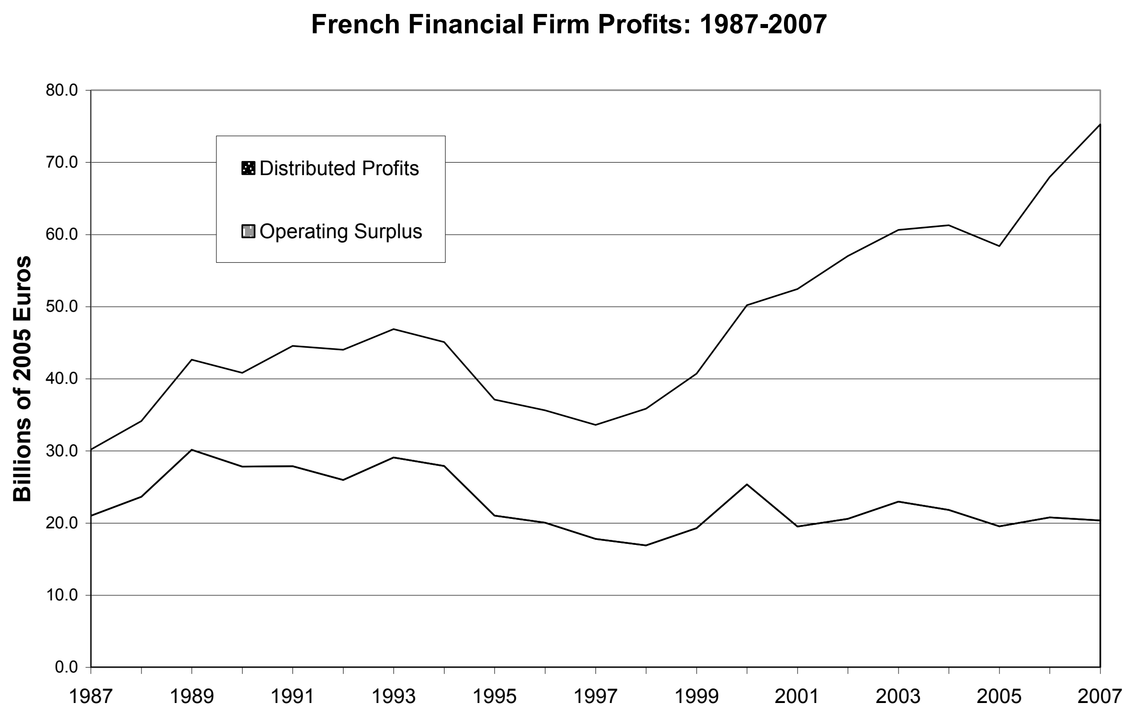

Figure 4 *Source: INSEE*

III. On the Other Hand: Liberalization Contained

In the end, the French financial system of the late-2000s looked quite comparable to those of its peer countries, including Britain and the United States – this despite the fact that most banks had still been nationalized into the 1990s. Its banks were large, diversified, internationalized, and participated actively in the markets for innovative financial products. Yet the relationships between this dynamic financial sector and resident French households and – to a somewhat lesser extent – between financial firms and French businesses remained quite distinct. The French state played an active role in limiting the financial access of households and maintained the capacity and willingness to intervene in the allocation of industrial credit. In essence, the French decided to liberalize the financial sector without fully liberalizing how its citizens and businesses interacted with it. The result has been a sectorally confined liberalization experience.

III.1: The Limits of Liberalization in the Non-Financial Sector

Financial deregulation and the competitive adaptation of financial firms also changed a great deal for French non-financial corporations – though the degree of French convergence on American or British non-financial business practices is easily overstated. Businesses have changed how they raise funds – with bond and equity markets have increasingly displaced traditional bank financing. While this change has made firms more vulnerable to input from financial stakeholders, it would be a mistake to see relations between financial and non-financial French firms as completely converging on Anglo-American norms.

As equity markets grew and the state privatized firms in the late-1980s and 1990s, what emerged was a densely interconnected system of cross-shareholdings. The biggest firms held large stakes in each other, exchanging seats on their boards and influencing each others' strategic decision-making. This effectively immobilized a sizable chunk of the firms' outstanding shares, ensuring that a firm's capital was controlled by strategic allies rather than potential adversaries. Although France desired dynamic capital markets, both the state and managers saw this system of cross-shareholding as a prudent bulwark against dangerous exposure to short-termist shareholders and foreign corporate raiders (c.f. Orléan 1999; Morin 2000; Schmidt 2003; O'Sullivan 2006; Comet and Pizarro 2011).

There is a great deal of debate over how much French industry has maintained this networked character. Some emphasize that cross-held share blocs have eroded since the mid-1990s, pointing to this as a sign that France is moving toward the Anglo-American financial model of dispersed but activist minority shareholders. François Morin (2000) dates the change to 1996, when insurance groups AXA and UAP merged. After the merger, the new firm declined to coordinate the many cross-shareholding blocs in which the business held large stakes. Instead, the newly formed conglomerate began to unwind its holdings, treating them more like portfolio positions to be liquidated when it became profitable to do so. Furthermore, where it was in a position to block foreign takeovers of its networked partners, it elected not to do so. The same has occurred with parts of the Gaz de France-Suez empire (The Economist 2000; Total 2004).

The rise in the portfolio view of the firm (that is, the view that a business is a financial asset rather than a productive business) has come together with foreign portfolio investors entering the French market. Despite being late in creating its equity markets, its stock market swiftly became among the most internationalized in the world. By the mid-2000s, nearly 50 percent of the listed equity for CAC 40 firms was in foreign hands (Le Roux 2010). What many French fear – and what anecdotal evidence is taking place – is that these foreign investors enter French equity markets and force firms toward maximizing shareholder value at the expense of other concerns (Betts 2008).

There certainly is evidence to support the idea that French firms have become more sensitive to shareholder pressure than in the past. Figure six shows how dividend payments as a percentage of non-financial firms' operating surplus has increased fivefold over the past three decades – from around 15 percent at the end of the 1970s to over 80 percent in the late 2000s. Share repurchases, a tactic for inflating share prices and returns on equity, appeared in the mid-1990s and grew to several percent of firms' surpluses in the 2000s.[68] The very top echelons of French industry are also permeated by stock-based compensation schemes – particularly in stock options – reflecting a growing effort to tie managers' pay to the long-term financial performance of the firm (Ponssard 2001; Cherraux and Wirtz 2007).

[68] INSEE

Yet there are reasons to question the degree to which French industry has given way to Anglo-American style shareholder value-oriented management. A study of activist shareholder moves prior to and after 2001 found that France continues to experience very few instances of shareholder revolts against management. In fact, in the twenty years following 1989, only 203 cases of confrontational activism toward management have taken place (Girard 2011). There were similarly fewer mergers and acquisitions in France than in the United Kingdom or Germany over the 1980s-2000s period. Many of the acquisitions that did take place – the *Gaz de France* merger with Suez being the largest among them – involved state-owned enterprises.[69] Foreign attempts to buy large French firms continue to provoke protective measures from French governments of the right and left, with the head of the *Caisse des Dépôts* saying at the end of 2009 that the state would vigorously fend off attempts to take over distinctly French firms like Danone (The Economist 2009).

Further studies maintain that while the *noyau dur* (hard core) blocs of French cross-shareholding have become smaller, the degree of integration between the blocks that remains has remained strong (Comet and Pizarro 2011). Moreover, the management of French firms is insulated from financial market pressure in other ways: family control of even the largest French firms remains common. Unquoted shares – stock in a firm that is not openly traded on exchanges – remain the largest components of French firms' liabilities.[70] This is a rather unique trait of French firm ownership, indicating that – while French executives have become increasingly sensitive to the demands of shareholders – they continue to retain a great deal of autonomy over their actions. They are neither completely constrained by large

[69] Institute of Mergers, Acquisitions, and Alliances
[70] Eurostat FBS

networks nor are they entirely vulnerable to the whims of financial markets (Schmidt 2003). Consequently they are under less pressure to make quick responses to market fluctuations.

This trend is reinforced by the lingering footprint of the French state. While shareholder control over firms has grown and state has certainly receded from the French financial landscape, the French government continues to hold significant sway over how capital is ultimately used. Despite the privatizations of the 1980s and 1990s, the French state still maintains outright control over 47 companies, as well as holding significant equity stakes in giants such as EADS, Areva, Gaz de France-Suez, Renault, and Air France-KLM (Agence des Participations de l'Etat 2011). Through ownership as well as selective enforcement of anti-trust rules, the French government has continued to wield significant power over M&A activity inside the country. Sometimes, as was the case with the troubled merger of Gaz de France with Suez, this was because the state itself owned the firms involved (The Economist 2007). In other cases, like the controversial (and ultimately overturned) approval of the sale of Vivendi's publishing operations to the Lagardère group in 2002, the state became involved in order to protect properties seen as particularly French (The Economist 2004).

In addition to continuing state ownership, the French government still demonstrates a fondness for subsidized loans. This has been particularly evident in the response to the financial crisis: in 2009, then-President Nicolas Sarkozy offered troubled automakers Renault and Peugeot low-interest loans in exchange for a promise not to close any plants (Hawranek and Huelsen 2012). In the struggle to restore growth to European economies in the years that followed, both the Sarkozy and Hollande governments have favored strategies that rely extensively on subsidized lending in support investment policies (European Commission 2010).

III.2: Simple Consumer Finance Despite Liberalization

Chapters four and five demonstrated how the French state's suspicion of household indebtedness – and desire to encourage household savings – started to become evident at the end of the 1980s. As the 1990s and 2000s progressed, little changed on this front. Whether due to Catholic sensibilities concerning usury and the morality of indebtedness (Trumbull 2012) or to concern over consumers' unfamiliarity with credit products (Department for Business Innovation and Skills 2004) or to the burden that unfamiliarity placed on the French legal system (Kilborn 2005), the French state – and French lenders – have resisted the temptation to repeat of the 1980s consumer credit boom.

Throughout the 1990s and 2000s, the state maintained a robust presence in consumer credit markets. The French government subsidized mortgages for low-income consumers and individuals buying or improving older properties, guaranteed the popular tax-free savings account (the *livret-A*), managed those deposits through the *Caisse des Dépôts*, maintained usury laws and controls over the advertising of credit products, and banned private firms from offering refinancing operations (Malaterre et al. 2003; Kilborn 2005; Trumbull 2012). The assumption throughout was that financial products and markets can be extremely dangerous, particularly for ordinary consumers.

Savings are still seen as worthy of state support and debt is still seen as something the state should discourage: the government continues to guarantee the returns on certain privileged savings accounts like the *livret* while successive governments have maintained and expanded efforts to restrict consumer access to debt. This pattern is evident regardless of the party in power. Laurent Fabius had banned consumer refinance loans under Mitterrand, Jean-Pierre Raffarin's government under Chirac mandated debt forgiveness for some low-income individuals in 2003, and François Fillon's government under Sarkozy promulgated the *Loi Lagarde*.

The role of France's usury laws in encouraging such caution should also not be understated. The 1978 *Code de la Consommation* was revised in 1989 to update the those usury laws, categorizing different types of credit and setting interest rate ceilings at 33% above the prevailing market average for each type of credit. The usury rates are often quite low – lower than a good many borrowers in Britain or the United States might regularly pay. For instance, the legal cap on interest rates for personal loans was 11.24 percent at the end of 2012.[71] For reference's sake, Citigroup's stated rates for personal loans in the United States range from 6.74 to nearly 19 percent.[72] Rates for mortgages, home equity loans, and various forms of installment agreements are significantly lower – ranging from just over 5 percent to just under 10. There are simply not as many qualified lenders at the rates that French banks are allowed to charge.

This has caused problems. France may in fact by "underindebted" and forgoing to the potential benefits of allowing its households to borrow more (Babeau 2006; Bourdin 2006). Worse, households without good access to financial markets can end up in one of two undesirable situations: First, more French are indebted to illegal loan sharks than in Britain – a problem thought to stem from the absence of facilities such as title or pay day loans. Alternatively, many French sub-prime borrowers ultimately get treated to closer-to-prime

[71] Banque de France
[72] As of March 2013

interest rates, creating problems down the road for the lending institution (Department for Business Innovation and Skills 2004).

In lieu of trusting refinance companies to keep consumers out of debt, the French debt-resolution scheme under the 1989 *Loi Neiertz,* heavily involves the state. The purpose of the law was to prevent overindebtedness and provide a streamlined system for mediating disputes over nonpayment, which it achieved largely through two innovations: First, it established local debt commissions of politicians, officials, and a *Banque de France* representative in each French *département*. These were charged with adjudicating individual cases of default and establishing repayment plans. Second, it set up – for the first time – a central register for negative credit reports, the Fichier Nationale des Incidents de Remboursement des Crédits aux Particuliers (FICP), which would be used to ensure that those in arrears or default would have their information shared with all potential lenders (Kilborn 2005; LoiNeiertz.com 2012).

Whether or not the law has been a success remains debatable. It adjudicates far more cases than the British analogue – the British Insolvency Service – though it must be noted that the overindebted in the UK have private alternatives to the state-mediated resolution process.[73] A British government report into the feasibility and efficacy of credit controls found that the French system was more draconian and tended to produce fewer successful resolutions of insolvencies than the British (Department for Business Innovation and Skills 2004). After use of the commissions declined during the booming mid-1990s, it has since skyrocketed in the 2000s, with more than 150,000 filings annually for much of the latter half of the decade.[74]

[73] BIS Insolvency Service, Banque de France
[74] INSEE

Activities that are common elsewhere – and legal in France – remain relatively uncommon. Home equity loans and refinancing based on accumulated equity in homes was not possible in France until the 2000s. This stands in strong contrast to Britain, where home equity withdrawals in the 1980s fueled much of the country's consumption during the decade. Even today, home equity loans remain restricted. As one website geared toward guiding American and British expatriates through the difficulties of household finance in France put it:

> 'Please note that refinance and cash out mortgages are not seen by French bankers as a way to stabilize your finances in a difficult time or to consolidate debt. Therefore, you must apply for refinance and cash out while you can still meet the French lending eligibility criteria'
> (National Association of Estate Agents 2012).

The regulatory hostility to consumer credit and overindebtedness in France has made a significant difference in terms of the households' access to credit and their overall level of indebtedness. Despite the fact that France and Britain have similar populations, the UK has roughly twice the number of credit cards in circulation as France.[75] French households' financial liabilities in 2007 amounted to just over 60 percent of GDP – as figure eight shows, a below-average figure for Europe.

[75] BBA and EuroMonitor

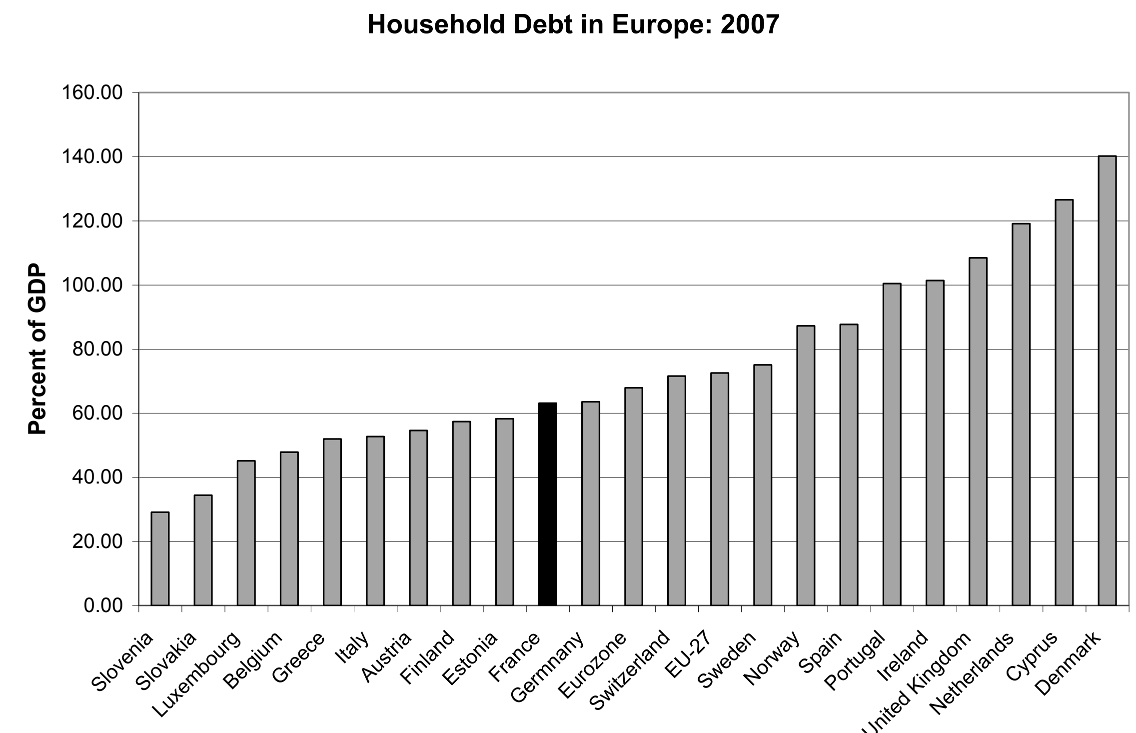

Figure 5 *Source: Eurostat*

The difficulty in extending credit to French households – particularly higher-risk borrowers who would pay higher interest rates – has depressed the appeal of securitization to the French financial services industry. While France was among the earliest adopters securitized consumer lending, it quickly fell off the European pace: by the 2000s, the French were among the smallest European issuers of securitized assets.[76] This was not because the French financial industry lacked the ability to create the products, nor was it out of a lack of desire by French banks to own securitized assets. Indeed, French banks owned a significant amount of the foreign-made assets that ultimately became toxic in 2007-08. Potential French borrowers, restrained by the state and incentivized to save, were simply not suited to the borrowing activity required in order to fuel a robust securitized debt industry

[76] SIFMA

III.3: Liberalization or Oligopoly?

As stated in the chapter one, liberalization only refers to the withdrawal of the state and the introduction of market pressures – it does not presuppose that such pressures will result in ideally liberalized market outcomes. In France in particular, there is a strong case that competitive pressures in the banking sector led to an oligopolistic market structure characterized by tacit collusion. The relatively stunted French market for consumer debt may make this particularly easy in the realm of consumer finance.

While competition clearly drove down the returns to intermediation, it is not clear that competition had the same effect on retail banking fees. Indeed, one of the competitive "innovations" of the French financial sector was the generation of a labyrinthine set of commissions and charges on virtually every transaction a retail consumer might want to conduct. French consumer group *UFC Que Choisir* (2010) found that the average bank disclosure of fees was 24 pages long and included more than 300 different surcharges, meaning that a consumer wishing to compare the major retail banks would have to compare thousands of individual fees. Their report argues that as much as 40 percent of retail banks' revenues come from such fees. This may go some way toward explaining how BNP-Paribas and other French attributed their stability during the financial crisis to the fact that over half of their revenue still came from retain banking (Pauget 2009; Lee 2010).

III.4: A Question of Culture?

The relative French aversion to debt is a tricky one to analyze due to the uncertainty over the causal force of "culture." Are the French less indebted because of government policy toward credit or is it because the French less culturally inclined to go into debt? The average British person charges nearly $2700 to credit cards each year; the rate in France is only $267 per year. In fact, by 2010 the Chinese had begun to charge more to their credit cards than the French![77] On online transactions, the French prefer to use debit cards and are actually more likely to use PayPal (which does not involve credit) than credit cards.[78]

This might lead one to assume that the French are constitutionally disinclined to go into debt. After all, their problem isn't lack of access: there are 34 million credit cards in circulation in France – less than the UK but far more than Germany, where only 4 million credit cards have been issued.[79] This would suggest that there is something to the culture argument: despite credit access – and despite the relatively low interest rates guaranteed by the usury rates – debt-based spending remains relatively low. Yet there is a problem with chalking up the entirety of France's low-debt tendencies to culture. During the late-1980s, French households reduced their saving just as fast as their British contemporaries – there was no major cultural gap in evidence then.

As with most things, it is likely that the truth lies somewhere in between. The French may have a cultural suspicion of finance – a thought entirely consistent with the political record of French political leaders – but that suspicion was briefly overridden during the late 1980s amidst the economic boom and accompanying optimism. When the boom of the 1980s gave way to record-level defaults and the creation of the *Loi Neiertz,* the French saw the wisdom of returning to their relatively high-saving, low-debt ways. It can be easy to take this line of argument too far: French households did indeed go further into debt in the 2000s. Nevertheless, the changes in France were far less pronounced than in other countries, most notably in Britain.

[77] Euromonitor International
[78] Forrester Research
[79] Euromonitor International

Indeed, this argument as it pertains to French households can be extended to French society as a whole: there was a strain of thinking among both everyday people and political leaders that trusting to the *puissances d'argent* was a mistake. When the consumer credit bubble burst and the country experienced the consequences discussed in chapter five, their suspicions appeared validated. While the government may have been willing to let the financial market develop in line with international norms – as seemed necessary to continue competing for capital in Europe's unified financial markets – it chose not to liberalize the domestic relations of those firms with businesses and families.

*   *   *

Where Britain in the late-2000s looked much as it had at the end of the 1980s, France did not. On one hand, the financial sectors in the two countries were roughly comparable, with similar-sized entities engaged in many of the same fields. Yet there were significant differences. The French state maintained a relatively heavy-handed role in industry. Consumer indebtedness was indeed on the rise but at relatively low rates. As a result, there was no real resurgence of the "backwards" reallocation of credit that had appeared in 1987-88, nor of the attendant rising inequality, widening external deficits, or growing macroeconomic fragility. The next chapter turns to a more direct comparison of Britain and France's experiences during the 2000s, contrasting how France's more reserved approach to finance performed vis a vis Britain's relative enthusiasm.

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Eight – Destructive Creation: Assessing the Consequences

'I think that some [financial innovation] is socially useless activity. On the other hand, I don't know whether that means the world would have been better off without any credit default swaps, or simply some'
' –Adair Turner, Chairman of the FSA, August 27, 2009

For much of the 1980s, Britain and France had faced similar challenges. Both countries' governments saw the need for their financial markets to be internationally competitive. As a result, they rationalized their old and repressed financial systems in similar ways: governments in both countries stepped back from resource allocation decisions, allowed domestic and international competition to flourish, and ultimately allowed credit to grow and flow as the market saw fit.

For Britain, initial reforms grew out of the desire to ensure that London remained a global financial capital. More than that, the idea of liberalization – championed by some within the new Tory majority of 1979 – was consonant with Thatcher's pro-freedom, pro-competition beliefs. For France, reform was foisted upon the Mitterrand government as the price of admission to European monetary integration. It was accepted – at least after 1983 – yet embraced by few. There was no French Thatcher and no tying technical reforms to a broad vision. Indeed, French governments continued to see a role for themselves in mediating between French citizens and financial markets.

These differences meant that – between the end of the 1980s and the close of the 1990s – the British and French approaches to liberalization began to diverge. Amidst the economic turbulence of the early 1990s, both countries sought to maintain internationally competitive financial firms that could participate in the full range of global financial activities. Yet while New Labour's Britain embraced the idea of competitive freedom and did little to encumber citizens' and firms' relationships with financial markets, French governments sought to protect their citizens from potential dangers, stepping between the domestic non-financial and financial sectors. The state acted to protect French firms, prevent foreign takeovers, encourage household saving, and suppress household borrowing. Where Britain chose to let liberalization penetrate the whole of its society, France opted to keep liberalization largely contained within the financial sector itself.

Those disparate policy choices allow for a comparison of two similarly-sized and equally developed economies – both of which both possess competitive, large, and innovative financial sectors – which nevertheless chose radically different approaches toward mediating the relationships between their financial and non-financial sectors. The purpose of this chapter is to examine the consequences of those divergent choices, examining how policies toward financial liberalization affected British and French resource allocations. The analysis that follows sheds light on Lord Turner's uncertainty (quoted at the outset over this chapter) over precisely which financial activities are "socially useless:" it suggests that it is not the financial tool (e.g., a credit default swap) that it is dangerous, but where that tool ultimately directs resources.

I: Resource Allocation Under "Backwards" Finance

Resource allocations in Britain and France after the early 1990s are markedly different – differences much more significant than what was seen during the 19980s. In a traditional economy, the non-productive sector saves, the productive sector borrows, and the intermediating sector facilitates the transfer between the two. Despite some erosion of this dynamic in the years before the crisis, this pattern generally continues to prevail in France. In Britain, however, the relationship has become reversed: the intermediating sector has encouraged the productive sector to save and the non-productive sector to borrow.

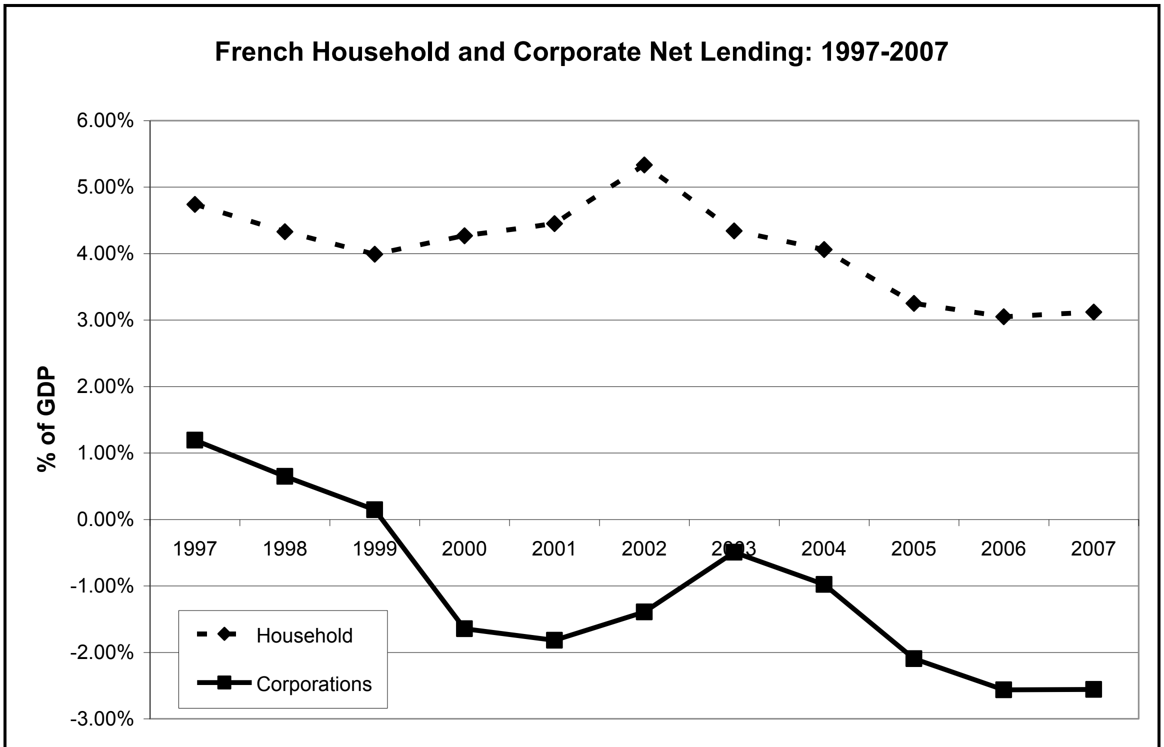

Figure 1

This is immediately evident from a comparison of firm and household behavior in Britain and France. As figures one and two show, the traditional relationship between the household and business sectors endured in France until the start of the financial crisis. In Britain, on the other hand, households had become debtors and corporations savers by 2002 – a state of affairs that continued until the crisis began. This reversal was the first of its kind in either Britain or France since 1987-88, at the height of the first financial boom-bust cycle.

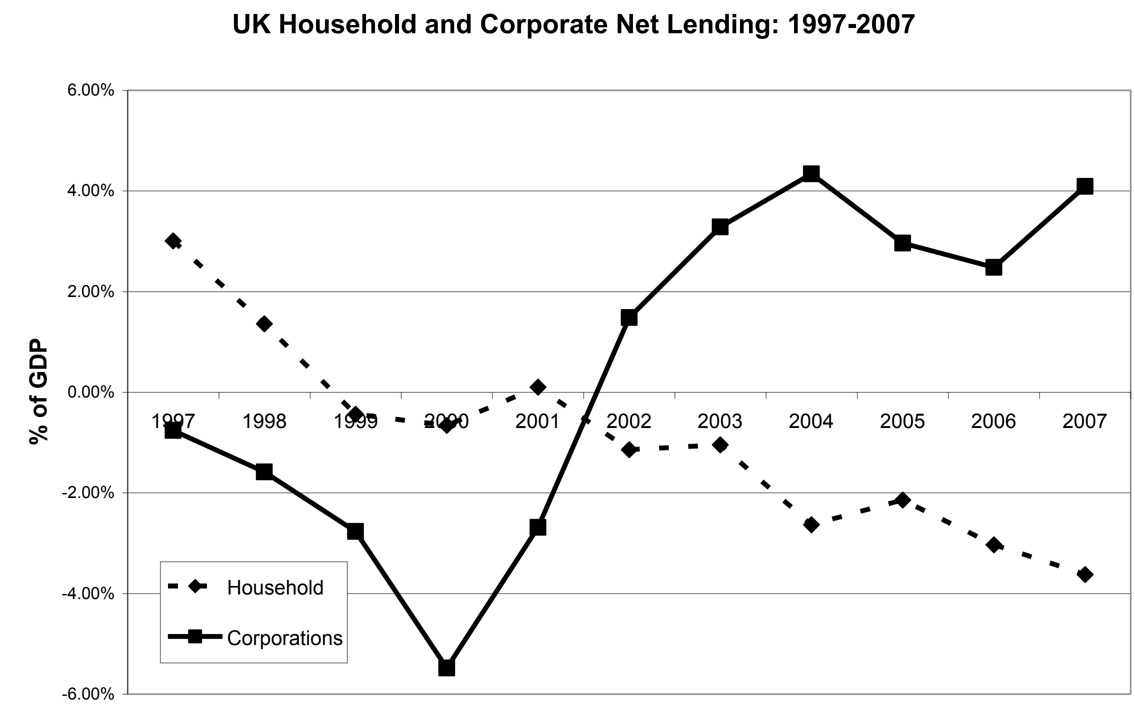

Figure 2 *Source: AMECO*

As would be expected from these figures, the composition of outstanding liabilities in the two countries also diverged sharply. For much of the 1990s, roughly 30-35 percent of all British borrowing came from the non-financial and government sectors while the other 60-65 percent came from the household and financial sectors. By the late-2000s, that split had slipped to 20-80, with the non-financial sector only accounting for 12 percent of outstanding British liabilities by 2008 (or more generously, 19 percent of private non-derivative liabilities). In other words, a full 80 percent of British financial resources were directed into sectors that do not inherently invest in creating new sources of productive income. The only other country in the developed world even remotely near such an imbalance was Ireland.[80] France, on the other hand, experienced virtually no change in the composition of its outstanding liabilities over the same time period: financial corporations accounted for

[80] Eurostat

roughly 35 percent throughout the 1990s and 2000s. The only change was a decline in the share of French borrowing accounted for by the government and matching increase in the share accounted for by the financial sector – though even that swing was only between 2-3 percent.[81]

The key driver of these disparate resource allocation patterns was not differences between British and French financial firms. Both British and French financial companies faced the same international competition and firms in both countries consolidated, expanded, and innovated in similar ways. Instead, the fundamental difference between Britain and France was in how the non-financial sectors were treated. In particular, household lending was curtailed – and savings encouraged – in France while there were few such efforts in Britain.

This difference made business strategies that focused on household borrowing more viable in Britain than France. This is particularly evident when examining the market for innovations such as securitized debt and collateralized debt obligations. The two countries began from roughly the same place, with both countries issuing similar levels of securitized debt during the mid-1990s. As figure three shows, the value of securitized debt outstanding in both countries was valued at about $17 billion in 1997. By 2007, outstanding French securitized debt was worth $35 billion while that figure for Britain had grown to nearly $600 billion.

[81] Ibid

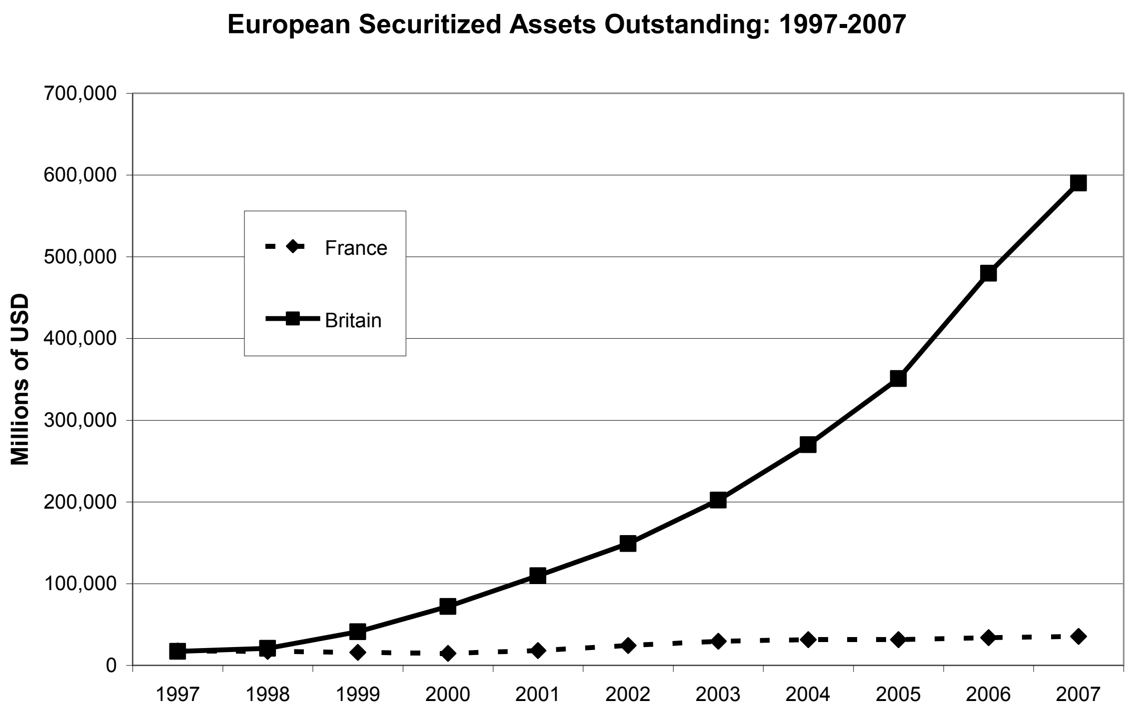

Figure 3 *Source: SIFMA*

So how could such a large disparity emerge? Several answers present themselves. One potential answer is that French banks had some particular aversion to securitized debt. However, this is clearly false. French financial institutions did own securitized assets; however, they generally bought them from abroad. The write-down cost alone of one French bank (BNP-Paribas) on sub-prime securitized mortgages in the United States – a small subset of all French-held securitized debt issued abroad – amounted to 17 percent of *all* domestically issued securitized debt of any kind.[82] The heavily internationalized French banking sector was engaged in many of the same activities as their British counterparts – it simply bought products that were not created out of French household borrowing.

[82] Bloomberg

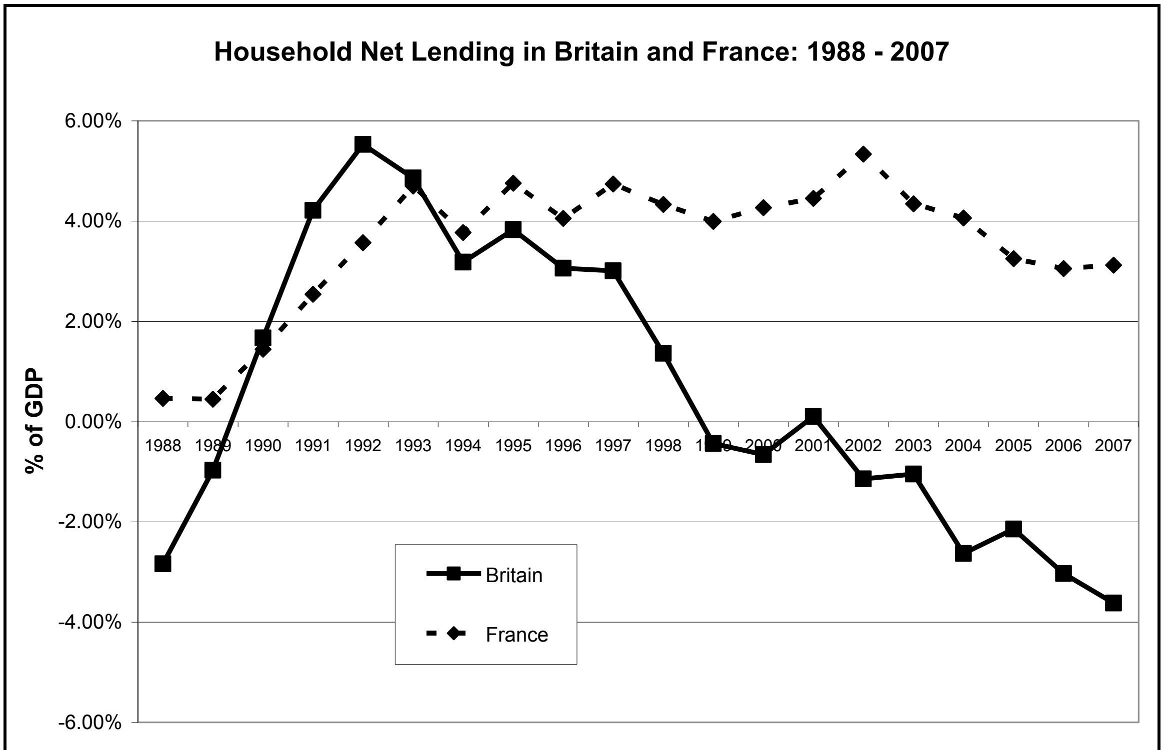

Figure 4 *Source: AMECO*

A more likely explanation for the divergence between the domestic markets for securitized debt in Britain and France is that the French did not borrow enough – in particular, at high enough interest rates – to fuel the development of such a market. After the events of the late-1980s and early-1990s, French savers demonstrated an unwillingness to reduce their savings rates. Figure four shows how both Britain and France increasing their net lending (i.e., net saving) amidst the early-1990s downturn – only to see savings rates again plummet in the UK while they remained relatively high in France.

As mentioned in chapter six, there are both cultural and policy-based explanations for the French tendency to save more and borrow less. The French affinity for net saving might be explained by a uniquely French hesitance to become overly indebted. But considering the fact that French households did become overly indebted in the 1980s, that explanation is somewhat lacking. Several policy changes during the late 1980s are thus the more likely candidates for stoking such a change in behavior. The banning of refinance companies, the imposition of a relatively strict debt resolution system under the *Loi Neiertz*, as well as the maintenance of usury rates conspired to discourage overindebtedness and high-risk borrowing all conspire to reduce borrowing and keep interest rates low. At the same time, the cap on *Livret-A* tax-free savings accounts was raised nearly 50% between 1986 and 1991 (from 68,000 to 100,000 francs). For comparison's sake, the UK's equivalent tax-free accounts developed under John Major during his time as Chancellor were (and continue to be) capped at roughly half the size of the *Livret*.

II: Finance and Growth – A Redux

Financial liberalization engendered an ultimately unproductive transformation of resource allocation in Britain – a transformation that did not take place to the same extent in France. This transformation also yielded a period of remarkable growth in Britain, where economic expansion outstripped France's for 13 out of the 15 years between 1993 and 2007.[83] And, as this section will argue, there is little doubt that the differing approaches to financial liberalization played a major role in generating this disparity. The question that remains is what *kind* of growth was produced by the process of financial liberalization – and whether that growth was ultimately sustainable or desirable.

II.1: The Role of Consumption

Recalling chapter five, both Britain and France in the 1980s experienced consumption-dependent growth predicated on rapid savings declines, household debt expansion, and consumption increases excess of wage growth. This was facilitated, in large part, by the

[83] World Bank

pressure on financial firms to cope to their new competitive environment by expanding their balance sheets. Many of the new assets generated as a result were created through consumer borrowing. The same pattern is in evidence after the late-1990s – but this time the pattern is far more evident in Britain than in France. Moreover, consumption-friendly financial innovation plays a bigger role in the balance sheet expansion of the 2000s than it did in the 1980s.

As would be expected considering the data on resource allocation, the expansion of household debt in Britain was far larger than in France after the mid-1990s. Households' debt overhangs in both countries remained relatively constant for much of the 1990s – around 70 percent of GDP in Britain and 40 percent in France. Between 1997 and 2007, however, British household debt jumped by 38 percent of GDP as compared to just 16 percent in France.[84] A disparity is also in evidence when comparing the gap between per-capita consumption growth and household income expansion in the two countries. In the 1980s, both British and French households ramped up consumption faster than their incomes increased. In the 1997-2007 period, however, French per-capita consumption grew significantly more slowly than income while the British continued to consume beyond their means (see figure five).

[84] Eurostat and INSEE

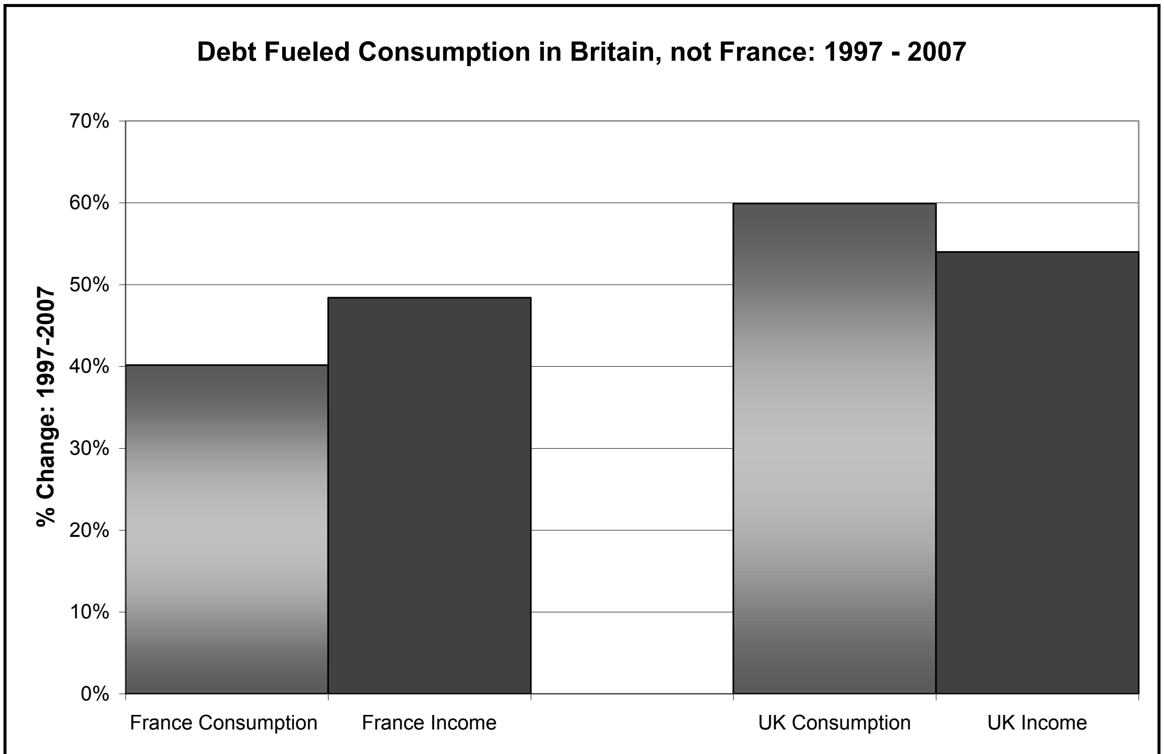

Figure 5

Considering the quite large discrepancy between Britain and France with regard to savings behavior, it is particularly important to note that the typical British and French households saw relatively similar increases in their nominal incomes during this period: earnings grew by over 48 percent in France and 54 percent in Britain. The big difference between the two groups of households was only evident in consumption, with British household consumption growing 50 percent faster than French household consumption. In other words, while British households did see far greater consumption increases than the French, the majority of that increase was achieved through borrowing rather than income growth.

Again, the connection between household behavior and economic growth is a crucially important one: as figure six shows, consumption remained the largest component of

GDP growth in both countries after 1997 leading up to the financial crisis. Tellingly, however, the reliance on consumption is far stronger in Britain than in France.

Average Contributions to British & French GDP Growth: 1997-2007

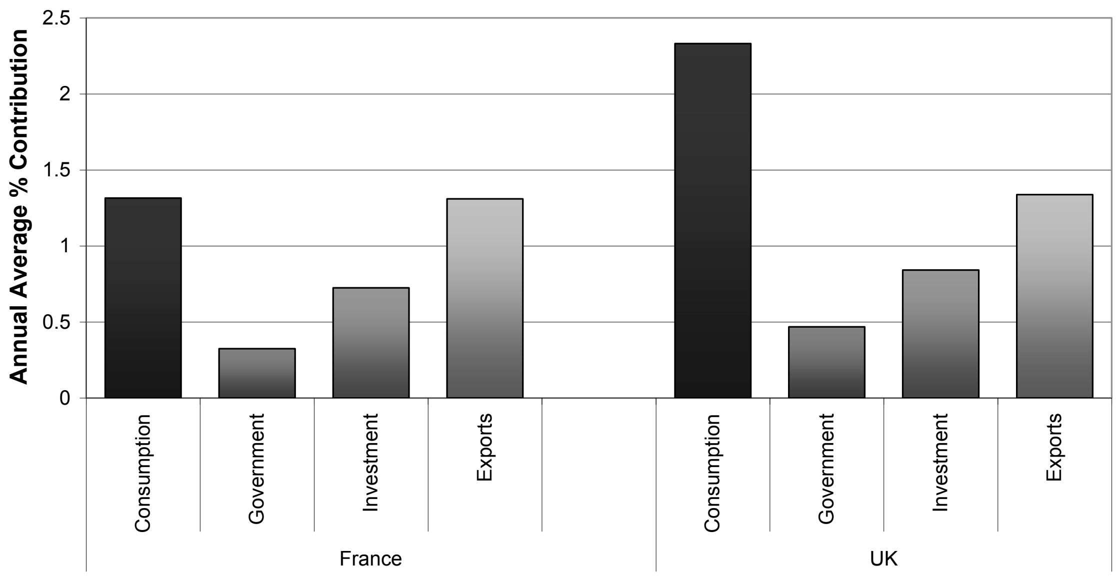

Figure 6 *Source: AMECO*

II.2: The (Non-) Role of Investment

The Schumpeterian argument for the finance-growth nexus rests in large part on the idea that freer, more liquid financial markets should stoke investment. That is, financial markets that are relatively unencumbered do a better job of mobilizing resources and evaluating alternative uses of those resources, ultimately allocating capital in a highly productive manner. Yet, as figure seven reveals, business investment in Britain tended to be lower than in France. The situation is truly puzzling: despite the fact that Britain's non-financial firms faced less state intrusion on their financial relationships, the French financial system appears more pro-investment than the British.

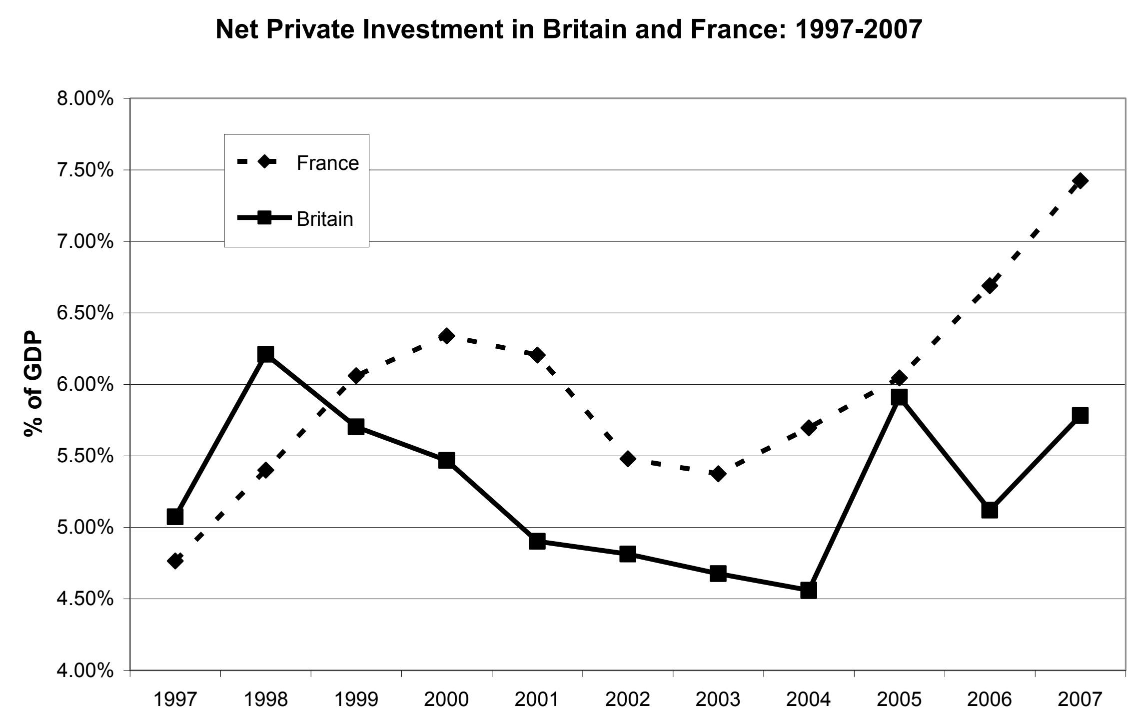

Figure 7 *Source: AMECO*

In short, it seems that the combination of financial freedom and unencumbered interactions between the British financial and non-financial sectors resulted in a sort of growth that was fueled through consumption rather than investment. This is not what Schumpeter had in mind when he argued for the existence of a finance-growth nexus. Indeed, he had disparaged consumer finance as something that was economically unnecessary. Britain effectively achieved faster growth by borrowing against its future –making intertemporal tradeoffs rather than building new productive capacities. Again, the question becomes why: why did British firms with access to such sophisticated financial markets invest less than their French counterparts?

In order to answer this question, it becomes necessary to consider the supply side of the market for financial products. In order for financial intermediaries to innovate or run larger balance sheets, they require savers who are interested in their new products and willing to provide large quantities of funds. This supply side of the market for loanable funds is comprised of large savers: pension funds, mutual funds, insurance companies, central banks, and large corporations who buy assets – including more innovative securitized products – which provide the funds that intermediaries push out to borrowers.

The development of British financial markets created a new obstacle to productive investment that affected this supply side of the market: the emergence of more dynamic financial markets and instruments incentivized traditionally investing firms to pull funds out of physical investment and into financial asset purchases.

In some cases, this meant purchasing consumer debt (i.e., indirect lending). This phenomenon did not spread as far into the non-financial sector as it did in the United States, where many large corporations hold mortgage-backed assets on their balance sheets. Nevertheless, while the largest British non-financials generally did not directly buy consumer lending products, other institutional savers did. For instance, Aviva, the largest British insurance company, owned over £25 billion in mortgage-related financial products in 2007 (up from £10 billion in 2002).[85]

In other cases, non-financial firms became even more directly involved in lending to households. The British supermarket industry was a remarkable case in this phenomenon in the late 1990s and early 2000s. Two of the largest UK-based supermarket chains, Tesco and Sainsbury's, started their own consumer banking divisions in 1997. Marks & Spencer, a department store that also operates an extensive network of supermarket-like shops, began taking savings deposits in 1999. Throughout the 2000s, all three expanded their services to include a menu of deposit account options, credit cards, insurance, and loans (Sainsbury's Finance 2012; Tesco Bank 2012; Marks and Spencer 2012).

[85] Aviva 2002, 2007 Annual Reports

At the same time that non-financial investment by British firms was in decline or stagnant, financial investment skyrocketed: the financial assets of British firms stood at 75 percent of GDP in 1997. By 2007, that figure had reached 136 percent of GDP.[86] Businesses simply found better things to do with their money in Britain's more variegated financial system. Though the same overall trend was in evidence in France (where financial asset holdings grew from 163 to 272 percent of GDP),[87] there is a subtle difference between the two countries' figures:

The largest share of French firms' financial holdings is comprised of unquoted shares – that is, shares that are not listed on any exchange. The pattern of French businesses holding each others' unlisted shares is part of the French legacy of forging strategic alliances through cross-shareholdings – a pattern reinforced by the state's privatization process during the 1990s (Culpepper 2011). Such assets are typically not held for portfolio purposes but for ensuring strategic coordination between firms. In short, the financial holdings of French businesses were more likely to be related to their core business while the financial holdings of their British counterparts were more likely to be purely financial. Consequently, British financial accumulation is likely to be a substitute for investment – both activities are meant to be income-generating – while French financial accumulation is not.

Indeed, French corporations' investment since the 1980s has been less volatile than in the United States, Britain, Germany, Italy, or the Netherlands.[88] Whereas variations in cash flow and profitability tend to impact investment decisions elsewhere, French firms'

[86] Eurostat
[87] Ibid
[88] Lowest variability in corporate investment as a percent of GDP since 1980 (France, UK, US, Germany, Italy, the Netherlands). Eurostat and BEA data.

investment decisions have been relatively insensitive to such changes (Mulkay, Hall, and Mairesse 2000).

III: Consequences of the Rise of Finance

It is highly implausible that Britain could undergo such a transformation of resource allocation without that change sending large ripples throughout the country. Chapter one predicted how these ripples would manifest; chapter five indicated that these ripples appeared as expected in both Britain and France at the end of the 1980s. With France and Britain pursuing quite divergent liberalization paths from the early 1990s onward, it becomes possible to put those chapter one predictions to an even stiffer test.

France has maintained the traditional household-business dynamic. Households save, businesses borrow, and growth is fueled by a more-or-less balanced mix of consumption, investment, government spending, and exports. Absent those restrictions, Britain's household-business dynamic was turned on its head. British businesses save, households borrow (and invest in residential property), and growth has become increasingly fueled by debt-supplemented consumption. By the predictions outlined in chapter one, this disparity would suggest that Britain should have been more vulnerable to economic shocks than France, Britain's inequality should have widened more than France's, and Britain's external balances should have deteriorated more than France's. In each of these cases, evidence suggests that these predictions are indeed borne out by the data.

III.1:Macroeconomic Vulnerability

By many measures, the changes to the British economy were positive developments. Debt allowed consumption to boom and fueled growth in the ostensibly highly productive financial services industry. Yet whether the financial services sector is actually productive in a real sense is open to question. Calculating the value added provided by financial firms is so difficult to estimate that most European countries simply exclude financial services from their value added taxation schemes (European Commission 2008). The calculations that do exist tend to show the UK's financial sector to be a high-value added sector – and far more productive than non-financial sectors like manufacturing.[89] However, if the financial services sector was even partially to blame for the economic crises of the early 1990s and late 2000s, some of the fallout must be attributed to it as "value subtracted." This problem is not unprecedented: Indonesia expended considerable effort after its late-1990s financial crisis trying to resolve the fact that traditional calculations of the value added by its financial sector came out negative (Widodo 2008).

Ultimately, the idea that such an expansion of the financial sector should be considered productive in a real sense is highly suspect. Finance fosters productivity by allowing other firms the resources needed to provide new goods and services. If the UK were acting as an international intermediary, bringing capital into the country in order to allocate it productively abroad, the British model would be sustainable. The result in that case would be large increases in the income-generating uses of capital abroad, from which the British financial services industry would take a cut (i.e., interest income and service fees). But that is not what has happened: instead, much of the capital flowing into the UK stays there,

[89] OECD STAN

generating a financial surplus with the rest of the world. Instead of capital being allocated to productive uses abroad, it is being allocated to non-productive uses at home.

The dubious nature of Britain's new economic model was revealed in 2007 and 2008. Global credit markets froze amidst growing worries over questions that had been glossed over during the expansion: was the growth of credit and the concurrent rise in asset prices actually sustainable? Apparently not: with credit tightening, asset prices fell, firms' balance sheets deteriorated, jobs disappeared, and defaults began to rise again. Those left holding the most bad debt – typically large banks – turned to the government to help them plug the holes in their balance sheets. According to the National Audit Office, the cost of the various guarantees, nationalizations, and loans to the financial sector cost the British taxpayer £512 billion by the end of 2010 (National Audit Office 2010), though the accounting of the contingent liabilities varies and could exceed £1 trillion. (Rowley 2011).

The banks were, in many ways, the luckiest victims of the financial collapse because the state was compelled to help them dispose of the debts that they had accumulated. The state itself, other firms, and private households faced the same dilemma without such a convenient option. There was no one to help those sectors emerge from the debt built up over three decades of credit-fueled economic activity. Household debt stood at 106 percent of GDP in 2010, the central government owed over 75 percent of GDP, and corporations had to repay more than 200 percent of GDP in short-term loans alone – all at or near record levels.[90] Britain as a whole was a debtor within the international financial system.[91] Absent a way to suddenly restore economic growth or allow debt to expand in perpetuity, there are only two choices for the overleveraged: default or austerity. Both choices are problematic.

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[90] AMECO
[91] AMECO

Widespread default risks triggering an uncontrolled domino effect. If firms or individuals (or governments) refuse to pay their debts, their creditors may, in turn, become insolvent and default on their own debts. The stability of any economy with a developed financial sector relies on debtors' commitment to repaying previous borrowing. When these promises are broken in unexpected numbers, chaos results. In 2008, for instance, British financial institutions wrote off a notional £9.7 trillion in lending to individuals – a 42 percent increase from the previous year.[92] Even so, households have largely avoided defaults on the level that occurred in the 1990s: mortgage repossessions peaked at 46,000 in 2009 – well below the 75,500 homes taken into possession in 1990.[93]

Instead, austerity appears to have been the preferred choice for British debtors. However, this carries its own potential difficulties. First, there is the problem of the paradox of thrift – or as Paul Krugman (2009) termed it, the paradox of debt. The idea holds that, as consumers (or governments) spend less in order to save more, the act of saving will itself trigger an economic contraction. As a consequence, the ratio of debt to income rises even as the savings rate rises. The extreme form of this paradox has not appeared: households have managed to reduce their debt burdens modestly since 2007. Yet doing so has been extremely costly, requiring a near-tripling of household savings rates to achieve even modest debt reductions. The cost to aggregate demand has been significant, with real consumption declining by the largest amount in over 50 years.[94]

In terms of the financial sector itself, it remains unclear whether widespread reform will take place. George Osborne, the present Chancellor of the Exchequer, announced in June 2010 plans to abolish the FSA and replace it with a number of successor organizations. This

[92] Bank of England
[93] Council of Mortgage Lenders
[94] AMECO

was an about-face from the logic behind the creation of the FSA in the first place, arguing that smaller and more activity-specific regulators are preferable to a single organization that oversees all aspects of finance (HM Treasury 2010). There are hints in the text of the plan subsequently published by the Treasury that some of the post-Thatcher orthodoxy toward finance may be reexamined. Aside from the suggestion that quantitative controls may return to the bank's toolbox for managing credit, the report concedes that:

> 'There is a strong argument that one of the reasons for regulatory failure leading up to the crisis was excessive concern for competitiveness leading to a generalised acceptance of a 'light-touch' orthodoxy, and that lack of sufficient consideration or understanding of the impact of complex new financial transactions and products was facilitated by the view that financial innovation should be supported at all costs (HM Treasury 2010)'

The British experience during the acute crisis and ensuing downturn stands in stark contrast to what took place in Franc, where the eruption of the financial crisis appears to have partially vindicated the suspicious French approach to consumer finance. French household net lending remained solidly positive through the early 2000s, leaving French consumers with one of the lower debt burdens in Europe. As a result, it suffered one of the mildest recessions among developed countries during 2008-09. Real French consumption, for instance, continued to grow after 2007. In Britain, by comparison, real consumption had still not returned to 2007 levels by 2013.[95] Whereas French households had some leeway to become more indebted in the downturn – thus cushioning the blow of the recession – British households were compelled to deleverage even as unemployment rose and incomes fell.[96] Indeed, the (2008) Lefevbre report to the National Assembly concluded that France's overindebtedness laws and the restrictions on the development of a subprime mortgage market were part of what insulated the French economy from the worst of the crisis.

[95] AMECO
[96] Eurostat

The lack of consumption fragility and consumer indebtedness in France also bolstered the French banking sector. The French government was compelled to craft bailouts, most notably with the renationalization and unwinding of Dexia. However, the pressure on French households to default or deleverage was far less, helping French financial firms to remain more stable than their counterparts in Britain, the United States, Switzerland, the Netherlands, and Germany during the acute phase of the crisis from 2007-08. By every measure – whether the cost of overall writedowns, public funds committed to banking sector supports, or total outlays of the public sector on behalf of financial firms – French financial firms were less vulnerable during the crisis (Deutsche Bank 2010). In terms of GDP, the French state spent less than one third what the British were compelled to offer the financial sector. Indeed, because of the fees the French state charged the banks, France has actually earned €2.4 billion from its bailout package (Groendahl 2011).

France's lower-debt, lower fragility financial regime would be expected to sacrifice growth during expansions yet suffer less severe reversals during contractions. This does turn out to be the case: considering to relative growth prior to the recession, French growth performance during the boom years of 1995 - 2007 (39.4 percent) compares less favorably to the eurozone average (44.6 percent) – as well as Britain's performance (67.8 percent). Yet the French undoubtedly outperformed the European Union and eurozone economies for the three years after the crisis struck. Per-capita GDP growth in the EU was 0.43 percent between 2008 and 2011, 0.89 percent in the eurozone, and 1.55 percent in France.[97]

Converted into a common currency, France's stability in the recession bested the British: French growth of 1.55 percent was preferable to Britain's *contraction* of roughly than 5 percent. Exchange rates do matter a great deal here: in unconverted terms, British per-

[97] AMECO

capita GDP grew by 2.9 percent over the same period. The difference between the two figures is accounted for by the collapse of the value of sterling in the early phase of the crisis. That instability, too, was an endogenous product of the country's debt and finance-dependent growth pattern: when the liquidity crises struck and financial markets froze, the appeal of lending to British borrowers declined, causing a depreciation of the pound.

III.2: Inequality

None of the fluctuations in inequality during the late-1990s and 2000s were as severe as those seen in the late-1980s. Nevertheless, inequality in Britain did continue to expand in ways attributable to the financial sector. Financial firms accounted for a disproportionate share of the increase in high-income earnings – constituting 60 percent of the gains made by the top decile (High Pay Commission 2011). At the close of the decade, the three most unequally paid CEOs (relative to their employees' salaries) all worked in financial or quasi-financial firms: the investment bank Schroeders as well as the two supermarkets-cum-banks, Tesco and Sainsbury's (Hutton 2011).

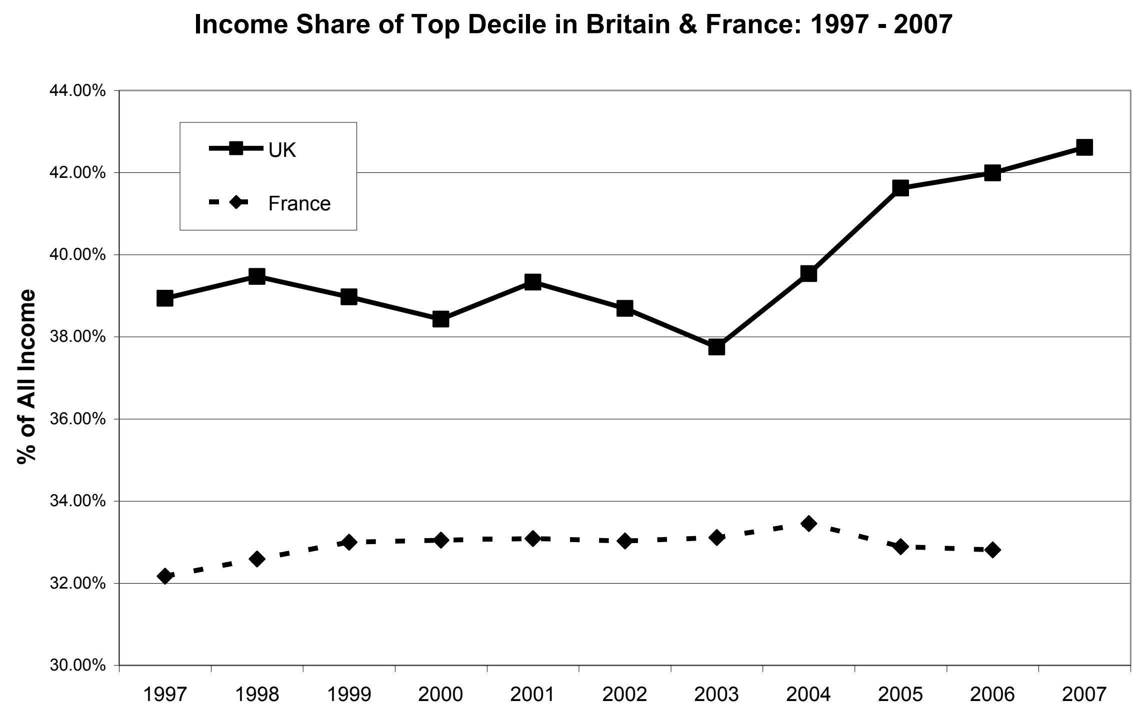

Figure 8 *Sources: Pikkety 2007 and Atkinson 2007*

It is important to remember that the connection between financial liberalization and inequality is not merely due to large salary increases by those working in the financial sector. It is also driven by growing investment incomes accruing to *réntiers* – that is, anyone who earns their income through holding financial products. The gain to *réntiers* might be expected in any country, since capital-holders can move their resources across borders.

Austerity of the sort pursued by Britain also disproportionately harms lower-income households. When firms shed workers or consumers are forced to pay off debt, it is the poor that have the least cushion in terms of savings and assets. If the state – often the final source of protection for these households – cuts back on social benefits at the same time, the consequences can be particularly dire. This has been occurring to some extent in Britain. The financial collapse and ensuing recession pushed British unemployment from a low of 4.7

percent in 2004 to an average of roughly eight percent since the crisis struck.[98] Cutbacks by the private sector have been accompanied by mildly regressive measures on the part of the government, with budget assessments showing that the lowest three deciles of British wage earners will lose 2 percent of their income annually between 2010 and 2014 as a consequence of tax and benefit reforms – compared to less than 1 percent for households in the seventh, eighth, and ninth deciles (Browne and Levell 2010). As a result, it is estimated that the 2010 and 2011 budgets will increase British poverty by 200,000 before 2014 (Joyce 2011). Finally, as articulated in chapters one and five, there is reason to expect that household borrowing intrinsically increases inequality by reallocating purchasing power to debtors at the expense of future income and wealth. This effect – and the austerity effect – should be more evident in Britain, where household borrowing was higher.

These facts are consistent with the fact that the expansion of British inequality greatly outstripped the miniscule – but non-zero – increase in French inequality (see figure 8). [99] The increase in *réntier* income should boost inequality everywhere, while other drivers of inequality were more specific to Britain. The same trend was in evidence when considering the incomes of the super-wealthy: the share of income going to the top percent of workers in both countries was just over eight percent in 1989; that jumped to 15.4 percent in Britain but only 8.9 percent in France by 2006-07.

Not only was the widening of French inequality less severe than the expansion of British inequality, but French inequality between 1989 and 2006-07 grew less than between 1981 and 1989. This is consistent with the argument that inequality expands particularly

[98] AMECO
[99] ONS

rapidly in periods of household credit growth: even within France, inequality grew faster during the period of greater household borrowing. Moreover, neither Britain nor France saw increases in inequality during the relatively low-debt early-to-mid 1990s. Again, each of these facts jives with the predicted liberalization-inequality connection.[100]

III.3: External Balances

The final macroeconomic consequence of backwards finance – or of the lack of it – can be seen by comparing the external balances of Britain and France. Britain, with debt-financed household borrowing, would be expected to import both goods and money: in order to spend money on foreign goods (i.e., a current account deficit), the country would need to sell assets to the rest of the world (i.e., a financial account surplus). Recall that there is a natural complementarity at work here: households that borrow in order to buy foreign goods produce attractive assets through the act of borrowing – assets that can be sold internationally to maintain a balance of payments.

[100] Pikkety 2007 and Atkinson 2007

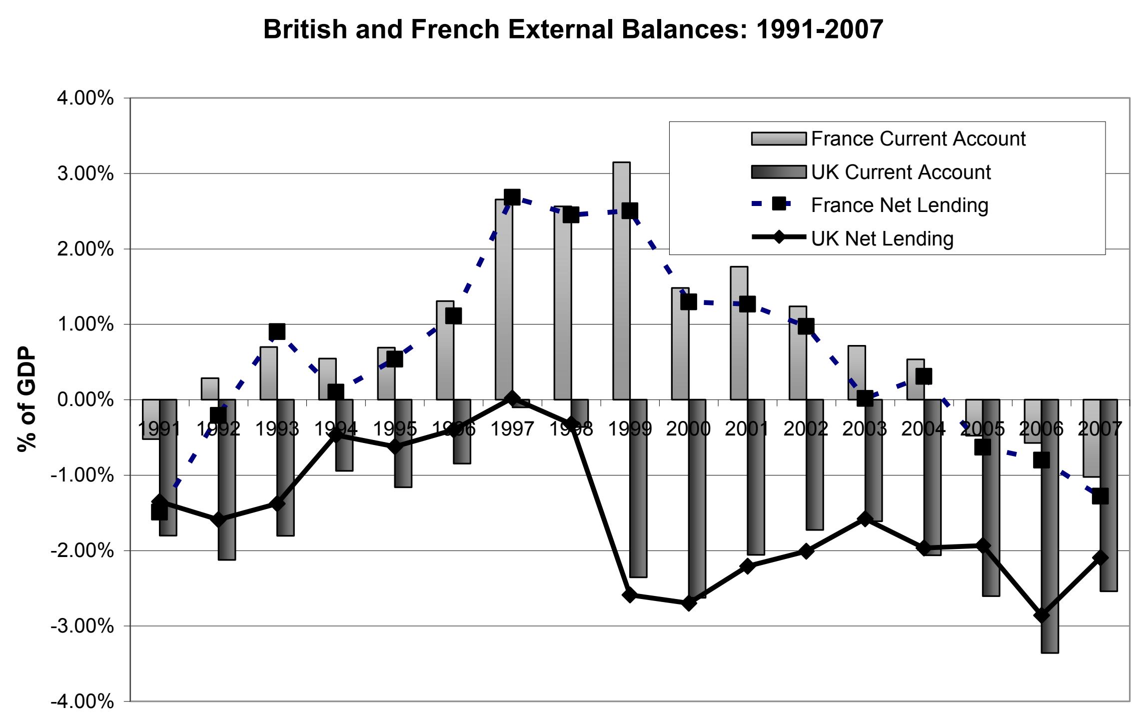

Figure 9

In the late 1980s, when this natural complementarity existed in both Britain and France, there were matching current account deficits and financial account surpluses in both countries. Since the early 1990s, with the complementarity in evidence in Britain but no longer France, only Britain exhibits a structural tendency toward external indebtedness. Figure nine shows how external imbalances shrank in both countries after the early-1990s recession – only to widen in Britain soon after the country's new credit boom began at the end of the 1990s. France was a net exporter of both goods and money for much of the post-1990s period, only returning to the pattern of current account deficits and financial account surpluses in the final few years before the financial crisis.

Here again, the trend is entirely consistent with the predictions made in chapter one: whenever either Britain or France began to allocate a greater share of financial resources to households, the countries' external balances deteriorated. Furthermore, when credit growth was choked off in either country, the trend temporarily reversed. This indicates not only the validity of the purported liberalization-imbalance link but also the fact that policy measures meant to restrict credit growth can go a long way toward mitigating the effects of that link.

III.4: Some Caveats

It stands to reason that France, in evading the unintended costs of financial liberalization, has also foregone many of the intended benefits. It is clear that French policies toward consumer debt reduced the total amount of credit available to the French economy and thus limited the amount of credit-enabled growth that could take place. Prior to the financial crisis, subsequent reports by the *Banque de France* and the French Senate argued that France was underindebted and that it was forgoing growth as a consequence (Bourdin 2006; Babeau 2006). As was noted earlier, France's growth performance after 1990 usually trailed Britain's – at least in years of growth. On this point, the Senate report is unambiguous:

> 'The growth of consumer credit has made a positive impact on French household demand and thus on the rate of economic growth. But the French have undoubtedly benefited less than others facing similar financial conditions' (Bourdin 2006, chap. 3). (translated by the author)

The report argued that French policy was oversensitive to the risks implicit in expanding financial markets for consumers while blind to the growth-boosting potential of consumption credit that had been harnessed in the more indebted Anglo-American economies. While the argument here is that such growth is of dubious value over the long term, it is still growth; that is, an increase in national income over the short- and medium-term.

There is a further downside to French financial repression: it is exclusionary. Because of the relatively low usury caps in France, non-standard (i.e., sub-prime) borrowers have significantly less access to credit markets in France. As a result, poorer individuals face credit tighter constraints than in countries with more liberal credit regimes. This, too, implies costs. Because high-interest loans to low-quality borrowers are illegal, for instance, a relatively large proportion of French borrowers are forced to turn to "loan sharks" or to credit products that are inappropriate for them (Department for Business Innovation and Skills 2004). Furthermore, restrictions on French household interactions with financial markets may contribute to the fact that the French face a daunting array of fees on everyday financial transactions – fees that inter-bank competition has done little to reduce (UFC Que Choisir 2010).

Likewise, the state's involvement in allocating credit to non-financial firms has also been problematic. One of the chief intended benefits of financial liberalization is the improved evaluation of alternative (productive) investment options. Whether or not this is always true, it is certainly possible that the state – even if incentivize income-generating uses of financial resources over non-income generating uses – may choose its investments poorly. The case in point here is Crédit Lyonnais, which was the largest financial institution in Europe in the early 1990s but no longer existed by 2005.

Crédit Lyonnais' motto in the 1980s was "the power to say yes," and it did evidently did say "yes" far too often. As a state-owned enterprise, it made several spectacularly bad lending decisions: it was exposed to Robert Maxwell's collapsing empire in Britain, had lent extensively to Bruce McNall (the fraudster and owner of the Los Angeles Kings hockey team), and most infamously provided the financing for a convicted Italian criminal named Giancarlo Parretti to acquire MGM studios – only to watch Parretti loot the company and then default. Aside from these high-profile mistakes, the company and its business finance arm had lent far too heavily to French commercial real estate endeavors and loss-making state-owned enterprises like Aerospatiale and steelmaker Usinor Sacilor, leaving it with a mountain of bad debt after the economic downturn in 1992-93. All told, the cost to the French taxpayer for sorting out the mismanagement of the state-run bank was around €15 billion (New York Times News Service 1995; McClintock 1997; Lecaussin 2011).

A final caveat about the French experience is that there is some evidence that the country's distinctive resistance to consumer finance was beginning to erode by the final years before the onset of the financial crisis. Household savings rates had begun to slowly decline and – for the first time – France began to see home prices rising sharply when compared to disposable income. Some financial products such as lines of home equity were beginning to become more common – though they were still subject to usury limits. It is entirely possible that, had the crisis not begun for several more years, French households may have found themselves more indebted than they actually were at the end of 2007.

IV: Conclusion to Part Two

The story of Britain and France's disparate experiences with liberalization could be simplified as a tale of two states making the same mistake – a mistake that only one of the countries learned from. Both countries encouraged their financial institutions to grow more competitive – domestically and internationally – forcing those businesses to adapt. Both countries watched as those adaptations generally facilitated a new allocation of financial resources that allowed households to become more indebted. Both countries suffered from the consequences of plummeting household savings and increased household indebtedness.

In Britain, overt suspicion of financial markets died amidst the prawn cocktail offensive and the ideological conversion of Labour into the pro-business, pro-finance New

Labour. The conversion was arguably half authentic: people like Gordon Brown did apparently buy into the idea that financial innovation could put an end to Britain's historical stop-go, boom-bust cycle. It was also clearly half calculated, with those like Tony Blair being straightforward in their argument that Labour faced an electoral abyss if it did not embrace business interests. The political calculus in Britain was much clearer than in France: the biggest winners during the 1980s in Britain had been wealthy businesspeople and *réntiers* – and Labour needed to woo those groups. Britain's post-1990s policy mix – nonintervention in financial markets, light-touch regulation, and openness to innovations in domestic financial practices – were seen as both politically necessary and ideologically acceptable.

France had neither the same political imperative nor an analogous ideological conversion. The *puissances d'argent* never shed their negative connotation in the eyes of French policymakers: there is a direct line from Pierre Mauroy to Nicolas Sarkozy to François Hollande in terms of overt suspicion of financial markets, institutions, and motives. The liberalization process itself had been compelled – not desired – as the price of achieving other policy goals. As a result, particularly after problems like household overindebtedness began to appear, the state consciously isolated its seemingly dangerous financial sector from the wider French economy. It allowed financial institutions the same leeway they possessed in other countries to engage in competitive innovation, consolidation, and balance sheet expansion, but forced them in large part to take these activities outside of France. Inside France, what remained was a relatively traditional financial sector, focused on saving by relatively unsophisticated households and borrowing by firms.

This analysis, it must be conceded, makes a serious implicit judgment. In arguing that France learned from its "mistakes" while Britain did not, it places a greater emphasis on the costs associated with the growth and resource allocation patterns that resulted from liberalization. It could be argued that Britain's choice to permit financial markets to operate without fetters produced more growth over the longer term and is therefore superior.

The failing of this argument is in its short-termism. Britain's approach effectively mortgaged the future. So long as households and financial services firms can borrow in the present, the economy will remain strong. But if Britain decides that it must deleverage – or if international creditors force them to deleverage – the primary driver of British economic growth disappears. Over the past decade, it has borrowed more yet invested less than France. It has seen incomes and wealth accumulate in the hands of the super-wealthy – i.e., those who are least likely to spend their wealth. With consumers shut off from credit, with investment not generating new sources of productivity, with money in the hands of those who don't spend it, and with an austerity-minded government in power, where is British growth to come from?

This is not to say that France has no problems – even problems stemming from its own financial liberalization. Aside from unrelated issues such as labor market rigidities, French banks are highly exposed to the European periphery mired in a series of sovereign debt crises. The fact that French banks are so exposed is due in part to the fact that French banks are some of the most internationalized in the world. That reliance on international activities is partially the result of the relatively strict restrictions on how French financial institutions are allowed to interact with domestic partners.

To conclude, the unintended consequences of financial liberalization in Britain affect households, banks, the government, and firms. The behaviors of each sector have been profoundly transformed by the liberalization process. In France, by contrast, households and

– to a far lesser extent – the country's network of interconnected firms has been kept partially insulated from the transformation of the financial sector. As a result, the French have largely succeeded in isolating the dangers associated with liberalization to the financial sector itself.

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Nine – Conclusion: How Much External Validity?

The stories of financial liberalization told in chapters three through eight give rise to a new set of questions concerning external validity. How representative are Britain and France when looking at the rest of the developed world? That is, if financial liberalization has led to a new allocation of financial resources that facilitates unbalanced and unstable growth in these countries, is that trend in evidence when taking a broader cross-section of advanced economies? How much variety is there across cases? Do countries tend to look more like Britain – enthusiastic liberalizers of not only financial markets but also the financial relationships of domestic non-financial sectors – or more like France – where government policy has tried to discourage net borrowing by non-productive sectors? Or do countries differ across a spectrum between the two archetypes? Most crucially, are the unintended consequences of financial liberalization are reliably more evident in countries that choose the British path over the French?

This chapter has two purposes: First, it briefly summarizes the developments in Britain and France described in the preceding six chapters, recapping the British and French evidence for each of the six propositions laid out in chapter one. Second, it assesses whether those propositions – and the British and French findings – can be generalized to a broader cross-section of developed countries. The chapter examines each of the propositions in turn before concluding with some thoughts on directions for future research.

I: A Methodological Note

It should be noted that different parts of this analysis will use observations from a varying group of countries. That is, the cross-section of countries examined has a shifting composition. The reason for this is straightforward: not all data is available for all countries. The many gaps in countries' reported data – and particularly the lack of high-quality historical data dating from prior to the mid-1990s – creates several problems.

First, it essentially makes more robust statistical analysis (such as the use of various types of regression) impossible without generating more observations through (a) expanding the analysis to less-developed countries, and/or (b) limiting the analysis to the most rudimentary statistics for which there is more historical data. Making either of these choices would degrade the quality of findings beyond what is justifiable. Instead, this analysis will make use of more basic means of data aggregation and comparison – weighted and unweighted averages will be employed, as will basic two-variable correlations. While these methods cannot provide the ostensible precision of statistical analysis, they are nevertheless useful – particularly when paired with the more in-depth discussions of two cases.

Second, the shifting composition opens the analysis to claims of problematic data selection – a danger illustrated by the recent high-profile mistakes of Carmen Reinhart and Kenneth Rogoff in their analysis of sovereign debts. The only remedy to this problem is transparency: each piece of analysis carries a footnote that details which countries are included in the sample. Every effort has been made to include as many countries as (a) are appropriate and (b) report the relevant data – though there are undoubtedly some cases where data is available but missing from this analysis. Data is only considered from countries that are members of either the OECD or the European Union – again, reflecting a conscious choice to avoid conflating the issues facing developed and developing financial systems.

II: Revisiting the Propositions

After the collapse of the Bretton Woods system in the early 1970s – a period "when finance was the servant" (Helleiner 1993) – the use of capital controls, dual exchange rates, and other mechanisms of managing financial flows were gradually phased out across the developed world. Germany, the Netherlands, and the United States have had a longer tradition of relatively open capital accounts. Japan and the United Kingdom joined them in liberalizing access in 1979. France and Italy were among the slowest OECD nations to follow suit, liberalizing capital flows as part of steps toward completing the single market and facilitating European Economic and Monetary Union. The last few stragglers within the OECD dropped their capital controls by 1995 (Klein and Olivei 1999; Simmons 1999). As barriers to capital flows were dismantled, governments were compelled to make their markets more competitive, eliminating restrictions on domestic financial practices and rules governing firm ownership – moves exemplified by Britain's big bang in 1986 and France's deregulation of its capital markets in the late-1980s.

The most visible consequences of this change have been in the size of financial markets and the degree to which they are connected. At the start of the 1980s, global output and global financial wealth were roughly equal; yet by the time Lehman Brothers declared bankruptcy in 2008, the worldwide value of financial assets had more than tripled relative to the size of the global economy. Gross cross-border capital flows in 1990 amounted to 4 percent of global output, a number which reached nearly 20 percent on the eve of the global financial crisis in 2007-08. Cross-border bank lending in 2007 alone reached $4.9 trillion.[101] Put simply, the liberalization of global financial flows and the abolition of strict state control over financial systems created a remarkable expansion in global credit and in the trade of financial instruments.

> Proposition 1: *Financial liberalization heightened the competitive pressures within the financial sector, compressing returns on traditional financial activities and compelling financial institutions to seek new sources of profit.*

While the story of liberalization and intensifying competition varies from country to country, the notion that competition began to intensify in earnest at the end of the 1970s is taken as a stylized fact in much of the literature (c.f. for instance Vives 2001; Beck, Demirgüç-Kunt, and Levine 2003). The process began in the United States, with the dismantling of barriers to interstate banking and the end of Regulation Q. It then spread to the countries of Europe, taking hold in Britain in the early-to-mid 1980s and swiftly moving on to the rest of the continent. Xavier Vives (2000) articulates the generally held position succinctly, stating that:

> 'The shortest way to characterize the transformation of the banking industry is to say that the emphasis has gone from regulation to competition. Indeed, [from the 1940s until the 1970s], rate regulation, entry restrictions, and charter limitations of banks (including the separation of commercial and investment banking) have been used by regulators to limit competition… in general, the regulatory changes have promoted competition by decreasing geographical and activity restrictions and thus reducing entry barriers.'

In other words, the post-1970s regulatory regime enhanced competition by removing legal barriers to both domestic competition (through charter limitations) and international competition (through exchange controls and bans on foreign bank ownership).

[101] McKinsey

These international trends are consistent with the British and French experiences. In Britain, the Tories lowered exchange controls, ended the corset, and eased the distinctions between banks and building societies. As the 1980s progressed, they liberalized competition on London's capital markets, breaking the distinction between brokers and jobbers and allowing foreign financial firms to begin purchasing domestic ones. The process of liberalization in France came somewhat later, with banking reform in 1984 reducing the specialization within French financial services. New capital markets and products developed between 1985-87 were no longer restricted to France's small state-regulated group of capital market participants, bringing more domestic and international competition – along with a more modern financial system more generally – to the country.

In both Britain and France, the double-edged nature of liberalization was apparent: for banks, the returns earned on lending were squeezed by competition; for capital market participants, basic commissions that had previously been fixed began to fall as brokers tried to undercut one another. The pressure on brokers forced market-makers' spreads to compress. Financial firms in both countries were obliged to shift strategies. Prior to the 1980s, financial institutions in both countries had relied on collusion and state control to maintain healthy margins on traditional financial activities. After the 1980s, the end of collusion and the withdrawal of state controls and protections meant that firms had to compensate for deteriorating margins.

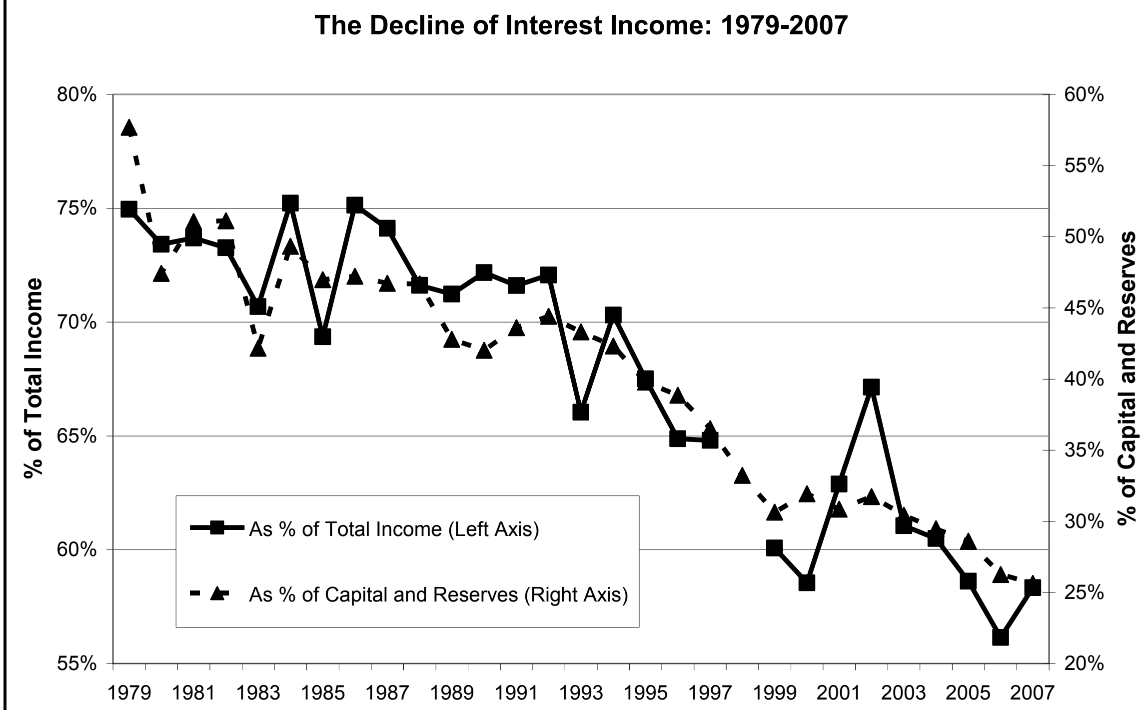

Figure 1 *Source: OECD*

Looking to the broader pool of developed economies, the same phenomenon is in evidence. The aggregate interest rates charged by lenders in developed economies dropped by an average of 36 basis points every year between 1981 and 2007.[102] Falling official rates, the elimination of quantitative ceilings on credit creation, and fewer restrictions in general meant more competition for lenders. The returns on simple intermediation were compressed as a result. Figure one shows the marked decline in the revenue that banks generated from interest in the post-liberalization era – both as a share of total net income and when compared to banks' capital and reserves. These figures articulate neatly how liberalization compressed

[102] World Bank World Development Indicators (WDI). Shifting composition (depending on which countries released data) of Australia, Belgium, Canada, Finland, France, Germany, Greece, Ireland, Italy, Japan, South Korea, Netherlands, Portugal, Spain, Sweden, Switzerland, the United Kingdom, and the United States

the returns to traditional deposit-and-lend banking, forcing banks to look elsewhere for income.[103]

Investment banks and brokerage houses faced analogous dilemmas. The most basic commissions and fees – such as those on exchange-traded instruments like stocks and simple derivatives – fell as part of the liberalization process. This was a consequence of both dismantling fixed-fee regimes and permitting new competition from discount brokers and eventually services such as online trading platforms. By the mid-2000s, per-share commissions in the United States had dropped to less than a third their immediate post-deregulation levels at the end of the 1970s (Goldstein et al. 2009). In recent years, traditional equity traders have shut down simply because, as one trader put it, "there aren't enough commission dollars today for the number of market participants" (Faux 2012). Commissions likewise declined in most major European markets, including on the Frankfurt, Euronext, and OMX exchanges (Munck 2006).

Competition further limited the return to arbitrage opportunities. Bid-ask spreads in the United States have been declining for decades (C. Jones 2002); when New York and NASDAQ stock exchanges moved from fraction-based pricing to decimals in the early 2000s, traders compressed buyers' and sellers' quotes almost instantly (Bessembinder 2003). While this reflects more complete and liquid markets, it also means that the margin to be made on market-making has fallen. Even the more esoteric yet relatively accessible tactics such as merger arbitrage – capturing the difference between a stock's acquisition price and the price it trades at just before the merger is complete – have seen drastic reductions in returns due in large part to competition (Jetley and Ji 2010).

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[103] OECD. Shifting composition of all OECD members (depending on which countries released data). A similar trend emerges regardless of the sub-sample used in order to avoid shifting composition problems.

Proposition 2: *Financial Firms adapted in three chief ways: consolidation, expansion, innovation*

Each of these three adaptive strategies was in evidence in Britain and France – and each is in evidence when examining the wider developed world. Consolidation – particularly through the explosion in merger and acquisition activity (M&A) within the financial sector, was among the most obvious of financial firms' adaptations to their new regulatory environment (Group of Ten 2001). France was particularly noteworthy in this regard, as its large community of local savings banks was consolidated into larger banking groups. The United Kingdom was something of an outlier, however, having gone through an extensive consolidation of its banking sector much earlier – as early as the beginning of the 19th century. Nevertheless, there was a modest compression of the investment banking and brokerage community following the big bang (R. C. Michie 2001).

Global M&A activity in developed country financial sectors skyrocketed during the 1980s and peaked at the end of the 1990s. In the 1990s alone, more than 8000 financial institutions in the 13 largest industrialized countries merged (Davis 2007). When the dust settled, the number of banks in OECD states had nearly halved between 1988 and 2007. The United States alone shed 13,000 institutions. Figure two reflects this trend among OECD countries reporting data in 1990 and 2007.[104]

[104] The United States is not included because of simple scaling issues. South Korea is not included because of a discontinuity in data reporting.

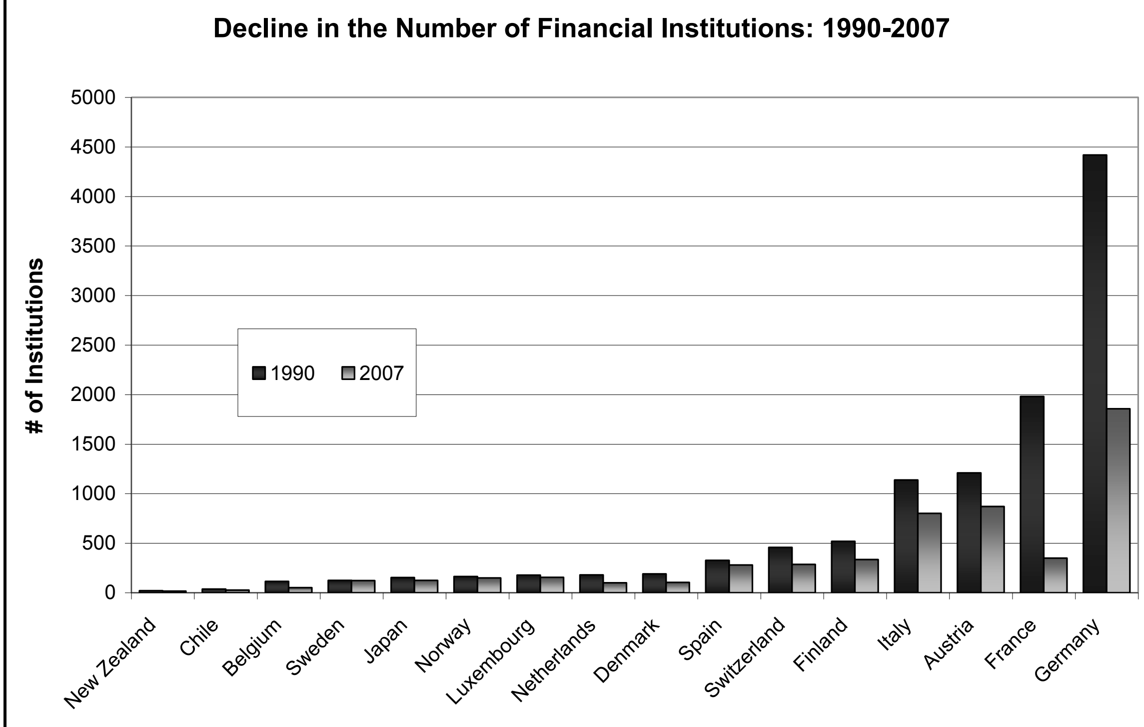

Figure 2 *Source: OECD*

While consolidation may reduce costs and therefore boost profits, financial firms in the era of intensified competition also needed new revenues. They sought these through both expansion and innovation. The expansion of financial firms' balance sheets has been readily apparent – both in Britain and France and elsewhere. In the European Union (EU), for instance, the value of all assets held within the financial sector grew from 295 percent of EU GDP to over 600 percent between the mid-1990s and the start of the financial crisis.[105] This trend is reflected not only across Europe but across all countries and all asset classes, the financial services industry created financial products whose value grew far faster than the real economy (Farrell, Lund, Foelster, et al. 2008; Farrell, Lund, Skau, et al. 2008; Roxburgh et al. 2009). The American commercial banking sector was among the relatively slow

[105] Eurostat Financial Balance Sheets

expanders during this period – yet even there, banks' on-balance-sheet assets rose from 59 to 79 percent of GDP from 1997 -2007.[106]

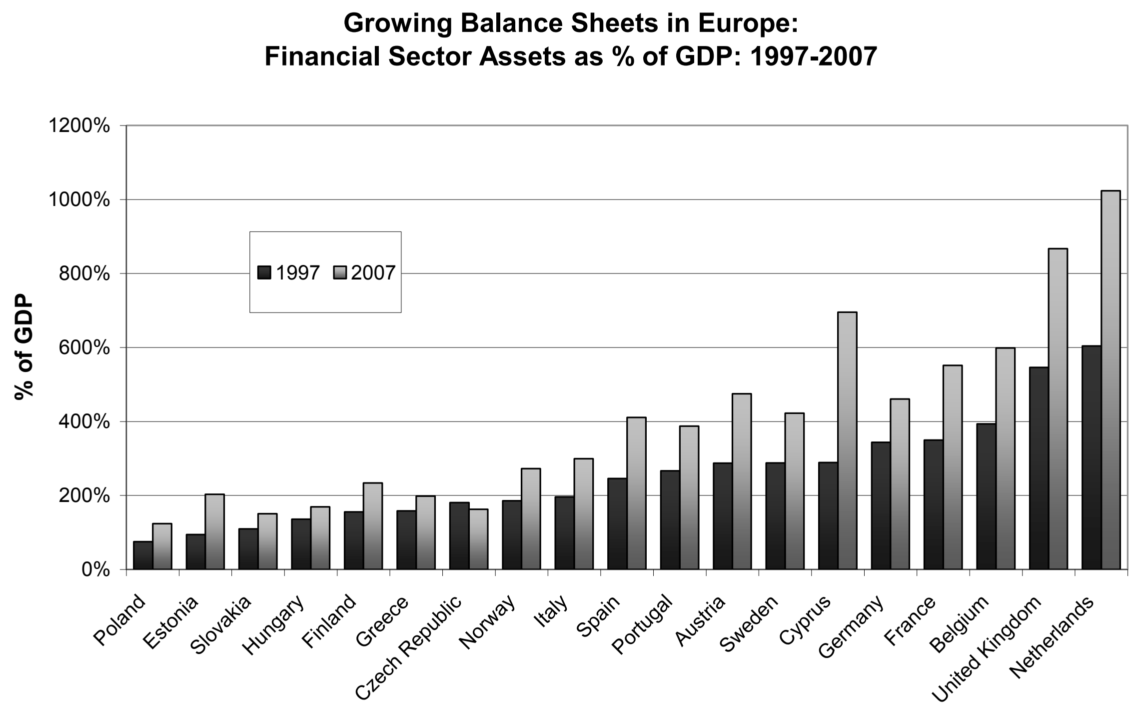

Figure 3 *Source: Eurostat*

Expanding and consolidating offered financial firms a means by which they could compel national governments – and, by extension, the taxpaying society at large – to absorb some of the risk from the firms' activities. Financial firms deliberately sought to extract implicit guarantees from government by becoming "too-big-to-fail" – that is, so large that allowing the banks to fail would be systemically destabilizing. As a result, those massive institutions became more attractive to larger uninsured creditors because it was believed that the government would provide a backstop in the event of the firm experiencing financial difficulties. The Kansas City Federal Reserve, in a prescient (2007) study of this

[106] US Federal Reserve

phenomenon, estimated that the largest U.S. banks had paid an extra $20 to $29 billion over dozens of acquisitions in order to ensure that they would receive such implicit guarantees.

Yet as important as consolidation and expansion were as competitive tools for financial firms, the most important response to intensified competition was arguably the development of innovative new financial products. Chapter one laid out the theoretical rationale for using innovative practices to generate profits. In short, it argued that innovations such as securitization, tranching, the advent of parallel banking, and the trading of risk through new derivatives, allowed financial firms to increase their leverage, create highly marketable products to attract new sources of funding, and ultimately engage in a range of activities without the requirement that they hold the assets generated by their activities.

Britain and France differed quite sharply in their adoption of these new financial products. In Britain, most economic sectors became somehow involved in these new markets. Banks produced them, large institutional savers bought them, and much of the borrowing was ultimately done by households. Innovation thus provided the lubricant for matching lenders and borrowers. In France, by contrast, participation in these new markets was more confined: while banks actively traded the most cutting-edge securities, they generally did not generate their own new assets out of domestic borrowing. And while businesses did hold more exotic financial instruments, most of their financial assets remained concentrated in unlisted shareholdings rather than the new classes of debt products.

The growth of the global market for such innovative products is striking. The value of securitization to the financial sector has been reflected in the rapid rise of new issuances of securitized debt – and their enduring economic significance even after the crisis. Securitization has existed in some form for quite some time: the United States pioneered today's recognizable mortgage-backed securities (MBSs) in the early 1970s and the first European MBS instruments were issued in 1985 in Britain. The conversion of other forms of consumer borrowing into securities soon followed – auto loans in 1985 and credit card debt in 1987. As figure four shows, the market reached its zenith in 2007, when nearly $4 trillion in new securitized debt was issued in the US and Europe together. That figure is larger than the GDP of Germany – and comprises over 5 percent of all global output.[107]

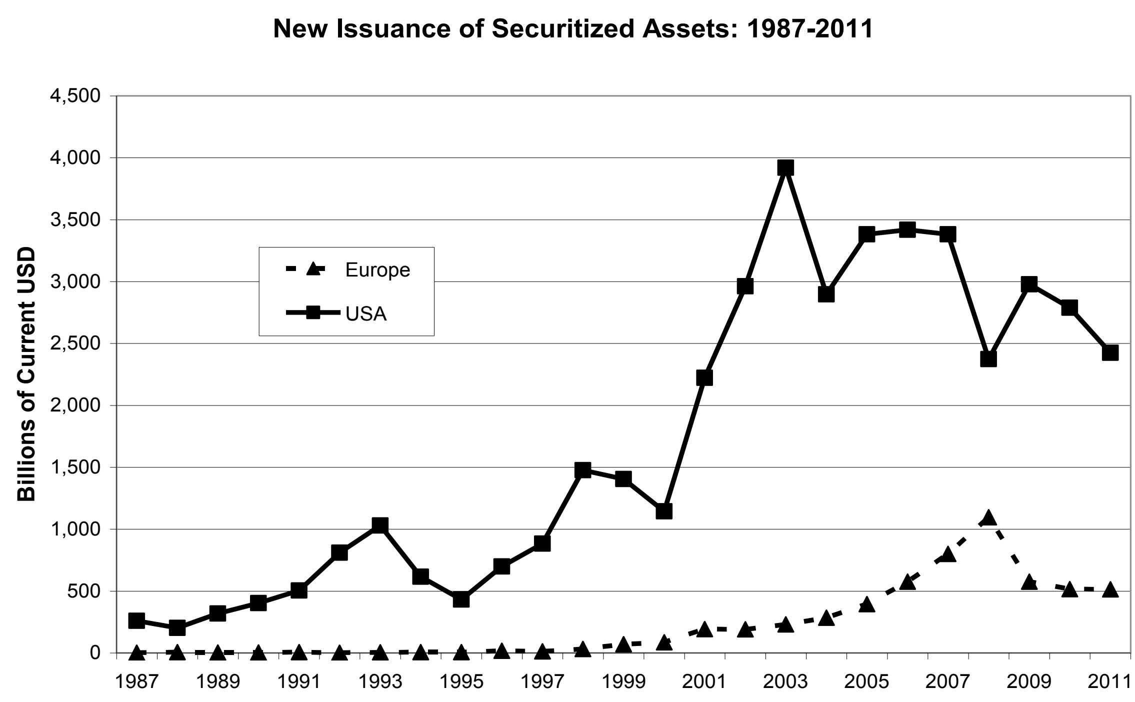

Figure 4

Global derivatives market saw similar growth patterns, with the highly concentrated market expansion in the early-to-mid 2000s shown in figure five. Among these products, interest rate and currency swaps form the largest portion of global market. It should be noted that notional values on interest rate and currency swaps are not economically significant in their own right (they are used to calculate the payments involved but are never actually

[107] Securitization data from Securities Industry and Financial Market Association (SIFMA). GDP from World Bank WDI. Non-agency residential MBS issuance in the United States only included from 1996 onward.

exchanged); however, they can be used to reflect the speed of the market's expansion. The notional value of credit default swaps is different – and far more likely to actually change hands. This is because securities can see their values reduced to near-zero, forcing the CDS issuer to compensate the contract-holder for the full value of the asset.

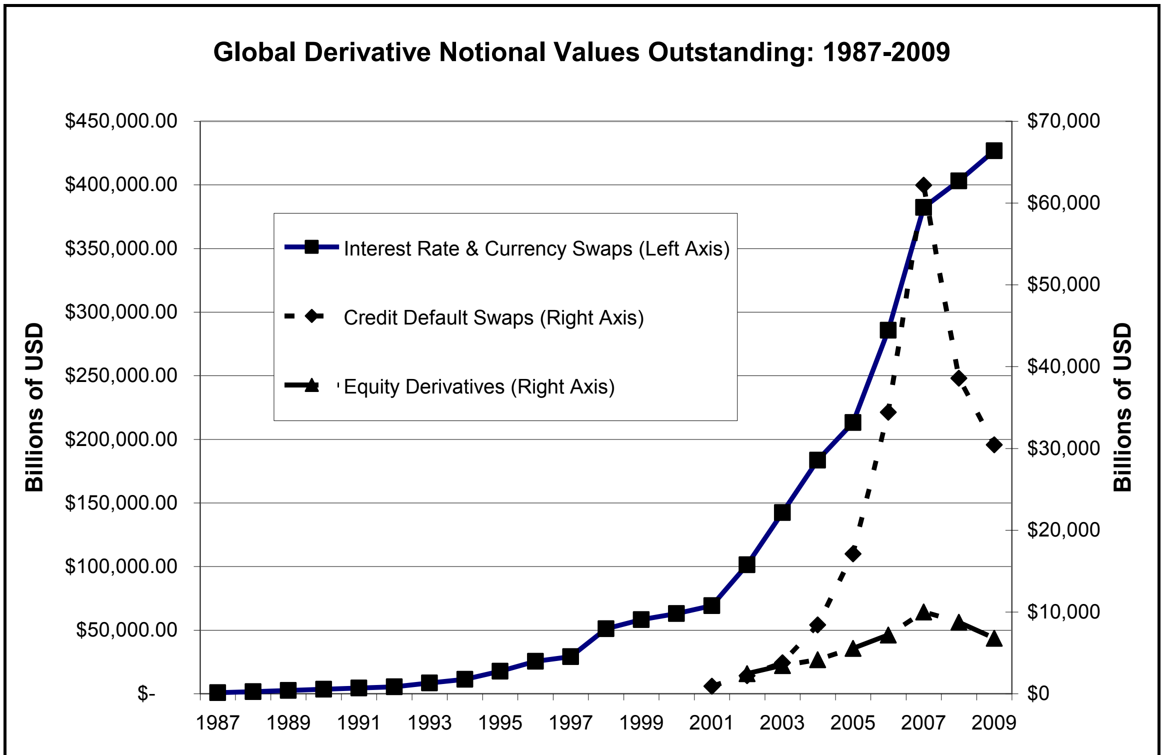

Figure 5

Asset-backed commercial paper (ABCP) programs grew at a similar pace, pulling funds through the financial sector and often into the household sector. In just the 36 months leading up to the peak of the market in July 2007, the amount of outstanding ABCP debt in the United States – comprising most of the global market – nearly doubled from just over $600 billion to nearly $1.2 trillion.[108]

It is also worth noting that, as financial institutions traded in more exotic instruments, they earned money in new and different ways. Each new product came with an array of fees

[108] SIFMA

that financial firms could charge for originating, repackaging, managing, and administering their inventions. Every layer of securitization promised an additional round of fees, as did managing the flows of repayment streams through the maze of obligations created by securitized products. Every OTC derivative generated further revenue in the form of service fees.

Looking at the revenue streams of American industry group FINRA (Financial Industry Regulatory Authority) in figure six,[109] virtually all traditional sources of revenue – commissions on exchange-listed products, asset management fees, and interest income – were relatively flat through the 2000s. What varied significantly was trading gains, which collapsed during the acute phase of the crisis, and "other revenue related to the securities business," a category that includes the service charges associated with the innovative products discussed here.

[109] SIFMA

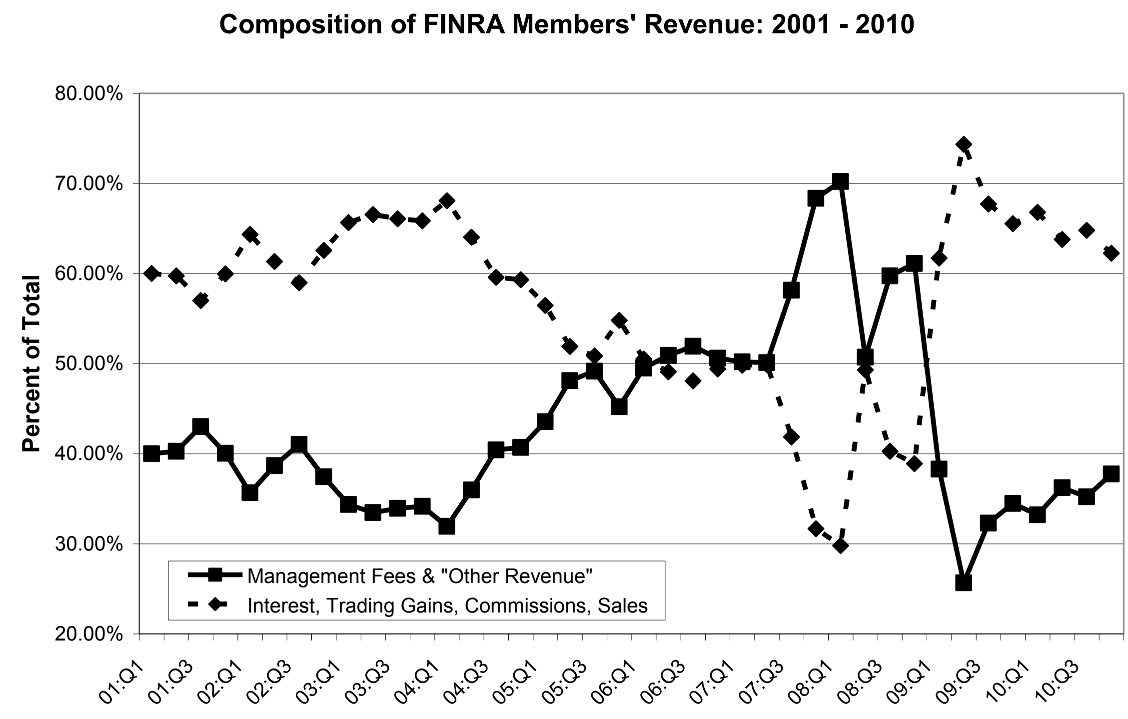

Figure 6 *Source: SIFMA*

Finally, the opacity of many of these instruments also meant that financial firms could take advantage of information asymmetries. Many innovative derivatives are exceedingly complex and, because they are not traded on public exchanges, difficult to price. In this world, traders stood to make enormous profits simply by getting their counterparties to take the wrong end of a bet. At a very crude level, clever sellers could simply rook their counterparties by selling them a product they did not understand (Das 2010).

> Proposition 3: *Financial firms' competitive adaptations resulted in an increased allocation of financial resources to the household and financial sectors.*

Financial firms cannot expand a balance sheets or increase leverage on a systemic level without the demand for new borrowing and a supply of new funding. Prior to deregulation, households had primarily played the role of savers. While they did borrow, their main interaction with the financial sector was as providers of deposits. Non-financial firms, in turn, did the vast majority of the borrowing. As financial firms adapted to the post-liberalization environment, however, this traditional relationship changed a great deal. As a result, a growing share of financial resources has ultimately been committed to sectors that generally do not directly generate new sources of productivity – households and financial firms.

The case studies of Britain and France in the 1980s offered an instructive illustration of how this happened. In both countries, financial firms became free from quantitative and qualitative credit guidelines as well as legal restrictions on what financial products they could offer. The result was a marriage between households looking to boost their purchasing power and financial firms looking to expand their balance sheets. While businesses also borrowed more, the larger share of new lending by the end of the decade was flowing to households. The same trend continued in Britain after a brief pause in the early 1990s. France, however, did not return to this "backwards" financial relationship. This fact is not inconsistent with this proposition: it merely reflects that state policies can still prevent such a reallocation of financial resources from taking place (i.e., that proposition six holds true as well).

Looking to the global system, is the same general trend in evidence? The answer is a very clear yes. Figure seven shows the household and corporate net lending (i.e., net saving) position for 30 – mostly European – economies between 1980 and 2007.[110] The contention of the proposition certainly appears to hold in this data: during both the late-1980s and then from the mid-1990s to the late-2000s, there were noteworthy declines in household net

[110] It represents a weighted average of the net lending figures from whichever subset of the 30 countries reported data. The same trend appears in analyses that hold the composition of the reporting group constant – so much so, that they are graphically indistinct for the most part. Likewise, the trend is virtually identical in the unweighted sample, with minor discrepancies introduced by giving the relatively extreme Baltic states heavier weighting. The included countries are: Belgium, Bulgaria, Czech Republic, Denmark, Germany, Estonia, Ireland, Greece, Spain, France, Italy, Cyprus, Latvia, Lithuania, Luxembourg, Hungary, the Netherlands, Austria, Poland, Portugal, Romania, Slovenia, Slovakia, Finland, Sweden, Norway, Switzerland, the United Kingdom, the United States, and Japan.

lending across these economies. As in Britain and France, that trend was interrupted only in the early 1990s. A concurrent upward trend in net corporate saving is generally in evidence as well.

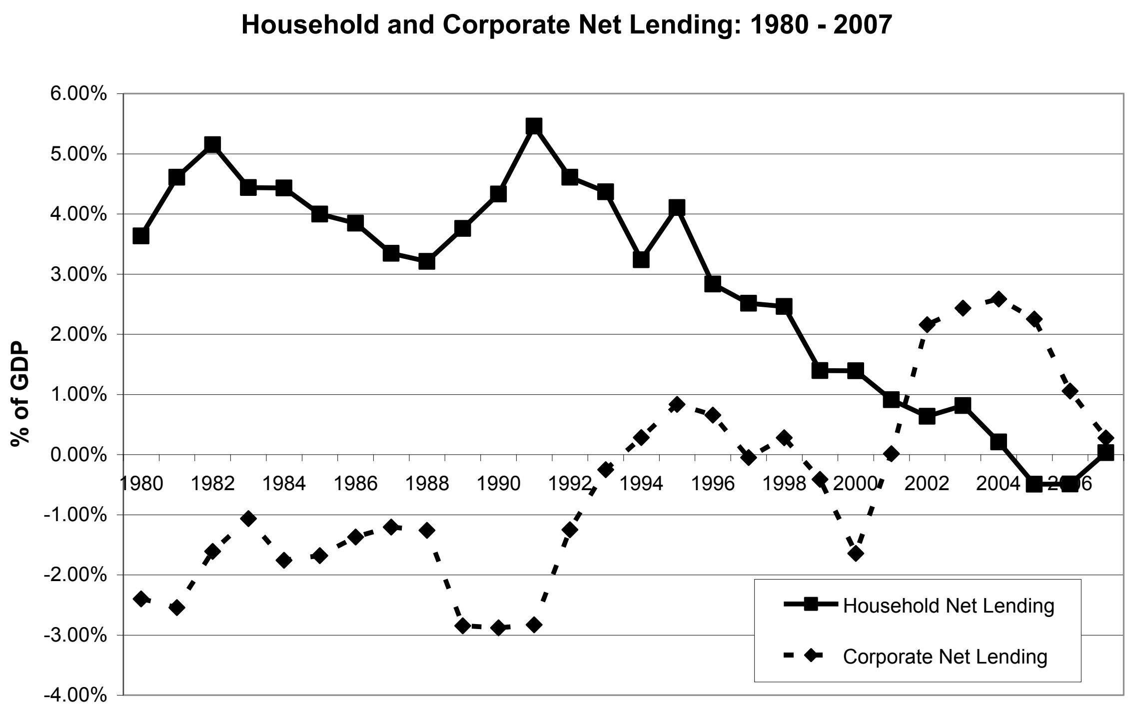

Figure 7 *Source: AMECO*

By the mid-2000s, households in this cross-section of countries became net debtors, borrowing more than businesses. This is effectively the same "backwards" resource allocation seen in Britain and France from 1987-88 and in the UK during the mid-2000s. These trends appear irrespective of whether countries are weighted equally or according to GDP – and in both averages made up of shifting compositions and in averages that hold the group of countries constant. In virtually all countries examined, there has been a secular decline in households' financial balances, particularly when compared to corporate financial balances. In other words, this trend is clear and robust, not the product of data selection.

Part of the reason for this robustness is the fact that the decline in household lending that occurred during the 2000s was remarkably consistent. Even in France, which resisted the expansion of consumer finance, household savings dipped in the final few years before the crisis.

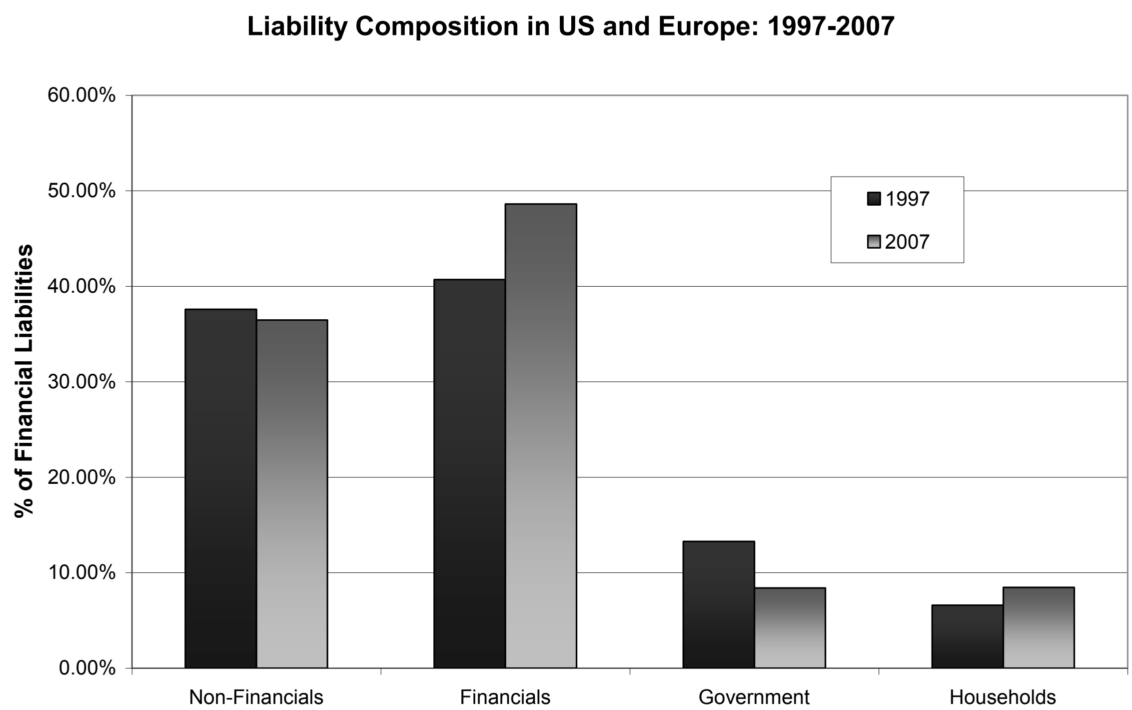

Figure 8 *Source: US Federal Reserve & Eurostat*

The effect of this reversal on the composition of outstanding liabilities is less clear and more subject to national variation. On the whole, it is nevertheless consistent with the narrative presented here. As figure eight shows, the non-financial and government sectors accounted for a smaller share of all outstanding financial liabilities in 2007 – on average – than they did in 1997. By the same token, households and financial corporations accounted for a larger share in 2007 than 1997.[111] This would seem to indicate a reallocation of credit from productive to unproductive sectors, confirming the account suggested by proposition

[111] Belgium, Denmark, Germany, Greece, Spain, France, Italy, Lithuania, Hungary, Netherlands, Austria, Poland, Portugal, Slovakia, Finland, Sweden, the United Kingdom, Norway, and the United States.

three. Even so, some care must be taken with these figures. In this case, whether or not countries are weighted by economic size makes a large difference: the relative resistance to household indebtedness in France and Germany – again, a disparity dealt with in proposition six – pulls down the average share of financial resources being allocated to households. Moreover, in extreme cases such as Britain, the expansion of the financial sector was so large that *all* other sectors declined in comparison – though the drop in the share of debt going to households there was far smaller than the decline in the share allocated to the government or non-financial sectors.

Despite these caveats, the visible reallocation of outstanding liabilities is particularly remarkable given the fact that governments and non-financial corporations themselves borrowed more (in absolute terms) throughout the period examined. This means that financial corporations and households generally increased their absolute borrowing faster than governments and non-financial businesses. Moreover, since non-financial firms began this period with large outstanding debts, the relative erosion of their share of debt all the more notable.

Furthermore, this data understates the growth of household debt. While a mortgage or auto loan will appear in financial statistics as a household sector liability, the funds that banks borrow in order to create the mortgage – such as through ABCP conduits – would appear as financial sector liabilities. The same is true for any debt-funded purchase of derivative products ultimately underpinned by the repayments of a household borrower. In the end, one simple borrowing transaction by a consumer can create many layers of financial assets and liabilities within the financial sector – the values of which are largely dependent on the household repaying its debts. The vast majority of all complex securitized assets sit on top of loans made to the household sector. Residential mortgages, for instance, underpin the majority of *all* securitized assets in the global marketplace. [112] In this way, the importance of household lending is substantially larger than reflected in this one representation.

> Proposition 4: *The resulting growth pattern (or "finance-growth nexus") is fueled by consumer debt and asset price appreciation rather than investment.*

In the accounts of financial liberalization in Britain and France during the 1980s, consumption rather than investment was the largest driver of growth. Much of this consumption was, in turn, either directly enabled by borrowing or indirectly facilitated through the wealth effect of rising home values. Particularly in Britain, households seeing their asset values rise decided to consume more and save less. The two countries' situations began to differ during the 1990s, as France's savings rates returned to their pre-1980s norms and consumption grew slower than income. Britain, on the other hand, swiftly returned to its 1980s pattern of debt-fueled consumption. The result of this disparity was faster growth in Britain – albeit growth that was predicated on rising asset prices and intertemporal tradeoffs.

Making this argument in a cross-sectional manner requires demonstrating that consumption in these countries has risen faster than incomes – indicating that households are spending out of borrowed funds. As was the true of Britain and France in the 1980s – and in Britain ever since – this is generally the case in the developing world. As figure nine shows, average consumption growth among OECD members grew faster than average income growth in 12 out of the 17 years between 1991 and 2007.[113] In the other five years (1991, 1995, 2001, 2003, and 2007), income gains were either equal to or very slightly larger than consumption gains. Taken together, incomes in developed economies grew an average of

[112] SIFMA
[113] Of all OECD members reporting data, shifting composition.

2.52 percent per year while consumption in the same countries grew an average of 2.99 percent annually. Household borrowing accounts for the difference.

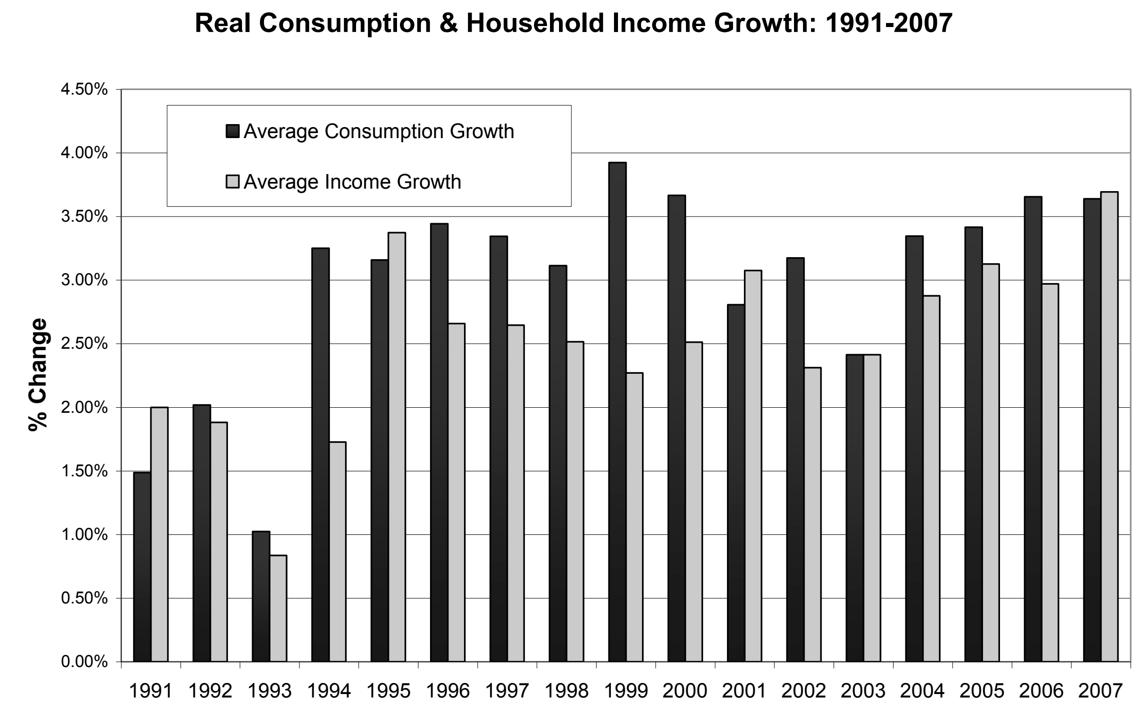

Figure 9 *Source: OECD*

To reiterate the point made in chapters five and eight, the contribution of debt to consumption is significant because advanced countries rely so heavily on consumption in order to grow. As figure ten demonstrates, not only has consumption been the largest driver of growth in developed economies, but its importance as a driver of growth has increased over the past thirty years. By the first years of the 2000s, two thirds of all growth in developed countries came through consumption – a higher proportion than at any time after the Second World War. At the same time, the relative contribution of investment has declined modestly, slipping from accounting for 18 percent of growth to 16 percent.[114]

[114] Of all EU and OECD members reporting data, shifting composition

Overall, this pattern should be expected in relatively wealthy societies that use their financial resources to spend rather than invest.

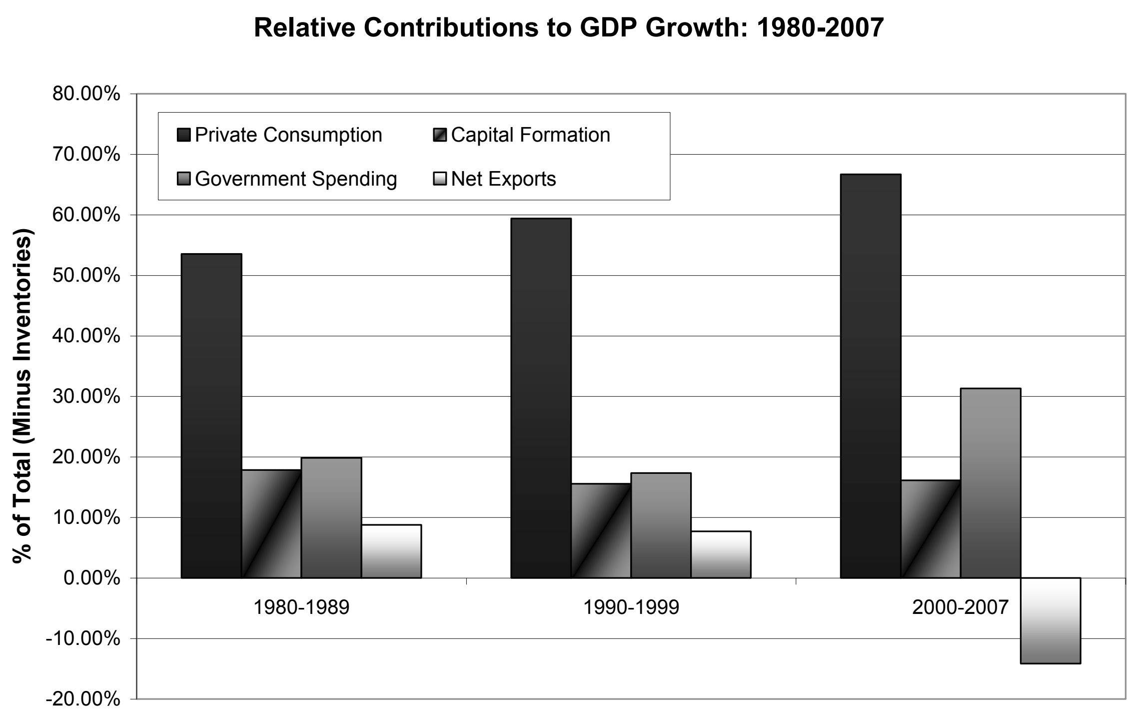

Figure 10

Source: AMECO

In fact – far from liberalization giving rise to an investment-driven finance-growth nexus – it is entirely likely that the reallocation of financial resources away from non-financial businesses and toward households and the financial sector has actively *disincentivized* productive investment. This conclusion should not be surprising: With few exceptions, households borrow in order to consume and invest in their homes. Financial firms generally borrow funds to create or buy financial assets. The fact that more credit is flowing to these two sectors suggests that income-generating uses of credit (i.e., investment) should decline.

Not only do the financial and household sectors draw in financial resources, there is reason to believe that financial asset purchases have increasingly become a substitute for investment (i.e., capital formation) in developed financial systems. In other words, firms might choose to make money through financial markets rather than through production. This phenomenon is fairly widely known, though it often goes by a different name: the "puzzle" of corporate cash hoards (Steverman 2010; Krugman 2013; Arends 2013). Referring to it as a puzzle of cash, however, is somewhat misleading. Take the case of Apple, which made a splash by announcing that it had more than $100 billion in cash on hand at the end of 2012. "Cash," however, is rarely just money: it often refers to a host of securities easily convertible to cash, including treasury bills, commercial paper and marketable longer-term debt. For instance, Apple's 2012 K-10 filing reveals that, of Apple's reported $121 billion in "cash," $46 billion was in corporate bonds, $20 billion was in US treasury bills, $2 billion was in commercial paper, and $12 billion was in mortgage and other asset-backed securities. These holdings are not cash; they are financial "investments" that are not being used for productive purposes.

The data presented in figure eleven bears out the intuition that resource allocations that prioritize the household and financial sectors tend to depress investment. It shows that there is a negative relationship between the ratio of "unproductive" debt (i.e., liabilities owed by the financial and household sectors) and change in business investment (private non-residential capital formation) between the late-1990s and 2000s. In other words, countries where resources were allocated toward the financial and household sectors tended to see larger declines in productive investment between the late 1990s and the 2000. On the other hand, countries with smaller household and financial sector liabilities tended to see increases in investment. This relationship grows stronger when eliminating the post-communist transition economies, in which the late-1990s and early-2000s were periods of highly volatile investment.[115]

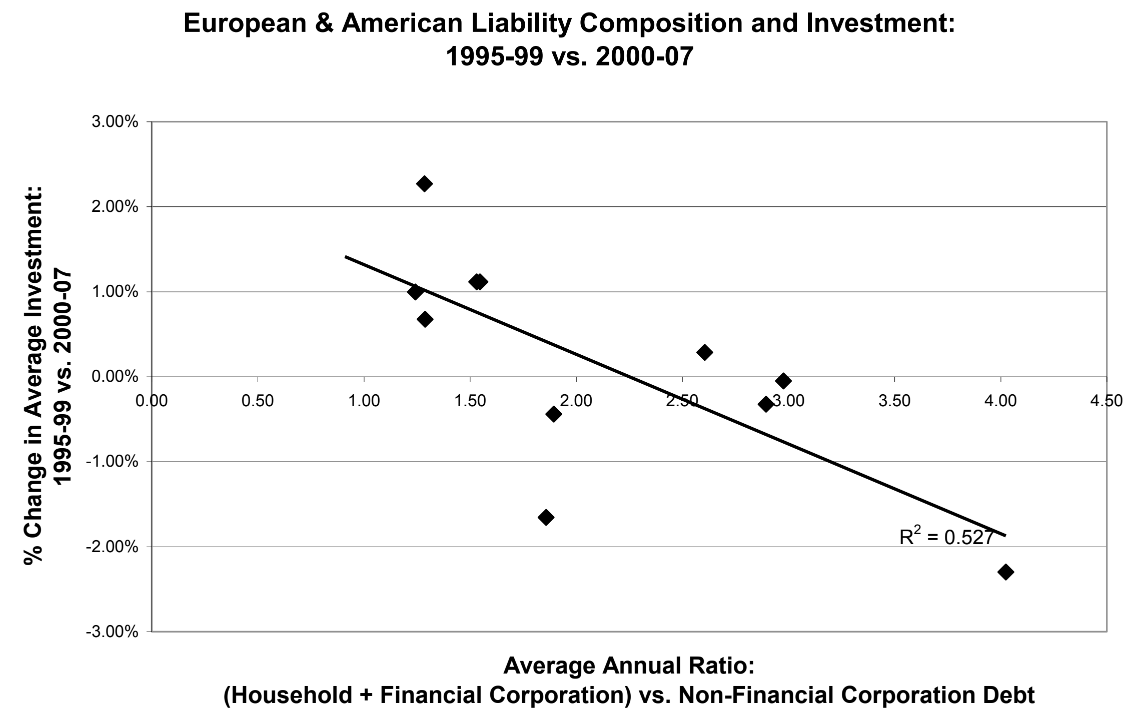

Figure 11 *Source: AMECO and US Federal Reserve*

[115] Authors' calculations from AMECO, Eurostat, and US Federal Reserve data. Countries included are: Belgium, Denmark, Germany, Greece, Spain, France, Italy, Cyprus, the Netherlands, Austria, Portugal, Finland, Sweden, the United Kingdom, the United States, Norway, and Switzerland.

Proposition 5: *That growth pattern is unstable, generates inequality, and is predicated on external imbalances.*

and

Proposition 6: *Preserving the "traditional" financial relationship between households as savers and firms as borrowers can mitigate this growth pattern and the accompanying negative consequences.*

The trends identified by the first four propositions all tend to hold across a fairly broad cross-section of countries, particularly when countries are aggregated together. Nevertheless, they are truer in certain countries than in others. Britain, for instance, is the archetypical exemplar of this account: it allowed its financial firms to liberalize and placed few restrictions on how domestic businesses and citizens interacted with the rapidly changing financial system, leading to an increasingly household- and finance- oriented reallocation of financial resources. France, on the other hand, typified the more cautious approach: while the country allowed its financial sector to liberalize, it has actively tried to discourage the sort of resource allocations seen in Britain – both by subsidizing savings and by restricting consumers' borrowing options.

Yet it bears remembering that even France experienced a period during which its resource allocation became "backward" and its growth pattern became more consumption- and debt-dependent. And while France's resource allocation and growth patterns since the early 1990s are quite dissimilar from that seen in Britain, household savings were beginning to fall and housing prices beginning to rise by the late 2000. Taken together with the aggregate trends presented in this chapter, one gets the sense that France is struggling against the current; that it maintains its exceptionalism only with effort.

The fifth proposition maintains that the sort of growth facilitated by financial liberalization is unstable, unequal, and results in external imbalances. The sixth proposition states that the emergence of these traits can be stymied through maintaining the traditional financial relationship between households and firms. These two claims are best examined together. Taken together, they should result in countries that exhibit more traditional financial relationships (like France) bucking the trend toward instability, inequality, and imbalance. Likewise, those countries that hem closest to the archetypical British story should manifest the undesirable consequences most clearly. Once again, this claim is largely supported by the evidence.

First, the rising ratio of debt to income naturally points to a greater degree of vulnerability to market fluctuations. In the event that income is interrupted or assets suddenly lose value, it is necessary for debtors to either default or deleverage. This fragility then spills into the real economy as consumers spend less, jobs are lost, and credit becomes scarce. In the case of the post-liberalization expansion of debt ratios, the vulnerability was particularly strong in those sectors that accounted for the largest increases in borrowing: households and the financial sector.

To deal with the financial sector first, it almost goes without saying that financial firms' balance sheets were extremely fragile at the end of the 2000s. Beginning with the UK's Northern Rock, Germany's Sachsen Landesbank in 2007, and continuing with Bear Stearns and Lehman Brothers in 2008, global financial institutions failed as credit dried up and it became clear that severe asset price corrections were in order. In the United States alone, 477 commercial banks either failed or were acquired in an effort to prevent failure from 2007 to

2013 – compared with 27 between 2000 and 2006.[116] Most major economies were compelled to offer significant assistance to their wounded financial institutions in order to prevent a systemic collapse of the global financial market. Many countries, particularly Spain and Ireland, are still struggling with the aftermath.

In the 2007-08 crisis, Britain, the United States, Spain, and Germany were each compelled to offer more than 20 percent of GDP in public funds to support troubled banks – though actual outlays were generally lower (Deutsche Bank 2010). Eurostat estimates that the global banking crisis cost no country more than Ireland, which directly paid over €41 billion to resolve its domestic crisis – more than Germany, despite the fact that the German economy is sixteen times larger. In sum, the IMF estimates that the cost to Ireland has been a full 41 percent of the country's GDP.

Furthermore, the late 2000s the first time taxpayers found themselves paying for the consequences of banks' risky adaptations to competitive pressure: the Swedish banking crisis in the early 1990s cost the country 2 percent of GDP (Englund 1999), the 1980s savings and loan crisis in the United States ultimately cost taxpayers $124 billion (Curry and Shibut 2000), and Japan's late-1990s financial crisis and attendant property boom-bust cycle cost the country 20 percent of GDP (Deutsche Bank 2010).

Overleveraged household sectors were similarly vulnerable at the end of the 2000s. Here, the data allows for a systematic comparison of those countries where households went into more debt and those where households continued to save. By plotting countries according to their household borrowing and the consumption volatility they experienced during the late-2000s, it becomes possible to ascertain whether more indebted countries saw greater instability. Indeed they did. Figure twelve demonstrates that the sharpest declines in

[116] FDIC

consumer spending occurred in those countries where households borrowed the most between 2000 and 2007 and had the greatest need to deleverage.[117] Britain and France, taking up positions in opposite quadrants, are highlighted.

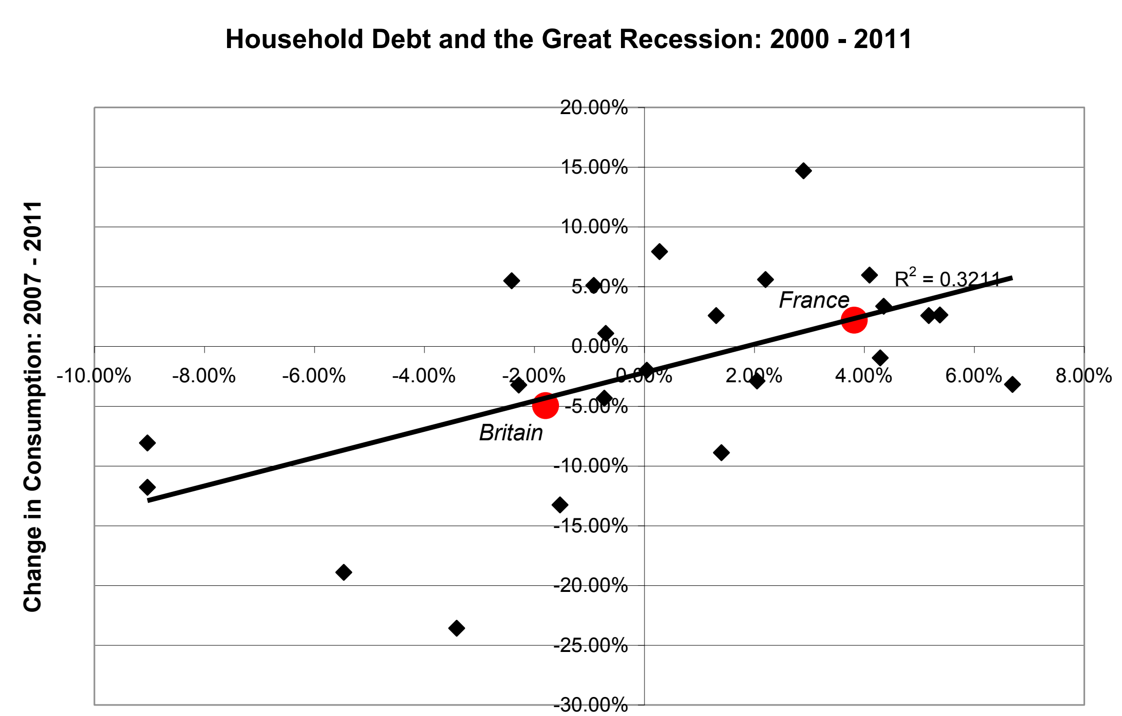

Figure 12

Source: AMECO

Again, as was the case with banks, the late-2000s crisis was not the first time since financial liberalization that household overleveraging led to macroeconomic disturbances. In the 1990s, Mervyn King (1994) – rather ironically, governor of the Bank of England for much of the overleveraged 2000s – found the same result for the recessions of the late 1980 and early 1990s. In other words, there is a consistent pattern reflecting that relying on household debt to fuel consumption in an expansion makes economies relatively more vulnerable to economic shocks.

117 AMECO

Second, this text has developed several causal links between growth predicated on household and financial sector growth and a widening of inequality. One link is simply that the increased mobility and freedom of capital *vis à vis* labor will lead relatively wealthy capital holders to benefit more than relatively poorer workers. The reallocation of financial resources toward asset purchases, in particular, has indeed caused the value of assets to boom. Yet the gains to be reaped from that boom only accrue to those wealthy enough to own assets in the first place – or to those who work in the asset-creation and management industry.

Not only have asset-holders benefited from the appreciation produced by the leveraged expansion of credit, but shareholders have directly captured a growing share of corporate profits. Taking dividends and share repurchases together, European shareholders received 400 percent more direct cash payments from the firms they owned in 2005 than they did in 1989. Over the same period, the profits of even the best performing firms – in Germany – only grew by 87 percent. Likewise, US shareholders took over 460 percent more cash from firms in 2007 than in 1993 even as profits grew by only 66 percent (von Eije and Megginson 2008; Bhargava 2010).[118] This inevitably has distributional consequences that favor holders of capital.

The rising compensation of financial capital-holders (i.e., investment income) relative to labor is one of the trends that even relatively traditional financial sectors are likely to have experienced: every country has some individuals who earn more of their incomes through financial markets than others. Indeed, this may go some way toward explaining why all but a small handful of OECD countries saw at least modest increases in inequality between the

[118] Also: Compustat, Worldstream, Datastream, US BEA, AMECO

1980s and the onset of the financial crisis.[119] Though the group of trend-buckers changes depending on the years and data used, the only OECD countries that consistently register declines in inequality during this period were Greece, Spain, and Turkey – three countries undergoing much broader transformations as they transitioned away from authoritarianism and toward political and economic integration with Europe.

An additional connection between a growing financial sector and inequality has been the rise of high wages within the financial sector. This has been a particularly large concern in Britain, where the Hutton Committee review of fair pay in Britain concluded that the outsized wages in the financial sector were a major contributor to wage inequality. Across most countries, financial sector wages have tended to increase faster than the national average wage. This was particularly pronounced in states with larger-than-average financial services industries like Canada, Australia, the United States, the United Kingdom, and the Netherlands: in 1994, the compensation of financial sector employees in those five countries was 56 percent above the average wage; by 2007, it was over 98 percent higher. In the United States, financial service workers now account for a greater share of the top 1 percent and .01 percent of wage earners than in the pre-1980 era (The Economist 2012). This is consistent with the data concerning the growth of very top incomes shown in figure sixteen: the wage share of the top 1 percent of income earners in an economy grew faster in economies with larger financial sectors.[120]

[119] This group changes based on the measure and time period used, but the only countries to regularly register *declines* in inequality were Spain and Greece, which emerged from authoritariasn

[120] Top 1 percent data aggregated from the World Top Incomes Database (from various sources). Contribution of financial services from OECD. Includes: Norway, Japan, Finland, Portugal, Spain, Denmark, Sweden, Italy, Canada, Ireland, the United Kingdom, Australia, France, and the United States

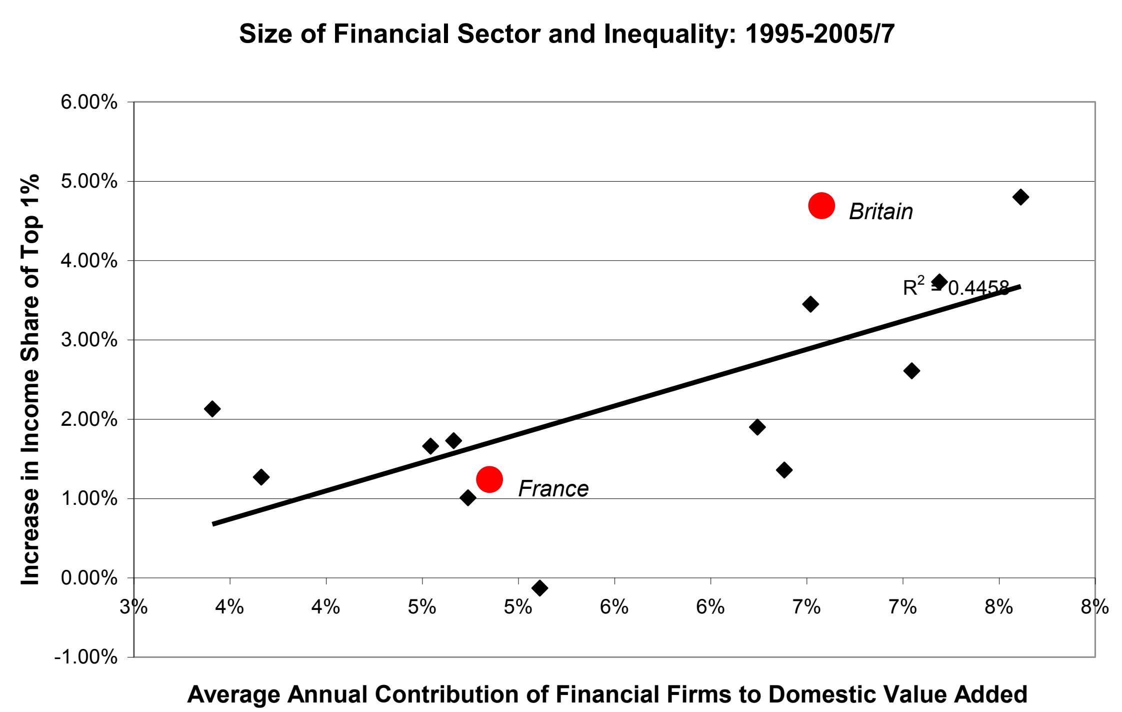

Figure 13

Sources: OECD, World Top Incomes Database

The instability of growth built on consumer and financial sector debt provides another link between liberalization and inequality. As noted above, the cost of bailing out troubled financial institutions during the financial crisis has been large – particularly so in places like Ireland. This is problematic when financial firms have been permitted to privatize the gains from their riskiest activities while socializing the losses. Globally, the share of national income accruing as profit to financial firms grew during the mid-1980s, fell during the late-1980s crises and early 1990s recessions, and then rose sharply from the mid-1990s through 2007 (Power and Epstein 2003; Crotty 2008). Overall, the financial sector has seen enormous gains in profitability since the 1980s. Yet when the good times turned bad, central banks and governments were forced to recapitalize wounded institutions and absorb problematic assets out of fear of a systemic collapse – costing ordinary taxpayers and contributing to the need for government austerity that can affect society's more vulnerable. As noted in Britain, this has mildly regressive effects. Those effects are likely to be more severe where the austerity measures are stricter – as in the European periphery in recent years. It is, however, still too early to fully determine this effect.

This dissertation has also argued that there is an almost mechanical linkage between household indedebtness and growing inequality. The evidence from Britain and France suggests that this might be the case; however, the same trend is not clearly apparent from a wider cross-section of countries. While the available data does suggest a very small positive relationship between inequality and consumer borrowing, the result is not significant (see figure fourteen).[121] Moreso than the data presented in figures twelve and thirteen, it is extremely sensitive to the removal of individual data points: for instance, pulling Denmark out of the sample – with its relatively high consumer borrowing but low inequality, makes the relationship appear artificially strong. In this case – at least with the data available – it is not possible to generalize the Britain-France comparison to a wider population of countries.

[121] Same countries as in note 20.

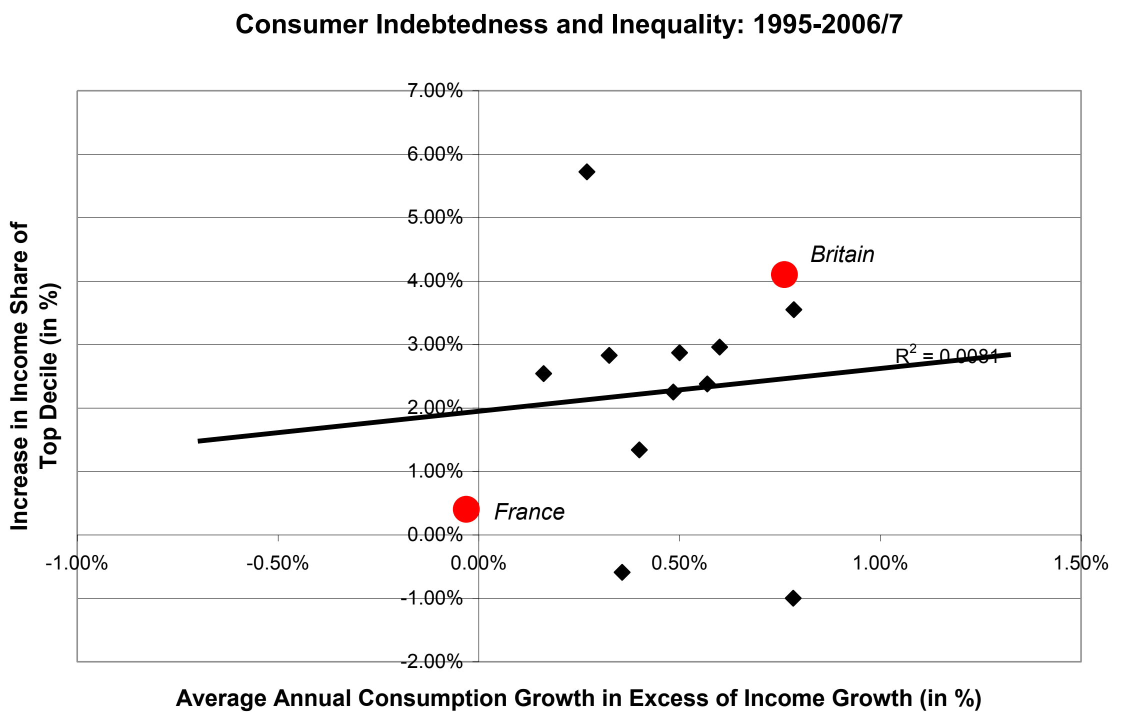

Figure 14

Source: OECD, World Top Incomes Database

Finally, proposition five maintains that the same features that allow debt-fueled and consumption-led growth – that is, an innovative financial sector and consumers who are not risk-averse – tends to lead to external imbalances. Table one shows that there is a positive relationship between household net lending and national net lending in the European Union. In short, where households borrow, the economy as a whole tends to borrow. Where households save, the economy as a whole tends to export capital. This reflects the complementarity between household borrowing and importing: the world's heaviest borrowers are also likely to be heavy spenders on imported goods. At the same time, those borrowers are also a source of new assets that can be exported abroad, facilitating a financial account surplus.

Table 1: Correlation Between Sectoral and National Net Lending: EU

Household Sector	0.49
Corporations	0.03
Government	-0.10

This is consistent with the evidence from Britain and France, where Britain has maintained a structural current account deficit and financial account surplus since the big bang. France, with its more debt-averse households, has not exhibited a reliable tendency toward surpluses or deficits in either account. Taking just the last few years of the 2000s prior to the crisis, there is a clearly positive relationship between households' net lending and the overall current account balance of the country in question. Figure fifteen shows how this relationship manifested between 2005 and 2007.[122] In sum, consumption-fueled growth – the sort of growth shown here to be caused in large part by debt – also fuels countries' external imbalances.

[122] Countries included: Belgium, Bulgaria, Czech Republic, Denmark, Estonia, Ireland, Greece, Spain, France, Italy, Cyprus, Latvia, Lithuania, Luxembourg, Hungary, the Netherlands, Austria, Poland, Portugal, Romania, Slovenia, Slovakia, Finland, Sweden, the United Kingdom, Norway, Switzerland, the United States and Japan.

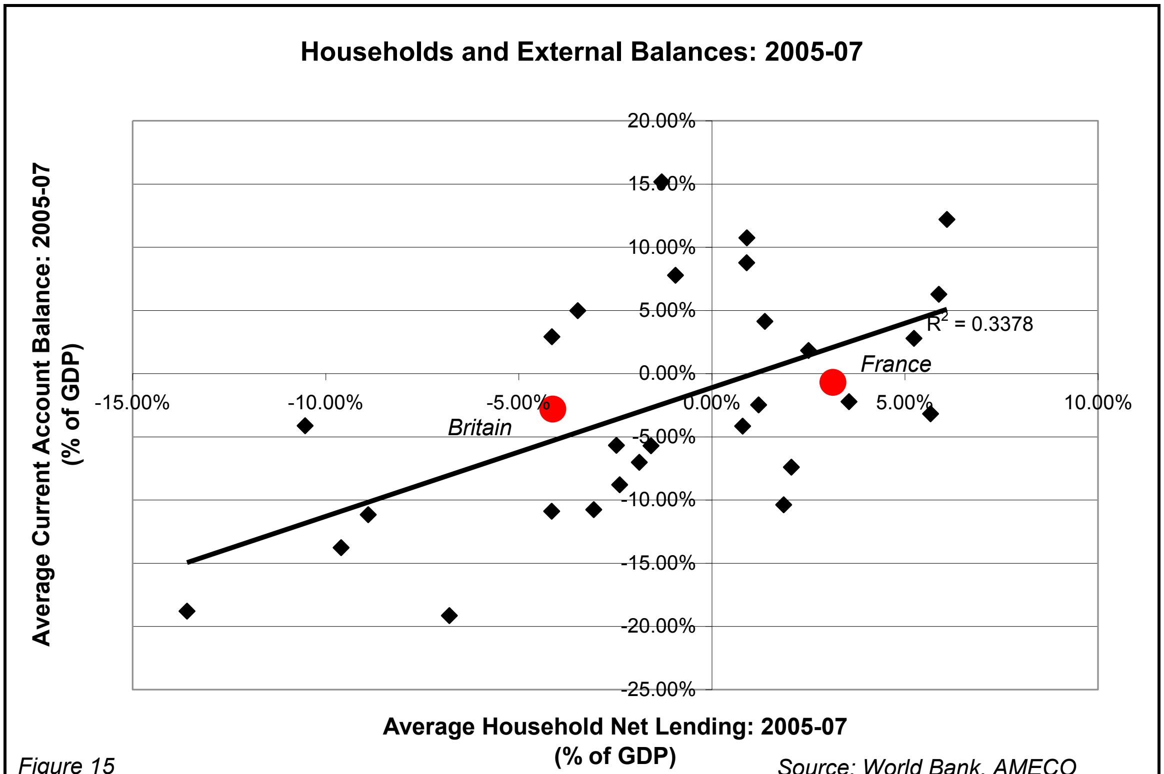

Figure 15

III: Conclusion

This summary permits the drawing of several fairly strong conclusions: First, the propositions laid out in chapter one and revisited here hold extremely well for Britain and France. Both countries encouraged competitive revolutions in their financial sectors that pushed their financial firms to adapt. Those adaptations tended to result in greater allocations of credit flowing to the household and financial sectors. This, in turn, fueled a sort of growth that was dependent on consumer debt and asset price appreciation, generating macroeconomic fragility, inequality, and external imbalances. While both countries experienced this pattern during the 1980s, France was largely successful in using the power of the state to reverse this reallocation of resources, mitigating the associated consequences as a result.

Second, this chapter indicates that – for the most part – the same causal story works for a broader cross-section of developed economies. The same trends that affected Britain and France have affected countries in Europe, North America, and East Asia. While there is still room for variation between countries and policies – a fact that the case of France makes clear – there is also a clear overall trend at work toward bigger financial sectors, more indebted households, and more debt-dependent growth. As a consequence, developed countries are increasingly confronted by increasing macroeconomic vulnerability, rising inequality, and persistent external imbalances that are driven in large part by household borrowing.

The most significant findings of this dissertation are threefold: First, *who* receives financial resources matters a great deal. Second, it strongly suggests that when the answer to the *who* question is households and the financial sector, the long-term result is likely to be undesirable. Third, these findings demonstrate that the state still matters. While financial institutions themselves may have converged on a set of international and relatively *laissez-faire* norms, governments have a great deal of influence over how those financial firms interact with their domestic households and businesses – and can use that influence to great effect.

Validating these results requires a great deal more work. More individual case studies are needed, particularly of countries that do not seem to fit the propositions laid out here – such as Denmark, which is relatively stable and equal yet also has one of the highest rates of household indebtedness in the world. The conclusions here must also be subject to more stringent statistical tests – though only where those tests can be conducted without making excessive concessions to the need for a large number of observations. And more rigorous consideration needs to be given to the cost-benefit analysis – particularly with regard to cases like Britain and France's: is it better to grow faster, more unequally, and with greater potential for significant setbacks? Or is slower growth, higher unemployment, but more equality and stability preferable?

These are largely questions for the politicians. The opening paragraph of chapter one quoted the Nobel Laureate Robert C. Merton, who identified the "core function" of financial markets. Nothing in these pages obviates the claim that financial markets have an extremely important economic role: allocating resources. The question this dissertation posed is whether allowing free market competition to guide those resources generates socially desirable results. The answer suggested here is that it does not.

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Curriculum Vitae

Gregory Fuller was born on March 9, 1983 in Newport Beach, California. After completing his undergraduate studies at Occidental College in Los Angeles, "Greg" traveled to Europe and worked as a professional teacher of English. During his years living in the Czech Republic, Poland, Spain, Azerbaijan, Britain, and Italy, he gained an interest in teaching pedagogy, met his wife, and deepened a life-long interest in Europe. Greg returned to higher education by completing his M.A. in International Affairs at Johns Hopkins' School of Advanced International Studies (SAIS), where he remained in the European Studies program under David Calleo and Erik Jones in order to complete his Ph.D. Greg is presently a Professorial Lecturer at American University, teaching courses on economics and political economy while continuing his research into how and why societies allocate financial resources as they do – and investigating whether some allocations may ultimately generate perverse results.