IPPR Commission on Economic Justice

On Borrowed Time

Finance and the UK's current account deficit

Discussion Paper

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The IPPR Commission on Economic Justice

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The IPPR Commission on Economic Justice

The IPPR Commission on Economic Justice is a landmark initiative to rethink economic policy for post-Brexit Britain.

Launched in November 2016, the Commission brings together leading figures from across society – from business and trade unions, civil society organisations and academia – to examine the challenges facing the UK economy and make practical recommendations for reform.

The Commission is undertaking a wide-ranging programme of research and policy consultation on issues including industrial strategy, macroeconomic policy, taxation, work and labour markets, wealth and ownership, sub-national economic policy and technological change. Through a major programme of communications, events and stakeholder engagement it aims to contribute to both public debate and public policy on the economy. Non-partisan, it has been welcomed by both government and opposition parties.

The Commission's Interim Report, *Time for Change: A New Vision for the British Economy*, was published in September 2017. Its Final Report will be published in autumn 2018.

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Summary

The UK's longstanding current account deficit indicates that the UK economy has a fundamental problem of international competitiveness. While in the past we have been able to support this through international borrowing, this is not sustainable in the long-term, particularly if Brexit leads to a weakening of the economy and its perceived attractiveness to overseas lenders and investors. This discussion paper sets out four key propositions on the drivers of our current account imbalance, the ways in which it makes our economy vulnerable and hampers overall economic performance, and the actions needed to reduce it.

1. **The UK has been able to maintain a current account deficit without a falling exchange rate due to large financial inflows from overseas.** Our current account deficit reached a peak of 6 per cent of GDP in 2017 – one of the largest of any advanced economy. This was financed by a similar-sized surplus on the UK's financial account, showing the capital flowing into UK assets from the rest of the world. Overseas purchasing of UK assets and lending to UK households and businesses has sustained a much higher exchange rate than would normally be expected given the current account deficit.
2. **The UK's unbalanced international position has been enabled by a combination of global imbalances, asset price inflation, and the financialisation of the UK economy.**
    - Since the late 1990s, national economies have become increasingly polarised between those with current account surpluses, and those which are net borrowers from the rest of the world. The factors that have caused these imbalances have also pushed down global interest rates. The UK's current account has experienced two related effects as a result: consumers have been able to fund more consumption through borrowing, increasing the trade deficit; and global demand for UK assets has pushed up sterling, reducing our competitiveness.
    - The UK's unusually sophisticated and large financial sector has helped to perpetuate the UK's imbalances: it facilitates a large volume of trading, much of which is speculative, and is an attractive destination for illicit capital flows, both of which increase demand for the currency and therefore push up its value. Regulators have in the past failed to adequately understand and counter the risks that this activity implies for the rest of the economy.
3. **These structural imbalances result from the financialisation of the UK economy, which has increased asset prices and financial instability, led to 'Dutch disease' and rising inequality, and driven financial market concentration.** Over the last 30 years the financial sector has grown as a proportion of the UK economy. It is now a major contributor to jobs, tax receipts and value-added in the UK economy. But these benefits have come at a cost.
    - Financialisation – defined as the increasing role of financial motives, financial markets, financial actors and financial institutions in the economy – makes makes the UK prone to financial crises, by increasing the volume of lending to businesses and consumers in the upswing of a financial cycle, and the withdrawal of credit as the bubble bursts, leading to periods of damaging debt deflation, and deeper and longer recessions than might occur otherwise.
    - By pushing up the value of the pound, it makes it more difficult for the UK's other exporting sectors to compete internationally, and increases

manufacturers' reliance on imported inputs. There is evidence that the strong pound has now been 'locked in', and that UK manufacturers have limited capacity to take advantage of currency depreciations when they do happen. This has been described as 'financial Dutch disease'.

- The UK's outsized financial sector has contributed to significant regional inequalities, with the growth of finance disproportionately benefitting London and the South East, and reducing the competitiveness of the manufacturing industries primarily located in the English regions.
- Finally, financialisation has helped to concentrate market power in the hands of a small number of large banks, reducing competition within the sector, and contributing to the flourishing of unethical working cultures.

4. **Rebalancing the UK's international position requires moderating the significance of finance within the UK economy and bringing asset price volatility under control, while nurturing non-financial exporting sectors.** In this context we argue for the following measures to rebalance the economy away from excessive dependence on finance and to limit capital inflows:

REGULATING THE FINANCE SECTOR

- **The Financial Policy Committee of the Bank of England should be given a target to control house price inflation, through a revised mandate set by HM Treasury**. This would be equivalent to the remit the Monetary Policy Committee has to control consumer price inflation. Under such a target the Bank of England should aim to keep nominal house price inflation at (say) zero per cent for an initial period – perhaps five years – to reset expectations, and allow affordability to improve. It should then be increased to the same rate as the consumer price inflation target of 2 per cent per year, meaning zero real-terms house price growth. The target should be implemented using macroprudential tools such as capital requirements, loan-to-value, and debt-to-income ratios. Since lending is not the only driver of house price inflation, the government should accompany this target with active housing policies designed to increase housing supply and restrict overseas purchases of UK residential property.
- **The corporation tax surcharge on banks should be abolished given its impact on small challenger banks and the bank levy should be increased in its place**. The levy should be applied to UK banks' and shadow banks' entire balance sheets at a rate that helps to curb systemic risk. This rate should be dynamic, rising and falling with the financial cycle alongside other macroprudential tools.

MANAGING CAPITAL FLOWS

- **A financial transactions tax on currency trading should be introduced as a form of qualitative capital control.** The tax should be levied at two rates. The lower rate of 0.005 per cent would be used in day-to-day transactions to curb volatility, and another much higher level would be implemented in the case of speculative attacks or large capital outflows. When the higher rate should be implemented, and at what level, should be determined by the Bank of England as part of its remit to promote financial stability.

TAMING OFFSHORE FINANCE AND MONEY LAUNDERING

- **The UK should implement publicly available, country-by-country reporting to curb corporate tax avoidance and create a blacklist of financial regulatory havens.**
- **A stronger regime of enforcement and sanctions should be implemented for those found to be undertaking illegal activity in or via the UK**. Those found to have engaged in or facilitated these activities should expect to face criminal convictions.

INDUSTRIAL STRATEGY TO SUPPORT THE UK'S EXPORTERS

- Alongside these measures focused on the financial sector, **the UK's industrial strategy should have a specific aim of reducing the UK's current account deficit by supporting and diversifying the UK's export sectors and strengthening domestic supply chains.** Over the long term, only a profound restructuring of our economy along these lines will enable us to rebalance our international position.

Together, these measures will help to reduce the relative size of the finance sector in the UK, and increase the proportion of socially useful activities that strengthen productive investment, output and productivity. They should also support the UK to move towards a different growth model: one which enables us to produce enough today to fund consumption sustainably into the future.

Introduction

For several decades, the UK has been buying more from the rest of the world than we sell to it. Our current account deficit peaked at 6 per cent of GDP in 2017 – one of the largest of any advanced economy. Though it has devalued since the 2016 vote to leave the EU, for most of this period the UK's currency has remained strong despite these imbalances. Macroeconomic theory would suggest that interest and exchange rates in the UK should adjust to bring about a reduction of the current account deficit. But this hasn't happened.

This discussion paper attempts to explain why. It makes four propositions.

1. **The UK has been able to maintain a current account deficit without a falling exchange rate due to high financial flows from overseas.** Our current account deficit – primarily the result of a trade deficit – is financed through an equally large surplus on our financial account.
2. **The UK's unbalanced international position has been enabled by a combination of global imbalances, asset price inflation, and the financialisation of the UK economy.** Asset price inflation in developed economies and unusually low global interest rates have caused capital inflows into countries like the UK and the US. The effect has been particularly pronounced in the UK because our financial sector has been so effective at translating that global capital into debt products for UK consumers.
3. **Financialisation of the UK economy has increased asset prices and financial instability, led to 'Dutch disease' and rising inequality, and driven financial market concentration.** Our debt-driven model of growth leaves us vulnerable to crises, and lengthens our recovery time. The financial sector increases demand for sterling, pushing up its value, which makes it more difficult for the non-financial sector to compete in international markets. Finally, as the financial sector has grown, it has become more concentrated and less competitive, to the detriment of the UK consumer.
4. **Rebalancing the UK's international position requires moderating the significance of finance within the UK economy and bringing asset price volatility under control, while nurturing non-financial exporting sectors.** Ultimately, we will only reduce our trade deficit by restructuring the economy in such a way that a diverse range of exporting sectors are able to thrive. This should be the long-term objective of industrial strategy. However, there are measures the UK could take to facilitate a rebalancing away from finance, and to reduce the vulnerability of the UK economy to the financial cycle, over a shorter time horizon.

The evidence and arguments for each of these propositions are gathered together in the following chapters, along with a range of policy recommendations. We welcome responses.

1. The UK has been able to maintain a current account deficit without a falling exchange rate due to large financial inflows from overseas

In recent years, the UK has run a consistent and often large current account deficit, reflecting an imbalance between the volume of imports and exports. Traditional macroeconomic theory would suggest that sterling should fall to account for the amount of capital that is flowing out of the UK. But with the exception of the period immediately after the financial crisis, and following the EU referendum vote in 2016, this has not happened. The reason the UK is able to finance such a large current account deficit without experiencing such a currency devaluation is that there is high demand for UK assets from abroad. In this chapter we set out recent trends in the components of the UK's balance of payments.

THE BALANCE OF PAYMENTS

The balance of payments is the sum of the current account, the capital account, the financial account, and net errors and omissions (a balancing item). By definition it must sum to zero. The formula for the balance of payments is as follows:

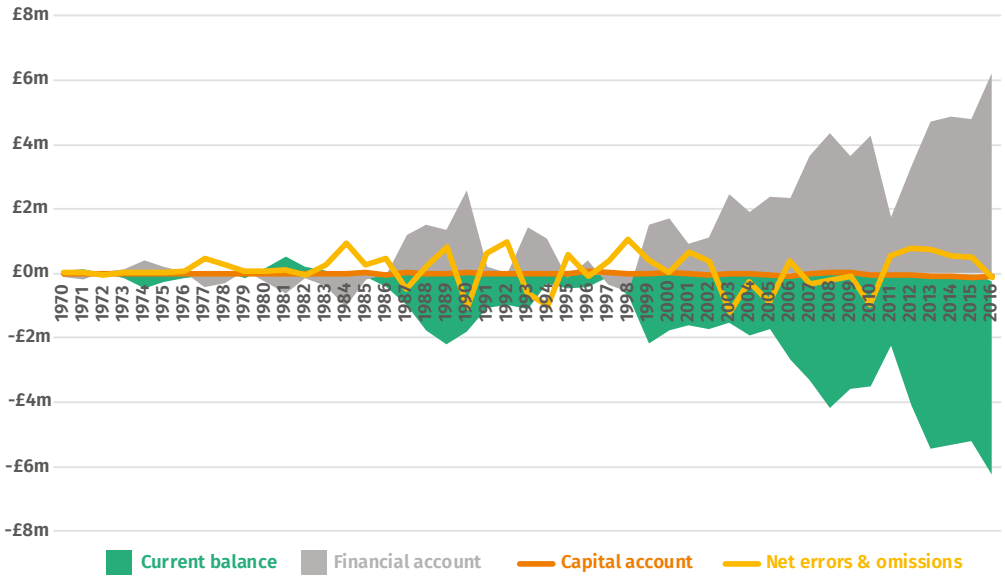
Current account + capital account + financial account + balancing item = zero

The UK's balance of payments is shown in figure 1.1. As this figure shows, the UK has a large current account deficit, an almost identical financial account surplus, and a small capital account deficit. To understand why we have an unbalanced international position, therefore, we need to know why the current account deficit has risen so dramatically since the late 1990s.

FIGURE 1.1

The UK has a substantial current account deficit, mirrored by an equally large financial account surplus

UK balance of payments, 1970–2016 (£m)



Source: ONS, 'Chapter 1: Summary of Balance of Payments' (ONS 2017)[1]

The capital account

The capital account measures flows of assets to and from the UK. It includes capital transfers from government and other sectors, and disposals of non-produced, non-financial assets. The capital account is currently in deficit, but only by 0.07 per cent of GDP. It is a marginal feature of the UK's balance of payments, effectively comprising the aid budget and payments to international institutions. We therefore exclude it from the analysis that follows.

The current account

The current account is the difference between what the UK sells to the world and what it buys from it. It is the sum of net trade in goods and services, net primary income (income from assets abroad, such as interest, profits, dividends from foreign investors, and remittances), and net secondary income (one-way transfers such as the international aid budget).

As shown in figure 1.2, the UK is a net exporter of services to the rest of the world. In 2017, the UK had a trade surplus in services worth 5.2 per cent of GDP. However, this is counterbalanced by a significant deficit in our trade in goods, which averaged 6.7 per cent of GDP in 2017, down slightly from a peacetime record of 6.9 per cent of GDP in 2016. This gave us a total trade balance of -1.5 per cent of GDP in 2017, down from -2.1 per cent of GDP in 2016.

Until recently, the primary and secondary income balances did not have a significant impact on the current account deficit. However, recently the primary income balance – which measures net income from the UK's overseas investments – has fallen. In 2017, the primary income balance was -1.6 per cent of GDP, an improvement on 2016 when it reached a record -2.6 per cent of GDP. This has

1 Throughout this report we use the latest available figures for comparable datasets. The latest available full Pink Book data is from 2016, but more up-to-date figures are available for the individual accounts.

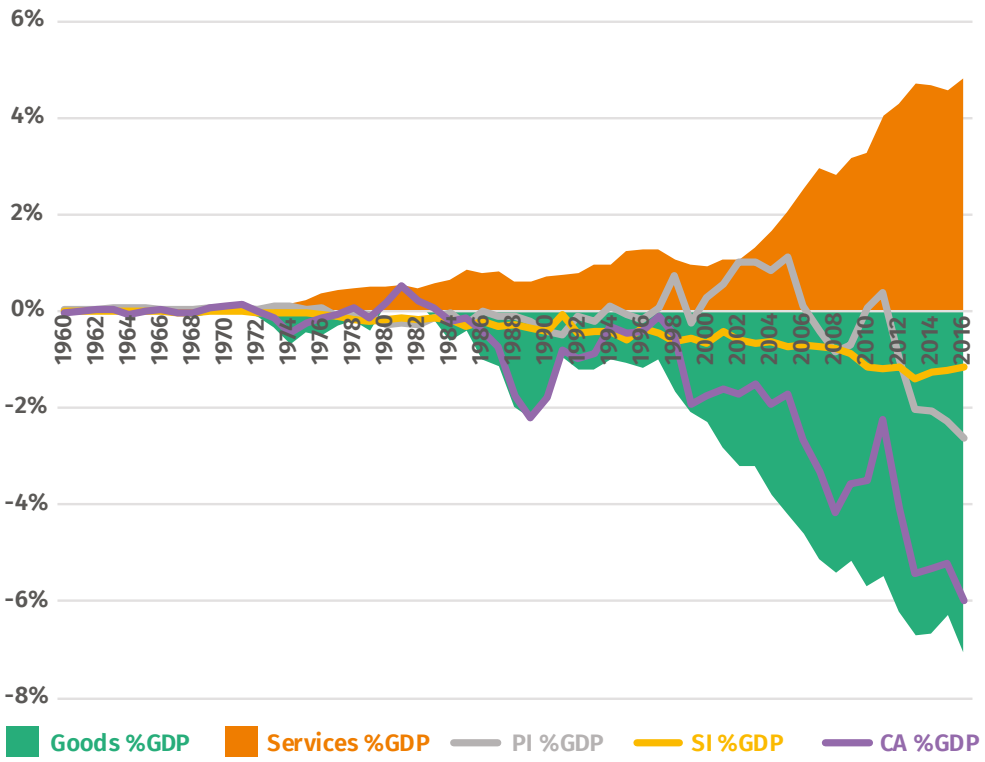
resulted in part from a reduced return on these investments due to lower growth rates in our major trading partners, and in part from increasing net direct investment in the UK (Stirling 2016; ONS 2018).

Together, these factors meant that the current account deficit reached a peacetime peak of 6 per cent of GDP in 2016, before recovering to 4.1 per cent of GDP in 2017. However, the latest data suggests this improvement may not last: the trade deficit widened to 1.8 per cent of GDP in the first quarter of 2018 – driven by a large deterioration in the goods deficit on the previous quarter to 7.4 per cent of GDP and a small deterioration in the services surplus to 5.6 per cent of GDP.

FIGURE 1.2

Three of the four components of the current account are now in deficit

Components of the current account, 1955–2017 (%GDP)



Source: ONS (2018a)

The financial account

The financial account measures flows into and out of UK assets. The stock of these assets is shown in the net international investment position (NIIP), which details foreign holdings of UK assets and UK holdings of foreign assets[2]. Because the balance of payments is an accounting identity, the surplus on the financial account each year mirrors the deficit on the current account, subject to net errors and omissions and the capital account.

The main components of the financial account are direct investment (primarily foreign direct investment [FDI] by UK companies, and investment in the UK on the part of foreign companies), portfolio investment (primarily financial institutions' and

2 Another way to think of this is that the financial account, which measures flows, is the equivalent to the budget deficit/surplus, whilst the NIIP, which measures stocks, is equivalent to the total outstanding national debt.

money managers' investments in securities), other investment (primarily deposits with financial institutions in the UK and abroad and loans made by banks), financial derivatives and employee stock options, and reserve assets. Reserve assets are a minor element and will be excluded from the analysis that follows.

Net direct investment into the UK has been positive for most years since the financial crisis, peaking at 9.6 per cent of GDP in 2016, meaning that more direct investment is flowing into than out of the UK. Most of this investment is undertaken by firms themselves, reflecting an increase in investment in UK firms by foreign firms. This represents a reversal of the pre-crisis trend, when much more direct investment flowed out of the UK than into it.

Portfolio and other investment, largely undertaken by financial institutions, are highly volatile, with huge volumes of capital flowing into and out of the UK via these accounts every year. In 2008, for example, portfolio investment in the UK was equivalent to a quarter of GDP. In both the pre- and post-crisis periods, portfolio investment has been positive in most years, averaging 3.9 per cent of GDP between 1997 and 2016. Net other investment flows are smaller and averaged -0.9 per cent of GDP between 1997 and 2017. This, however, disguises a huge amount of volatility in the other investment account, which can quickly go from a large positive figure in one year (10 per cent of GDP in 2012) to a large negative one in the next (-3.3 per cent of GDP in 2013). These trends are discussed further in chapter 3.

FIGURE 1.3

Financial flows into and out of the UK are large as a percentage of GDP, and are quite volatile

Financial account balance, 1997–2016 (%GDP)

Source: ONS, 'Chapter 1: Summary of Balance of Payments' (ONS 2018a)

Net errors and omissions

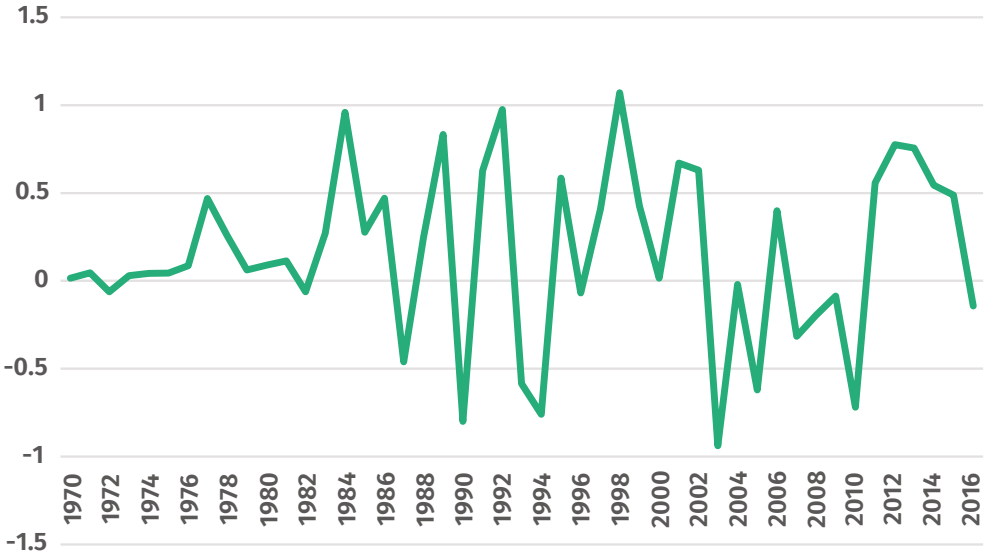
Net errors and omissions (NEO) is a balancing item or statistical discrepancy that is used to make the balance of payments sum to zero, preserving its status as an accounting identity. The IMF states that the errors and omissions that build up over the course of compiling the balance of payments often balance out, and that

the presence of a large net residual can hamper interpretation. The NEO item has been in surplus every year but one since 1993, and it looks to be becoming more volatile over time. As Klein (2017) points out, 'summing these flows up over time produces distinctly non-random patterns' – which suggests that, rather than it being an error, illicit funds are habitually flowing into the UK.

FIGURE 1.4

Net errors and omissions appear quite volatile, but sum to a large net positive figure between 2000–16

Net errors and omissions, 1948–2016 (%GDP)



Source: ONS, 'Chapter 1: Summary of Balance of Payments' (ONS 2018a)

THE ROLE OF THE EXCHANGE RATE

A country's exchange rate is a measure of the value of its currency relative to another, or, if expressed in effective terms, to a basket of currencies weighted according to trade flows between the countries. It is determined by a number of factors, and the relative importance of each is mediated by the characteristics of the currency in question.

Firstly, the more a country sells to the rest of the world, the greater the demand for its currency, as domestic currency is required to buy a country's exports (Krugman et al 2014). The value of the currency, in turn, determines the price of a country's goods on world markets so a strong currency dampens demand for exports (ibid). Exports, imports and the exchange rate should therefore move towards a stable equilibrium over the long term.

Secondly, and relatedly, the interest rate is a key determinant of the value of a currency, especially in an era of very high capital mobility (ibid). This is because capital tends to flow into countries that have high interest rates, leading to the appreciation of those countries' currencies. Over the longer term, interest rates should adjust in order to balance demand for and supply of a currency. Countries with current account deficits should have falling interest rates and those with surpluses should have rising interest rates.

Inflation converts the impacts of both of these variables into a 'real' return on assets (ibid). High levels of inflation reduce real interest rates and therefore

reduce demand for a currency. High and volatile inflation make it essentially impossible to know what a currency will be worth from one day to the next, meaning investors are highly unlikely to want to hold an investment in that currency. A country's 'risk premium' – a subjective concept that indicates investors' expectations of risk – also influences its currency's value, and includes expectations of inflation, as well as other factors such as government debt and political stability.

The traditional economic argument is that current account deficits are nothing to worry about because they will ultimately self-correct through adjustments in inflation, interest rates and the exchange rate (Krugman et al 2014). A current account deficit in one country, sustained by a surplus in another, should cause interest rates to rise in the surplus country and to fall in the deficit country – subject to inflation, risk, and expectations (ibid). This should lead to an appreciation of the surplus country's currency and a depreciation of the deficit country's currency, and cause their current accounts to rebalance.

The fact that the UK economy has not experienced such an automatic adjustment of its currency to its large current account deficit suggests that something is preventing the exchange rate from adjusting. Further, the relationship between the UK's current account deficit and the exchange rate has broken down over the last 40 or so years (Springford and Tilford 2016). This has become particularly clear following the significant devaluation that has taken place in the wake of the vote to leave the European Union. This devaluation should have improved the competitiveness of the UK's exports and increased earnings on our overseas investments, leading to an improvement in the current account.

However, these effects do not appear to have materialised. In the immediate aftermath of the Brexit vote, the current account deficit grew to a peacetime record. Rather than boosting exports, the devaluation was accompanied by an increase in the trade deficit in the third quarter of 2016. There was some improvement through 2017, but in the first quarter of 2018 the trade deficit – in particular the goods deficit – deteriorated again. This has not been counterbalanced by increases in the primary income account because of lower returns on UK overseas assets due to low growth amongst our trading partners, and net sales of UK assets to the rest of the world, discussed further below. Instead of improving our economic fortunes, the devaluation of sterling has simply translated into higher domestic inflation, while yielding little benefit to the current account.

Instead of improving the current account, the sterling depreciation has impacted the financial account, leading to a deterioration of the UK's international investment position. Firstly, there has been an increase in net direct investment into the UK – mainly in the form of increased foreign holdings of UK companies. While net direct investment was a drain on the financial account before 2008, since then it has been significantly positive in all years but one, running at an average surplus of 2.7 per cent of GDP since 2009. This also shows up in the portfolio investment account; there have been net inflows into UK equities since the financial crisis in contrast to the net outflows before the crisis. This is mainly because, as the value of sterling has deteriorated, UK companies have become cheaper for foreign companies to buy. Normally, currency effects would also imply that the income these new owners derived from the company was reduced, but many of the companies being bought made much of their revenues overseas. In 2016, the value of inward mergers and acquisitions activity (foreign acquisitions of UK companies) was the highest it has ever been.

Secondly, since 2007, there has been substantial consolidation in the UK banking sector, reflecting banks' attempts to improve their balance sheets (BBA 2014). Between 2001 and 2007, inflows into UK currency and deposits were positive every

year, at an average of 5.3 per cent of GDP, but since 2009, these have been negative every year but one, at an average of 4.9 per cent of GDP (excluding the negative year). Flows in other areas of the financial account have had to make up for this. Aside from increased direct investment outlined above, the UK has also continued with the pre-crisis practice of selling large amounts of debt securities to the rest of the world, and is now also selling large amounts of Government debt to foreign investors and UK banks.

It is common for commentators to argue that the UK's international position is sustainable because of demand for UK assets, which can be expected to remain high (see, for example, Burgess and Shanbhogue 2017). This is an accurate reflection of the UK's international business model, but we argue in this paper that such a model is not sustainable over the long term.

By selling assets to the rest of the world via the financial account in order to finance our current account deficit, the UK is building up substantial liabilities to foreign investors. Like any build-up of debt, if this is used to finance productive investment that creates growth over the long term, then it is not necessarily something to worry about (Ghosh and Ramakrishnan 2006). However, instead of investing to boost the economy, we have been borrowing to fund current consumption, financed against assets such as real estate. The following sections discuss how this model emerged and how it culminated in the largest financial crisis in a generation.

2. The UK's unbalanced international position has been enabled by a combination of global imbalances, asset price inflation, and the financialisation of the UK economy

The UK's persistently unbalanced international position is surprising in a country with control over its own monetary policy and a free-floating exchange rate. In this chapter we seek to explain this phenomenon by charting the emergence and development of the UK's unusual form of economic growth and the mechanisms that have allowed the UK to sustain this model for so long.

GLOBAL IMBALANCES AND ASSET PRICE INFLATION

In recent years a group of debtor countries, including the US and the UK, has arisen alongside a group of creditor countries, including China, Japan and Germany (Bernanke 2005). Current account surpluses in creditor countries are linked to deficits in debtor countries, as the latter import the products of the former (ibid).

According to standard macroeconomic theory, these imbalances should have been self-correcting as capital outflows caused interest rates to fall in debtor countries and inflows caused them to rise in the creditor ones (Krugman et al 2014). However, in the run up to the crisis this did not happen. Ben Bernanke (2005) famously argued that global imbalances were due to a 'global savings glut' (GSG) in which developing countries 'hoarded' large supplies of global savings in order to protect themselves against future financial crises. Exchange rate pegs and limits on capital mobility in some parts of the world reduced viable investment opportunities which caused extra capital to be directed into deficit countries' assets (Bernanke 2011). This exerted downward pressure on global interest rates and capital expenditure, leading to a consequent increase in asset prices.

The GSG hypothesis is important in explaining the imbalances that allowed the US and the UK to run such high current account deficits in the run up to the financial crisis, but it doesn't tell the whole story (Geet 2015). To fully account for the dynamics that led up to the crisis, this explanation must be combined with an analysis of the demand for the assets of the deficit countries, which was both a driver and a consequence of asset price inflation. This asset price inflation was, in turn, caused by the financialised growth model the UK and others opted to pursue from the 1980s onwards (Laibson and Mollerstrom 2010; Adam et al 2011; Hein et al 2017).

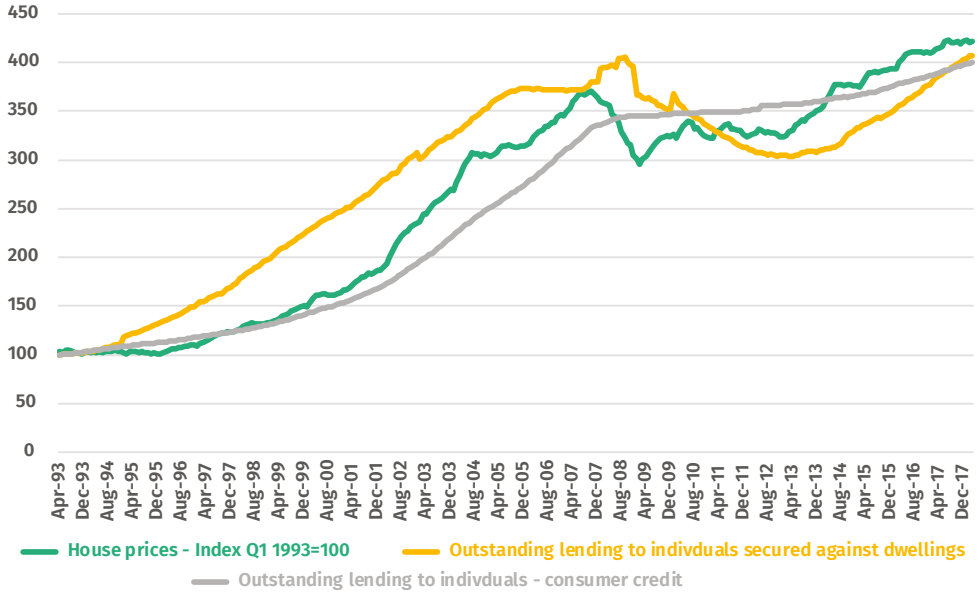
In the lead-up to the financial crisis, deficit countries, including the UK, pursued what could be characterised as a 'debt-driven private demand' model of growth, which was catalysed by the financial deregulation that took place in the 1980s and the 'big bang' that followed (Hein et al 2017). In the UK, this liberalisation allowed for a dramatic expansion of private credit that drove up asset prices (Ingham and Thompson 1993). The same process took place in the US (Favilkis et al 2012). In the fourth quarter of 2017, UK house prices were almost 10 times their value in the fourth quarter of 1979 (Shabani et al 2014). Consumer prices increased just five times over the same period (ONS 2018c).

During this same period, housing grew from 53 to 66 per cent of households' net assets, creating a wealth effect that allowed households to borrow more, financed by cheap funds from abroad (Shabani et al 2014). Between the late 1980s and 2008, household debt increased from around 50 to 100 per cent of GDP and savings rates also fell to all-time lows by 2007 (Harari 2018). Equity withdrawal also grew every year from 1997 to 2007, peaking at £140 billion annually in 2006 before sharply declining during the financial crisis (Reinhold 2012). Over this period there is a clear correlation, not only between mortgage debt and house prices, but also between consumer credit and house prices, showing this wealth effect in action (see figure 2.1).

FIGURE 2.1

House prices, outstanding levels of mortgage debt and outstanding consumer credit have increased in lockstep, falling briefly after the global financial crisis before rising again

House prices (Index: Q1 1993 = 100), outstanding lending secured against dwellings (Index: April 1993 = 100), and consumer credit (Index: April 1993 = 100)



Source: Nationwide (2018), Bank of England (2018)

These rising asset prices impacted the current account in two ways. Firstly, asset price rises boost household wealth, allowing consumers to finance higher levels of current spending through debt (Aizenmen and Jinjerak 2014; Bergin 2011). This debt-fuelled consumption meant that consumers were demanding more goods than the UK was able to pay for through its own production, based on the increasing value of their assets (Aizenmen and Jinjerak 2014; Laibson and Mollerstrom 2010). This increased financial flows into the UK, leading to a deterioration in the current account (Favilukis et al 2012).

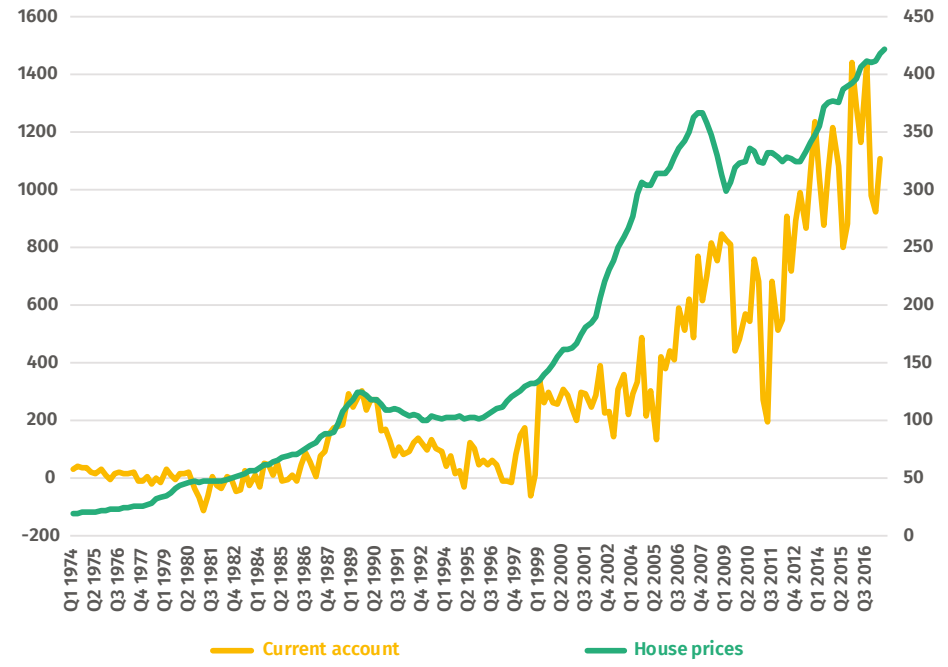
Secondly, ceteris paribus, high and rising asset prices exert upward pressure on the exchange rate by increasing international demand for UK assets, making UK exports more expensive and imports cheaper, and leading to a deterioration in the current account (Guschanski and Stockhammer 2017; Favilukis et al 2012). While this exchange rate appreciation should lead to lower demand for UK assets, if international investors expect UK asset prices to continue to rise, they are likely to invest in those assets even if a strong currency makes them look expensive – especially in the context of low global interest rates (Bernanke 2011).

In turn, these inflows inflate asset prices and therefore demand for credit further, creating a self-reinforcing cycle (Kermani 2012). Plotting house prices and the current account together certainly suggests that the two are correlated, as shown by figure 2.2.

FIGURE 2.2

The current account has deteriorated as house prices have risen since the late 1970s

House prices (Index: Q1 1993 = 100 – right axis) and the current account deficit (Index: Q1 1993 = 100 – left axis)



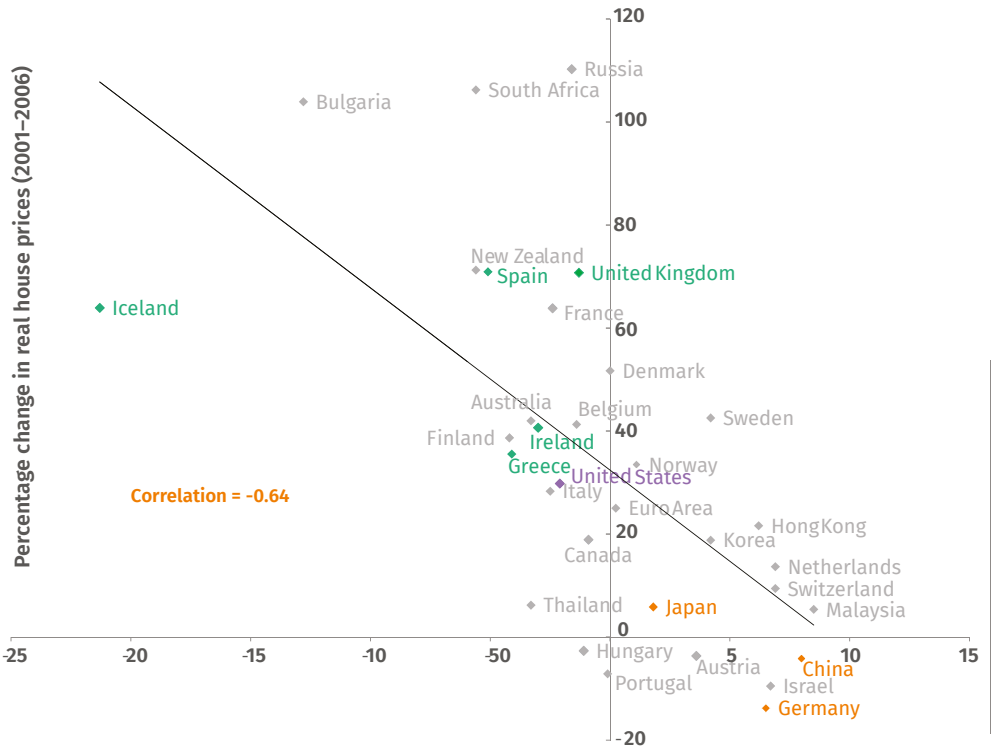
Source: Nationwide (2018) and ONS (2018a)

These processes created a self-reinforcing cycle in which increased levels of bank lending pushed up house prices, and high house prices allowed consumers to borrow more against the rising value of their homes, increasing financial inflows and exacerbating the current account deficit (Kermani 2012). In a low interest rate environment, partly explained by currency pegs in surplus countries, this process has gone on for longer than might have been expected (Kermani 2012; Ferrero 2012). These patterns are visible in both the current and financial accounts from the 1980s onwards. The UK current account deficit averaged 1.9 per cent of GDP between 1997 and 2008 (ONS 2017). This was balanced by net inflows into UK currency and deposits via the other investment account (which would have allowed banks to increase their lending), and debt securities via the portfolio investment account. Together, these two aspects of the financial account averaged 6.2 per cent of GDP during the same period (ibid). Other elements of the financial account, such as foreign direct investment, were negative for most of the same period (see above). Ferrero (2012) has shown that there is a strong positive correlation between current account dynamics and house prices all over the world (see figure 2.3).

FIGURE 2.3

There is a strong positive correlation between increases in house prices and increases in current account deficits around the world

Current accounts and house prices in advanced and emerging economies



Source: Ferrero A (2012)

FINANCIALISATION

The UK was able to sustain a large current account deficit and a strong exchange rate due to a combination of low global interest rates and asset price inflation. These forces were global in nature, yet the UK economy's response to them has been unique. In 2006, for example, the *Economist* claimed that sterling was almost 20 per cent overvalued against the dollar using its 'Big Mac index' of purchasing power parity (Economist 2006).

This section argues that the UK's role in hosting a major global financial centre has created a number of distortions in its economy, many of which have also impacted on the currency and the current account. This has prevented the UK economy from adjusting to a more sustainable growth model since the financial crisis.

Speculation

The City of London is one of the largest financial markets in the world, with 37 per cent of the global market in foreign exchange trading (Norfield 2014; TheCityUK 2017). Much – though by no means all – of this trade takes place using sterling. The huge volumes of trade in sterling that take place in the City each day place upward pressure on the value of the currency because they increase demand for sterling via increases in the *velocity* of money – the speed at which money changes hands. There is strong empirical evidence to support the theory that the faster the velocity of money, the stronger the exchange rate (Karfakis 1991; Gargano et al 2017).

In fact, the value of a currency is often not determined by so-called 'economic fundamentals' over the longer term. The 'efficient market hypothesis' would suggest that, given full information, markets will achieve prices that reflect all knowable information at the lowest possible transaction cost to the owners and recipients of capital (Stirling 2017). In contrast, Keynes (1936) argued that financial markets are driven by a 'beauty contest' where behaviour is influenced by the apparent attractiveness of securities, which is based on how much other market actors are investing in them. Rather than reflecting information about the real economy, prices in these markets come to reflect the behaviour of other market actors. This tendency has been exacerbated by increasing levels of short-term, high frequency trading, with hedge funds and high frequency traders making up 72 per cent of equity market turnover in the UK (Kay 2012).

There is now evidence to suggest that currency markets operate in the same way, with the value of exchange rates reflecting speculation at least as much as economic fundamentals. A strand of post-Keynesian literature has argued that the value of particular currencies over long time periods is determined by 'non-fundamentals', and that this often leads to bubbles in currency values (Kaltenbrunner 2011; Davidson 2011; Priewe 2016). Priewe (2016) argues that Forex markets are 'speculative markets par excellence' and do not function according to the efficient market hypothesis. This is a tendency that has been exacerbated by 'modern algorithmic technical trade' which leads to much greater levels of short-termism and speculation over currency values, which in turn can drive 'speculative long waves of appreciation and depreciation' in the context of exchange rate flexibility (ibid). Over the long term, however, fundamentals matter and this often leads to cycles of extreme appreciation followed by swift devaluations.

Complexity and regulatory capture

There is widespread agreement that a large part of the blame for the financial crisis lies with regulators who failed to account for the build-up of risk in the sector (FSA 2011; Haldane and Madouros 2012). Regulators failed to ensure that banks were holding enough capital to account for potential losses on their riskier assets, failed to account for increasing levels of leverage, and completely failed to note the build-up of risk in the so-called shadow banking sector (Freeman 2010).

This last point is particularly significant. Shadow banks, defined as institutions that lend money without taking deposits that are guaranteed by the state, grew dramatically in the run-up to the financial crisis (Adrian and Ashcraft 2012). Much of the risk that built up in the banking system was concentrated in these shadow banks, as they were less tightly regulated than deposit-taking institutions. In practice, the two sectors were very closely linked through banks' creation of 'special investment vehicles' and other off-balance sheet entities to hold riskier investments (Shabani et al 2014). Since the financial crisis, non-bank financial institutions have become even more important to the UK's banking sector – in the UK the shadow banking sector is responsible for 50 per cent of the financial system's total financial assets (Bank of England 2017).

The size of the financial sector in the UK has made both banks and shadow banks more difficult to regulate for two reasons. Firstly, the complexity of the UK's financial system and the inefficiency of its regulatory structure has made it difficult for regulators to keep apace of developments within the sector (Haldane and Madouros 2012). Haldane and Madouros (2012) argue that both the modern financial system and modern financial regulation have become 'too complex', preventing regulators from being able to keep up with changes and allowing financial institutions to take advantage of loopholes that inevitably arise with a complex regulatory apparatus. This complexity is exacerbated by issues of institutional design. For example, the tripartite arrangement in which regulatory power was shared between the Financial Services Authority (FSA), HM Treasury

and the Bank of England meant that no single institution had the power or the responsibility to oversee the financial system as a whole (Dolphin 2013).

Secondly, this complexity has increased the risk that regulators will be subject to capture due to asymmetric information and the close links that are required between regulators and market actors (Hardy 2006; Pagliari 2012). The theory of regulatory capture was developed by Stigler (1971) who argued that groups of firms, particularly in the context of high market concentrations, are able to exert influence over regulators to ensure the implementation of regulation that aligns with their interests. Baker (2010) has argued that this process has gone particularly far in the financialised economies of the UK and the US, and has increased as the financial sector has become more dominant.

The lobbying efforts of the finance sector have not only reduced the regulation to which the sector is subject, they have also affected policy decisions in several other areas. Green (2016) has argued that successive governments have been influenced by a so-called 'City-Bank-Treasury nexus' (comparable to the 'Wall Street-Fed-Treasury nexus' in the US) that privileges the interests of finance in the south of England over other industries in the rest of the country. Davis and Walsh (2016) argue that the increasing power of the Treasury has led to the adoption of a 'Treasury view' throughout the regulatory apparatus including a belief in free trade, well-functioning capital markets, spending control, and a strong currency. This has led to monetary policy in the UK being consistently geared towards maintaining the value of sterling in order to protect the profitability of the finance sector, at the expense of exporters (Hazledine 2017; Green 2016; Christensen, Shaxson and Wigan 2016).

Illicit capital flows

Over recent years increasing attention has been drawn to the role of London in international money laundering, in particular the role it plays in facilitating tax avoidance and evasion, and through the role of sterling in facilitating illicit capital flows (Eurodad 2017). There is clearly no easy way of determining the impact of these activities on the value of sterling, but there is some evidence to suggest that illicit capital flows do account for a sizeable and growing portion of the capital that flows into the UK. The 'net errors and omissions' (NEO) item in the balance of payments provides a neat illustration of this point.

In principle, these errors should balance themselves out over the longer term. However, as pointed out by Klein (2015), summing the NEO account up over the last 30 years 'produces distinctly non-random patterns'. In fact, the NEO item shows a significant amount of money flowing into the UK – in 2009 this amounted to 1 per cent of GDP and has rarely fallen below 0.5 per cent since.

The fact that this capital is shown in the NEO section means that statisticians have not been able to determine exactly where the capital is coming from or how it has entered the country. But there is strong evidence to suggest that at least part of these inflows represent illicit capital flows not captured by the financial account. A report by Deutsche Bank finds that 'systematic net inflows into the UK [via the net errors and omissions item] seem to track money leaving Russia, as well as high-end London house prices' (Klein 2015).

3. Financialisation of the UK economy has increased asset prices and financial instability, led to 'Dutch disease' and rising inequality, and driven financial market concentration

The UK's pre-crisis growth model was clearly not sustainable, ending as it did in recession following the largest financial crisis in a century. But since the global financial crisis, the UK has failed to increase its exports to the rest of the world and rely less on domestic consumption, despite significant falls in the value of sterling. Instead, household debt and asset prices have returned to pre-crisis levels, and international trade continues to act as a drag on growth. This section outlines the longer-term impacts our financialised growth model is having on the British economy.

FINANCIALISATION AND CRISIS

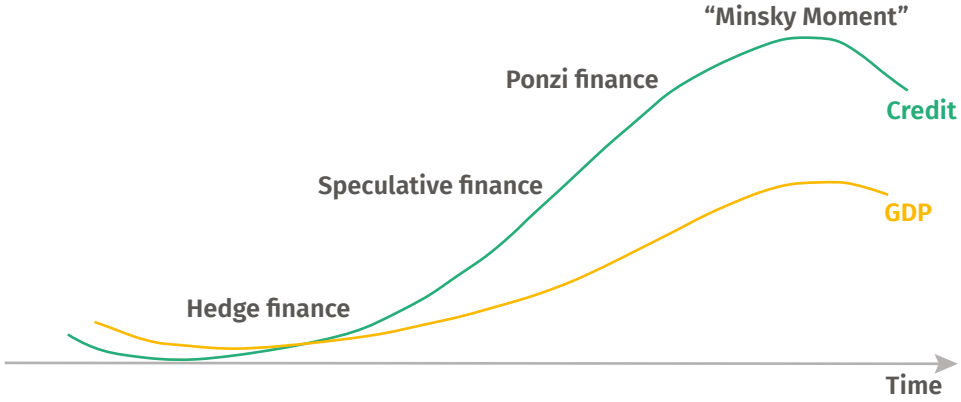
Lending against existing assets – and real estate in particular – undertaken by a sophisticated finance sector in the UK has led to asset price inflation that would not otherwise have occured (Ryan Collins et al 2017). This has increased the risk of speculative bubbles and debt-deflation cycles, but it has also put home ownership out of reach for much of the population.

A growth model built on rising asset prices and ever higher levels of borrowing will always be especially prone to financial crises. Borrowing from the rest of the world and failing to invest the returns productively means sacrificing future consumption for current consumption, making a correction inevitable (Ghosh and Ramakrishnan 2006). The UK's large finance sector – and persistent international imbalances – allowed for this correction to be deferred for such a long time, but it is now clear that the so-called 'Great Moderation' of the early 2000s –a period of relative stability based on debt-financed consumption – was mis-named.

Hyman Minsky's theory of asset price inflation captures these dynamics well; in fact, the 2007 crisis has been described as a 'Minsky moment' by some economic commentators (Whalen 2008; Wray 2015). According to Minsky's (1992) 'two price theory', asset prices are governed by different rules to prices for other economic outputs (Randall Wray 2015). During the good times, investors become overly optimistic based on their recent experience of risk and overinvest in assets that are increasing in price (Minsky 1992). Regulators also under-regulate during this period, exacerbating these dynamics (ibid). In this sense, 'stability is destabilising' and financial behaviours are heavily procyclical, which is what underlies the emergence of bubbles. Eventually, the financial cycle enters a phase of 'Ponzi finance' with investors piling into assets one after another based purely on the speculation-driven price rises of the recent past (ibid). This creates further asset price inflation, driving a positive feedback loop that leads to bubbles which eventually burst, creating a 'Minsky moment'. Since the global financial crisis, economic commentators seized upon Minsky's work to argue that 'Minsky was right' (Wolf 2008), and a number of studies since the financial crisis have backed this up, empirically and theoretically (Kregel 2008a 2008b; Goodhart et al 2015; Vercelli 2009; Randall Wray 2011).

FIGURE 3.1

Stylised Minsky cycle



Source: Adapted from Minsky

Unrestricted lending of the kind seen in the UK before and after the global financial crisis exacerbates these dynamics, extending the Ponzi finance phase and leading to a 'Minsky moment' of much greater magnitude, because only a portion of the investment undertaken by firms will be financed from retained earnings. As their optimism grows after several periods of strong returns, investors will borrow more and more to invest in riskier projects because they anticipate that their returns will continue to grow, and that they will therefore not have any trouble servicing the debt (Goodhart et al 2015). These views are reinforced by the asset price rises that are generated by their investment decisions. These dynamics are exacerbated by low credit spreads, but even as borrowing rates increase, investors will continue to put capital into riskier projects because the 'expected penalty for default decreases' (ibid).

The reason the financial cycle matters is that, when the Minsky moment occurs, it can lead to an extended period of 'debt deflation'. Fisher (1933) argued that once panic selling of assets begins, it catalyses a chain reaction throughout the financial system. This causes deflation in the real economy, leading to falls in profitability, further liquidation of assets, and even greater deflation, which affects employment, output, and financial stability in a debt deflation spiral that mirrors the upswing described in Minsky's work (Fisher 1933; Goodhart et al 2015).

In this way, high levels of indebtedness of the UK economy driven by the finance sector led to the Minsky moment of the global financial crisis and the recession that followed. Only the US, the financialised economy par excellence, experienced more pain as a result of the crisis. As Marazzi (2011) argues, financialisation 'defers the rendering of accounts … precisely because the amount of credit to companies and consumers can keep increasing despite the signs of the inversion of the cycle of the real economy'.

FINANCIAL 'DUTCH DISEASE'

Some commentators have argued that the UK suffers from a form of financial 'Dutch disease', in which the outsized finance sector leads to an overvalued currency which negatively impacts other economic sectors, and therefore regions where finance is less significant (Standing 2016; Kaminska 2016). 'Dutch disease' – a reference to the experience of the Netherlands after the discovery of natural gas in the 1950s – is a term used to describe the currency appreciation and consequent

decline in international competiveness that arises from the strong performance of one particular sector in an economy relative to others.

Dutch disease has manifested itself in the UK in two ways. Firstly, with a strong currency boosting purchasing power, the UK economy has become extremely reliant on imports for consumption, while our manufacturing exporters have found it more difficult to compete and retain a domestic market share (Jacobs et al 2017). This means that devaluation generates significant cost-push inflation, of the kind that the UK has experienced since the Brexit referendum (Springford and Tilford 2016). Secondly, over time the strong pound has become 'locked in', as manufacturing sectors have developed a reliance on relatively cheap imported inputs. Path dependencies have now developed in UK manufacturing that make it harder for the sector to take advantage of currency depreciation when it does happen (Kitson and Michie 2014).

This reduced capacity to benefit from exchange rate depreciations has been evident in the wake of the financial crisis. Between July 2007 and January 2009, the effective value of sterling declined over 25 per cent (ONS 2018). The pound dropped again when the UK voted to leave the European Union: since the vote, the value of sterling has fallen 25 per cent in effective terms (ibid). This precipitous decline has failed to lead to an improvement in the UK's current account. In fact, it has catalysed an acute deterioration in the current account deficit, which peaked at 6 per cent of GDP in 2017. Since its low point, the current account has recovered somewhat, but statistics from the first quarter of 2018 show that the trade balance has started to deteriorate again (ONS 2018).

INEQUALITY

The UK's financialised growth model has contributed to significant regional and wealth inequalities. Given the economic geography of the UK, the growth of the finance sector has disproportionately benefitted London and the South East, while reducing the relative importance of the manufacturing sectors primarily located in the English regions.

In 1970, financial and insurance activities made up 5 per cent of total gross value added, next to 27 per cent for the manufacturing sector. By 2007, manufacturing and finance both made up about 10 per cent of the UK economy. Just 2.4 per cent of jobs in London were in manufacturing in 2017, compared to 10.2 per cent in the North East, 9.4 per cent in the North West, and 9.7 per cent in Yorkshire. In contrast, 6.5 per cent of the capital's jobs are in finance compared to 2.9 per cent in the North West, 2 per cent in the North East, and 2.8 per cent in Yorkshire. Overall, London is responsible for producing almost 30 per cent of the UK's total output and on this metric the UK is now the most regionally unequal country in Europe (Jacobs et al 2017).

Asset price inflation in the UK has also increased wealth inequality by increasing the returns to wealth, which is unequally distributed (Roberts and Lawrence 2017). Today, the rate of return to capital, including housing and equities, exceeds the rate of growth of the economy as a whole (Piketty 2014). If capital were owned equally throughout the population, the increasing returns to capital – and the appreciation of assets – would not cause rising inequality. However, different individuals and households hold different assets and liabilities, which generate differing rates of return and increase in value at differing rates (Roberts and Lawrence 2017). According to the most recent wealth and assets survey, wealth in the UK is twice as unequally distributed as income, with the top 10 per cent owning 44 per cent of the nation's wealth next to 9 per cent for the bottom half (ONS 2018d).

MARKET CONCENTRATION

One consequence of the UK performing the role of global financial hub is that the UK's banking sector has become very concentrated. Today, the six largest banks in the UK account for 86 per cent of the personal bank account market, while the five largest banks account for 89 per cent of the business account market (FCA 2017). The largest six lenders also account for 77 per cent of regulated mortgage lending, the top nine banks have 81 per cent of the UK's credit card market, and the largest five banks provide 66 per cent of all personal and business loans (ibid). The very high rates of interest that many banks have been able to charge since the financial crisis, despite the very low interest rate environment, reflect a lack of competition in the sector that is particularly harmful for the less well-off (ibid). This lack of competition and high rates of interest are a significant source of the UK consumer debt problem: the Financial Conduct Authority (FCA) recently found that some credit card providers were allowing 'performing' customers to remain in long-term debt to extract greater revenues from these customers, even if this meant their building up unsustainable levels of debt over time (ibid).

In 2014, when the UK's four largest banks had a collective market share of 75 per cent in personal and business current accounts, the Competition and Markets Authority (CMA) launched an investigation into UK retail banking. The CMA found that the behaviour of the major banks was having an 'adverse effect on competition' in the sector and proposed a series of measures to improve transparency and bank engagement with customers, including a new mobile app designed to improve transparency. On the one hand, this has supported the emergence of so-called 'challenger banks', and has bolstered the UK's growing FinTech industry. However, the CMA's proposals did not go far enough in curbing the dominance of the big four banks, and no challenger bank has yet been able to gain more than 5 per cent of the market share. The FCA (2017) recently concluded that the 'sector remains concentrated, with continued low levels of switching'.

4. Rebalancing the UK's international position requires moderating the significance of finance within the UK economy and bringing asset price volatility under control, while nurturing non-financial exporting sectors

Tackling each of these problems requires tackling the UK's unbalanced relationship with the rest of the world. This means moving away from a debt-fuelled, consumption-driven model of growth based on borrowing, and towards a model which enables the UK to finance most of its current consumption through current production. Doing so will require a combination of short-term measures to limit the strength of the UK's currency and longer-term measures to reduce the power of the finance sector in the economy.

EXCHANGE RATE CONTROLS

In theory, one way to fix the UK's imbalances would be to force a depreciation of sterling through a managed exchange rate policy, such as an exchange rate peg. This could, if sterling fell far enough, redirect consumer and business demand towards domestically-produced goods and inputs and reduce our reliance on imports.

In 2011, Switzerland stunned markets by implementing a currency ceiling for the Swiss franc against the euro. The central bank announced that it would set a minimum exchange rate of 1.20 Swiss francs per euro. At the same time, the bank announced that it was 'prepared to buy foreign currency in unlimited quantities' to achieve a 'substantial and sustained weakening of the Swiss franc' (Klein 2015). Since the announcement, the central bank has spent 633 billion Swiss francs attempting to limit the appreciation of its currency by purchasing foreign currencies, swelling the central bank's foreign reserves to almost 700 billion.

But Switzerland's action has in many ways proven the exchange rate liberalists right. Between 2007 and 2011, Switzerland had engaged in open market operations to the tune of 246 billion Swiss francs attempting to lower the value of the currency. This failed, and in 2011 the hard peg was introduced. Billions were spent on attempting to keep the country's currency below the peg, until it was abandoned in 2015. According to the FT, 'the net effect has been a sustained 10 per cent appreciation of the franc and another 300 billion francs of foreign exchange reserves added to the balance sheet' (Klein 2015).

Overall, the Swiss experience seems to prove the received wisdom. In the context of international capital mobility, it is all but impossible to implement an exchange rate peg to achieve a pre-determined, 'desirable' value of the currency. Investors will simply take advantage of the arbitrage opportunities this offers, betting that the peg will be abandoned, and placing continuous upward pressure on the value of the currency. Any attempt to devalue sterling through these mechanisms is likely to create similar issues for UK policymakers.

CAPITAL CONTROLS

Many of the problems outlined above result in part from the volumes of capital moving in and out of the UK, and the volatility of these flows. Since the 1980s, the amount of capital flowing around the world, and the speed with which it moves, has greatly increased, leading some economists to term the period since 1979 the era of 'financial globalisation' (Lane 2012). Gross cross-border capital flows rose from about 5 per cent of world GDP in the mid-1990s to about 20 per cent in 2007, or about three times faster than world trade flows (OECD 2011). According to the IMF, financial globalisation has meant that 'global finance has become dominated by herd-like short-term risk-reward calculations' which have increased the risk of economic crises (Ghosh and Ramakrishnan 2006).

One way to limit capital mobility is through the use of capital controls, but until recently there was a strong international consensus against this (Rafferty 2017). This was based on several arguments. Firstly, technological change is alleged to have made it effectively impossible to implement viable capital controls (Ghosh and Quereshi 2016). Investors are increasingly able to work their way around any attempts to limit capital mobility, and regulators often find it hard to keep up with the dynamism of financial markets. Secondly, many economists argue that capital account liberalisation improves productivity by increasing the effective size of domestic financial markets in the same way that international trade increases the size of markets for goods and services (Moschella 2012). This both increases the available pool of investment for businesses, and increases competition, making domestic financial systems work more efficiently. Thirdly, it is argued that capital account liberalisation increases international risk sharing, improving macroeconomic stability (Lane 2012).

However, many of these effects have failed to materialise, and financial globalisation has created its own significant economic distortions (Lane 2012). A number of studies have found that the alleged links between capital account liberalisation and GDP growth are unconvincing (Prasad et al 2007; Satyanath and Berger 2007). Moreover, capital account liberalisation has dramatically increased the volatility of international financial markets, and has increased many countries' exposure to exogenous shocks (Ghosh et al 2014). Rather than promoting risk sharing, recent literature has found that certain capital inflows, particularly inflows into debt and related debt instruments, can increase a country's susceptibility to crisis by reducing risk sharing (Ostry et al 2010). There is now strong empirical evidence to suggest that high levels of capital mobility played a central role in the build-up to the financial crisis, and the crisis itself (Milesi-Ferretti and Tille 2011). As a result, there is now much greater support for the restriction of capital mobility than there was before the financial crisis (Rafferty 2017), and a number of authors have argued for capital controls in its wake (Felix 2005; Pettifor 2011).

There are several different ways that capital controls could be implemented. Controls on capital outflows are thought to be less effective than those on inflows, but perhaps that is because the former are often implemented during financial crises (Edwards 1999). Controls on inflows are generally seen as more effective. There is now strong evidence that controls on capital inflows shift the composition of capital away from short-term, risky assets toward longer-term ones (Ostry, Ghosh, and Qureshi, 2015).

Capital controls can be direct (sometimes called 'quantitative') or indirect (qualitative). Direct capital controls generally take the form of specifying a certain amount of capital that is permitted to enter or leave the country at any one time, while indirect controls are often tax measures that serve to disincentivise the movement of capital out of the country. Indirect controls are seen as particularly 'desirable and effective' by the IMF (Yung-Lee 1997). In this sense, there is not an

'on/off switch' for capital mobility, rather there are a series of policy measures that can serve to direct and limit the speed of capital inflows and outflows.

TACKLING FINANCIALISATION HEAD-ON

A more long-term response to the problems financialisation imposes on the UK economy would be to try to adjust the balance of the economy away from finance. A stock response to this argument is that the UK depends on its finance sector for financing a great deal of its growth and public spending, even if it is associated with significant negative externalities. The finance sector contributed £119 billion to the UK economy in 2017 – or 6.5 per cent of economic output (TheCityUK 2017). As a proportion of total output, this makes the UK's finance sector the eighth largest in the OECD (ibid). At the end of 2017, over one million people were employed in the UK's finance sector – 3.2 per cent of UK employment – and financial services contributed £27.3 billion worth of tax revenues to the Exchequer in 2016/17 (ibid).

But the growth of finance has transformed the structure of the UK economy, and it is now arguable that the benefits associated with the finance sector are more than outweighed by the substantial costs it has imposed (Christensen, Shaxson and Wigan 2016). As outlined above, the growth of the finance sector has contributed to the UK's high levels of consumer debt, our unbalanced international position, and some aspects of our socioeconomic and regional inequality. Its activities proved particularly expensive after the global financial crisis, when revenue support to banks peaked at just under £20 billion, or 1 per cent of GDP (Haldane 2010). Andy Haldane (2010) has estimated that the UK has experienced £1.8–7.4 trillion worth of losst output through the great recession catalysed by the global financial crisis. A recent study estimates that Britain suffered a potential output loss of 12.5 per cent and a decline in the growth rate from 2.7 to 1.9 per cent (Ball 2014). Today, it is clear that the UK's finance sector has grown too big relative to the rest of the economy.

Some have argued that, in the wake of the vote to leave the European Union, the UK needs to protect its financial sector as it is one of the few industries in which the UK has a comparative advantage. The removal of EU passporting rights is likely to lead to a number of banks relocating, which means the UK will no longer be responsible for providing the implicit subsidies to these banks – but it will also reduce our measured GDP and employment.

However, it would be short-sighted to leave such an important question as the size of the financial sector, and the nature of financial activities that take place in the UK, to be determined by Brexit. While the removal of passporting rights would be likely to affect the operations of a certain number of large banks, other, riskier financial services are less likely to be affected (Lavery et al 2017). It is notable that not all financial companies feel threatened by Brexit: some hedge funds, private equity firms, and those engaged in Forex trading see Brexit as an opportunity to escape the tough regulation that has been implemented in the EU in the wake of the financial crisis (ibid). A more considered view is required.

5. Recommendations

As laid out above, if the UK fails to address its current account deficit, it will remain extremely vulnerable to any changes in the global macroeconomic environment. Already, the vote to leave the European Union has caused sterling to fall 25 per cent on a trade-weighted basis, increasing the price of imports and pushing up inflation. Worse shocks in the future could provoke capital flight, with severe adverse consequences for all parts of the UK economy. The UK should look to initiate a gradual, orderly rebalancing of its international position, or risk having a disorderly correction inflicted on it.

In this section, we suggest a series of measures to address the financialisation of the UK's economy, which will in turn reduce the current account deficit. It is important to note that these recommendations would not fully address the problems described above. Over the long-term, the only solution to our international imbalances is a profound restructuring of our economy, involving a diversification of our exporting sectors, and the strengthening of domestic supply chains. Recommendations to that end are beyond the scope of this paper, although we make reference to the need for a comprehensive industrial strategy. For a more detailed discussion, see Jacobs et al 2017.

REGULATING THE FINANCIAL SECTOR

Since the financial crisis, there has been a turn towards macro-level analysis of systemic risk in the financial system, which has been termed the 'macroprudential turn' (Baker 2018). Among institutions such as the Bank for International Settlements, the IMF and the Bank of England, there is a growing consensus that the regulatory approach that preceded the crisis was based on a set of mistaken assumptions about how financial markets work.

The macroprudential approach emphasises four elements that are not present in traditional micro-level economic analysis (Baker 2018). Firstly, the behaviour of the whole cannot be understood by knowing the behaviour of individual elements (that is, examining financial institutions individually does not reveal the true extent of risk across the system as a whole). Secondly, when left to its own devices, the financial system trends towards instability rather than equilibrium. This tendency is due to two final elements – procyclicality and complexity, concepts used to describe the way in which interactions between agents across the economic cycle lead to the build-up of risk as the financial cycle goes on, and as actors in the system become more closely integrated.

The Basel III recommendations, negotiated by the Basel Committee in 2010, are one outcome of the macroprudential turn. Compliance with the recommendations is voluntary, and it is expected that the 27 jurisdictions that have signed up to Basel will implement its recommendations through national legislation. Basel III involved both macro and micro prudential regulation to address both bank-level and systemic risk. The original recommendations included: higher capital ratios, based on stricter definitions of so-called 'tier 1' capital; leverage ratios relating banks' balance sheets to their capital stocks; the implementation of dynamic capital ratios and other measures to dampen procyclicality; and a net stable funding ratio requiring banks to have enough liquid assets to cover their costs for at least 30 days.

There is widespread agreement that, as one commentator has put it, Basel III is 'necessary but not sufficient' (Byres 2012). Basel III was designed primarily to protect the banks from the business cycle, not the reverse. While limiting activities of individual banks and other finance companies, it has failed to reduce systemic risk to acceptable levels or prevented rising debt levels and asset price inflation (Schwerter 2011).

As such, we propose an overarching reform to macroprudential policy, both to counter systemic risk and limit house price inflation. The Financial Policy Committee (FPC) of the Bank of England should be given an explicit house price inflation target, set by government. This would be analogous to the mandate the Monetary Policy Committee (MPC) has to control consumer price inflation. The aim of such a target would be to set property price expectations (a critical driver of house price inflation), reduce excessive debt, and reduce capital inflows by disincentivising property investment. The target could be set at (say) 0 per cent per annum nominal growth for an initial period – say five years – to bring the cycle of inflation and expectations under control, and then settle on a 2 per cent per annum nominal price inflation target; this would effectively mean holding house prices constant in real terms, given that the consumer price inflation target is also 2 per cent.

Currently, the FPC achieves its objectives via controls on loan-to-value and debt-to-income ratios allowed by mortgage providers, and controls on the proportion of mortgages in bank portfolios. The FPC recently implemented a loan-to-income ratio of 4.5 per cent for 15 per cent of new mortgages, even though the Bank of England recently estimated that around 11 per cent of mortgages exceeded this ratio in 2015 (Chakraborty et al 2017). Implementing targets that bite requires giving the FPC a strong mandate to limit asset price inflation. Since house price inflation is different in parts of the country, the FPC's guidance should be regionally specific.

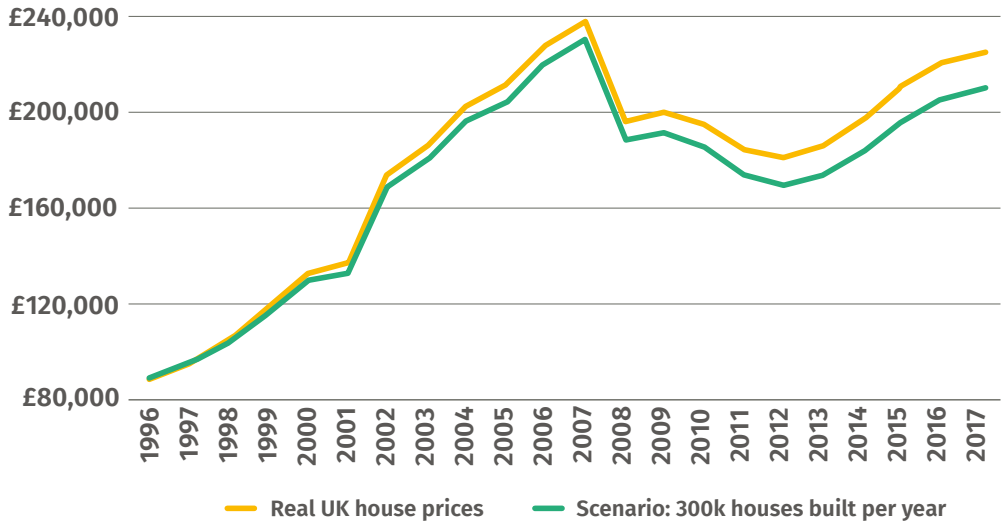
There is a risk that a target for house price inflation, tackled through macroprudential tools, could inadvertently increase inequality, by reducing access to credit for the poorest borrowers. To mitigate this risk, we recommend that the exact nature of the target, and the tools the FPC be given to achieve it, be determined jointly by the Bank of England and the Treasury, and be put out for consultation before being implemented.

House prices are also determined by other factors, not least the supply of housing, and therefore adoption of the target would need to be accompanied by a much more active housing policy. This might include public housebuilding, changes to planning policy, and curbs on overseas purchases of UK homes (Ryan-Collins et al 2017). The FPC should be able to request that the government do more with housing policy if it judges that it will be unable to meet its target through macroprudential tools alone.

It is also worth noting, however, that recent research has shown that the level of mortgage lending is the primary determinant of house prices (Ryan-Collins et al 2017). According to research from Iain Mulheirn (2008) of Oxford Economics, if the UK had built 300,000 houses per year since 1996 we would have 2.1 million more homes today – but this would only have reduced house prices by 7 per cent. Supply appears important, particularly in areas of the market like social housing, and appears to be becoming more important over time, but lending appears to be the primary determinant of house prices (Ryan-Collins et al 2017).

FIGURE 5.1

Increasing the supply of homes would not have had much effect on house prices



Source: Mulheirn (2018)

RETHINKING THE BANK LEVY

Since the financial crisis, the UK government has introduced reforms to the way banks are taxed. The bank levy is a tax on the global balance sheets of UK and foreign banks which operate in the UK and is paid by banks whose total liabilities exceed £20 billion. The levy was introduced at a rate of 0.075 per cent, with the proviso that it should always raise at least £2.5 billion per tax year. As such, the rate has risen and fallen depending on expected revenues in that year, reaching 0.21 per cent in 2015/16. In that year, it was announced that the bank levy would fall each tax year until it reached 0.1 per cent in 2021, when it would only apply to UK banks' domestic assets. Additionally, a corporation tax surcharge for bank profits over £25 million was introduced on top of the bank levy in 2016.

There are several problems with the current design of the tax. Firstly, the tax only applies to banks – that is, state-insured, deposit-taking institutions. While ensuring that banks pay some contribution for their insurance by the state, in practice, as the financial crisis showed, there are very close links between the banking and 'shadow banking' system (Adrian and Ashcraft 2012). Moreover, much of the risk to which traditional banks were exposed was built up in the shadow banking system, which is also where much of their profits came from (ibid). Limiting the bank levy to ordinary deposit-taking institutions therefore, both fails to ensure financial stability and does not capture many of the rents produced by financial institutions outside of the traditional banking system, which were at the heart of the financial crisis.

Secondly, the corporation tax surcharge has a minimal effect on the systemically important institutions where risk is most concentrated and a much greater impact on the smaller 'challenger banks' that have emerged since the financial crisis (Barber and Hunt 2016). This is both a result of the level at which the levy is set – most banks have profits over £25 million – and because large international banks are able to shift profits to low-tax jurisdictions in order to avoid the levy. As such, since 2016 the impact of the taxes on smaller banks has been proportionately larger than on bigger ones, even though the latter still make up the majority of revenues (ibid). The concentration of the UK's banking sector allows the large

banks to take advantage of so-called 'monopoly rents'. Tackling rent seeking and curbing risk in the financial sector therefore requires a relatively greater tax burden to be placed on larger banks over smaller ones.

We argue that the corporation tax surcharge should be removed given its impact on small challenger banks. Instead, the bank levy should remain, and be applied to UK banks' and shadow banks' entire balance sheets at a rate that helps to curb systemic risk. This rate should be dynamic, rising and falling with the financial cycle alongside other macroprudential tools.

MANAGING CAPITAL FLOWS: A FINANCIAL TRANSACTIONS TAX ON CURRENCY TRADING

Financialisation has dramatically increased the volume of capital flowing into and out of the UK, only some of which is of genuine social value. These capital flows are associated with an increasing risk of financial crises of the kind described above.

IPPR has argued elsewhere for the extension of Stamp Duty Reserve Tax (SDRT) to cover a greater portion of equity transaction (Stirling and King 2017). Here, we argue that this should be accompanied by the introduction of a tax covering currency transactions. The former would help to curb trading volumes, limiting upward pressure on sterling through this channel, while the latter would act as a qualitative capital control on both inflows and outflows.

The UK already has a financial transaction tax (FTT), known as SDRT, which is considered very effective and easy to administer (Burman et al 2015). SDRT levies a charge of 0.5 per cent on the purchase of shares at the point of certifying a legal transition in ownership. Revenues from this tax are consistently worth between £3 and £4 billion per year, with 90 per cent of this collected automatically via the central securities depository computer (Stirling and King 2017). The tax is exceedingly hard to avoid because it is levied on the 'issuance principle': no matter where you are in the world, you have to pay the tax if you register for legal ownership of a share issued by a UK-based company. This is why 50 per cent of revenue is successfully collected from non-UK residents (ibid). However, the exemption for 'market makers' – mainly asset managers and hedge funds – now means that 40 to 50 per cent of share turnover is eligible for exemption.

The market maker exemption dates back to before the era of financial intermediaries, and we argued in our previous paper that it should be removed (ibid). We argued that incentives for excess trading should be reduced by replacing the 100 per cent relief on SDRT for intermediaries with a new rate of 0.2 per cent, which would reduce turnover generated by intermediaries by around 60 per cent, and overall turnover in equity markets by about a quarter to a third, as well as raising around £1.2 billion by the 2020s. Extending the reach of SDRT should go some way to reducing turnover in securities markets, combatting the impact of transaction velocity on the value of the currency, as outlined in chapter 3. However, this would not reduce the volatility introduced to the value of sterling by speculation over the currency as an asset in its own right.

To do this, we propose the introduction of a currency transactions tax to reduce destabilising speculative activity and therefore curb exchange rate volatility, reduce 'noise' in markets and increase the importance of fundamentals (Burman et al 2015). Specifically, **we argue for the introduction of a two-tier 'Spahn' tax. This would have a low basic tax rate on all spot currency transactions of 0.005 per cent and a higher additional rate that would be levied in the case of speculative attacks or large capital outflows at the discretion of the Bank of England** (Spahn 1996; Jetin and Denys 2005).

We would propose that the main rate of the tax should be levied at 0.005 per cent – this is towards the lower range of tax levels that have been proposed, but

the lower rate could be increased over time (Stubbs 2012; Jetin and Denys 2005). Estimates from Stubbs (2012) suggest that the introduction of a CTT at a rate of 0.005 per cent on pound sterling would raise $2.5 billion by 2020. Converting this into sterling at the current exchange rate suggests that a tax of 0.005 per cent could raise up to £3.75 billion by that year (ibid). This rate will not be so high as to have a severe negative impact on liquidity in financial markets or price discovery, but will still impact financial stability and reduce short-termism and speculation (Spahn 1996).

On its own, such a tax would not be high enough to curb large speculative attacks (Jetin and Denys 2005). This is why we argue for the application of a 'two tier' rate structure which imposes a high penalty - up to 90 per cent in some cases - on 'windfall profits' in the case of speculative attacks (Spahn 1996; Jetin and Denys 2005). When such a tax should be imposed and at what rate should be determined by the Bank of England based on its remit to promote financial stability.

The base for a new Spahn tax should be as broad as possible to prevent avoidance and increase the ease of implementation. That means it should cover market makers as well as banks, mirroring the coverage of a reformed SDRT. We would also propose that the tax be levied on currency derivatives as well as spot trades, since otherwise it would be possible to avoid the tax by using forward transactions or various forms of derivatives. Most securities would be taxed based on their price at sale, but derivatives don't always have such a price at sale, or a payment at the end (Burman et al 2015). This is not an impossible problem to solve, and many existing or proposed FTTs instead levy the tax on the notional value of the derivative but at a lower rate than the normal value for securities, including the FTT that was proposed by the EU in 2011 (ibid). We argue for the same approach, with a tax on the notional value of derivatives levied at 0.0025 per cent, half of the normal rate. As with any element of tax design, this has its own trade-offs, but it is preferable to exempting derivatives from taxation altogether or taxing them too highly.

In terms of how to implement the tax, Spratt (2006) has tackled this issue extensively analysing the current administrative system for foreign exchange transactions, and showing that innovations in the use of large value payment systems operated by central banks have changed the way currencies are exchanged to the point that the imposition of a Tobin tax is 'easy, cheap, and all but impossible to avoid' (Stubbs 2012). As a United Nations Development Programme report points out, 'foreign exchange activity in the currencies of nearly every country depends on a few electronic communications networks (ECNs), for trading and on CLS Bank and SWIFT for settlement [so] each of those countries can apply the CTT unilaterally to its own currency' (Schmidt and Bhusan 2001). This also tackles the issue of whether or not such a tax can be administered unilaterally – several authors have now argued that this is possible and desirable (Stubbs 2012; Schmidt 2008). However, it would clearly be easier to introduce, and would be more effective, if such a tax were introduced multilaterally (Stubbs 2012), and this would therefore be the ideal arrangement.

TAMING OFFSHORE FINANCE

The sustained positive balance in the net errors and omissions item of the balance of payments provides some indication of the scale of money laundering and tax evasion that takes place in sterling. Sterling is a particularly attractive currency to use for these activities for several reasons. First, London is a major conduit to a network of secrecy jurisdictions, including countries like Jersey, the British Virgin Islands and the Cayman Islands (Shaxson 2011). Second, the London property market is a significant sink for laundered money from destinations like Russia and the Middle East (Garcia-Barnardo et al 2017). Thirdly, until recently, sterling had been a strong currency not subject to too much volatility.

Reducing the use of sterling for illegal activities should be an aim in itself. Money laundering in sterling, often via UK banks, facilitates many activities that governments across the world are attempting to tackle through other policy measures (Shaxson 2011). Proceeds from international terrorism, drugs and people trafficking, and sanctions evasion have all been laundered through London in recent years (Eurodad 2012). But there are other good reasons to clamp down on the money laundering and tax avoidance that take place in or via the UK finance sector. Reducing sterling's role in these activities will help to stem capital inflows into the UK, thereby placing downward pressure on sterling and helping to correct the recent overvaluation.

IPPR has called previously for mechanisms to improve transparency for the money that flows into and through London. Earlier this year we recommended in our report on business taxation that the public register of beneficial ownership (PRBO) should be extended to the overseas territories and that country-by-country reporting should be extended to more companies, and the results made publically available (Blakeley 2018). In May, the House of Commons voted through the Sanctions and Anti-Money Laundering Bill, which included a provision to extend the PRBO to the overseas territories.

This is welcome, but transparency should be taken further. The register does not extend to the so-called 'crown dependencies' like Guernsey, Jersey and the Isle of Man due to the constitutional arrangement between the UK and these territories that prevents Parliament from compelling them to act. Murphy (2018) has recently argued that the constitutional arrangement between the UK and the crown dependencies is actually fairly vague, and there is a provision to allow for intervention in the case of a 'grave breakdown or failure in the administration of justice'. There is a danger then, in the absence of action in the crown dependencies, that illegal activities will merely be shifted to these locations. **As such, there is a strong case for a review to consider constitutional options for intervention in the crown dependencies to implement the PRBO.**

Alongside the PRBO, **the UK should implement publicly available, country-by-country reporting to curb corporate tax avoidance and create a blacklist of financial regulatory havens** (Blakeley 2018; Shaxson 2011). Aside from increasing transparency, we should improve enforcement and implement more severe sanctions for those found to be undertaking illegal activity in or via the UK. The current sanctions do not play a significant role in deterring banks from engaging in these kinds of behaviours (Shaxson 2011). Banks found to have knowingly or unknowingly facilitated illegal activities in the UK should be liable for much higher fines, and those found to have engaged in or facilitated these activities should also be expected to face criminal convictions.

INDUSTRIAL STRATEGY

As laid out in this paper, the strength of the UK's currency, which has arisen partly as a result of the strength of our financial sector, has had a negative impact on the UK's exporters. This has taken a severe toll on the UK economy, leading to financial instability, asset price inflation, and inequality. It is not a model that is sustainable over the long-term, as the financial crisis demonstrated. There is a strong case for moving away from a short-termist, debt-fuelled, consumption-driven growth model, and towards a model of economic growth in which the UK produces enough today to support a high standard of living for its population over the long term.

In a recent IPPR paper (Jacobs et al 2017), we argue that industrial strategy should be used to promote 'structural change' in the UK economy, with a combination of supply-side reforms and mechanisms to stimulate demand. A major focus of such a strategy should be on increasing exports and frontier innovation, strengthening

UK supply chains to reduce import dependence, and raising productivity across the UK economy as a whole.

Traditional macroeconomic theory suggests that countries have a 'revealed comparative advantage' in particular sectors, and that focusing on such a comparative advantage yields welfare gains for all market participants (Krugman et al 2014). If Ricardian theory held, all countries would be specialising in a select number of industries, with less advanced countries concentrating on less complicated products and more advanced economies producing more complicated products (Jacobs et al 2017). Traditionally, the UK was thought to have a comparative advantage in financial services due to its location (on Greenwich Mean Time, allowing it to engage with markets all around the world during normal trading hours), its legal system and its currency (Norfield 2012).

However, the evidence presented in this paper suggests that the size of the UK's financial sector has been driven less by a competitive edge in the sector than by unsustainable levels of consumer debt and a permissive global macroeconomic environment. In fact, there is now a growing consensus that Ricardian trade theory is not supported empirically (Jacobs et al 2017). Instead of a single specialism, there is evidence that the most advanced countries in the world are also the most diversified in their export base (Hausmann et al 2011; Cristelli et al 2013; Dolphin 2013). The UK has, however, become less diverse in its exports over time.

Sustained and targeted government intervention is needed to reverse these trends, expanding and diversifying the UK's exporting sectors. Part of this will be achieved through the mechanisms outlined above to limit the size of the UK's financial sector, the amount it is able to lend against existing assets, and its role in currency speculation. This should provide a lower exchange rate for exporters. However, a more active industrial strategy to support the UK's trading sectors will be required as well.

Conclusion

The UK's international position is not sustainable. It rests on an expansion of consumer credit, collateralised against existing assets, which is creating financial instability, harming other sectors in the economy, and perpetuating large inequalities. In this paper, we have suggested some ways in which the UK can be helped to move away from its debt-driven, consumption-dependent growth model towards one that relies on a higher level of exports. Together, the measures proposed in this paper would help to reduce the size and significance of the 'socially useless' (Inman 2009) activities of the financial sector in the UK, and wean the UK consumer off relentless house price inflation. They should also support the UK to move towards a different growth model: one that enables us to produce enough today to fund our consumption sustainably into the future.

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