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1
The nature of the problem

Have the banks failed industry? In Britain there has long been a sizeable body of opinion that has believed so. Throughout this century economists and other commentators have expressed doubts about the role played by British monetary institutions in providing the financial services – especially the provision of long-term finance – essential for nourishing a modern, competitive industrial sector. For these critics, financial deficiencies are seen as a serious weakness in British economic development.

Doubts first arose towards the end of the nineteenth century and beginning of the twentieth century when the UK began to face increasingly stiff competition from other industrial nations and such doubts have resurfaced whenever British industry has been seen to be performing badly. At the time of World War I criticism was levelled at the failure to finance large-scale industrial combines of the sort that the enemy, Germany, was apparently so successful at promoting (Foxwell, 1917). During the interwar period, the banks were condemned for not doing enough to promote the extensive restructuring of industry which many thought essential if the country was to recover its export markets and reduce the abysmally high rates of unemployment (e.g. Clay, 1929, *186–9*). In the post-World War II period, too, the inadequacy of financial provision has often been highlighted as a serious contributor to Britain's relatively poor growth performance (e.g. Carrington and Edwards, 1979).

There is no doubt, then, as to the long-standing nature of the charge against the banks. At the same time, the banks have always had their own champions who have hotly denied allegations of failure. In a nutshell, the whole question remains controversial. It

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is important, therefore, to weigh up the arguments on all sides. Moreover, the longevity and importance of the debate means it is essential to do this within a proper historical as well as theoretical perspective. This will not only allow an assessment of what happened in the past but should also enhance understanding of the present performance of the British economy.

(i) The meaning of 'failure'

The debate on the role of financial institutions has to be seen in the much broader context of anxiety over Britain's growth record – over the loss of industrial hegemony at the turn of the last century and over the economy's chronically poor performance relative to that of other industrial nations throughout most of the twentieth century.

Much of the case rests on *a posteriori* reasoning (i.e. arguing from effect to cause). The 'effect' in this case is the UK's growth record which is widely accepted as having been 'unexceptional-to-poor'. It has been common to argue that for a mature economy such as the UK, the pace of growth is largely set by the performance of the industrial sector, especially manufacturing, where the potential for productivity gains is high. Yet, in aggregate, British performance has been poor. Two major deficiencies have been identified which have a direct bearing on the role of banks. The first is the comparatively low rate of investment in the UK; and the second is the allegedly lower take-up rate of new technology. Now, there are many possible explanations for these two features of British economic history – the poor quality of British entrepreneurs, the low level of technical education and training, factor availability and the inflexible attitude of the labour force are four of those commonly canvassed – but deficiencies in financial provision have been to the fore amongst potential 'causes'.

The banks' detractors believe that the type and adequacy of financial services supplied can seriously affect the rate of capital accumulation (and this, in turn, is generally associated with the rate of obsolescence). True, the greater provision of bank funds for industry will not in itself be sufficient to ensure a high rate of investment (industrialists might not take up funds even if they were available) but it is seen as an essential prerequisite (industry will

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not be able to invest more if the funds are not available). The strength of the argument rests heavily on international comparison, for it is alleged that in other capitalist countries financial institutions have more actively promoted the provision of long-term funds for industrial investment. Moreover, in some cases and in some periods, the banks in these other countries appear to have protected their commitments by taking a more active role than their British counterparts in the management and strategic planning of the businesses of industrial clientele. In these countries, it is claimed, there has been closer cooperation between the financial and industrial sectors (sometimes under the auspices of the state) and this has been successful in fostering economic growth. In Britain, on the other hand, it is widely accepted that throughout most of the past century-and-a-half the main financial institutions – the deposit banks, the discount houses and the merchant banks – have concentrated on short-term credit provision and/or on holding their longer term assets in the form of government and public utility securities (from both home and abroad). They seem to have shied away from long-term loans and investments to domestic industry and it is this which is said to have been to the detriment of industry. It is in this sense that banks are alleged to have 'failed' industry.

Underlying this claim is a view of how markets work, about the possibility of market failure over the very long term. The money and capital markets can be likened to other competitive markets in which demand and supply are reconciled and price and the allocation of resources determined. Seen from a neo-classical perspective it seems incredible that over a number of months, or years (let alone decades or centuries!) unsatisfied demand would not provoke a positive response on the supply side to the profitable opportunities so created – surely suppliers would act to increase their profits by correcting any obvious deficiency? In fact, if you believe that markets – including British financial markets – work quite well, then it is simply not credible that British industry could have been constantly demanding long-term capital (creating a potentially profitable opportunity for those banks prepared to meet the demand) which profit-making financial institutions refused to supply. In effect, acceptance of the rationale of markets – with the usual assumptions of rationality, optimality and of profit-

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maximising – denies the possibility of bank 'failure' in this area. In fact, in this particular case, it is often suggested that the absence of certain financial services probably reflected the lack of demand for them rather than any failure on the supply side. It is likely, so those who believe in the efficacy of markets argue, that the demand of British industrialists for funds from outside their companies was either insignificant or was being met from sources other than the banks. On this line of argument, then, if banks did not provide long-term industrial finance there were sound market reasons for not doing so – there was no large volume of unsatisfied demand. In general, therefore, an important group of economists, and the logic of a widely used body of economic theory, would deny that the banks could have failed industry.

In contrast, the banks' critics are much less sanguine about the effectiveness of competitive forces and, from a variety of standpoints (outlined in the next chapter), they allege that serious market failure has indeed occurred. All these allegations hinge, to some degree, on a belief that the potential for a higher rate of industrial investment has, indeed, existed in the UK over a very long period, but that banking practice frustrated its realisation. For the critics, either the market failed to provide the opportunities in which those seeking industrial funds could effectively signal their demand, or financial institutions proved insensitive to the market opportunities so created: i.e. that the market for financial services was neither perfect nor efficient.

To reiterate, differences in the approach to the effectiveness of market forces – whether a particular commentator is optimistic or sceptical – underlie much of the division of opinion that exists over the question of whether or not the banks failed British industry.

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2
Explanatory schema

Before looking at the debate in any detail, it will be useful to categorise the various theoretical explanations that have been offered for the failure of British banks to develop sufficiently their provision of industrial capital. Below, three types of schema, or models, are distinguished although it will become obvious that there is a great deal of overlap between them.

(i) Early start thesis

The term 'Early Start Thesis' is usually applied to a line of argument dealing with Britain's economic performance in general. Within this general analysis it is claimed that the fact that the UK was the first country to industrialise created disadvantages in later years, compared with those countries which made a late start on the path to industrialisation. The allegation carries with it a strong implication of market failure in the sense already discussed – an allegation that once patterns of economic relationships, institutions and policy are well established they are resistant to change and, as a result, do not behave 'efficiently'. In the specific case of financial markets, it has indeed been common to claim that a fair degree of inflexibility developed. That once established, historical patterns of banking practice and policy persisted beyond the time when they were most appropriate to the economy's needs.

One of the most formal statements about the impact of 'early start' on the nature of financial provision was put forward by Alexander Gerschenkron in the 1960s (Gerschenkron, 1966). In fact, Gerschenkron's main concern was with those European

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countries which industrialised after the UK, but his analysis carried strong implications for the 'early starter' and it has coloured many of the later comments on British financial development.

Gerschenkron envisaged a staggered sequence of national industrial revolutions. Britain's was the first, with 'great spurts of industrialisation' following in other European nations after varying time intervals. For Gerschenkron, relative timing was critical. The longer it was before a particular country industrialised, the more economically backward it would be relative to existing industrialised nations. As a result, each new industrialiser faced circumstances differing, at least in degree, from those that had confronted its successors: on the whole, the degree of competition on world markets would be more intense; the scale of operations needed for establishing a successful industrial sector would be that much greater; over time, too, an increasing technical sophistication would be required, and so on. In other words, the longer it took before an industrial revolution was experienced, the more 'economically backward' the industrial newcomer would be on the eve of its own industrialisation.

According to Gerschenkron, this state of relative economic backwardness carried fundamental implications for the nature and course of the development process itself and accounted for some of the most important national differences in the way economic development has been carried through. Such national differences are far-reaching, embracing the particular forms of economic institutions and relations established within a country. Especially relevant was the prominence Gerschenkron accorded to national differences in financial institutions and markets.

Gerschenkron's view of the relationship between financial development and economic backwardness can be illustrated from the contrast he drew between Britain and Germany. Following the conventional wisdom of the time, Gerschenkron accepted that Britain had undergone an industrial revolution in the late eighteenth/early nineteenth centuries and that Germany had not experienced a 'great spurt' until the 1860s.[1] On the eve of her industrial revolution Britain had not been economically backward but, on the contrary, had been amongst the industrial leaders of the eighteenth century and had already experienced a long period of agricultural and commercial expansion. One consequence was that there

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existed substantial sources of funds independent of the banks and these could be utilised to finance development. Moreover, for the most part the fixed capital needs of the nascent industrialists of the late eighteenth and early nineteenth centuries were not onerous. The standard of technology was crude compared to what was to come later, in most cases the scale of production was small (in workshops rather than factories) and, as the new British products did not have to face competition from existing suppliers endowed with superior technology and market share, the whole process of technical change was relatively gradual and within the means of most British industrialists to finance. As a result the demands on British banks for long-term industrial capital were few. Instead the banks concentrated on augmenting the existing supply of media of exchange (e.g. by issuing notes), improving the means of remittance and meeting customers' short-term credit needs. The requirements of the economy thus gave rise to the creation of the British 'credit bank' system.

Gerschenkron contrasted the fact that German industrialisation occurred much later, at a time when British industrialists already enjoyed market dominance and technical superiority in many areas. German entrepreneurs thus had to establish industrial plants both large enough and sufficiently well equipped to be able to compete with the more advanced economy of Britain. Consequently, their fixed capital requirements were larger, so large that internal funding was not feasible. According to Gerschenkron, from an early stage German industrialists had to turn to financial institutions for funds. From the onset of the industrialisation process, then, strong financial–industrial links had to be forged. Moreover, German banks played a leading role (at least, initially) in the strategic planning of industrial development. For instance, they were active in promoting greater concentration of ownership and a larger scale of production within heavy industry, two developments Gerschenkron uncritically accepted as beneficial in the period up to World War I. In Britain there was no marked industrial reorganisation or concentration movement 'because of the different nature of relations between banks and industry' (Gerschenkron, 1966, *15*). By implication, then, the failure of British banks to do the same for British industry was detrimental.

To reiterate: according to this line of argument, Britain's 'early

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start' meant that the country developed a banking system that was appropriate to its needs at the time of the industrial revolution but one which was to become less suitable to the requirements of a maturing economy.

The weakness in this case, though, is the absence of a convincing explanation for the alleged immutability of early institutional arrangements and financial relations. Over the decades, why did they not alter in such a way as to meet more satisfactorily the perceived requirements of the economy? Why did British banks not meet industry's fixed capital needs if this is what was required? It is crucial to the case for those who allege market failure on this scale and over such a long period, to explain *why* financial institutions proved so unresponsive.

(ii) Institutionalists

In many respects Gerschenkron's comments on UK financial institutions are indirect (secondary to his concern with the more backward economies of the nineteenth century) but others have been much more explicit in both their allegations and their explanations. One such group of critics are those who can conveniently be grouped under the heading 'Institutionalists'. The general concern of this group has been with Britain's overall long-term economic performance but part of the analysis deals specifically with financial provision.

A recent statement of this view emphasises two aspects of British economic history (Elbaum and Lazonick, 1986, *1–17*):

(i) First, it is argued that the form of industrial development in the nineteenth century differed markedly from that of the twentieth century. During last century British markets tended to be atomised, with numerous suppliers operating on a relatively small scale and with easy access to these markets for newcomers. Individual firms were often small, usually owned and managed by the same people (frequently within the one family); and their products were often differentiated and produced in small batches to customised orders. The twentieth century, on the other hand, has belonged to corporate capitalism, with mass production techniques and scien-

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tific management, with an emphasis on standardisation, managerial controls and the ready acceptance of new technology.

(ii) The second feature that is emphasised is that whereas nineteenth-century Britain may have developed institutions appropriate to the type of industrial production of the day, those institutions proved unable to generate a successful transformation to forms more suitable to corporate capitalism. In this, Britain lagged seriously behind countries such as the USA, Germany and Japan.

In many regards, then, the 'institutionalist' case is a variant of the 'early start thesis' – the UK is seen to have suffered from decisions taken during her early experience of industrialisation. It is also open to much the same criticism – namely, given the obvious rewards for change and adaptation in the 'right' direction (higher rate of growth for the economy as a whole, higher profits/lower costs for individual market agents), why did it not happen? The strength of the argument, though, rests on the fact that the UK's long-term growth record has indeed been poor in international terms. Moreover, supporters of this view point to the individual case studies which seem to confirm that there were serious problems involved in the application and adaptation of many factors considered important for successful adoption of mass-production techniques.

Elbaum and Lazonick deny that these failings arise solely from the innate conservatism of the British people – after all, many other societies (Japan and South Korea, to take just two examples) have successfully broken through the barriers imposed by traditional society. Instead, they emphasise the reactionary, constraining influence of the institutions and institutional relations established during the nineteenth century. 'Britain's distinctiveness derived less from the conservatism of its cultural values *per se* than from a matrix of rigid institutional structures that reinforced these values and obstructed individualistic as well as collective efforts at economic renovation' (1986, *2*). Nevertheless, the manner in which institutional rigidity *autonomously* inhibits industrial development is not clear from their analysis. In fact, despite claims to the contrary, it is very difficult to imagine general institutional structures having reactionary effects which were independent of society's cultural conservatism. The difficulty in drawing out the distinction is sharply

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increased by the meaning given to 'institutional structures'. The institutionalists interpret this very widely and, in practice, it has come to resemble the extensive list of economic, social and political 'failings' that has long been current amongst critics of British capitalist development. Thus, amongst other factors, Elbaum and Lazonick point to deficiencies in education and training, in industrial relations, in the attitudes of trade unions, in managerial techniques, in the structure of markets, in the role of the state and in the implementation of government policy.

Within this list, financial provision has also been singled out as culpable. Here, the main criticisms have been that:

(i) British financial institutions have concentrated on short-term credit creation, having persistently shied away from providing long-term funds for industry.
(ii) City of London institutions have exhibited a strong predilection for holding overseas assets and financing international trade. They have been much less involved with domestic industry.
(iii) City institutions have successfully influenced exchange rate and monetary policy to their own advantage. Thus, for long periods, the authorities have favoured high or stable exchange rates and 'dear money' and this has operated to the detriment of domestic industry.

(iii) Financial interests within a socio-political context

A number of studies have been inspired – either directly or by way of reaction – by Marxist models of capitalist development. Of direct relevance has been the concern with the extent of class cohesiveness amongst British capitalists. At the beginning of the century Rudolf Hilferding characterised the later stages of capitalism as experiencing a distinct concentration of economic and political power into the hands of industry, with a corresponding demise of commercial and landed interests (Hilferding, 1910).

He envisaged the closest cooperation between financial and industrial capitalists in this process, with the banks in a dominant position as the suppliers of funds and the effective arbiters on competing claims for finance. At this stage of capitalism, the interests of industrial companies and banks would converge,

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