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“Britain’s Financial System: Facilitator of, or Constraint on, the ‘New Economy’?”

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Introduction

Two years have now elapsed since the tech-stock share bubble burst – most notably on the NASDAQ in New York, but engulfing other high-tech markets as well. In Britain, as in other countries, the overall stock market environment has been relatively bearish in the intervening period. The two events are not causally linked, in that the subsequent decline in established and blue-chip markets is not directly attributable to contagion spreading from the high-tech sector. Yet, taken together, these events have served to divert the attention of both the academic and the policy communities from the wider implications of the 'new economy'. The 'new economy' became so associated with the image of an ever more bullish stock market that the mere presence of falling share prices has stalled the debate about what the 'new economy' is, what benefits it could bring, and how it could be integrated into existing economic structures. I suggest that the time is now right to revisit that debate and, in so doing, to reclaim the discussion of the 'new economy' from the share price bubble with which it has been popularly linked.

This article draws on the comparative political economy of financial systems. It is usual within that literature to focus on the distinction between, on the one hand, the capital market based financial systems of the US and the UK and, on the other, the bank based financial systems of Western Europe and South-East Asia. Each system is built upon a specific set of institutional conditions which, in turn, provide specific forms of comparative advantage for the national economy in which such conditions

are embedded. Of particular concern for this study is the suggestion that bank based financial systems are more effective in facilitating the integration of fully developed production technologies into existing economic structures, whilst capital market based financial systems provide significant first-mover advantage in facilitating the initial development of those new technologies.

The conclusion one might draw from this is that Britain's capital market based financial system will ease the introduction of 'new economy' operating procedures into the British economy. However, I argue that such a conclusion misunderstands the nature of capital flows into the British stock market. The vast majority of such flows circulate only to increase the nominal value of the original capital asset. They are used to purchase shares of established companies who have only limited recourse to the stock market to provide new working capital for themselves. Indeed, the new investments of these established companies are almost entirely self-financed through retained trading profits. As such, Britain's capital market based financial system provides few sources of finance for new productive investments, be that in the 'new economy' or elsewhere. I conclude with a number of observations on the policy implications of this finding, focusing in particular on the possibility of creating market incentives to increase the flow of funds through the stock market into new productive investments.

Comparing Financial Systems: the Received Wisdom

It is generally accepted that the US 'new economy' – the undoubted star performer in this area – has benefited significantly from the dynamism of its capital market based financial system. Nonetheless, the impact of the capital market on the US 'new economy' has been something of a double-edged sword. In a whole range of cases, the highly liquid nature of the American venture capital market in the late 1990s led to the capitalisation of 'new economy' companies that were unable to recover their costs through profits generated from the product market. Instead, their cost recovery strategies required that they raise further funds through the stock market, thus reinforcing the existing share price bubble on NASDAQ. Prior to the tech-stock crash, the US stock market appeared to be operating to two distinct logics. For established firms without digital prospects, price/earnings ratios were forced down as investors demanded good news on profits as a sign that operating costs could be more than adequately recovered through the product market. By contrast, for 'new economy' firms with digital prospects, price/earnings ratios were allowed to inflate to historic highs as investors overlooked adverse profits warnings and accepted that costs could be recovered through the capital market. Whilst the US capital market clearly helped to feed the dynamism of the country's 'new economy' in the late 1990s, it is also clear that it was responsible for creating the financial house of cards that collapsed so spectacularly amidst the subsequent tech-stock crash.

Despite this cautionary tale of capital market excess, UK policy-makers have tended only to emphasise the positive nature of the relationship between the capital market and the 'new economy'. They have pointed to the fact that the US and the UK have similar capital market based financial systems to suggest that Britain is singularly well placed to emulate America's 'new economy' successes. Moreover, such a suggestion

extends beyond the policy-making to the academic community. It is certainly the conclusion that one might read into the comparative political economy literature on financial systems.

Two distinctive trajectories of economic development are invoked within that literature, corresponding to an ideal-typical dualism around which the financial systems of the advanced capitalist economies can be distributed analytically. On one side of this dualism we find bank based financial systems, on the other capital market based financial systems. The former typically exhibit smooth development trajectories, which reflect institutional conditions that reward investments oriented towards long-term/low-risk gains. The latter typically exhibit more punctuated development trajectories, in which the short-term/high-risk orientation of the system is most effective in those moments of creative destruction where new technologies overhaul the modus operandi of the existing productive regime. I now take each system in turn, as they have different implications for the way in which the 'new economy' is likely to develop.

Firstly, bank based systems are assumed to provide institutional conditions suited to assimilating innovations within existing firm structures, rather than to promoting innovation per se. Close inter-personal relations are encouraged between bank personnel and the managers of firms. Through such relations, firms find that they are under relatively little pressure to recover costs immediately, and so can develop business plans oriented specifically to the long-term. With banks ensuring favourable terms for the allocation of investment capital beyond the short-term, firms have the opportunity to engage in the internal restructuring required for the development of

new production regimes based on new technologies. However, whilst firms operating in bank based financial systems may experience institutional conditions favourable to becoming efficient *users* of new technologies, the same conditions are usually argued to restrict their capacity to *develop* new technologies in the first place. The quid pro quo of banks' willingness to make investment capital available on a long-term basis is their unwillingness to fund potentially high-risk projects. The development of 'new economy' innovations around digital technologies clearly constitutes one such project.

The comparative political economy literature on financial systems suggests that capital market based systems are more suited to capitalising technological innovations. Within such systems, investment capital is made available to firms on a purely competitive basis. Unlike in bank based systems, established firms are not privileged (vis-à-vis new start-ups) in the allocation of credit. For, the close inter-personal relations that shape the allocation of credit in bank based systems, and which can only develop over time as a firm becomes established in its product market, are simply not a feature of the arms-length relationship between finance and industry in capital market based systems. It is assumed to matter less in capital market based systems *who* is proposing the business plan than it does *what* the business plan is.

Capital markets are assumed to act as a means of matching the risk-return preferences of lenders to the proposed business plans of borrowers. A bank that increases its exposure to liabilities by making credit available to firms on a long-term basis is likely to be relatively risk-averse in its pattern of lending. Moreover, because individual bank managers have few incentives, if any, to depart significantly from the asset/liability ratio of the sector as a whole, all banks are likely to be relatively risk-

averse. The same is not assumed to be the case within capital market based systems. Capital markets are argued to provide the ideal institutional conditions for facilitating innovation, as they bring together large numbers of anonymous lenders with, potentially, equally large differences in risk-aversion. Some of these lenders will not believe that the return to innovation will be sufficiently large (be that 'new economy' innovation or otherwise) to make their savings available to firms operating at the frontier of technological development. Yet, some may well do so. Lenders within capital market based financial systems may therefore have less of a generic tendency towards risk-aversion than lenders in bank based systems.

It is certainly argued in much of the literature on the 'new economy' that the absence of such a tendency within the American financial system was highly conducive to the development of the US 'new economy'. Moreover, given the institutional similarities between the financial systems of the US and the UK, many have pointed to the possibility that Britain can simply import America's 'new economy' successes. I turn now to challenge that supposition.

Financial Systems in Theory and Practice

Whilst the above account of the 'comparative institutional advantage' of bank based and capital market based financial systems dominates the academic literature in this area, it is nonetheless a caricature of actually existing financial systems – and a fairly crude one at that. It is premised upon an ideal-typical dualism, in which every

country exhibits either one set of institutional conditions (and, therefore, one form of comparative institutional advantage) or another. Moreover, each set of institutional conditions is assumed to be experienced in full. Thinking in such terms may be acceptable as an academic thought experiment, but it is unlikely to provide a reliable guide for policy. Three points might usefully be made in this respect.

Firstly, it is clear that the distinctions between bank based and capital market based financial systems have never been as sharp in practice as they are in theory. The comparative political economy literature focuses almost exclusively on the structure of financial institutions rather than on the financial instruments they issue. The latter comparison is likely to downplay the significance of differences between financial systems, whilst the former is likely to highlight them. And even here it is important not to over-emphasise the differences between national financial systems. Banks are key actors in those national economies typically characterised as exhibiting capital market based systems, and capital markets are key actors in those national economies typically characterised as exhibiting bank based systems. For instance, before their divergent trajectories in the 1990s, the Japanese stock market had overtaken the American as the most highly capitalised in the world. Yet, Japan is assumed within the comparative political economy literature to be one of the two prime exemplars of a bank based financial system. More recently, in 2000, when the respective boards of directors of the London Stock Exchange and the Frankfurt Deutsche Börse agreed to merge their exchanges, this was presented as a merger of equals. Yet, Germany is assumed within the comparative political economy literature to be the other prime exemplar of a bank based financial system.

Secondly, even if the distinction between bank based and capital market based financial systems was as robust in practice as in theory, there may still be reason to question the further supposition that capital markets will necessarily be better for encouraging technological innovation. This conclusion, although received wisdom in the academic literature, is read off from a remarkably small number of isolated historical cases. In particular, it is based on the capitalisation of the railways in mid-nineteenth century Britain and the capitalisation of the electronics and computer based industries in mid-twentieth century America. In both instances, significant sources of investment capital were raised through share issues on the stock market. Yet, there are many more instances in which the development of productivity enhancing technologies is completely unrelated to the strength and vitality of the domestic stock market. Indeed, the two countries with the most deeply capitalised stock markets – the US and the UK – have the least impressive productivity indicators of all the OECD countries in the post-war era.

Thirdly, and most importantly in policy terms, it is necessary to focus not only on the overall level of stock market activity, but also on the specific pattern of share trading that dominates the market environment. Britain may well boast a highly liquid and a deeply capitalised stock market, but this is no guarantee that the flow of funds within that market will facilitate entrepreneurship, be that in the 'new economy' or elsewhere. Indeed, there are many reasons to suggest that this is unlikely to be the case.

For a start, trade in the shares of FTSE-100 firms dominates all other stock market activity, roughly by a factor of four. Over three-quarters of all investments on the

London Stock Exchange (LSE) are concentrated in only one hundred firms. This is trade in the established shares of established firms. It is conducted to provide a stable asset base in the portfolios of the large institutional investors that are the major players on the LSE. It does not in general provide new funds for productive investments. The companies whose shares are traded most extensively in Britain are almost entirely self-sufficient in terms of funding new capital investment projects. Indeed, this is an accurate reflection of the corporate sector in Britain as a whole. Throughout the period 1980-2000, the UK corporate sector retained a significant residual in undistributed cash earnings of around £1 billion – a figure which is very close to that sector's overall spending on productive investment. Around nine-tenths of new productive investments within the British corporate sector have originated in ploughed-back profits over the last twenty years.

The main role of the stock market within British society is to turn household savings into new wealth and future consumption possibilities, rather than new productive capabilities. Thus, the stock market is no longer tied to the productive needs of the economy, so much as to the reproductive needs of the prevailing social structure. With the productive emphasis of the stock market being reconsidered in this way, there is no guarantee that Britain's capital market based system is compatible with the financial needs of the 'new economy'. Indeed, it is possible to state the argument in stronger terms than this – the specificities of Britain's capital market based system would appear to be wholly incompatible with the financial needs of the 'new economy'.

We may also be led to this conclusion by recognising a number of important differences between the capital market structure of the US and the UK. Perhaps most significantly, Britain lacks the degree of integration of America's venture capital, primary and secondary stock markets. Whilst the cautionary tale about over-exuberant venture capital markets recounted earlier in this article remains a relevant warning about the limits and weaknesses of the venture capital cycle, Britain's stock market structure provides few incentives for a buoyant venture capital industry to promote 'new economy' entrepreneurship. By contrast, prior to the tech-stock crash, US venture capitalists found a vibrant secondary stock market in NASDAQ. This made possible profitable 'exit' from investments in 'new economy' start-ups, in a way denied similar firms in Britain.

Capitalising a 'New Economy' in Britain

Our understanding of the 'new economy' in Britain is therefore conditioned by whether we focus on the actual structure of the UK's capital markets, or the theoretical advantages provided by an ideal-typical capital market structure. The policy debate in Britain may thus far have been oriented around the latter, certainly in the extent to which its capital market structure has yet to appear in that debate as a potential impediment to future 'new economy' successes. However, as soon as we focus on the actual structure of the UK's capital markets, it is clear that policy-makers must do more than constantly reiterate their faith in British entrepreneurship for the UK to develop a significant 'new economy' sector. Equally, changing educational

norms to emphasise vocational learning in the areas of computing and information technology is insufficient on its own to initiate a knowledge-based economy. Two other changes are also required.

Firstly, it is necessary to change the structures of Britain's financial system, in order to foster deeper integration between the venture capital, primary and secondary stock markets. British venture capital firms have directed significantly more of their investments into existing companies than their American counterparts. They have concentrated most of their operations in financing merger and acquisitions activity, rather than new start-ups. In large part, this is due to the very different degrees of capitalisation of Britain's primary and secondary stock markets. The absence of a deeply capitalised secondary market affords relatively few opportunities for successfully 'exiting' investments in newly established firms (whether they are located in the 'new' or the 'old' economy). Instead, British venture capitalists tend to be attracted to control contests for established firms within the primary market.

Secondly, and more importantly, it is necessary to change the dominant investment culture in Britain, in an attempt to reconnect trading patterns on the stock market with the productive needs of the economy. At present, the vast majority of that trade is directed at reinforcing existing wealth differentials within society rather than into new capital formation. To what extent may it be possible to use a system of market incentives in order to redress this current imbalance?

At heart, the issue may be how to change the *perceptual* environment in which fund managers and other institutional investors operate, to make it feel just as normal for

them to direct the savings they command into fledgling companies seeking to expand production as into established companies seeking merely to protect their share price. Of course, such perceptual shifts first require changes to the *institutional* and the *legal* environments in which investors operate.

It would make sense to target such reforms at institutional investors in particular, such is the control that they are able to exert over the market as a whole. The power of the funds is generated through the way in which the personal savings of thousands of small investors are aggregated into a single portfolio, and it is demonstrated by the fact that around fifty top fund managers in effect 'own' a majority stake in UK industry.

Most funds, especially those that provide for personal pensions cover, would seem to be perfectly able to diversify their investments to generate new flows of capital into firms seeking to expand existing productive capacities. For, their liabilities are stable, predictable and, in most instances, extend far into the future. Any short-term liabilities they may have can easily be covered by maintaining part of their portfolios within the area of the market dominated by trade in the share of FTSE-100 firms.

However, whilst there may be no reason why pension fund managers are unable to diversify their investments in the interests of capitalising new firms, they have thus far shown little willingness to do so. I suggest reform of the settlements system through which shares are traded in order to encourage investors to act in this way. Settlements systems throughout the European Union are currently being overhauled as national exchanges respond to single capital market legislation by aligning themselves

competitively one against another, so now might be the ideal time to contemplate such proposals.

I propose changes to the settlements system to allow settlement costs to be written off against withholding and/or capital gains tax. However, such reforms should not apply across the board, but should be targeted at shareholdings in companies listed on secondary stock markets. In order to tailor this proposal specifically to the interests of the 'new economy', a sliding scale of exemptions could be introduced, structured in favour of high-tech markets in particular. Working to the same principle, FTSE-100 firms should not be included in the exemptions scheme.

Such proposals would lower the costs of trading in shares listed on 'exempt' markets relative to those in FTSE-100 firms. As a consequence, this would increase their effective price above the value of their market price, offering market incentives for funds to diversify their portfolios. Funds are renowned for trading on very small margins, so the level of the exemption would not have to be large for us to expect a reform of this nature to elicit a significant change in the pattern of investor behaviour. The cost to the exchequer of such a scheme would be small, and could in any case be recouped by the subsequent increase in corporation tax receipts resulting from a boost to productive capacity.

It may be possible to reinforce these behavioural shifts by introducing additional changes to capital gains law. Portfolio investors who have gross fund status enjoy both capital gains and income tax exemptions. It would be relatively straightforward to make these tax breaks conditional upon funds diversifying their portfolios by

increasing their exposure to secondary markets. In order to remain eligible for continuing tax relief, funds would have to demonstrate a balanced investment schedule which was not unduly weighted towards the shares of FTSE-100 firms. To target such a scheme specifically at the 'new economy', once again special dispensations could be offered to funds that invested in high-tech stock above a certain threshold.

Conclusion

If the usual distinction found in the academic literature between the comparative advantage of different financial systems holds true, Britain would appear to be doubly damned in relation to the 'new economy'. On the one hand, it lacks a bank based financial system and, as such, is typically argued to lack the institutional conditions for assimilating developed digital technologies into existing economic structures. On the other hand, actual flows of funds around its capital market are likely to impede the development of new digital technologies in Britain, even though it is capital market based financial systems that in general are argued to perform such tasks. On the whole, stock market investments in Britain are not directed into the capitalisation of new productive capacity. Consequently, the prospects do not seem to be good for Britain to be either a successful assimilator or a successful innovator in digital technologies. Will the 'new economy' therefore bypass Britain altogether?

I have used this article to argue that this does not necessarily have to be the case. However, the investment culture currently embedded in Britain's capital markets is likely to prove – and, indeed, has already proved – a significant constraint on a British 'new economy'. I have suggested a number of policy reforms aimed at redressing the current imbalance between the amount of investment that British stock markets channel into FTSE-100 firms compared with the amount of investment that is channelled into new firms. My proposals focus in particular on inducing new patterns of behaviour amongst institutional investors, by providing them with market incentives for investing in high-tech firms. Whilst questions may legitimately be raised about the specific details of the proposals contained here, I suggest that the broader case for introducing policies of this nature is largely unanswerable.

Suggested Reading:

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