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**BRITISH  
IMPERIALISM  
&  
FINANCE**

**A contribution to the theory of contemporary imperialism**

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Thesis submitted for the degree of PhD

2014

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## **Declaration for PhD thesis**

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Tony Norfield

Signed: \_\_\_\_\_ Date: 8 July 2014

**Total number of pages: 226.**

## **Abstract**

This is a Marxist analysis of how the financial system supports the appropriation of surplus value from other countries. While the focus is on Britain, the analysis shows how a Marxist understanding of the international financial system can throw light on a key aspect of the economics of imperialism today, one that follows from the normal, day-to-day operations of financial markets in the imperialist world economy. It argues that the economic content of imperialism is not only based on the trend towards monopoly, but on a world economy dominated by a small number of powers, especially in the sphere of finance. Marx's concept of fictitious capital is found to be superior to Hilferding's concept of finance capital for analysing these developments. However, the thesis also shows that 'fictitious' deposit creation by banks, largely ignored by Marxist analyses, is a key part of the financial mechanism.

The thesis demonstrates the key role of finance for British imperialism through discussing the evolution of the global financial markets since 1945 and analysing the structure of the UK balance of payments data over the past three decades. It shows the importance of revenues from financial services exports and the way in which banking and portfolio flows fund relatively high returns from foreign direct investments. This analysis also shows how the UK-based banking system intermediates global financial flows, providing finance from developing countries to other major powers, particularly the US, a feature that is closely linked to the role of UK-linked tax havens.

## **Acknowledgements**

Working for a PhD is not only a way of analysing the world and trying to say something new, but also one that subjects to a critique one's understanding of many things that may have been taken for granted. I am glad that in this process I have had the benefit of discussions with a longstanding friend, Susil das Gupta.

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# **Chapter 1      British Imperialism Today**

'This business of [being] a second-tier power - we are probably, depending on what figures you use, the fifth or sixth wealthiest nation in the world.

'We have the largest percentage of our GDP on exports, apart from the tiny countries around the world, we run world shipping from the UK, we are the largest European investor in south Asia, south east Asia (and) the Pacific Rim, so our money and our wealth depends on this global scene.'

'We are a permanent member of the (United Nations) Security Council and I think that gives us [a] certain clout and [a] certain ability.'

'These mean we are not a second-tier power. We are not bloody Denmark or Belgium, and if we try to become that, I think we would be worse-off as a result.' (Lord West, a former First Sea Lord in 2002-2006, *The Telegraph*, 22 September 2011)<sup>1</sup>

## **1.1    Analysing Britain in the world economy**

This angry statement of Lord West at a Labour Party press conference caused a minor diplomatic embarrassment, with due apologies to 'bloody Denmark and Belgium'. His assertion of Britain's prominent position in the world was not only unusually blunt; it was also an understatement. Being a military man, he could have noted Britain's involvement in five wars under the Labour Government of 1997-2010 (Kampfner, 2003), actions followed up by Britain being one of the key proponents of intervention in Libya and backing the opposition in Syria and elsewhere.<sup>2</sup> Of more relevance to the subject of this thesis, he could also have cited British ownership of the world's major corporations and Britain's prominent role in financial markets.

In 2010, Britain had the second largest stock of overseas direct investments in the world, at \$1689bn (UNCTAD, 2011, p. 191). While this was only one-third of the US investment stock of \$4843bn, the UK figure is bigger relative to its GDP. In terms of individual companies, the UK also ranks highly. Data from a *Financial Times* tabulation of the Top 500 global corporations by stock market value in 2011 show the UK in second position, with 34 companies having a total capitalisation of \$2085bn, while the US, in first, had 160 companies with a total market value of \$9602bn (FT, 2011). Another survey shows that, of the world's top 100 non-financial corporations, ranked by the value of foreign assets they held in 2008, 18 were US companies, 15 were British, 15 French, 13 German and nine

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<sup>1</sup> Interpolations in [ ] brackets are made by the author, those in ( ) brackets are made by the newspaper citing the speaker.

<sup>2</sup> In 2011, Prime Minister Cameron and French President Nicholas Sarkozy were the main proponents of the NATO (mainly US-led) attacks on Gaddafi's regime in Libya. In October 2011, UK Defence Secretary Liam Fox had to resign following revelations about his involvement of a 'friend' in official government business. Press reports suggested he had been conducting meetings with US, Israeli and other promoters of action against Iran. See, for example, reports in *The Telegraph*, 16 October 2011.

were Japanese. The three biggest UK-based corporations held second, third and fourth place: Royal Dutch/Shell Group plc, Vodafone Group plc and BP plc (UNCTAD, 2010).

The same UNCTAD report's listing of the top 50 *financial* companies, ranked by their overseas assets in 2008, is even more striking. Here Britain shares first place with the US, each having seven banks or other financial institutions in the top 50. Britain directly owns some of the biggest global players in global finance, even though foreign banks and institutions account for the bulk of the City of London's business. France and Canada each had five institutions in the top 50, Germany and Switzerland each had four; Japan, Italy and Sweden each had three. The balance sheets of UK-based banks are *five times* the value of UK GDP, with the relative size of banks in Britain second only to Switzerland, a much smaller economy (BoE, 2010, p. 324). London is also one of the world's leading financial centres and the most international in its business reach.<sup>3</sup> However, Lord West is correct that Britain is a major world power, even if he omitted mention of other qualifications for that status.

My thesis topic is 'British imperialism and finance' an object of analysis that sits at the intersection of three fields of inquiry. The first is the economic relationships in *contemporary* global capitalism, focusing on the past three decades. I will show that there is a hierarchy in the world economy that distinguishes a small group of powerful countries from the rest, where the former have a privileged position in trading, investment and financial relationships. The second is the form taken by the financial system that underpins these relationships. The third is the position of the British economy in the global system. Each field of inquiry will be analysed only for the light it sheds on the other two. For example, I discuss international trade and investment principally in terms of the currencies used and the flows of financial wealth, and especially how these relate to the position of the British economy. I employ a Marxist theoretical perspective and use the term 'imperialism' to refer to a particular stage of capitalist development.<sup>4</sup> The main objective of the thesis is to show how the financial system works to support Britain's position as an imperialist power. However, I also aim to show how a Marxist understanding of the international *financial* system can throw light on a key aspect of the economics of imperialism today, one that follows from the *normal operation of financial markets* in the imperialist world economy.

Some further clarifications are worth making at this point. The term 'finance' is often used in relation to particular financial institutions, especially banks, or to single out the 'financial' sector of an economy from the 'non-financial'. In this thesis I will discuss banking and other financial operations or refer to the financial sector, since these are institutional forms and economic entities whose size and development is covered by official statistics.

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<sup>3</sup> Chapters 4, 5 and 6 give further details and analysis of the UK financial sector in the world economy.

<sup>4</sup> See Lenin 1976a. Chapter 2 will examine the concept of imperialism.

However, my concept of finance is tied neither to a particular type of institution, nor to a separate 'financial sector' of the economy. All kinds of capitalist company have financial operations, not simply banks. The state also performs key financial functions in the domestic and international spheres. Furthermore, I will not be discussing whether the financial sector is 'good' or 'bad' for the national economy, or how it does, or does not, support industry. Instead, I will explain how the forms taken by finance result from the way in which the accumulation of capital has developed under modern imperialism. It will be shown that access to finance both reflects economic power in capitalist society and is also a means of retaining that power.

### **The invisible imperialist**

Despite Britain's position in the world, the academic literature has virtually no coverage of the economic aspects of *contemporary* British imperialism. This might seem an exaggerated claim, but it is supported by several observations. Firstly, my investigation of the literature using EBSCO and other search engines found *nothing* on developments in the last 30 years when using the search terms 'British imperialism', or any variants of these. None of the hundreds of books, journal articles and other references related to the period after 1970-75, by which time Britain had shed most of its colonies. Secondly, when Britain's international position is discussed in the literature, the focus is on politics rather than economics and on the common (or possibly conflicting) strategic interests that the UK has with the US (Dumbrell, 2004; Haseler, 2007; Niblett, 2007; Wallace and Phillips, 2009). Some other published work does discuss Britain's role as an imperialist power in the more recent period, but these analyses are also from a historical, political or diplomatic perspective, with little or no focus on the economic dimensions (Curtis, 2003; Newsinger, 2006). The one major recent work, entitled 'British imperialism: 1688-2000', which does give detailed coverage of the economic aspects of Britain's relationships with the rest of the world is very weak on the post-1970 period (Cain and Hopkins, 2002). In 700-plus pages, this book has barely *eight* on the years after 1970. Nevertheless, it does make an interesting, one-line point that the City of London 'can now function successfully only by acting as an intermediary for powers whose economies are far stronger than Britain's' (p. 643), an issue taken up in this thesis.

While the economics of contemporary British *imperialism* gets no academic coverage, there have been analyses of the British financial sector. However, these analyses are either some 30 years old, or they pay little attention to the links between finance and imperialist power, or both. The last detailed analyses date back to the 1980s, before the 1986 'Big Bang' reforms of the City of London. They examine the evolution of the financial sector in the context of British imperialism, but are principally concerned with the relationship of the City to British economic policymaking – especially in the debate over whether financial interests were controlling policy to the detriment of manufacturing industry (Coakley and

Harris, 1983; Ingham, 1984). More recent analyses have a similar focus, whether they see the City's operations as a successful example of providing competitive financial services in the world market (Michie 1992), or whether they are critical of the City and its alleged domination of UK economic policy (Talani, 2012).

Since Britain's continuing status as an imperialist power is neglected in the academic literature, it is not surprising that there is no analysis of the role the financial sector plays for British imperialism today.<sup>5</sup> This could be because there is nothing more to add after previous research. However, that is unlikely, given that the British financial system has grown dramatically in the past thirty years. This thesis aims to fill a gap in research by providing a Marxist analysis of that development.

## 1.2 Imperialism and finance in the contemporary academic literature

As previously noted, the literature covering British imperialism and finance in recent decades is thin on the ground. However, there is a wide range of other relevant work on finance and imperialism over the past 20 years or so. It is worth examining this to see how far it can throw light on my topic and what issues might remain unresolved. The literature I will review is principally that written from a Marxist perspective, but I will also include other work that is critical of capitalism. The classical Marxist works on capitalism, imperialism and finance, for example Hilferding's *Finance Capital* and Lenin's *Imperialism: the Highest Stage of Capitalism*, will not be covered here, but their arguments will be examined in later chapters. Nor will I discuss the work of other writers on imperialism if their analyses do not address developments over the past two or three decades, nor throw light on contemporary links between finance and imperialism.<sup>6</sup> Two key questions when assessing this literature are:

- (a) Does the analysis account for the external (non-national) source of revenues accruing to the financial sector
- (b) How far does the analysis throw light on the role the financial system plays for contemporary imperialism?

The answers to these questions, especially the second, will bring out how fully the topic of finance and imperialism is addressed, even if it does not directly cover the case of Britain. I will indicate where there are weaknesses or gaps, both in order to understand the role of

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<sup>5</sup> I do not claim that there has been no publication *anywhere* that has examined the topic of British imperialism and finance in recent decades. However, this does seem to be true of the English language academic literature. The only analysis I have otherwise come across on a web search has been Yaffe 2006. The analysis here, however, differs in many respects from Yaffe's, as will be discussed below.

<sup>6</sup> This means that I will not be discussing most of the authors reviewed in Anthony Brewer's comprehensive survey (Brewer, 1990).

finance for *British* imperialism and to have a fuller appreciation of the part that finance plays in the world imperialist system.

Since the breakdown of the Bretton Woods monetary system in the early 1970s, there has been a dramatic boom in worldwide financial market activity and trading. Currency values and interest rate levels have been far more volatile than in previous decades, and the banking and financial sector has grown far faster than GDP or the growth of international trade. For many writers, this development is described as 'financialisation'. However, as Lapavitsas notes, there is 'no commonly agreed use of the term', although 'it certainly refers to the extraordinary growth of finance during the last two to three decades' (Lapavitsas, 2009a, p. 4). Owing to the pervasive character of the financial system, analyses that use the concept of 'financialisation' investigate a very wide range of phenomena: from consumer credit, to the financial derivatives market, to the growth of new forms of financial institution and financial deals (national or international) that have an impact on economic growth. However, there are few analyses where there is any link to an understanding of the role that finance plays for imperialism, particularly British imperialism.

### Sources of financial profit

What is the source of the profits made by banks and other financial companies? At one level, this question can be simply answered: just look at the differences between a bank's borrowing and lending rates, how much it makes from investing in or selling securities, or the commissions, dealing spreads and fees that a financial institution makes for the services it provides its clients. However, a Marxist analysis of this question aims to look more deeply for the source of the profit, using a framework that distinguishes between those activities that are *productive of value and surplus value* for capitalism and those that are not. From this perspective, financial companies only operate in the 'sphere of circulation'. A bank lending money, or buying/selling a security, or advising on a company takeover, may assist a transaction, or finance a productive investment project, but it is not producing anything itself by its actions. Instead, the revenues of financial companies and their costs of business are an appropriation from the aggregate of social value produced elsewhere.

This Marxist conception of the status of finance is at odds with modern national accounting methods that aim to give a positive 'value' for the services produced by this sector of the economy.<sup>7</sup> However, the Marxist concept tallies more closely with a 'common sense' perspective on the role of banks and other institutions that would agree that while banks, etc, do make a profit, they make it by taking a cut from what others have earned. In radical

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<sup>7</sup> See Christophers 2011 for an interesting review of the way in which official statistical bodies, especially those in the UK, have tried to break with tradition and present the financial sector as being productive in the economy.

literature, finance is usually seen as unproductive of value. However, this literature is far from being consistent on the source of the earnings in the financial sector.

Take the case of Lapavitsas, who has extensive writings on financial issues. In one paper produced in 2010, he states clearly that 'the profits of financial capital arise out of surplus value generated in production' (Lapavitsas, 2010, p. 15) agreeing with the traditional Marxist position. But in a paper published in the previous year he argued that:

'Financial institutions – above all, banks – are not parasites subsisting on the profit-flows of industrious productive capitalists. In principle, they are capitalist enterprises offering necessary services in the sphere of circulation.' (Lapavitsas, 2009b, p. 143)

This formulation that banks provide 'necessary services' blurs the distinction between those capitalist activities that are productive of value and those that are unproductive. It fails to clarify that while an operation might be necessary, it could still be unproductive. As a later discussion will argue (Chapter 2, Section 6), financial institutions *can* be considered as parasitic on productive capital.

Lapavitsas identifies several sources of financial profit. One is where 'banks have adopted investment banking methods generating profits through fees, commissions and trading on own account' (Lapavitsas, 2009a, p. 8). This observation is correct, but he does not explain the source of *these* profits. Where profits are made in what Marx calls the 'sphere of circulation', then these gains for the banks are a loss for someone else, but Lapavitsas does not specify *who*, or *how* this occurs. There is a separate, but related issue of financial profit from capital gains on financial securities, discussed in another work (Lapavitsas, 2013, Chapter 6), where there is a more complex relationship to value produced because it is based upon the market's discounting of *future* production. I will deal with this in Chapter 3, Section 3.4. However, the principal focus of Lapavitsas's analysis is on financial profit that he claims derives from the *wages of workers*. Noting that working class people have become more heavily involved in the financial system over recent years, via consumer credit, mortgages, pensions and in other ways, he states that financial institutions 'have been able to extract profits directly and systematically out of wages and salaries' (Lapavitsas, 2009a, p. 8). This process he calls 'financial expropriation', a topic also taken up in his later work where he argues that it amounts to a 'direct transfer of value from the income of workers to the lenders' (Lapavitsas, 2013, p. 143). This is the basis for his notion that finance 'exploits' the working class - not only the other capitalists - so that it 'exploits us all', as in the subtitle to his 2013 book.

This notion of 'financial exploitation' conflicts with the use of the term exploitation in Marxist theory, where it is based on the extraction of surplus value from workers in capitalist

production. While there are cases of predatory lending that eat into workers' disposable incomes, if the interest payments, fees, etc, do take the widespread, persistent and systematic form that Lapavitsas assumes under 'financialisation', then ultimately the deduction is from surplus value, not from the value of labour power.<sup>8</sup>

These weaknesses of Lapavitsas's arguments aside, for my present purposes the other problem is that he pays little attention to any source of financial profits from *outside* the national sphere. He argues that whereas Lenin, following Hobson, noted in the early 1900s that the rich imperialist powers lived off rentier incomes from their loans to other countries, today rich countries, particularly the US, are more commonly *borrowing* from poor countries (Lapavitsas, 2013, p. 67). That is correct up to a point, but he ignores the broader issue of how such borrowing helps finance higher-yielding foreign investment from the US (and the UK), and the fact that the US and other rich countries *do* still earn large rentier incomes. For example, in 2012, US gross investment income from abroad was \$770bn, while the net figure after investment income payments was \$232bn (BEA, 2013d, Table 1, lines 13 and 75).

Duménil and Lévy add more of an international dimension. Under the heading 'Pumping income from the rest of the world', their analysis of the 'economics of US imperialism' highlights how the US has become dependent on inflows of finance, and that 'huge and growing flows of income are drawn from the world and contribute to the remuneration of capital in the country' (Duménil and Lévy, 2004b, p. 658). They make the important observations that there are different (higher) rates of return on US foreign direct investment compared to foreign portfolio investments, and that foreign investors earn a lower return in the US than the latter does on its overseas investments. This enables the US to generate significant net income flows from overseas, given its higher ratio of direct investment, despite the fact that it has a deficit in its net foreign investment stock position (Duménil and Lévy, 2004b, pp. 664-665).

These are positive features of Duménil and Lévy's analysis, although the main facts are well known among analysts of the US balance of payments.<sup>9</sup> Duménil and Lévy do not examine *why* there are different rates of return on FDI assets compared to portfolio assets, nor why rates of return in the US appear to be lower than those on US investments overseas. They simply note that the US benefits from having a 'hegemonic' role in the world economy and document the differential flows of income. Similarly, there is no discussion of what role finance plays in the 'economics of US imperialism', apart from the fact that the financial sector expanded dramatically in the period that they and others call 'neoliberalism'.

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<sup>8</sup> For further discussion of this point, see Norfield 2014 and Fine 2010 (especially p. 100).

<sup>9</sup> See, for example, the analyses of Mataloni 2000 and Landefeld *et al* 1992 on the difference in rates of return on direct investment.

As with many other writers, they argue that the neoliberal period began in the late 1970s, with a rejection of previous so-called Keynesian policies and a turn to 'monetarism' in both the US and UK, under Ronald Reagan and Margaret Thatcher.<sup>10</sup> They correctly note that the return differences on investments that favour the US were evident even *before* what they call the neoliberal era, and are a result of US 'hegemony' (Duménil and Lévy, 2004b, p. 665). However, they also argue that a rise in rates of return after 1980 is due to 'large real [inflation-adjusted] interest rates and flows of dividends'. This is part of their general thesis linking neoliberalism to high real interest rates, as a sign of the domination of finance in the economy under neoliberalism. However, they pay no attention to the *steady decline in real interest rates*, both in the US and in other major capitalist countries since the early 1980s, a fact that contradicts their thesis. In more recent years, nominal interest rates have been close to zero and real interest rates have been *negative*.<sup>11</sup>

Duménil and Lévy make some interesting calculations of the rate of profit in the US, comparing the profitability of the non-financial to the financial sector. They note a big rise in financial profitability versus the non-financial and explain this as following from 'the new neoliberal pattern of incomes from the 1980s onward'. (Duménil and Lévy, 2004c, pp. 98-99). The statistical observations are plausible, but in my view they result from the different position of the financial and non-financial sectors within the capitalist economy, in particular the access that each has to the central bank and to the money and credit markets.<sup>12</sup> Simply saying that the profitability gap results from a 'neoliberal pattern of incomes' is tautological since their thesis is that neoliberalism and higher financial sector returns are part of the same process.

Their view is that the financial sector expanded dramatically due to a 'policy coup' by a group of financial capitalists (Duménil and Lévy, 2004a, p. 86). This follows from their method of separating the growth of finance from the process of capital accumulation and counterposing the so-called 'real' sector of the economy to the 'financial'. From a Marxist perspective, this overlooks the point that the purpose of capitalist production is profit, not the production of 'real' goods. As will be argued throughout this thesis, the financial system has developed in relation to the accumulation of capital on a global scale, especially prompted by

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<sup>10</sup> See, for example, the collection of essays in Saad-Filho and Johnston 2005. There is reason to question both the generally accepted timing of the policy change and what was really happening under the 'Keynesian' and 'monetarist' or 'neoliberal' policies (see, for example, Panitch and Konings, 2009, pp. 234-5). However, these issues are not of direct concern for this thesis.

<sup>11</sup> I received no response to my question to Duménil on this point in a seminar at King's College in London on 2 March 2011. In Duménil & Lévy 2004b (p. 664) they show a chart that clearly indicates a drop in the rate of interest after 1985 and through to 2002, but this is not discussed. A similar chart and a similar lack of comment are found in Duménil and Lévy 2004a (p. 70). Their latest theory is that we now have a crisis of neoliberalism, since the financiers have lost control of the markets! See Duménil and Lévy 2011.

<sup>12</sup> This is a key distinction between the different sectors that will be explored in Chapters 2 and 3.

the crises impacting the major powers.<sup>13</sup> These financial developments have enabled the US and the UK, in particular, to secure significant revenues from foreign sources.

Crotty has also done some interesting work on the profitability of financial firms. He focuses on US companies and notes that the complexity of their published accounts, and the scale of the assets and liabilities that are 'off-balance-sheet' make it 'extremely difficult to calculate a meaningful profit rate for the financial sector as a whole' (Crotty, 2007, p. 3). This is undoubtedly true, although he notes that a wide range of indicators that can be used as proxies all show that 'financial sector profits over the past 14 years [to 2007] have been impressive'. He then addresses the question of 'why financial sector profit rates rose in this period when real-sector profits were disappointing', a question that he finds unanswered in the financialisation literature (p. 4). It is a phenomenon he considers paradoxical when put in the context of the supposedly 'cut-throat' competition in the financial sector.

His answer is that high competition and high profitability could coexist in those years for four overlapping reasons: there was a rapid growth in demand for financial services, a concentration of capital in the financial sector increasing oligopolistic power, greater risk taken on by the banks, and, most importantly, 'giant commercial and investment banks have turned innovation into a core business', achieving high margins on new derivative products (Crotty, 2007, pp. 5-6). It is a pity that, in this article, he explicitly sets aside the question of the origin of financial profits and does not address it elsewhere. However, he does provide a useful review of some mechanisms through which the speculative dynamic in the financial sector worked itself out. His 2007 article ends with the apt comment that 'I am tempted to say that this Golden Age will end with a bang rather than a whimper' (p. 41).

Crotty overplays the 'innovation' reason for high financial profits and does not pay enough attention to the question of financial leverage. He notes how the use of credit derivatives, in particular, allowed financial institutions to maximise leverage and profitability (Crotty, 2007, p. 18). Yet this observation is only tangentially linked to the important question of low returns on investments that prompted the rise in leverage in the first place. High leverage can appear to be an attractive business strategy if a company has relatively low financing costs and access to a large volume of funds (see Chapter 3, Section 3.3 and Appendix A3.2). These are advantages most often available to financial companies in imperialist countries, an issue that Crotty does not explore.

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<sup>13</sup> In this thesis I do not examine in any detail the relationship between the growth of the financial sector and trends in capitalist profitability. My assessment of the evidence does suggest that a declining trend of profitability has an important role in spurring financial developments. However, the links between the two are complex. It is beyond the scope of this thesis to analyse this particular question satisfactorily, given the need to discuss data and measurement issues and when comprehensive data is available only for the US. More importantly, my thesis has different objectives. My analysis of these questions using US data is given elsewhere (Norfield 2012a, pp. 113-117; 2013c, pp. 116-117; 2014).

## The role of finance for imperialism

In the post-1945 period, the US has stood out as the major capitalist power and most discussions of international financial relationships naturally focus on its role. As the world's largest economy, most efficient producer and biggest creditor after 1945, the US played the dominant role in establishing the Bretton Woods monetary system and designing it in a way that promoted US interests (Steil, 2013). This system went through a series of crises in the 1960s that ultimately led to its collapse in the early 1970s (Hudson, 2003; Eichengreen, 2011). The post-1970s period is the object of analysis here, but, given that my focus is on Britain, not the US, the problem is that the literature rarely discusses the issue of contemporary finance and imperialism except in relation to the US. British imperialism appears at most as a willing, but minor, accomplice in America's plans. The omission of Britain's role is more than an empirical oversight. It reflects a narrow conception of the role of imperial finance, one that often pays little attention to the day-to-day mechanism of privilege and is drawn instead towards examples of financial crisis, particularly those in which the US, or a US-dominated IMF, is seen to impose harsh conditions on debtor countries.

One of the most developed theses on the role of imperial finance in the past decade or so is Gowan's 'Dollar-Wall Street Regime' concept (Gowan, 1999). He summarises well many of the features of the financial system that give the US economic privileges in the world economy. Other states had to sign up to the system of financial regulation that the US wanted and open their markets to US financial institutions, or else they would face the threat of exclusion from needed sources of funds. The US used its financial strength as a tool of state power (Gowan, p. ix and p. 4). He contrasts productive investment with investment in finance and argues that the growth of global capital markets 'privileges the interest of rentiers and speculators over the functional requirements of productive investment' (p. 12). This meant that some of the more industrially productive powers, such as Germany and Japan, were disadvantaged when it came to finance and had to do America's bidding.

Gowan has an important insight when he notes that the motive behind the US financial strategy from the early 1970s was 'to compensate for competitive weakness in its productive sectors through taking predatory advantage of its monetary and financial sector dominance' (Gowan, 1999, p. 127). In fact, the development of the global financial system since the 1980s had the effect of increasing the power of the US, despite its persistent current account deficits. Crises often also led to flows of financial capital into the US – both the legal and the criminal – in the more liberal regime that was established. Many countries that feared renewed destabilisation, especially in Asia, moved to build up massive foreign exchange reserves, which essentially meant that their post-crisis trade surpluses were spent on buying US government securities. The 'Dollar-Wall Street Regime' was also a means for the US to

get 'a functional equivalent of Britain's Indian Empire' (p. 129), where other countries paid for the costs of empire, delivered cheap goods to the US and were a big market for US exports.

Gowan's book was written in the wake of destabilising financial crises, from the Asian crisis in 1997-98 to the Russian and Long-Term Capital Management crises of 1998, as well as the drastic austerity imposed on Eastern Europe in the early 1990s, and it provides interesting and vivid material. However, while it is true that the frequency of financial crises has increased since the 1970s (Rogoff and Reinhart, 2008), so that they are characteristic of modern finance, his perspective ignores the *regular mechanism* of imperial financial appropriation. This is shown particularly in Gowan's limited coverage of the UK. Because the UK does not appear as the main driver of global financial policies, he simply characterises the City of London as operating 'principally as a servicing centre for the dollar currency zone and as a satellite of Wall Street' (Gowan, 1999, p. 26). He notes the UK's role in establishing the eurodollar market and makes other comments on how the UK opposed European financial regulation, but he sees this from the angle of how this benefited the US, not whether there was any rationale in this policy for the UK.

This omission is consistent with Gowan's perspective of seeing world events as being driven only, or at least mainly, by the US. His analysis is inclined to see every financial crisis as being beneficial to the US, and even planned by it *in advance*.<sup>14</sup> While there is little doubt that major powers do try to steer events in their favour, it is surely going too far to suggest that they can control the huge financial markets that their policies have unleashed. A more plausible view is that the privileged position of US imperialism in the global financial system means that it is more able to benefit from that system's operation in *both* good and bad times, *not* that it plans crises on purpose as a means of gaining extra power from them.

Helleiner does a more thorough job of outlining the contemporary role of finance for imperialism, and he also covers Britain in some detail. He shows the explicit role of governments in determining the nature of the global financial system. Rather than the 'globalisation' of finance resulting from faster international communications technology or other technical developments, he shows that at every step in the process there were determined state actions to promote a particular mode of financial development. He puts these measures in the context of both the industrial *and* national interests of the state(s) concerned, instead of being the result of the interests of one section of capital, the financiers, as in Duménil and Lévy's analysis discussed earlier. Most importantly, he notes the dramatic

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<sup>14</sup> Gowan gives some evidence for the view that US policies were directed against Japan's economic and political aims in Asia in the late 1990s (Gowan, 1999, pp. 106-107), and that the US prompted high oil prices in the early 1970s as a tactic against European and Japanese competition (pp. 19-24). But he admits that he has only very circumstantial evidence, at best, of the US government encouraging US hedge funds to disrupt various markets in US interests.

growth in the volume of overseas investments by US corporations from 1945 up to the 1960s that led these companies to begin lobbying politicians for the removal of restrictions on international flows of finance (Helleiner, 1996, pp. 119-120). This was the critical point behind the later shift to 'free market' or 'neoliberal' ideology that more usually gets discussed as resulting from the (often unexplained) domination of, or successful policy pressure from, financiers. However, despite noting this, he can still view the developments in policy more as government choices, influenced by groups of intellectuals, rather than as a result of these changes in the global economy (pp. 121-122).

Helleiner notes that the US's structural financial power in the world economy of the 1960s and early 1970s enabled US policymakers to preserve 'policy autonomy', namely that they were more free to determine domestic economic policy than other countries. This was because the US did not face the same balance of payments constraints on excessive spending and trade deficits. He sees the turning point in the 1978-79 dollar crisis, when 'foreign governments and private investors had suddenly attempted to impose an external discipline on US economic policy' and facing this 'new external constraint', the US had to choose between policy autonomy and its commitment to financial liberalisation. The fact that it did the latter was 'crucial for the globalisation process as whole' (Helleiner, 1996, p. 133). But this interpretation ignores how little choice the US had to ignore the demands of the markets, given the failing US economy of the 1970s. It also sets aside his earlier recognition of how financial liberalisation had become more in the interests of US capital. It is hard to believe that policy controls could have got the US economy out of the hole it was in, or that it could have been restructured enough in the conditions of the old policy regime. Instead the financial liberalisation measures can more plausibly be seen as opening up a *new* source for US revenues from the world economy. There had been both an intellectual and a practical rejection of the previous Keynesian approach to policy, and Helleiner himself notes that 'the entire business community (and particularly the large US banks)' were 'solidly behind Volcker', the US central bank president who drove up interest rates as part of an anti-inflation policy. President Carter had little choice but to agree to new measures, and Congress also favoured an austerity programme after the failure of the previous Keynesian policies and continued stagflation. Helleiner's approach, however, stresses contingency over inevitability.

While Helleiner does not use the term imperialism, his analysis does recognise the privileges of a small group of powerful states in the global economy. He does not attempt to explain finance, or financial and economic crises in terms of Marxist theory, and he pays little attention to the profits an imperialist power might gain from its financial advantages. This would not be such a problem for his analysis, except that in the case of the US it leads him to look at outcomes as more accidental than the previous evidence he has presented would

imply. After citing four key turning points in the trend to financial liberalisation from the late 1970s to the early 1980s, and illustrating how the economic stresses of the time gave UK, US and French policymakers little choice, he then argues that: 'Had controls been introduced in any of these cases, the globalisation trend would have been set back considerably' (Helleiner, 1996, p. 144). This may be true, but to suggest that financial controls could have been introduced contradicts the logic of the material he has used to explain the course of events.

Helleiner's argument is particularly weak on UK financial developments. He claims that 'Britain supported liberalisation in finance because of its "lagging" hegemonic commitment to London's position as an international financial centre, a commitment derived from its past as a financial hegemon in the nineteenth century' (Helleiner, 1996, p. 167). Britain was indeed a 19<sup>th</sup> century financial (and economic) hegemon, but the British state's promotion of finance in the late 20<sup>th</sup> century can be explained on the basis that the British financial system is a structural part of the international operations of British capitalism *today*, underpinning the role of Britain as an imperial power. Britain did not have a 'lagging' commitment to finance from the 1970s. It had a *forward-looking* view on how the existing status of the City as a global financial centre could be leveraged to its best advantage, as I will discuss in Chapter 5.

Panitch and Gindin have written extensively on imperialism and global finance, together with other scholars principally originating from York University, Canada (see, for example, the collection of essays in Panitch and Konings, 2009). This work is rich in historical detail and makes valuable points that argue convincingly against some common misconceptions about the mechanism of US power in the world economy, especially those that underestimate how far other major capitalist countries – and minor ones – have bought into the form of global capitalist system that is dominated by the US. However, although they are correct in arguing that, in many respects, other countries have accepted US power, they exaggerate the sustainability and breadth of this consensus and they mistakenly see the US as the sole driver of global developments, largely to the exclusion of other powers, not least the UK. Their work is wide-ranging and here I will only examine the issues relevant for this thesis.

Panitch and Gindin correctly criticise analysts who understand US economic problems in the 1970s and the decline of the dollar as a sign of a weakening hegemonic power, when this overlooks how far the post-Bretton Woods international monetary system became a means whereby the US could actually reassert its power (Panitch and Gindin, 2005, p. 62; Seabrooke, 2001, p. 105). In this respect they have a similar analysis to Gowan's. They also discuss how US banking practices spread throughout the global financial system even before the breakdown of Bretton Woods, based on the prominence of the US dollar in global

markets, and how the turn towards a more aggressive US anti-inflation, high interest rate policy from 1979 was accepted by other powers in a general shift towards an anti-working class stance, with measures to curb the power of trade unions and to cut labour costs. I agree with these aspects of their analysis, and with the assessment by Panitch and Konings that neoliberalism and monetarism 'reconfigured the institutional parameters of American finance in a way that allowed the American state to regain a considerable degree of control over financial markets' (Panitch and Konings, 2009, p. 233). Their stress on the power of the US state is a useful corrective to the views of those who see persistent US trade deficits as a sign of weakness, when the ease of financing these deficits is better seen as a sign of *financial strength*. This is something that will be shown later as also applying to the UK in recent decades, although in a different manner (see Chapter 6).

However, there are two weaknesses in Panitch and Gindin's approach for the purposes of the current discussion. One is that their concept of imperialism and finance is largely confined to the *political* sphere, with a focus on the power of the US Treasury and Federal Reserve in the global capitalist system in direct negotiations with other states or via the IMF and World Bank. They discuss in general terms the economic advantages accruing to the US from the resulting foreign business opportunities for US corporations, financial and business services companies, but report no data to suggest what the scale of such advantages might be. The closest that they get to this is to cite the widely known example of how only a small share of the final selling price of Apple's iPod is accounted for by the China-based factory that produced it (Panitch and Gindin, 2012, p. 288). Elsewhere in the same work they note the expanded exploitation by US corporations of low-cost labour in southern US states and also overseas, but they spend no time on the *overseas* dimension and do not discuss the huge wage differentials (ones that go well beyond differences in productivity) between the US and its cheap-labour supplying countries, something that is a characteristic feature of modern globalised production. Similarly, in the financial sphere, they note that the US obtained easy funding for its external deficits owing to the international role of the US dollar – initially from Japan, then principally from China - but they pay little attention to the manner in which this acted as a *subsidy* from the world economy, a privilege that resulted from US financial power as an imperialist country.

These omissions ignore the economic substance of imperialism, especially as they relate to finance. If such points are sidelined in relation to the US, the 'hegemon', then it is not surprising that they fail to discuss these in relation to the UK. In their exaggeration of US power, they follow Gowan in seeing the City of London merely as a 'satellite' of Wall Street (Panitch and Gindin, 2012, p. 12 and pp. 117-118). Major US banks do operate from the City and the US dollar is the principal currency traded, but this 'satellite' view overlooks some key

points. The UK gains significant economic benefits from having the biggest international banking centre and its own banks have an important share of this business (see Chapters 5 and 6). Furthermore, the nature of the UK-based banking and credit market is very different from that in the US. Far from US dollar LIBOR – the *London* Interbank Offered Rate for bank loans in US dollars – being 'effectively the internationally "traded version" of the Fed's interest rate' (Panitch and Gindin, 2012, p312), it is a rate that represents a financial market that *does not exist in the US*. For historical reasons (Konings, 2009, p. 51), the US has no equivalent to the UK's highly developed interbank money market for unsecured loans of different maturities in US dollars, let alone in other currencies, and that is why there is no such thing as a 'NYIBOR' for New York.

Their political analysis also goes too far in stressing the continuing financial power of the US. There is an unintended irony in the way they trace different historical phases of US power, but then offer the implied message that the latest phase of US hegemony is one that will last indefinitely - a reincarnation of Fukuyama's 'End of History' thesis. For example, their 2012 book makes many references to US Treasury Secretary Robert Rubin's management of and influence on the resolution of global financial crises (with 13 citations in the index), and poses the US as the world's 'chief financial architect' (Panitch and Gindin, 2012, p. 277), but they misjudge the security of the US position in this respect.

Firstly, while Europe's euro member countries are now in a disastrous financial situation and unlikely to challenge US financial power in the foreseeable future, this does not mean that they have not tried to do so in the past and may do so again. At least since Jean-Jacques Servan-Schreiber's *Le Défi Américain* ('The American Challenge') published in 1967, this has been part of what eventually became the euro project. The currency turmoil in the 1970s following the break up of the Bretton Woods system was the key initial stage, since that caused chaotic developments in intra-European trade relationships, something that Germany and France were particularly concerned to manage better. It is feasible that defensive measures could be imposed by euro-based politicians against what they see as disruptive financial markets, ones in which the US (and the UK) have been heavily involved. While that would not necessarily be the first step towards a war between imperialist powers, it would be an example of inter-imperial conflict that goes beyond simple economic rivalry between competing countries or companies. Panitch and Gindin argue that there has been no such inter-imperial conflict in the latest crisis, and that it has been characterised by cooperation among the main countries, led by the US. They argue that 'the conflicts that have emerged today in the wake of the greatest capitalist crisis since the 1930s are taking shape ... less as conflicts *between* capitalist states and their ruling classes than as conflicts *within* capitalist states' (Panitch and Gindin, 2012, p. 330). This glosses over the turmoil in Europe,

when the issue has become one of who will pay for the crisis, an issue that is already destabilising political relationships between the major capitalist powers. One example is that Britain's Conservative Party is planning a referendum by 2017, if it is in power then, on the UK's EU membership, with the threat to pull out of the system if more favourable membership terms are not renegotiated (Pickard and Parker, 2013).

Secondly, Panitch and Gindin dismiss China as a potential rival to the US by arguing that it is embedded in the US-designed system, for example by owning a huge volume of US dollar-denominated debt in its foreign exchange reserves that effectively cannot be sold. However, while they are correct in noting limits to China's projection of power, this is done in terms of questioning whether China has 'the capacity to take on extensive responsibilities for managing global capitalism' (p. 336), as if that were the issue at stake. They omit to mention that the Chinese state has used a large volume of its US dollar funds both to recapitalise Chinese banks and for other purposes that have riled US politicians, including for overseas investments by state-owned and privately owned Chinese companies in Africa, South America, the Pacific and elsewhere. US Secretary of State Hillary Clinton argued in 2011 for an increase in her budget on the following lines:

'Let's just talk, you know, straight *realpolitik*. We are in a competition with China. Take Papua New Guinea: huge energy finds ... ExxonMobil is producing it. China is in there every day in every way, trying to figure out how it's going to come in behind us, come under us ... I might also mention China has about a \$600m development programme for these Pacific island nations. And what do we have in a response? Zero.' (Kynge, 2011)

One might dismiss this as Clinton simply arguing for more funds, but there are many other indications that the US is all too aware that China's growing strength represents a 'security' threat to US interests as well as an economic one. Since it was created in 2000, a special China Economic and Security Review Commission every year provides the US Congress with an examination of all the current issues. The November 2010 report covered US-China economic relationships, China's 'growing air and conventional missile capabilities', its activity in Asia (especially in relation to Taiwan) and examples of China's 'cyber attacks' on the Internet. The report pointed to the 'intensification of a number of troubling trends'. It worried most about China's improved military capability (US Congress, 2010). These are issues that potentially challenge US hegemony, even if no serious challenge is likely for some years. This potential challenge is also true in the financial sphere, given the manner in which the Chinese authorities have, at their own pace, taken steps to build up the role of the Chinese currency internationally.<sup>15</sup>

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<sup>15</sup> China's financial moves are slow, but determined and cumulative. The share of Chinese exports priced in local currency has risen sharply in recent years to around 12%, and the central bank has begun

This discussion has strayed from the topic of imperialism and finance from the perspective of Britain's role. But the point was to argue against understanding the US as an unassailable hegemonic power running a global system in which British imperialism is only an insignificant bit player.

In a recent work on imperialism, Callinicos also pays little attention to British imperialism today. The only reference to events after the 1970s is briefly to mention Britain's attacks on Iraq in co-operation with the US, and to note the 'recent reorientation of British capitalism around the City, which now rivals Wall Street as the world's most important financial centre' (Callinicos, 2009, p. 193). He says that this reorientation was a 'response to relative economic decline', but that is all. In a work whose title includes the phrase 'global political economy', there is no attention paid to the contemporary role of finance for British imperialism. However, the conceptual rationale for *ignoring* the giant vampire squid in the room is suggested by Callinicos' own assessment of imperialist economics.

Callinicos's concept of imperialism today appears to have no economic substance that is distinct from 'normal' capitalist exploitation of workers. For example, he makes the commonly argued point that the 'backward' countries, where wage levels and living standards are much lower than in the advanced countries, also have much lower productivity than advanced countries. The lower wage levels correspond to their lower productivity, so that they are not exploited more than workers in advanced countries (Callinicos, 2009, p. 181). Hence, there is no more economic exploitation of these workers than is found for workers in advanced capitalist countries. While that perspective tallies with some comments of Marx in *Capital*, there are a number of factors that would question it today.

Most important is that over the past 30 years or so there has been a boom in major corporations' investment in production facilities in poor countries. Today, a wide range of manufactured goods is made in those countries using modern technology on a par with what is available in the rich countries. Nevertheless, despite much longer working days and more intense labour, workers in those factories may be paid barely 5-10% of the wages received by workers in the rich countries.<sup>16</sup> Callinicos ignores this, and instead uses another point to

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to establish FX swap arrangements with other major central banks in Asia and Europe, but not (up to March 2014) the US. Given the size and growth of the domestic market, the Chinese stock exchanges, including Hong Kong, Shanghai and Shenzhen are already the second largest in the world in terms of market capitalisation and turnover (see Chapter 4, Section 4.5). This is not the basis on which one would expect China to be willing to remain subordinate to the US, contrary to Panitch and Gindin's view.

<sup>16</sup> See Norfield 2011. Smith 2010 makes valuable points on these issues, notably on the distortions from a value-producing perspective of statistics on FDI and GDP. Smith also points to immigration controls, and the general controls on a free movement of workers internationally - another barrier to competition - that help maintain the large international wage gaps. On this topic, also see Chang (2010, pp. 26-27).

support his notion that there is no particular exploitation of poor countries by imperialist ones: statistics on foreign direct investment. He cites the fact that the bulk of FDI flows are between advanced countries, not from advanced to poor countries, to claim that 'the figures are indicative of the judgements of relative profitability made by those controlling internationally mobile capital' (Callinicos, 2009, p. 201). In other words, he implies that the profitability of investments in the advanced countries is higher than elsewhere. Smith notes that this reading of the FDI data ignores the more recent shift of manufacturing FDI to poor countries, that much inter-advanced country FDI is of non-productive capital, and that the FDI data do not account for the companies in poor countries that are part of the rich monopolies' value chains (Smith, 2010, Chapter 2; Smith, 2013).

The world economy is dominated by a small group of countries, and this has economic consequences. It is not a case where all workers from all countries are exploited equally. The concept of imperialism used in this thesis is based upon Lenin's analysis that stresses the economic privileges of a small group of major powers in the global economy, privileges that, in one form or another, depend on their domination of the world market. This may be through them being the monopolistic/oligopolistic sellers or buyers of a wide range of commodities, through controlling access to export markets or supplies of key materials, or having special access to finance, or a variety of other advantages. Although Callinicos notes the use of military force by the US and others, this seems to have no relationship to maintenance of their economic privileges. This, presumably, is why he sees no need to delve into the economics of British imperialism: there is nothing to discover that is different from the regular operations of capitalist companies anywhere.

In contrast to Callinicos, Harvey places a special focus on the division of the world economy under imperialism and the privileges of the imperialist powers. In common with other analysts, most of Harvey's comments are focused on US imperialism, but he does pay some attention to the role of other powers. His analysis of imperialism centres on his concept of 'accumulation by dispossession'. This is his application of Marx's concept of the 'primitive accumulation' of capital (Marx, 1974a, Part VIII), the violent process by which a propertyless class of wage labourers was created, to imperialism today. He links this new version of 'primitive accumulation' closely to the development of the financial sector from the 1970s:

'Some of the mechanisms of primitive accumulation that Marx emphasized have been fine-tuned to play an even stronger role now than in the past. The credit system and finance capital became, as Lenin, Hilferding, and Luxemburg all remarked at the beginning of the twentieth century, major levers of predation, fraud, and thievery. The strong wave of financialization that set in after 1973 has been every bit as spectacular for its speculative and predatory style.' (Harvey, 2003, p. 147)

He notes the financial crises that wreaked havoc in many developing countries from the 1970s, and the way that US and IMF pressures forced countries to adopt policies that opened them up to further exploitation. Companies from the imperialist powers took over cheap assets in these countries at cut-price levels and took advantage of the new facilities set up to exploit low-cost labour. He sees this as an important mechanism for warding off a 'crisis of over-accumulation' in the core imperialist countries: 'Low profits in the core regions could thereby be supplemented by taking a cut out of the higher profits being earned abroad' (Harvey, 2003, p. 67). Although Harvey's presentation tends to ramble and encompasses a very wide range of events, he makes the important point that imperialism is characterised by monopoly privilege, and that military intervention is just the 'tip of the imperialist iceberg':

'Free trade and open capital markets have become primary means through which to advantage the monopoly powers based in the advanced capitalist countries that already dominate trade, production, services, and finance within the capitalist world. The primary vehicle for accumulation by dispossession, therefore, has been the forcing open of markets throughout the world by institutional pressures exercised through the IMF and the WTO, backed by the power of the United States (and to a lesser extent Europe) to deny access to its own vast market to those countries that refuse to dismantle their protections.' (Harvey, 2003, p. 181)

Harvey's focus on the predatory aspects of imperialism is as unusual as it is a welcome recognition of events in the world economy. However, apart from some other weaknesses present in his analysis of capitalism, imperialism and crisis,<sup>17</sup> this emphasis on 'accumulation by dispossession' also tends to sideline the regular mechanism of accumulation by capitalist exploitation. The latter does *not* depend on economic and financial crises. As Smith points out, there has also been an important change in 'the core processes of surplus-value extraction' in the world economy since the 1970s, one that has developed through 'the globalisation of production processes'. This is 'a system of interaction that is entirely internal to the realm of the capital relation', not the external method of 'dispossession' claimed by Harvey (Smith, 2010, p. 55).

Harvey also puts the issue of finance under the 'dispossession' heading by focusing on crises and the advantages that these bring to the imperialist powers, in particular the US. Outside of this focus on crises, he does not discuss the role that finance plays for the main imperialist financial powers, the US and UK.<sup>18</sup> One of the objectives of this thesis is to spell out how the normal, regular mechanism of finance works, especially for British imperialism, thus filling this gap.

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<sup>17</sup> His theory of the 'over-accumulation' of capital is vague, for example, and his concluding proposal to fight for a new 'New Deal' and a 'more benevolent imperial trajectory' contradicts the notion that capitalism/imperialism is in a serious crisis (Harvey 2003, pp. 210-211). A critique of these aspects of his theory is outside the scope of this thesis.

<sup>18</sup> Neither is there such a discussion in his major work, *The Limits to Capital* (Harvey, 2006).

Foster is a prolific writer who has covered many aspects of economic imperialism from a radical perspective. His work provides some useful reference points for my analysis, although he too has little focus on the UK. He belongs to the US *Monthly Review* School of analysis, which has long analysed monopoly in domestic (mainly US) and international markets. Foster has recently focused on what he terms 'global monopoly-finance capital' (Foster, 2011, p. 34). His methodology is a hybrid of Marxism and Keynesianism, with a stress on how monopoly capitalism tends to stagnate and needs wasteful spending (including on military and imperial ventures) to sustain aggregate demand growth. In this context, he explains the dramatic growth of the financial system since the 1970s as resulting from the lack of profitable outlets for investment in productive areas of the economy. Foster looks upon this as another means by which aggregate demand could be boosted in the capitalist economy: 'Given deep-seated stagnation tendencies, there was no alternative for the capitalist economy but continuing financialization' (Foster, 2010, p. 7).

Foster cites earlier work by Magdoff and Sweezy, major analysts in the *Monthly Review* School, that argued how rising levels of debt in the US economy from the 1970s were important in sustaining aggregate demand, but that this led to 'the emergence of an unprecedentedly huge and fragile financial superstructure subject to stresses and strains that increasingly threaten the stability of the economy as a whole' (Foster, 2010, p. 4). Hence, the main contradiction for Foster is that the means by which the crisis was averted or postponed was also the mechanism for generating a far worse crisis when the financial bubble burst. This argument works reasonably well as a descriptive account of events. The major capitalist economies did grow more slowly from the 1970s, and there was also a progressively diminishing effect on economic growth of further expansions of credit and finance. Yet, Foster's fundamental theory is that capitalism tends to stagnate due to ineffective demand.

His argument is that there is a growing economic 'surplus', or gap between the value of the mass of goods that capitalism produces and the ability of consumer spending to buy those products, due to constrained wage levels. Thus, for Foster, the issue becomes one of how capitalists can sell the commodities they have produced when the (high) level of profits means that consumer incomes, and so consumer demand, is deficient. This ignores the more fundamental question of how capitalists can produce commodities *profitably*, taking into account the rising volumes of necessary investment, and is a position common to underconsumption theorists. It is not surprising that Foster attempts to fit new phenomena, such as the growth of financial markets, into this outlook, but of relevance to this thesis are Foster's views of imperialism and finance. He asks: 'How is monopoly-finance capital related to imperialism, globalization, and financialization in the periphery of the world capitalist economy?' (Foster, 2010, p. 10). His answer is that:

'Even China and India, despite their huge economic advances, have not been able to break out of the imperial systems of foreign exchange and financial control, which leave them often passively responding to initiatives determined primarily within "the triad" of the United States, Europe, and Japan.'

and he correctly states that:

'This system can allow some degree of industrialization in the periphery, but continues to seek to hold onto the reins of power through monopolies in foreign exchange, finance, technology, communications, strategic natural resources, and military power'. (Foster, 2010, p. 11)

However, he offers no explanation of how the monopolies in finance work, and his observation is left at the level of description, important though that is compared to the omission of these factors from much of the other literature. Given his confused notion of 'surplus', neither is it clear how, in his theoretical perspective, the exploitation of poor countries by rich ones can be a benefit for the capitalist-imperialist system.

Carchedi's work on value theory, crisis theory and imperialism has a focus on contemporary economic issues, the analysis of which might offer useful insights for this thesis. He recognises that there are dominating and dominated countries in the world economy, but his analysis of the post-colonial period of imperialism – ie after the period when direct political domination was the means of exploiting colonies – focuses on 'dependent development' (Carchedi, 2001, p. 115). In this phase, the economic exploitation comes about through the appropriation of surplus value in the standard Marxist model of 'unequal exchange'. Here, the lower technological levels of the dependent countries, and their correspondingly lower organic compositions of capital, bring about a transfer of value in favour of the more developed (higher composition of capital) imperialist powers. In this analysis, as rates of profit are equalised in the market and 'prices of production' are formed, the prices of commodities produced by the latter move above their values, while prices fall below their values for the former countries.

While Carchedi does allow for oligopolistic domination of markets and unequal rates of profit in international trade (Carchedi, 2001, p. 121), the core notion in his analysis is that the competitive advantage lies with the more productive (higher organic composition) capitalist producers. He notes 'the primary importance of technological competitiveness' and 'the advantages deriving from it to the European Union as one of the major economic blocs'. This is despite him seeing several EU institutions and policy regimes, such as the Common Agricultural Policy, as means by which the market is manipulated in Europe's favour vis-à-vis non-member countries (p. 117). Hence, although he often observes that an imperial mechanism of domination is in play, this does not have any direct role in his theoretical

exposition, which is principally based on economic advantage (disadvantage) through higher (lower) productivity.

When it comes to finance, Carchedi's analysis is weak. He can only note 'seigniorage' as the mechanism for imperial gain, or the advantage a country has from its (paper) currency being held and accepted abroad. He sees this as important for the US and the dollar, and potentially (writing in 2001) for EMU and the euro. He has no analysis of how the mechanism of finance offers far more substantial gains for the imperialist countries able to use it. Access to easily available and low-cost finance for all purposes, including the funding of deficits or to invest in other countries, is far more important as a regular source of direct or indirect income than the relatively slow growing benefits gained from seigniorage (see Chapter 4).<sup>19</sup>

Chesnais is much stronger on the analysis of finance and modern imperialism from a Marxist perspective. He sees imperialism as being 'centrally related to the domination of a precise form of capital, namely highly concentrated interest and dividend-bearing money-capital' (Chesnais, 2007, pp. 122-123), but also stresses how 'financial assets generate legally protected claims on the current and future production and centralisation of surplus [value]' (p. 124). He distinguishes between productive capital and finance, and views financial claims on total surplus value as 'likely to affect the rate of accumulation' (p. 124), but does not view the two dimensions of capital as opposed to each other. Instead, countries that possess companies that are part of a global oligopoly *and* large institutional financial investors are all 'partners in the global system of imperialist domination' (pp. 131-132). This holistic perspective is central to my own analysis of imperialism and finance. However, for examples of how imperialist finance works, Chesnais tends to focus on the subordination of weaker countries, especially their high cost of borrowing from major financial centres (pp. 133-134). This is an important issue, but only a small part of the broader mechanism of value appropriation by the key financial powers that is discussed in this thesis. Ivanova also has a highly developed analysis of contemporary finance and imperialism, but her principal focus is on the US dimensions of the process and in her analysis there is some blurring of the role of dollar 'seigniorage', strictly speaking, and the broader benefits for the US of the dollar as world money (Ivanova, 2010, p. 114, p.117; 2013a). However, she clearly establishes links between the expansion of the financial system and the worldwide problems of capital accumulation (Ivanova, 2011, 2013b).

Yaffe is a Marxist author who has given a great deal of attention to British imperialism and finance. In this respect, his work is the exception to the rule, although his

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<sup>19</sup> Carchedi examines the examples of 'dollarisation' in Latin America as another example of dollar seigniorage, and also argues that Germany wanted to develop the international role of the Deutsche mark/euro in order to gain such seigniorage benefits, which conflicts with my observation of the behaviour of German policy makers and of the European Central Bank (Carchedi, 2001, Chapter 5). France, not Germany, was the country jealous of the US dollar's seigniorage benefits.

work is nowadays not part of the academic literature. However, his coverage of financial developments does not develop further than looking at the financial sector as unproductive of value, hence being parasitic on the productive economy, even if he puts this correctly in the context of the imperialist world economy. Given that the UK is the site of a major global financial centre, he terms British imperialism as a 'gigantic usury capital', following Lenin's description of France in the early 20<sup>th</sup> century (Yaffe, 2007, p. 7). He also notes that the UK manages to earn more from its foreign investments than it pays on the higher value of foreign investments in Britain itself. The clear implication is that the rate of return on the outward investments is higher than that on the inward investments, and he cites official figures showing that the rates of return are particularly high for investments in dominated countries. Yet, he gives no analysis of how this happens, and instead focuses on large debt service payments from dominated countries. This is a mistaken understanding of how the mechanism of finance works for British imperialism, or indeed for modern imperialism today.

Far from being dependent on 'usury', implying a benefit from high rates of interest, debtor powers such as the UK (and the US) thrive most when interest rates are low. This is because relatively low-cost funds are used to finance more lucrative industrial and commercial investments abroad. The access to finance and the low funding costs are based on their position in the imperialist world economy, and their premium-rate investments are principally from direct investments, especially in dominated countries, not from loans or portfolio investments.<sup>20</sup> That is the reason behind their ability to gain a much higher return from investments abroad than the return they have to pay on investments by foreigners in their own countries. They also gain large revenues from financial dealings, as from the City of London, and these profits depend not only on their dominant financial positions in the world economy but also on the profitability of global capitalist production (see Chapters 4 and 6). Yaffe rightly focuses on imperial domination, but he fails to analyse the mechanism through which the international transfers of value operate.

### 1.3 Key issues to analyse

The previous survey of the academic literature found no substantial analyses that would fall under the heading of 'British imperialism and finance' covering the period since the 1970s. Most of the coverage in the literature relates to the US domination of the global monetary system and it rarely examines the relationship between the regular, day-to-day operations of the international financial system and imperialist economic power. The role of the financial system for British imperialism today is clearly a neglected area of research, and I will

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<sup>20</sup> See Chapter 6, Table 6.8, for the different returns on different types of investment for the UK. For the different returns on foreign direct investment by country, see Norfield 2011 (for the US) and Norfield 2013a (for the UK).

examine the theoretical concepts and empirical evidence relevant to this area under four headings:

**(a) Is there any economic content to the concept of imperialism?**

As noted above, some Marxist authors do not think there is any essential *economic* difference between capitalism and imperialism, even if they use the term imperialism to describe aspects of the world capitalist system today. In such a view, the imperialists appear to be simply the big capitalist powers – perhaps only the US – differing quantitatively, not qualitatively, from the smaller ones. However, as the aphorism from dialectics has it, quantitative changes can become qualitative. This question underpins the interpretation of the role of finance for British imperialism in the context of Marx's theory of value.

**(b) What is the role of finance?**

Marx's analysis of finance is fragmentary. Even if there were a fully developed analysis in *Capital*, the global financial system has changed dramatically since the second half of the 19<sup>th</sup> century. Building on the previous question of the economic content of imperialism, I will analyse how the financial system has developed into a means by which imperialist powers can gain economic privileges.

**(c) Principal features of the Anglo-American financial system**

The historical evolution of British finance must be understood in order to grasp the form it has taken today, in particular, post-1945 developments and British imperialism's relationship with the US. Analysis of this topic will help explain why Britain was reluctant to join in the various European projects for monetary cooperation and eventual monetary union. This historical analysis also has a value in highlighting the complex mode of cooperation and rivalry between the different imperial powers in the fields of trade, finance and general economic policy.

**(d) What is the role of finance for British imperialism?**

This is the key question, one that has been absent from the academic literature in recent decades. I will explain the contemporary role of finance, showing that it is an integral part of the way in which British imperialism appropriates surplus value from the rest of the world. This will be done using a wide range of data on international financial flows.

While this thesis discusses many aspects of contemporary financial developments, it is not a study of what, from a variety of perspectives, has been called 'financialisation'. Nor does it aim to be an analysis of the 2007-08 financial crisis and its aftermath, although important dimensions of that crisis are elucidated by the coverage here, from the role of

financial leverage, to the privileged position of the US Federal Reserve in the provision of finance, to the financing 'options' open to the City of London in the midst of the crisis in 2008. Instead, it is a study of how the financial system is a key feature of the economics of contemporary British imperialism, using evidence available up to early 2014. My objective is to explain how it works today using Marx's theory of value.

I address the previous four topics, (a) to (d), both theoretically and empirically. Chapter 2 introduces some key concepts used in the thesis, discussing the role of the state, the nature of imperialism and the position of finance. This assesses Hilferding's concept of 'finance capital', arguing that it is more appropriate to use Marx's concept of 'fictitious capital' in the analysis of imperialism, although special attention must be also given to the role of banks in creating 'fictitious' deposits. Chapter 3 looks closely at Marx's analysis of capitalist profitability. It proposes a means of understanding the role of the financial sector in a Marxist framework, highlighting the role of leverage for banks. Chapter 4 examines the contemporary forms of financial privilege, detailing not only those accruing to the US, but also those gained by a range of other countries that play the role of hubs in the global financial system. Chapter 5 is more of an historical analysis, looking at the key political and economic events and placing these in the context of developments in the global market. This chapter focuses on British relationships with the US and Europe since 1945, providing a framework for understanding British policymakers' reluctance to 'join Europe'. Chapter 6 details the contemporary role of finance for British imperialism, analysing the balance of payments and international banking flows data of the past 30 years. This brings out both the economic benefits that accrue to the British state and the British economy in general, and the key position of the UK-based financial sector in the global capitalist system, including the relationships with tax havens. The final chapter concludes with a summary of the main arguments and a note of more recent developments that indicate how the relationship between British imperialism and finance is far from being only of historical interest. It remains a key dynamic of British imperialism today.

## **Chapter 2      Imperialism and Finance**

This chapter explains some of the key concepts used in developing the argument of this thesis: what I mean by 'Britain' as a state in the world economy, what is the relationship of capitalism to imperialism and how 'finance' needs to be understood in relation to capitalism, imperialism and the state. The chapter begins by discussing capitalism, the nation-state and imperialism and then moves on to the concepts in Marx's theory of value that provide a basis for understanding what I term the 'economic essence' of imperialism. My aim is not to offer a general theory of the state, of imperialism, or, indeed, of finance, but to discuss the relevant aspects for this thesis. One underlying theme is to explore how far the concept of imperialism can be said to have particular *economic* characteristics, rather than simply being understood in terms of one country, or countries, dominating others through military or political pressures. I will outline how a concept of imperialism can be derived from Marx's theory of value as presented in *Capital*, even though that work did not examine the relationships between different countries in the world market. Then I will discuss Lenin's theory of imperialism and note how the main features he described offer a useful way of viewing power relationships in the world economy today. My assessment of the literature on imperialism is focused on those aspects of Marxist theory that relate to the economic aspects of imperialism, more particularly on the financial dimensions that only a few authors cover in any detail. These financial dimensions will be analysed more fully in subsequent chapters.

Section 2.1 examines how the capitalist state's role in economic relationships also extends to the financial system and the relationships of national companies with other states. This discussion offers a view of the economic content of imperialism, one where a company, or the state itself, has economic advantages that result from its position in the world economy. I distinguish these from the advantages that relate more directly to a company's competitive position based upon its technology or organisational ability. Section 2.2 notes that Marx's theory explains how a more productive, higher organic composition of capital company receives a transfer of value from the less productive in the process of profit rates being equalised, but also argues that this mechanism by itself cannot be used to explain the *economic* aspects of *imperialism*. The impact of monopoly and market domination is considered in Section 2.3. It proposes that although monopolistic methods of trying to secure profits are not necessarily any different from 'normal' capitalism, because the methods are played out on the international stage with powerful states in support of monopolistic companies, this becomes a defining feature of an *imperialist* world economy. However, there is an important and less evident dimension to this as shown in Sections 2.4 to 2.6: the relationship of imperialism to finance. Section 2.4 offers a critique of Hilferding's concept of

'finance capital'. It shows the need for a different view of how fictitious capital operates under monopoly capitalism. Section 2.5 examines the role of fictitious capital and financial power, while Section 2.6 discusses how to understand the operations of financial institutions in the context of Marx's theory of value and the concept of 'parasitism'. In Section 2.7, the previous arguments are brought together, showing that there is a link between parasitism and imperialism, based upon the state's role in the world economy. Section 2.8 concludes with an empirical measure of the relative position of different countries in the world economy. This is a summary of a country's economic, military and financial power in an 'Index of Imperialism', one that finds the US and the UK in the top two positions.

## 2.1 Capitalism, the state and imperialism

The capitalist economy is a holistic entity with a particular set of social relations between the owners of the means of production and those who work for them. This set of relationships goes far beyond the labour contracts between workers and employers. It includes, for example, the legal framework for property rights and the means of enforcing those rights, the mode of doing business and the acceptable currency for business transactions. The latter are necessary for the capitalist economy to function, and they imply the need for a power that operates outside the relationships between individual companies and workers: the state. It is rare for capitalist companies – at least nowadays, in the richer countries – directly to enforce the capital-labour relationship if the market mechanism that supplies a compliant workforce breaks down. Neither do individual companies decide on what is to be the legal tender, or whether there is to be military action and war with other countries. Individual capitalists will have opinions on all these things and will attempt to influence the outcomes, but the decisions are a state decision, usually resulting from an assessment among ruling elites of what is the best course of action. While those decisions may not be made without conflict between different groups of capitalists, perhaps with one particular group winning, the capitalist state nevertheless appears as an independent force, separate from and standing above individual capitalist companies. In Marx and Engels's words: 'The executive of the modern state is nothing but a committee for managing the common affairs of the whole bourgeoisie' (Marx & Engels, 1973a, p. 37).<sup>1</sup> This management process has to take account of developments in *all* social classes, and the state's ability to be influenced by social pressure endorses the appearance that it is an independent body. Furthermore, the state is concerned about economic and social reproduction as a whole, not simply the more narrowly defined economic issues, although the latter are the concern of the analysis here.

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<sup>1</sup> See Jessop 2012 for a discussion of the role of the capitalist state in Marxist theory.

While there can be conflicts between what is judged to be good for the national system as a whole and what is good for an individual capitalist, the economic health of the national state apparatus and its ability to act will largely depend upon the profitability of the domestic capitalists, even if their profits do not derive only from the domestic economy. By the same token, capitalists of a particular country will, in principle, be in a stronger economic position if the state oversees the national economic system and takes action in their general interests. It is anomalous for a major capitalist power to have a state apparatus that works only for its own benefit, for example, determining laws and managing affairs in order to enrich state officials.

The productivity and competitiveness of companies might seem to have a greater importance than state power, even a logical precedence over it, in determining a country's economic strength and influence in the world market. After all, how are the state's functions to be paid for if not from tax revenues, revenues that are burdens capitalist companies must bear directly, in profits or sales taxes, or indirectly via taxes on the incomes of owners or employees. For example, a state cannot have significant military operations worldwide if this cannot be afforded, a fact that British policy makers had to accept in the strategic decision to withdraw from 'East of Suez' in the late 1960s (Pham, 2010). However, to focus only on companies would be to overlook a number of key factors.

One critical aspect of the state's economic role is to manage the monetary system, or at least to set the framework for it. What is to be the legal tender within national boundaries? What currency is acceptable for the purpose of tax payments? How can this be done in a way that does not disrupt business calculations and transactions? How is the banking and credit system to be organised? These are features impacting the whole economy, not simply one area of business, so state regulation of monetary issues is important for all capitalist economies.

Historically, state regulation of the monetary system preceded the formation of central banks, but such institutions eventually emerged everywhere as the state tool for performing this function. The oldest central banks were initially set up as private companies with state backing – for example, Sveriges Riksbank of Sweden and the Bank of England – acting as a means both for the state to issue currency and to fund state spending, especially for wars. The instability of a system of private banks also leads to the formation of a central bank with a state-sponsored 'lender of last resort' function, even if this occurs much later, as in the case of the US Federal Reserve System that was established only in 1913. Private capitalist banks gain a special status vis-à-vis other capitalist companies in this kind of system. They normally have unique access to central bank credit, although they must usually also meet official criteria and gain a licence before they can begin operations, in particular for those

operations that allow taking deposits from the public.<sup>2</sup> Whatever may be the fantasies of 'libertarian' pundits in the US, no major capitalist company wishes to operate in an economy where everyone issues their own currency, or where the fiat currency has to be fully backed by gold to prevent 'corruption' by state authorities.

The nation-state's role also includes managing relationships with *other* states, something that individual capitalist companies are normally not in a position to do themselves. This explains the business delegations to other countries led by prominent politicians. The formation and development of the world market is the economic basis for these relationships, for example where the state negotiates trade and investment deals, provides special tax rates, guaranteed loans or other things. This will involve both cooperation *and* rivalry between states, because there is a multiplicity of economic relationships, and the relative power of each state can be decisive.

This raises an important issue that, in various forms, comes up in the later analysis: what is the relationship between the nation state and the capitalist companies in the national territory? As Marx explains, the creation of the world market is one of the 'cardinal facts' of capitalist production (Marx, 1974c, Chapter 15, p. 266). The accumulation of capital naturally extends beyond national boundaries, so this can create a tension between companies that do not necessarily look upon their national economy as the key source of their profits and the nation state that will be concerned with the viability of the domestic economy. The state will mediate this process and attempt to find policies that assist both a profitable expansion of its capitalists into the world market *and* domestic economic expansion. This is consistent with the state implementing policies both to attract inward capital investment and at the same time to support an outflow of capital.

A company's international relationships may start with little or no state backing, but the state remains part of the deal, even if it is only in the background. For example, large capitalist companies normally have shareholdings from investors based in a wide range of countries. However, it remains rare for such a company not to be closely linked to a particular nation-state. 'International' companies are usually national companies that have expanded beyond their original structure through mergers, takeovers and foreign investment. But while this can, unusually, change the nationality of a company, it normally becomes clear that it is

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<sup>2</sup> In the UK, for example, money *lending* is lightly regulated, but it is far more difficult to get a *deposit taking* licence from the Bank of England. The debtor need not worry if the creditor goes bust (the money has been already lent and the terms of the loan are usually fixed), but the depositor has much more reason to worry if the bank holding his or her deposits is under threat. The failure of a bank is likely to have widespread economic effects – including raising the risk of other bank failures and causing trouble in the national (even international) payments system. This may even be true for a smaller bank, such as the UK's Northern Rock. Central bank and regulatory authorities nowadays distinguish 'systemically important financial institutions' from others.

from German to British, or British to American, etc, not from British to 'international'. This is reflected in the predominant nationality of the controlling management, and often in the location of the stock exchange where the company has its principal share listing.

There are some exceptions to this, given that the evolution of a particular company might involve close cooperation between more than one country's capitalists – as with Royal-Dutch Shell and Unilever, for example, which are UK- and Netherlands-based companies. But it is interesting that a major capitalist is likely to decide to change nationality if the bulk of his or her business interests ends up outside the country of origin. For example, Rupert Murdoch, Chairman of News Corporation, changed his citizenship from Australia to the US in 1985. Business strategy for Murdoch was to move into television, and his purchase of the American Fox Broadcasting Company required that he became a US citizen. Another exception is that a company principally owned by capitalists of a particular nationality might list its equity on a (bigger) foreign stock exchange in order to get more access to funds in a bigger market or a more prominent global ranking for the company's corporate assets. In the past two decades, it has been common for all major exchanges to encourage listings by major international companies. However, by the end of 2010, UK residents, from individuals to financial institutions and others, held almost 60% of the value of shares quoted on the London Stock Exchange, one of the world's biggest (ONS, 2012, Table A, p. 21). The FTSE-100 equity index may not represent the domestic British economy since it is composed of companies that operate worldwide. Nevertheless, it is majority-owned by British capitalists.

The economic rationale for this 'national' core of individual companies is that the nation-state is the backer of capitalist corporations that are its 'own'. Of course, this is not guaranteed in every single case: the operations of a particular corporation may conflict with that of others, or their demands may not be judged to be compatible with the 'national interest'. However, capitalist companies can depend upon their nation-states more consistently to back them up in foreign business relationships – a natural reflex – than they can rely upon the foreign recipients of bribes, or other inducements, to be able to do the same. This does not mean that capitalist companies are 'patriotic' or sentimental about 'home'; they will make hard-headed business calculations. Sometimes that will conflict with the 'national interest', as with the transactions frequently made with countries that are considered to be enemies of national policy. Examples are many. The most recent are European banks dealing with Iran against a sanctions policy agreed by EU member states, or, in previous years, companies like Shell and BP of the UK dealing with Rhodesia (now Zimbabwe) when trade was officially restricted by UK sanctions (Nyangoni, 1985, p. 128).

Even the supposedly nation-effacing phenomenon of 'globalisation' does not mean that corporations can avoid their dependence on the nation-state to which they nominally belong. As one columnist put it:

'the next time IBM China gets in trouble in China, call Jiang Zemin for help. And the next time Congress closes another military base in Asia, call Microsoft's navy to secure the sea lanes of the Pacific. And the next time Congress wants to close more consulates and embassies, call Amazon.com to order a new passport.' (Friedman, 1999)

He could also have added: 'the next time US corporations complain about infringement of intellectual property rights, call on McDonalds to refuse to sell Big Macs to the country concerned'. The capitalist corporation clearly depends on the power of the nation-state, even if it is also inclined for good business reasons to be unpatriotic.

However, the relationships of national states to capitalist companies are more complicated than implied by the previous remarks. There are many examples where even a powerful state will favour a company operating on its territory that is not nationally owned but which may be important for national employment or business prospects. It can go even further than this, as with the example of Lakshmi Mittal, an Indian steel tycoon, who was feted by the 1997-2010 Labour government and supported in his wider European business interests, not only in his operations in the UK. This might seem paradoxical, but it indicates an important 'demonstration effect' where a government showing itself willing to support companies can also attract other inward investment. One might wonder at the government's propensity to prostrate itself in this way, but there nevertheless remains a national economic rationale for such actions. The 'British economy', as all economies, is a collection of many different capitalist companies, not all of which are British in any national citizenship sense. Nevertheless, the companies located in the UK are part of the foundation of UK economic income, employment, tax revenues and wealth.

The capitalist state is a key player in the world economy, setting the terms of business both for international trade and for cross-border investment flows. While a company will set the price of the product or service it provides, given conditions in the market, that price might be subject to an import tariff and local taxation, or the product may not even be saleable in another country if there are government standards with which it does not comply. Or a company may want to invest in another country, but could face restrictions on which areas are open to foreign investment. These are limitations on the operation of the market set by state policy. However, such policies are also open to negotiation between states, including the political pressure that one state may be able to exert on another.

Corporations headquartered in particular nation-states will tend to be the main ones benefiting from the actions of the respective governments, also making it easier for these corporations to consolidate their position in the world economy. In turn, the more powerful their states will become, to the benefit of all 'national' capitalists and even to the population at large. There is an important symbiotic relationship between the nation-state and corporate power, one that will also support the power of some countries at the expense of others when dealing in the world market.

This leads to a provisional definition: imperialism can be seen as the hierarchy in the capitalist world economy based upon the combination of economic and political power possessed by particular states. The term 'hierarchy' is used to connote a degree of stability in the power rankings of countries. For example, although the relative importance of countries in the so-called Group of 7 (G7) major powers has changed over time, the membership has not since 1975 and it accounts for only a small percentage of the world's population. The designation and membership of such groups has expanded in more recent years, but even the largest, the G20 from 1999, was initiated by the original G7 (Kirton, 1999). The more inclusive organisations of the world economy that aim to have 'everyone' as members – such as the International Monetary Fund, the World Bank and the United Nations – are also run by a small group of key powers, with the US being able to veto any key decision that is against US interests and to promote those that are. This is not to argue that power rankings under imperialism will stay unchanged, but it does suggest that there are benefits and privileges from being on top that will tend to support the maintenance of such a position.

On this basis, one can also view the *economic* content of imperialism as being the economic advantages that may be gained by capitalist companies when they are backed by their own states in dealing with other countries in trade or investment relationships. However, the economic aspects of imperialism are wider than this. Even if national government policy does not explicitly back their operations, companies from a particular state might still have advantages when dealing internationally. However, these would need to go *beyond* what an individual capitalist company might gain by its own productivity or economic competitiveness compared to other companies in the (world) market if one is to put them under the heading of an 'imperial' economic advantage.

The concept of imperialism is bound up with economic gains from being an imperialist rather than not being one. If it were bad in economic terms for a country to maintain the trappings of an imperialist power, whether these be colonies, an extensive military, foreign embassies, a spy network or some other means of keeping a decisive global influence, then one would expect that over time enough business interests in that country would exert political pressure to change policy. Government policy would then adapt to new

economic conditions. Insofar as the infrastructure of imperialist power projection remains, the logic is that this is consistent with the perceived benefits, even though these may be longer-term strategic benefits.

My argument is that one can distinguish a 'technical' and an 'imperial' set of features for a company. The former depend on a company's technical or organisational abilities compared to its competitors. These relative advantages will change over time, and may even disappear as the market evolves. The latter include those a company might get through the direct backing of its state in trade and investment deals. These can be anything from import controls to inter-governmental pressure for export and foreign investment deals, to threats of retaliation if foreign assets are expropriated. Additionally, this second set will include those advantages that originate from a company's home location or nationality: which legal system is used for its business dealings, which stock market lists its shares, which are its local banks, what is its business currency, and so forth. In this sense, the term 'imperialist' can apply to companies as well as to states, given the company's more broadly defined relationship to the imperialist state.

What distinguishes an imperialist *company* in this framework is not its size or competitive success, nor even its global importance as a big producer of goods or provider of services, although it will often be a big company given the advantages it enjoys. What distinguishes an imperialist company is the backing it receives from a powerful nation-state in the world economy, and any advantages it gets because it is located in and identified with that imperialist state. Likewise, what distinguishes an imperialist *state* is not its control of a mass of weaponry, but its ability to exert power in the world economy on behalf of its 'national' capitalist companies. To examine these issues in more detail, I will next summarise the points from Marx's theory of value that relate to the 'technical' set of features described earlier, ones based largely upon competitive advantages. These are closely linked to the 'imperial' set of features discussed subsequently, but the latter will be considered subsequently in a more specific discussion of finance.

## 2.2 Value production and transfer

Marx's theory of value explains the origin of capitalist profit and how the dynamic of capital accumulation takes particular forms. Value theory applies to a system of exchange, where the products of labour take the form of commodities. Capitalism, the historically specific form of organising social production in which the products of labour are commodities and in which labourers work for the profit of the capitalists, the owners of the means of production, is also the one in which commodity production and exchange is most generalised. The value of commodities is a function of the socially necessary labour-time that went into their

production, both directly in terms of the new expenditure of 'living' labour by the workers and indirectly as a result of the value transferred to the product by the means of production. The profit of the capitalist employers depends on the amount of surplus value produced by the workers, which, in turn, results from the time that they work after reproducing the value of their own labour power.

This leads to the definition of *productive labour* in Marxist theory: the labour that produces value and surplus value for capitalism. Marx's analysis in *Capital* is focused on the dynamic of this process, and Volumes 1 and 2 deal almost exclusively with industrial capital because this 'is the only mode of existence of capital in which not only the appropriation of surplus value, or surplus product, but simultaneously its creation is a function of capital' (Marx, 1974b, Chapter 1, p. 57). Industrial capital is, then, the most general and most important form of capital, and the one that is considered to employ *productive* workers. Not all productive labourers are directly employed by industrial capital, however. One such group of productive workers is involved in the transport and packaging of commodities, since this function can also add to their use-value (Marx, 1974b, Chapter 6, pp. 151-153). Another group includes producers of use-values that are *not* material commodities who nevertheless work for a capitalist company, for example in private hospitals and education (Marx, 1974a, Chapter 16, p. 477; Marx, 1969, Addenda 12, Section H, pp. 410-411). It is not the concrete, 'use value' form of labour that determines whether or not it is productive for capital, but the social form in which it is organised.

Productive labour under capitalism can only include those workers employed by capitalist companies, but not all such workers are productive. Many workers employed by capitalist companies do not produce value and surplus value. These are principally the ones operating in what Marx calls the 'sphere of circulation'. One area of this is the selling or buying of commodities, including the accounting processes, as in the case of those working for commercial capital. Another important area covers the workers in the more specifically *financial* sphere, providing loan capital so that others may do the producing, or performing other services in the exchange of titles to the ownership (and use) of money and other assets. This includes banks, pension funds, asset managers and other financial companies. However necessary these functions may be for the operation of the capitalist market system, and whatever profits the workers in these occupations may bring to their capitalist employer, via mark ups, fees or interest payments, workers in the sphere of circulation do not produce new value (hence, no surplus value either) for the system as a whole. Neither are the costs of these operations transferred to the values of commodities. Their work is not part of the production by capital of use-values as commodities. The capital invested in the commercial and financial spheres is part of society's total capital advanced, but all the running costs, depreciation and

profits registered are effectively deductions from the value, essentially the surplus value, produced elsewhere. Similarly, while these activities *may* have the effect of leading to a greater output of value and surplus value in the capitalist system, the higher values are still the result of the *productive* sector's output.

Another group of workers is not employed by private capital at all, but is nevertheless important to note briefly: public sector workers in local and central government. They have become increasingly important in the post-1945 period, along with the expansion of state expenditures and taxation. This is a big topic to analyse in its own right, and it falls outside this inquiry into the role of finance. However, from a value perspective, public expenditure is largely financed through taxation and it is a drain on how much of the total surplus value produced may be used for further private capitalist production. This is so even if some of the expenditures may also benefit sections of private capital.

Value expansion, or making profit, is the aim of capitalist commodity production. Competition puts pressure on individual capitalist companies to cut their costs as a means of raising profits, something that applies to all kinds of capitalist company, including commercial and financial ones. Even though the latter companies produce no value or surplus value, that fact need not concern them. Their profits can still rise if they reduce their unit costs. Cost reduction can only be done on a systematic basis by raising productivity, although there will also be attempts to force input prices and wages lower when possible. Given that there are usually economies of scale and scope in production, this also tends to lead to the domination of the market by the bigger capitalists. A greater output usually enables lower unit costs, higher revenues enable purchases of more efficient fixed capital and large-scale buying of raw materials is often less costly per unit, as is the transport and marketing of a greater mass of products, etc. This is again true not only for companies in the productive sphere, but also for those in commerce and finance. Pressure on companies to compete and expand profits also implies the need to expand markets beyond local or national boundaries as more buyers of the higher volumes of output are sought, so expanding the world market.

Marx explains the logic behind the growth of the world market, but he does not discuss the way it operates in *Capital*, except to give some brief, marginal comments to note some issues that were to be dealt with in a later volume discussing 'competition' (see below). Instead, at a higher level of abstraction, he discusses the mechanism of value production and derives the laws of the system as a whole. In these can be found some key concepts for the current discussion, but they are ones which need to be developed further in order to clarify the relationship between capitalist exploitation and imperialism.

The first issue is the formation of the average rate of profit. Here, Marx explains how there is a tendency for the prices of commodities to diverge systematically from their embodied values representing the amount of socially necessary, or abstract, labour they contain. This is because, under capitalism, commodities are exchanged as products of capital, not as simple commodities that contain so much labour time. Capital is invested wherever the rate of profit is highest, and the advance of capital to produce commodities will tend to result in a single, average rate of profit across the economy. Since unpaid labour is the source of surplus value, and a given amount of capital advanced in different sectors of production will employ different amounts of living labour compared to constant capital, this creates a discrepancy between the value embodied in commodities and the average market price (price of production) at which the commodities will tend to exchange (Marx, 1974c, Chapter 9). The result is a transfer of (surplus) value from the sectors with the lower compositions of capital to the ones with the higher compositions via the difference in prices. However, values and prices of production continue to be driven by developments in productivity and accumulation.<sup>3</sup>

The total surplus value of the capitalist system determines the size of the total profit, but the divergence of prices of production from the prices that would directly reflect values brings about a redistribution of the surplus value between the different capitalists in a way that tends to equalise profit rates. If prices of production were not sufficiently higher or lower than values, then profit rates would diverge. This would induce a shift of capitalist investment and production from the lower profit sector to the higher profit sector. Market prices then move to bring about levels of prices that tend to result in equal profit rates.

This mechanism is often used to explain how richer capitalist countries or companies get transfers of value from poorer ones, assuming that the companies from the richer countries have a higher composition of capital (Callinicos, 2009; Carchedi, 2001; Emmanuel, 1972). This is based upon more socially necessary labour time being exchanged for less in trade, given the formation of prices of production in the world market. However, although valid as an explanation of how one might 'give' some labour time to another for free, this is no different from general capitalist market operations and so should not be considered a distinguishing feature of an *imperialist* world economy, one in which the world economy is divided between a small group of major powers and the rest. Simply relying upon this mechanism would effectively be saying that there is no *economic* substance to imperialism, and that imperialism is just capitalism plus the military and political power of the rich countries.

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<sup>3</sup> This is not the place to discuss the wider ramifications of Marx's treatment of the so-called transformation problem, for which see Fine and Saad-Filho 2004 (Chapter 10). Chapter 8 of this book also discusses the different compositions of capital - the technical, value and organic compositions - that are not discussed in this summary.

A separate mechanism, but one related to that based on prices of production, occurs in Marx's discussion of companies that have a better than average market productivity. Here a company has lower costs than its competitors in the same sector. Then it may sell at the same price as others, but it will realise a 'surplus-profit' (Marx, 1974c, Chapter 10, p. 198). This also implies that its selling price for the commodity could be lower than the average market price, so it can gain market share but still earn a rate of profit higher than its competitors. Competitive pressures will nevertheless tend to force others to follow its technical lead or to make their own advances and its competitive advantages will tend to be eliminated. Only insofar as the better techniques are *not* generalised will the company remain in a favourable position. But its position is nevertheless based upon superior productivity, not upon any form of market privilege, still less upon one that could be put under the heading of an imperial privilege.

The previous mechanisms assume that capital can flow freely between different sectors of the economy. If there are barriers to new capital moving into the higher profitability sector, then the averaging of the profit rate will be impeded, perhaps for a very long time. Marx briefly notes the possibility that monopolies might 'stand in the way' of an averaging process when discussing the extra profits available from investing in the colonies of the major countries (Marx, 1974c, Chapter 14, p. 238). He also notes how some sectors of industry may have such a high organic composition of capital, and demand such a large scale of investment – for example, railways – that the form of investment in these sectors, principally via the stock market, means that this area of investment is separated from the rest of the capitalist economy, and its profit rate, assumed to be lower, does not enter into the averaging process because it is received as a form of interest payment (Marx, 1974c, Chapter 14, p. 240).<sup>4</sup>

Other factors to allow for here would include different values of labour power and rates of surplus in the world economy. Marx notes the use of 'slaves, coolies, etc' in the colonies of the major powers, and that 'different national rates of profit are mostly based on different national rates of surplus value', giving an example of a higher rate of surplus-value in the more developed country (Marx, 1974c, Chapter 8, p. 151). This illustrates the status of Volume 3 of *Capital* as a stage in the (incomplete) analysis of capitalism, not the conclusion. These subjects, as well as the issue of paying wages below the value of labour power, were to have been part of the analysis of competition, separate from that in the three volumes of *Capital* (Marx, 1974c, Chapter 14, p. 235). For the same reasons, Marx's analysis in *Capital* was based on an abstract, universal capitalist economy. Although it dealt with the forms of capital that emerge, it did not systematically deal with the different economic status of countries and their relationships to each other.

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<sup>4</sup> This topic raises many issues and is discussed further in Chapter 3.

When considering how further to develop a Marxist analysis of these issues, there is the likelihood that *something else* has an influence over the profitability of a company in the capitalist system that is separate from, though possibly related to, its productivity and competitive advantages. That is the topic for sections 2.3 to 2.6, which will discuss different aspects of the 'imperial' set of factors that generate privileges for certain national powers – and their companies – in the world economy.

### 2.3 Monopoly and imperialism

The previous section argued that the 'price of production' mechanism of value transfer is not something that can be used to illustrate what is special about the economics of an imperialist, as compared to simply a capitalist, world economy. Many writers have discussed other methods of exploitation, sometimes in addition to the former, to illustrate the economic gains that capitalists from dominating countries can make from others (Amin, 1976; Emmanuel, 1972; Frank, 1978; Wallerstein, 1974). Examples of the methods that lie outside the power of an individual capitalist company, or of the 'free' operation of the market, include a dominating state power that undermines local industries in weaker countries so that they are dependent on the major country's exports, or restricting their ability to export to major consumer countries except under favourable terms for the latter, which usually involve getting privileged access to the weaker country's domestic markets in bilateral trade deals. Such examples are important, but they are commonly examples of one state enforcing conditions on another to achieve an economic gain at the other's expense. To that extent, they are examples of *political* power and fall outside a more distinct *economic mechanism* for imperialist gains. Force, extortion, dispossession or robbery may bring a return, and they are important features of imperialism (for example, Harvey, 2003, especially Chapter 4 'Accumulation by dispossession'). But they are not the *modus operandi* of an economic system any more than piracy can be seen as a mode of production.

In what way can imperialism be said to operate as an economic system distinct from 'pure' capitalism? To answer this question it is necessary first to determine what is distinct about imperialism as a form of capitalism, and for this purpose it is worth investigating the characterisation given by Lenin. The factor that Lenin saw as underlying the economics of imperialism was monopoly: 'If it were necessary to give the briefest possible definition of imperialism we should have to say that imperialism is the monopoly stage of capitalism' (Lenin, 1976a, p. 700). Imperialism for Lenin is monopoly capitalism, but he is careful to place this concept at the level of the world market, relating to the capitalist system as a whole, not simply to monopolies on a national stage. The tendency towards monopoly is a natural result of competition and capital accumulation, and at first sight this tendency may appear to

have little to do with imperialism. Instead, the presence of large corporations dominating different areas of production, commerce and finance might be seen simply as a later phase of capitalist development with no clear dividing line from an earlier stage. However, Lenin is able to make such a distinction by referring to developments in the *world* market. His often-cited five basic features of imperialism make this clear:

'(1) the concentration of production and capital has developed to such a high stage that it has created monopolies which play a decisive role in economic life; (2) the merging of bank capital with industrial capital, and the creation, on the basis of this "finance capital", of a financial oligarchy; (3) the export of capital as distinguished from the export of commodities acquires exceptional importance; (4) the formation of international monopolist capitalist associations which share the world among themselves, and (5) the territorial division of the whole world among the biggest capitalist powers is completed. Imperialism is capitalism at that stage of development at which the dominance of monopolies and finance capital is established; in which the export of capital has acquired pronounced importance; in which the division of the world among the international trusts has begun, in which the division of all territories of the globe among the biggest capitalist powers has been completed.' (Lenin, 1976a, p. 700)

This is a multi-faceted description, yet it is clear from points (4) and (5) that Lenin's definition of imperialism involves the control of the *world* economy by groups of monopolistic companies - not simply monopolised production in particular countries - and also a hierarchy of nations in the world economy, with the 'biggest capitalist powers' dominating. The mechanism of control, elaborated with many examples in Lenin's pamphlet, is where monopolistic companies can exert power over the operation of markets, whether by price fixing, by driving out competitors or by other means. These methods, in Lenin's analysis, are propagated throughout the world economy via a new form of capitalist organisation that combines bank and industrial capital, 'finance capital' (a term borrowed from Hilferding, see Section 2.4), one that is also bound up with the export of capital and the state's seizure of colonies or the domination of weaker capitalist countries.

For Lenin, the economics of imperialism is distinguished not by monopoly *per se*, but by monopolistic features of the *world* economic system. The role of the state is important here too, because of the uneven development of world capitalism. More economically developed countries will tend to have more productive companies that are larger and stronger in the world market, and some states will tend to have bigger resources than others. Lenin's five features were posed as the key aspects of a single imperialist reality, not as independent factors. Although Lenin's *Imperialism* pamphlet is subtitled 'A Popular Outline', it is important to note that it was based on extensive research, compiled in the 800 pages of the 'Notebooks on Imperialism' (Lenin, 1976b). In the years ahead of writing the pamphlet Lenin had also made an extensive study of philosophy, including Hegel's *Logic* (Lenin, 1972).

Following the outbreak of war in 1914 and the collapse of the Second International, he aimed to clarify his concepts about the nature of modern capitalism and the related class issues.

In this and the next section, I will take issue with some aspects of Lenin's characterisation of the economics of imperialism. I agree with the centrality of monopoly to the concept of imperialism, but Lenin's view of how this works, and the relationship to finance, needs to be both developed and amended in order better to understand the development of imperialism today.

Firstly on monopoly, it is worth contrasting Lenin's views with those of Bukharin, the principal economist of the Bolshevik Party. Lenin wrote an approving introductory text for a book on imperialism by Bukharin, in December 1915, before writing his own *Imperialism*. That text appeared to endorse Bukharin's views, although this text only noted in general terms the rise of monopolies and its focus was on attacking Kautsky and other political opponents. In his *Imperialism and World Economy*, however, Bukharin made a number of extreme claims, based around the notion that there was 'a very strong tendency towards transforming the entire national economy into one gigantic combined enterprise under the tutelage of the financial kings and the capitalist state, an enterprise which monopolises the national market and forms the prerequisite for organised production on a higher non-capitalist level.'

(Bukharin, 1973, pp. 73-74; emphasis in the original). Later, Bukharin states that:

'State power has become the domain of a financial oligarchy; the latter manages production which is tied up by the banks into one knot. This process of the organisation of production has proceeded from below; it has fortified itself within the framework of modern states, which have become an exact expression of the interests of finance capital. Every one of the capitalistically advanced "national economies" has turned into some kind of a "national" trust.' (p. 108)

These ideas were superficial generalisations that depended upon extrapolating the previous formation of cartels, the close links between banks and industry in Germany, Russia and Japan, and the exigencies of the war economy after 1914. The notion of one national 'gigantic combined enterprise' corresponded to no actual development and contradicted fundamental features of capitalism, given its basis in private property and its expression in markets. Bukharin's implied conclusion was that 'state capitalist trusts' could eliminate crises in the national sphere, leaving competition only to the international sphere (Bukharin, 1973, pp. 123-4). In later, private comments, Lenin clearly differed with this view (Cohen, 1980, p. 35).

Lenin's approach to the question was different from Bukharin's, if not completely the reverse. As Lenin's own summary definition of imperialism indicates, especially point (4) on 'the formation of international monopolist capitalist associations which share the world among themselves', he sees the dynamic originating from capitalist companies who are major players

in the market. The logic is not, as Bukharin proposed, for a single state capitalist entity to form in opposition to other states, but for the big corporations in the world economy to do deals with each other. However, these deals are *unstable relationships*, given the uneven pattern of capital accumulation and commercial advantage, plus economic and political changes, especially when the world economy has already been divided up into colonial trading blocs that give no other outlet for capitalist business. In this case, a redivision of economic power and influence results in war:

'The capitalists divide the world, not out of any particular malice, but because the degree of concentration which has been reached forces them to adopt this method in order to obtain profits. And they divide it "in proportion to capital", "in proportion to strength", because there cannot be any other method of division under commodity production and capitalism. But strength varies with the degree of economic and political development. In order to understand what is taking place, it is necessary to know what questions are settled by the changes in strength. The question as to whether these changes are "purely" economic or non-economic (eg military) is a secondary one, which cannot in the least affect fundamental views on the latest epoch of capitalism.' (Lenin, 1976a, p. 689)

Lenin did not need to spell out the point that different states would go to war to defend the interests of their capitalists when he was writing in the middle of World War One. He focused on the economic backdrop to that conflict – a change in the economic relationships of the major powers that also changed the balance of forces (Lenin, 1976a, p. 706). The key relationship that is not dealt with clearly by Lenin, however, is that between states and their corporations or monopolists. Where critical business interests for the corporations based in a particular state are threatened, then this also threatens the economic viability of that state, as noted in Section 2.1. So, one would not expect that state to 'go gentle into that goodnight' as its capitalists lose in competition, especially if that competition is deemed to be 'unfair' or aggressive, but instead to 'rage, rage against the dying of the light' (Thomas, 1951). However, there is not a simple identity of interests between monopolists and 'their' state, a point that can be seen by considering the national and international policies of the state towards monopoly. This will also bring out the error in Bukharin's 'state capitalist' perspective.

Monopoly power is presumably good for the monopolist, but it may be less so for the national economy in which it operates. Hence, there is usually a state policy against local monopolies and cartels, complete with legislation or regulatory bodies to limit the abuse of market power. This is a rational move on the part of state authorities for the working of the domestic capitalist system, since a stranglehold over the supply of key commodities and services by a few companies could be damaging for all the others. Marx had already noted in *Capital* that the establishment of monopolies in certain spheres had provoked 'state

interference' (Marx, 1974c, Chapter 27, p. 438). Probably the most famous early example was the Sherman Antitrust Act of 1890 in the US, although it took other state measures to limit the power of Rockefeller's Standard Oil, a trust that refined 80% of the national US oil output and overwhelmingly dominated the production, transport and markets for a range of other oil and energy products (Yergin, 1990, pp. 107-110). There have been further 'anti-monopoly' policies in the US in the past century, and in other countries that have agencies to investigate and legislate on market power. One is the UK's optimistically named Competition Commission, a successor to its Monopolies Commission. Yet these have done little to prevent a fairly steady drift towards further monopoly power. A fascinating book on such power, based on evidence from US Senate sub-committee hearings, dating back to the 1957-62, uncovered widespread market manipulation in US domestic industries as diverse as autos, steel, pharmaceuticals, bakeries and defence (Kefauver, 1966). There has been no such work published for the UK, apart from some low-key reports from the Office of Fair Trading. One of the most extreme examples of monopoly today is in South Korea, which local people dub 'the Republic of Samsung'. The latter company's conglomerate structure, from road construction to oil rigs, to hotels, insurance and smart phones, accounts for a fifth of national output (Harlan, 2012).

In many other countries, state-backed rescues of companies or sectors in crisis, from shipyards to banks, have also involved promoting mergers and takeovers. This suggests that despite what may be a formal anti-monopoly stance in state policy, there remains an overriding logic from the process of capital accumulation towards the formation of yet more monopolies. Even when there has been the 'privatisation' of formerly state owned industries and services, often presented as a move to promote competition and efficiency, the result has been that the state has given the contract, or sold most of the shares in the original company, to one of a small number of major private corporations.

The concern a particular state might have about market domination in the domestic sphere does not extend to the operations of its companies in the *international* market. On the contrary, large companies get significant backing from their states for expanding their foreign business. The logic here is that the consequence of any exercise of monopoly power is another country's burden, one that might even favour the home country via the improved profitability of the domestically based company. Apart from any technical cost advantages that might result from larger-scale global operations, international expansion also enhances the global market position of the company, boosting its monopolistic power.

Perhaps the only exception to this lax international policy is where EU member states have adopted an anti-monopoly policy *within the EU area*, as a means to promote a large single market that is considered to be in member countries' joint interests. Hence, there have

been (limited) official measures against price fixing in the EU, as detailed in a study of some 20 cartels (Harrington, 2006). Harrington notes that these cases were the most egregious examples, and hence the ones discovered by official investigators. The likelihood is that there were many others operating under the official radar.

The result of the trend towards monopoly is that the worldwide production of most of the key products and the provision of most of the key services of modern capitalism is today dominated by a small number of companies. Fewer than 10 or so companies often control the bulk of *global* activity in particular products and services, despite the further opening up of the world market in the past 30 years. To give some examples:

- Nearly one-third of global motor vehicle production in 2011 was attributable to just three companies: General Motors (US), Volkswagen (Germany) and Toyota (Japan). Thirteen companies accounted for three-quarters of output (calculated from OICA, 2012).
- Two US companies, Lear Corporation and Johnson Controls, account for the bulk of the supply of automotive interiors, following a string of acquisitions in Europe and Asia. In China, Johnson Controls in 2012 was reported to have 44% of the automotive seating market (Forbes, 2013).
- Four companies controlled some 65% of the global elevator and escalator market in 2012, one American and three European (Trefis, 2013). Otis Elevator, the largest, is itself owned by United Technologies, the huge US military contractor and engineering corporation.
- In the case of beer, so to speak, in 2009 just four companies provided over half of the world's consumption (Jones, 2010).
- Glencore, the largest Swiss company and a constituent of the FTSE100 equity market index, ahead of its merger with Xstrata in May 2013 'controlled more than half the international tradable market in zinc and copper and about a third of the world's seaborne coal; was one of the world's largest grain exporters, with about nine percent of the global market; and handled three percent of daily global oil consumption' (Silverstein, 2012).
- For mobile phones, a more recently developed market, the degree of monopolisation is little different. In 2010, six companies accounted for just over 60% of global sales (Gartner Research, 2010).
- In the financial sphere, one indirect measure of global monopoly power can be taken from how concentrated the sector is in countries whose banks play a big role in the

international markets. In 2011, the share of total assets of the *top three* banks in the following countries was: US, 40%; UK, nearly 80%; Germany, nearly 70% (Haldane, 2012, p. 3, p. 14). A more direct measure is available for the global foreign exchange market: 10 banks accounted for nearly 80% of business in 2012 - four from the US, three from the UK, two from Switzerland and one from Germany (Euromoney, 2013).

The monopolistic corporations of the world are far from being equally distributed among countries. An UNCTAD report showed that of the top 100 international non-financial corporations, ranked by total assets in 2008, 75 had a 'home' in just six countries: the US, UK, France, Germany, Japan and Switzerland (UNCTAD, 2010, Annex Table 26).

The monopoly plot thickens when allowance is made for the links between different corporations, or when the position of a company is not measured by the share it has of its particular market, but by the degree of ownership it also has of other companies. One fascinating study used a network analysis of the ownership links between some 43,000 transnational corporations based in 116 countries in 2007 (Vitali et al, 2011). Using the assumption that owning 50% or more of a company's equity, directly or indirectly (through subsidiaries, etc) implied control, it found that *less than half of one per cent* of these companies – principally financial, but also non-financial companies – controlled an astonishing 40% of the world's international corporations measured by market value.

Monopoly power of capitalist corporations is evidently a key characteristic of the world economy. While states do not necessarily support monopolistic power within their own national territories, they do support their 'own' large corporations in their dealings in the world market. This can range from assisting in the protection of 'intellectual property rights', usually meaning patents owned by domestic companies, to leading trade delegations of major companies wishing to enter foreign markets. Such methods of trying to secure profits are not necessarily any different from 'normal' capitalism, but because the methods are played out on the international stage with powerful states in support of monopolistic companies, this becomes a defining feature of an imperialist world economy and is part of what I would term the economics of imperialism.<sup>5</sup> It is not the whole picture, however. There is another important dimension, one that is far less evident and which is the subject of this thesis: imperialism and finance. Sections 2.4 to 2.6 focus on this topic, bringing out the links between monopolies, state power in the world economy and the economic advantages an imperialist power, and its companies, can gain.

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<sup>5</sup> The argument here is not that monopolistic tendencies in business and commerce eliminate competition and innovation. Recent years have seen many innovations, especially in consumer technology. The point is that competition takes different forms from pure price competition and big companies have the upper hand when it comes to funding research and maintaining market power, for example through fighting legal battles over patents (see Palmer, 2012).

## 2.4 Hilferding's concept of 'finance capital'

Lenin's depiction of the relationship of finance to imperialism was a more important weakness in his analysis for the purpose of the current discussion. Here I will examine imperialism from the perspective of finance.

Point (2) of Lenin's summary description of imperialism, 'the merging of bank capital with industrial capital, and the creation, on the basis of this "finance capital", of a financial oligarchy', was taken from Hilferding's conception of finance capital (Hilferding, 1981), one that Bukharin also adopted. Although Lenin disagreed with Hilferding's political outlook, and noted that he (almost) ignored the division of the world and 'the relationship between finance capital and parasitism' (Lenin, 1976b, p. 202), Lenin agreed that there was a 'merging' of bank capital with industrial capital.

Hilferding's concept of finance capital does not simply argue that banks invest money in industry and end up controlling the economy; his *Finance Capital* is a rich discussion of contemporary trends. However, his many comments on the banks' financial power and banks investing in industrial companies do support this narrow interpretation. Even when Hilferding notes the lower dependence of industry on bank capital in England, because 'the public does directly what is done by the bank' when purchasing industrial shares, he immediately moves on and says that:

'An ever-increasing part of the capital of industry does not belong to the industrialists who use it. They are able to dispose over capital only through the banks, which represent the owners [of this capital].'(Hilferding, 1981, p. 225)

In England's case, at least, the banks were far from being the key owners, or the only representatives of capital. However, Hilferding broadens out the view of only the banks being in control by arguing that 'with the increasing concentration of property, the owners of the fictitious capital which gives power over the banks, and the owners of the capital which gives power over industry, become increasingly the same people' (p. 225). So, while he does focus on bank power, it is the class of fictitious capital owners who control the banks, and this class of people have close personal connections with owners of industrial capital. Nevertheless, because it is the finance capitalist who 'increasingly concentrates his control over the whole national capital by means of his domination of bank capital' (p. 225), this still places the banks at the centre of the process.

This formulation is wrong. Firstly, he appears to be distinguishing a 'fictitious capital' ownership of the banks from a 'capital ownership' of industry. But the owners of industrial companies are the owners of its equity capital, usually in the form of quoted financial

securities that are fictitious capital.<sup>6</sup> Secondly, the owners of fictitious capital in industrial companies do not have to secure this ownership indirectly by owning fictitious capital in banks. He may here be referring to owners of *bank deposits*, deposits that the banks use for industrial investment. But this confuses fictitious capital with bank deposits, it does not allow for the banks' ability to create their own deposits and it implies that money capitalists do not use their own bank deposits for industrial investment. Hilferding correctly focused on fictitious capital as a key feature of monopoly capitalism, but in doing so he elevated banks, which are *dealers in* as much as *owners of* fictitious capital to the position of having complete *power over* capital. For this reason, he could argue that 'taking possession of six large Berlin banks would mean taking possession of the most important spheres of large-scale industry' (Hilferding, 1981, p. 368).

Hilferding's position on finance capital is usually criticised because it did not apply to the UK, the most prominent imperialist power. Large British companies did not depend upon bank finance for long-term investment since they were profitable enough to finance themselves for this purpose – helped by captive Empire markets. Hilferding was well aware that this implied a different relationship between banks and industry in the UK, one where banks mainly provided financial services to UK companies – selling their shares on the equity market, providing them with short-term credits, trade finance and so forth (Ingham, 1984, pp. 33-35). Nevertheless, this criticism of Hilferding is inadequate, because it does not allow for the fact that his model did appear to apply well to Germany (his main example), the US, France, Russia and Japan. The first two countries were second and third, behind Britain, and the remainder were numbers four to six in Lenin's list of the top imperialist powers (Lenin, 1976, p. 202). Five out of six is not a bad mark.

However, a closer examination of this point sharply reduces the score. Hilferding's concept of finance capital is defined from the perspective of the *national* economy. He argues that the monopolisation process results in a block of capital, 'finance capital' managed by the banks, the owners of which favour a powerful state that can implement their wishes at home and, especially, abroad (Hilferding, 1981, pp. 334-335). He takes the international capitalist economy into account, but he does not relate the form taken by 'finance capital' to the position that each country has in the world market. This means that his concept does not include Britain, and it also leads to a one-sided understanding of what was going on elsewhere. British-based capital, with Britain being the first industrial country and the one with a huge commercial empire, was under far less pressure to form cartels and trusts, or to develop strong links between banks and industrialists, in order to compete against rivals. The situation was

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<sup>6</sup> Privately owned companies do not have publicly quoted securities, but they are usually much smaller enterprises than the monopolistic companies.

different for capitalists in countries that were newer entrants into the world market. Even so, their formation of trusts, etc, did not necessarily imply that the banking arm of the group was in control. Japan's *zaibatsu* (Mitsubishi, Mitsui, Sumitomo, Yasuda) were extreme examples of a linked group of companies, with intra-group cooperation and cross-shareholdings between heavy industry, light manufacturing, insurance, trading and banking. The bank was important for mobilising capital in these groups, given its role in credit markets, but it was not necessarily the one running the group: it depended on business from the other companies as much as they depended on its funds and financial services. In the case of the US, although JP Morgan's business portfolio seemed the quintessential bank-dominated form of finance capital, his rival Rockefeller had financial operations that grew out of the huge profits from his monopoly of the oil business.

Hilferding's perspective prevented him from seeing *fictitious capital*, not 'finance capital' dominated by banks, as the common factor in all these forms of capitalist organisation. His coverage of fictitious capital started out by developing Marx's analysis from the fragmentary comments in *Capital* into a full discussion of the role of the stock market (Hilferding, 1981, Chapters 7 and 8). However, it ended up on a narrow path by focusing on the banks' role in company share flotations. He introduces a new concept here, 'promoter's profit', but that discussion also reveals a lack of clarity about what was happening.

Promoter's profit for Hilferding was based on 'the conversion of profit-bearing capital into interest- (or dividend-) bearing capital', where the rate of profit is higher than the rate of interest (Hilferding, 1981, pp.111-112). A simple example to illustrate this is where a company needs \$100m for its capital investment, its profit rate is 10% and the rate of interest is 5%. A further assumption is that the dividend return on equities is the same as the rate of interest, because the equity investment by money capitalists buying the shares is seen as a form of investing money-capital. In this case, \$200m of the company's shares could be sold on the market, but it need only invest \$100m in order to make the \$10m, or 10%, profit that would pay 5% on the equity issued. The remaining \$100m is 'promoter's profit'. The new equity owners merely earn the (lower) rate of interest on their shareholding, while the \$100m of surplus funds flowing in from the equity issuance can be used by the original owners, either as personal wealth and income (if they sell some shares) or to expand their operations. This is basically Hilferding's argument. It captures an important aspect of fictitious capital formation in share flotation – the potential for the company's owners to boost their wealth dramatically by 'going public' – but in his exposition it is the *banks* that get the extra funds.

Hilferding must have assumed that the banks were the ones owning the company whose shares are being floated, so they benefited from the inflation of equity values. In some cases he does; in others he implies that the banks are earning a promoter's profit simply from

issuing the shares (Hilferding, 1981, p. 128). This mixes up the revenues from fees that a bank will receive from the company whose shares are floated on the market with his original concept of promoter's profit, a confusion that results from his obsession with banks. In another place, although using the term 'money powers' rather than banks, he argues that:

'Capitalist property used to arise essentially from the accumulation of profit, but the creation of fictitious capital now opens up the possibility of promoter's profit. By this means, a large part of the profit is channelled into the hands of the great money powers, who alone are in a position to give industrial capital the form of fictitious capital. This profit does not flow to them in the way dividends are paid to shareholders, in the form of fragmented annual payments, but is capitalised as promoter's profit, and received in the form of money, both relatively and absolutely considerable in amount, which can immediately function as new capital. Thus every new enterprise pays, from the very outset, a tribute to its promoters, who have done nothing for it and need never have any dealings with it. It is a process which is always concentrating large new sums of money in the hands of the big money powers.' (Hilferding, 1981, p. 142)

To claim that 'a large part of the profit' accumulates in the hands of the banks, as a 'tribute' based upon a string of equity market flotations, is surely a mistake. A much more representative scenario is where the banks get tens of millions in fees for floating the shares, but the *founders* have their wealth boosted by billions. The 2012 Facebook flotation, for example, raised \$16 billion for the company, which paid less than \$200m to the banks organising it (bank fees are usually from 1% to 4% and this was at the low end of the range). This initial flotation turned *all* the shares, not just the ones newly issued, into assets priced on the market and this gave Facebook a market capitalisation in excess of \$100bn (Spears, 2012). As a result, Mark Zuckerberg and the original founders/owners accumulated tens of billions in new financial wealth. Hilferding was more accurate in saying that 'large new sums of money' arise from the creation of fictitious capital. But even this ignores the point that the equity assets owned do not need to be turned into cash in order to function as new capital.<sup>7</sup> The equity assets can directly act as *collateral* for new loans, or often as a *means of payment* in acquisitions of other listed companies.

These criticisms of Hilferding's 'finance capital' concept point to the need to define more clearly the role of *fictitious capital* under monopoly capitalism. Setting this out is an important step in clarifying the 'economics of imperialism' as it relates to finance.

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<sup>7</sup> Hilferding sometimes gives the impression that banks receive the promoter's profit in the form of money because the funds advanced by the buyers of the equity issue end up inside the banking system. However, these funds would have been in the banking system at the start of the process. He does not discuss the process of bank credit creation, so he is unlikely to be referring to this mechanism.

## 2.5 Fictitious capital, money capitalists and financial power

The accumulation of capital implies the tendency to monopolisation, the growth of the world market and the evolution of the financial system. Capitalist companies have a growing need for different forms of finance, including commercial credit to facilitate the buying and selling of commodities, foreign exchange dealing to facilitate international trade and borrowing funds both for working capital and for long-term investment. At a certain stage in this development, fictitious capital becomes a key part of the financial system.

Marx uses the term 'fictitious' for this type of capital because the form of capital to which it refers is actually a financial security, not real, invested capital. In the case of government debt securities, the securities' price is not necessarily based on *any* existing capital at all, but only on the ability of the government to service and repay its debts. In the case of a private capitalist company's debt or equity securities, the owner of the security will have some claim on the company's assets, but the *price* of the security will not reflect that. For private debt securities, the price will be calculated as for government bonds, as a function of the discounted cash flows from coupon and principal repayments (including a risk factor). For equity securities, there is no repayment of principal (although the security may be sold on the market), and the security's price is derived as the discounted value of (expected) future dividend payments. If the company goes bankrupt, then the price will reflect the value of the assets remaining to pay off the company's liabilities to the security holder. The price of the security does not reflect the value of the company's assets, except that the value of company assets will tend to set a lower bound for the security's price. *Ceteris paribus*, if market interest rates rise, the discount rate on the expected future cash flows increases and the price of the security falls, and *vice versa*. The sum of money the security can fetch on sale is not a simple reflection of the value of any invested capital, and perhaps no reflection at all.

The price of the fictitious capital security nevertheless reflects the command that its owner has on social labour. This occurs in two ways. Firstly, there is a power potentially given to a creditor over the property of debtors, implying some form of control by the creditor, whether as a bondholder or as an owner of a company's equity. Even if there is no such power – for example, if an equity holder has negligible voting rights over company decisions – then the owner of the security still has a liquid asset that can be sold for cash on the market. This is a second form of command over social labour that comes from having monetary wealth. The peculiarity of fictitious capital is that it is a form of previously invested money-capital (committed for months, years, or, as with equities, indefinitely), but it remains a (relatively) liquid asset and can be turned back into money, used as collateral for loans or used as a form of money in other deals.

Fictitious capital assets – financial securities – represent an important evolution in the form of value, with striking effects on the dynamics of capital accumulation because they are a development of the credit system that goes beyond simple bank loans. Marx summarises a number of these effects in his notes on the formation of joint-stock companies: by issuing shares to attract new funds for investment, companies can grow to a scale formerly impossible for individual capitalists; this process 'is the abolition of capital as private property within the framework of capitalist production itself' because capital is 'endowed with the form of social capital'; the owner of capital becomes 'a mere money-capitalist' investing in the enterprise, while the managers are now administrators of other people's capital; such a system reproduces both monopolies and 'a new financial aristocracy, a new variety of parasites in the shape of promoters, speculators and simply nominal directors; a whole system of swindling and cheating by means of corporation promotion, stock issuance, and stock speculation' (Marx, 1974c, Chapter 27, pp. 436-438).

In Marxist value theory, money-capital is seen at each end of the sequence for the circuit of industrial capital:  $M - C \dots P \dots C' - M'$ . However, in the later stages of capitalist development, the  $M$  term has a far more complex relationship to the production of value and surplus value than this simple scheme would imply. For Marx, and also as shown by Hilferding, money-capital, via the formation of fictitious capital, acts as a new force in society. Fictitious capital, as part of the credit system, gives a new momentum to capital accumulation, one subject to financial booms and busts and one that also develops into a 'colossal form of gambling and swindling' as the gap grows between the ownership and control of capital (Marx, 1974c, Chapter 27, p. 441).<sup>8</sup>

In this process, capitalists tend to become 'mere money-capitalists' rather than the active capitalists depicted in the cartoon versions of the fat, cigar-chomping, 19<sup>th</sup> century industrialist whom Marx nicknamed 'Moneybags'. However, the money-capitalists are not just bankers, but a diverse group that emerges from this evolution of the form of value in monopoly capitalism. This group includes the stratum of rich individuals who manage their own assets, boards of directors of the major corporations, the managers of investment funds and other financial institutions. Among the rich individuals are the so-called oligarchs in Eastern Europe who have gained control of their country's assets, and other *nouveaux riches* who have 'risen without trace' after being in a position to get political favours that often include directorship/ownership of former state-owned companies. As capitalist society's productive assets, and even its non-productive (in value terms) assets, take the form of

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<sup>8</sup> Chapter 3, Section 3.4, discusses further the relationship of fictitious capital values to value production.

financial securities, this facilitates the concentration of economic wealth and power, especially through company mergers and takeovers as noted in Section 2.3.

In a recent discussion of the concept of finance capital, Hoca defines it as 'commodified capital, which circulates in financial markets and is controlled by the class of finance capitalists mainly through financial institutions, and monopolises industrial capital by constituting a large and increasing part of it, especially after crises' (Hoca, 2012, p. 428). By 'commodified capital', Hoca refers to Marx's comments on capital itself becoming a commodity, whether as loan capital or as a claim on capital in the form of fictitious capital (p. 425). His definition is an improvement on Hilferding's view of finance capital, but other important distinctions need to be made when assessing the role of finance.

Firstly, although the source of surplus value is the exploitation of workers by industrial capital (used as a short-hand term for all forms of *productive* capital), the revenues accruing to owners of fictitious capital, or indeed to loan capital, do not have to come *directly* from industrial capital. It is a consequence of the way in which the credit system obscures value relations – 'money creates money' – that owners and controllers of financial assets of all kinds need pay no attention to whether the returns on these assets are claims on industrial capital, on commerce, on the financial sector or from the government. Notably, in the financial debacle of the late 2000s, a key part of the explosion of financial asset holdings was in the form of Collateralised Debt Obligations that were securities with a claim on future *residential mortgage payments!* As the latter episode suggests, ignoring the productive foundations of the source of interest, profit and dividends can lead to problems. Nevertheless, this is a characteristic feature of contemporary finance. Secondly, capitalist financial operations do not simply comprise the ownership and control of 'commodified capital'. There is also the question of financial transactions, as the earlier note on bank fees from floating shares illustrates and as will be discussed further in Section 2.6. Thirdly, appreciating the fuller dimensions of fictitious capital and money-capital also means that one must recognise that it is not only the 'finance capitalists' or the 'financial aristocracy' who benefit from the revenues. A much broader stratum of society in the richer countries does too, although usually on a far smaller scale, as indicated by the widespread ownership of financial assets.<sup>9</sup>

The financial form taken by modern capitalism is not encompassed by particular financial institutions, but includes all types of capitalist company, intertwined with the role of the state in the domestic and international spheres. Capitalist individuals, companies and states express their economic power via their financial power, and especially in terms of how far they are able to marshal and control social resources. In this respect, I would argue that

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<sup>9</sup> This third point is somewhat tangential to the thesis, but evidence on the widespread holdings of financial assets in the US and the UK is included in Appendix 2.1.

fictitious capital - the tradable financial security - is the key common element of all aspects of modern finance. Equally, I would stress that fictitious capital is not solely owned and controlled by 'financial sector' capitalists, although most of this discussion covers the role of banks and financial companies in creating and trading financial securities. However, there is also a related, but separate, 'fictitious' form of capital that results from the ability of banks to create credit and other financial assets, and this latter issue is examined in more detail in Chapter 3.

## 2.6 Financial operations and parasitism

In this section, I discuss further aspects of the financial system in relation to Marx's theory of value. Examining the ways in which different financial institutions operate brings out more clearly the links to what in Marxist theory is termed 'parasitism'. This is necessary before going on to discuss the financial dimensions of imperialism and I will begin by outlining Marx's discussion of this issue.

Marx makes a key distinction between industrial and merchant capital. In the system of capitalist commodity production, the merchant capitalists perform the role of exchanging M into C, or vice versa, *as part of the circuit of industrial capital*. While the operations of merchant capital are unproductive of value, Marx determines the capitalists system's average rate of profit as the return on the investments of both the industrial and the merchant capitalists (Marx, 1974c, p. 338). Although they function very differently, the close interaction between these two forms of capital implies that a capitalist with operations in one function could easily transfer to the other, and the flow of capital would tend to equalise returns.

Merchant capitalists are involved only in the circulation process M – C – M', leaving out the central sphere of commodity *production*. Marx notes that this form of capital 'breaks up into two forms or sub-divisions, commercial capital and money-dealing capital' (Marx, 1974c, Chapter 16, p. 267). The former are focused on the buying and selling of commodities; the latter specialise in managing the different forms of money circulation that arise from the commercial function. The money dealers handle payments for the other merchants and for the industrial capitalists, including foreign exchange dealing and the discounting of commercial paper. Both of these latter items are advances of *money*, in exchange for a different form of money or for a security, not an advance of *capital* (Marx, 1974c, Chapter 19 and pp. 428–429). This is an important distinction, because it places these money-dealing items also in the

commercial buying/selling sphere. The charges for these services would also tend to give their operations an average rate of profit.<sup>10</sup>

The money-dealing function evolves, however, and Marx introduces another key concept from this development: interest-bearing capital.<sup>11</sup> Here, money is not exchanged for other forms of money or securities, but is 'turned into a commodity as *capital*' by being advanced as money capital to the 'functioning capitalist' who can use it to produce surplus value and who later returns the money back to the owner with interest (Marx, 1974c, p. 343). This leads to the formula for interest-bearing capital:  $M - M'$ . Marx also includes the merchant capitalist, not simply the industrial capitalist, as a potential recipient of funds from the money capitalist, but in both cases it is assumed that the loaned funds are invested as capital and gain a surplus value (p. 353). Even if the funds are not invested profitably, then the money capital still has to be repaid with interest. Marx's concept of interest-bearing capital is narrower than *all* loans of money capital for whatever purpose, but this is consistent with his aim in Volume 3 of *Capital* to analyse 'the process of capitalist production as a whole'.

The emergence of interest-bearing capital highlights the way in which the status of the individual capitalist is diminished and instead the power of money capital becomes decisive. In this explanation, Marx is clearly looking only at the capitalist form of finance, not at earlier forms of usury, and he notes that 'with the development of large-scale industry money capital, so far as it appears on the market, is not represented by some individual capitalist, not the owner of one or another fraction of the capital in the market, but assumes the nature of a concentrated, organised mass, which, quite different from actual production, is subject to the control of bankers, ie the representatives of social capital' (Marx 1974c, p. 368). This particular formulation goes too far, however, and elsewhere Marx notes more accurately that the banks, having developed out of the money-dealing function of the merchant capitalists, become the 'general managers of money capital' and 'confront the industrial and commercial capitalist as *representatives of all money capitalists*' (emphasis added, p. 402). This is because banks derive their funds from industrial and commercial capitalists, from the deposits of money capitalists and from the idle money of all classes. Banks clearly do have power over money capital, since there are millions of depositors who will have little idea how the banks might use their funds. Individually, their deposits cannot act as money capital, and they can only become money capital after the banks aggregate these deposits into loanable sums. As Marx notes, this is doing more than just acting as a middleman between the money

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<sup>10</sup> Fine 1985-86 discusses the distinction between money-dealing capital and interest-bearing capital.

<sup>11</sup> Michie 1992 discusses the history and development of the City of London and implicitly endorses Marx's analysis of this transition from commerce, to credit and interest-bearing capital, although he makes no reference to Marx in this work.

capitalist and the borrower.<sup>12</sup> However, even this formulation ignores that money capitalists, while they keep funds in banks, will also have control over their funds and other assets and will not necessarily depend upon banks to act for them.

Banks and other financial institutions frequently have operations that combine the two distinct functions of providing commercial money-dealing services and of advancing interest-bearing capital. The value aspects of the different financial operations should be seen as depending not so much upon the particular acts performed as upon the role they have in relation to the circuit of industrial and commercial capital. When they are part of that circuit, the capital advanced for them can be seen as participating in the equalisation of profit rates, otherwise not (a topic further discussed in Chapter 3). However, it can still be debatable conceptually whether some financial activities fall under one heading or the other. The following discussion gives my views on how to characterise such operations:<sup>13</sup>

- **Bank money-dealing** activity is relatively clearly defined, consisting of dealing in short-term money market instruments (certificates of deposit, commercial paper, etc) and foreign exchange dealings (in spot, forward and swap deals) for industrial and commercial companies. However, banks managing deals of this kind also take on market risk of their own, and their dealings usually evolve into taking 'proprietary positions' that have little to do with customer business, in which case the money-dealing capital heading is no longer really applicable. Bank foreign exchange deals, for example, are also with financial institutions, not simply with industrial and commercial companies. If banks make longer-term loans for investment, that is under the separate heading of advancing interest-bearing capital. If a bank invests in a company's bonds or equities, then this is an alternative means by which it can advance money capital, but this is unusual on any significant scale, despite Hilferding's views. Where banks issue new securities – bonds or equities – in the market for a fee, or buy and sell securities already issued, is that money-dealing? I would argue that it is not. Even though banks may buy these securities, this would not normally be the means by which companies get cash for their *ongoing* operations. It is not the same as a bank paying a discounted cash value for commercial paper. When banks buy or sell these securities, then they make a dealing margin and they might also profit from a rise or fall in the price of the security. But these revenues are more properly put under the heading of the returns from dealing in interest-bearing capital, not to money-dealing capital in Marx's sense.

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<sup>12</sup> Furthermore, the banks also have power over money capital in their ability to create deposits, a topic discussed in Chapter 3.

<sup>13</sup> Ingham's table of City functions and his discussion of their commercial or financial character is a useful starting point for the analysis that follows (Ingham, 1984, Table 2.3, p. 61).

- **Broker** business might also fall under the heading of money-dealing: getting a fee for connecting the actual buyers and sellers of securities and for giving advice on the market. Brokers are often, though not always, incorporated into bank operations. The more important part of the broking operations in modern capitalism are in the **financial exchanges**, whether stock exchanges or futures and options exchanges, but the important members of these exchanges nowadays are banks. Yet, these broking activities would not really fall under the heading of money-dealing, since the securities that they trade are normally based on interest-bearing capital. The bulk of their activity is not offering commercial money-dealing services to industrial and commercial corporations.
- **Asset managers**, including hedge funds, control large sums of fictitious capital – which may be a claim on private or on state revenues – but they are doing so as managers of other people's money. They sell their financial services for a fee that is usually taken as a percentage of the value of assets held, not as a return from those assets (which could even be negative), although hedge funds will also take a share of the profits made by the fund. Hence they are advancing money capital on behalf of others, although this still gives these asset managers a social power. Their fees are for a service provided to money capitalists and other providers of loan capital, and their operations should be considered as being under the heading of interest-bearing capital.
- **Insurance companies** can be viewed as being in the commercial sphere, but there is also an overlap with operations of interest-bearing capital since they are investing in financial securities. They take in payments for providing financial services and invest these revenues in financial securities and other assets to generate the funds to pay for claims from policyholders. Individuals or companies may hold the policies. The value-categorisation of insurance is tricky, however, because it also depends on the nature of the insurance. For example, the insurance policy may be for the assets of a capitalist company or for the personal property or life of a worker. In the former case, the insurance premiums should be considered as a deduction from surplus value and the policies' payouts simply a redistribution of surplus value (Marx, 1972, pp. 357-358). In the latter case, the workers' insurance premium payments can be considered to be part of the wage or value of labour power if they are a normal part of living costs, while the policies' payouts are a repayment compensating for loss. In this latter case, workers' savings have become 'metamorphosed into capital' as they are returned to the control of capital by the insurance companies - and also by pension funds, considered next (Harris, 1976, p. 165, p. 170).

- **Pension funds**, as insurance companies, can be seen as operating in both the commercial financial services and the interest-bearing capital sphere. They use regular incoming payments to invest in a variety of assets, principally fictitious capital, and use the revenues obtained from these to pay pension incomes. Like insurance companies, but on a much larger scale, these funds also have considerable power in their ability to allocate money capital to different fictitious capital assets - government bonds, corporate bonds, the equity of companies in a variety of sectors - or to property or anything else that appears to offer an attractive future return. As in the case of the premium payments made to insurance companies, the pension savings of individuals become metamorphosed into capital and are controlled by capitalist companies. In the 2000-2011 period, pension funds invested in commodities, via derivatives, and this was one factor behind the sharp rise in a wide range of commodity prices (Norfield, 2012, pp. 118-120).

This discussion points to the broad definition of 'finance' that I will use in this thesis. Within the category of finance, I include *everything* that arises from the evolution of money-dealing in capitalist society, both the pure money-dealing capital forms, where money is exchanged, where money is advanced as capital and where it takes the form of fictitious capital.

On the side of money-dealing capital, I include the provision of short-term commercial credit by banks to industrial and commercial companies, such as dealing in commercial paper and other money market instruments, the provision of trade finance, and where banks provide foreign exchange or other financial services to companies. The second area of finance I include in my definition is those operations that derive revenue from advances of money-capital. This includes the relevant operations of banks, including dealing operations, plus the asset managers and brokers dealing in fictitious capital. The activities of insurance companies and pension funds fall into both camps, and they can obviously exert market power since they are in control of a large volume of money capital.

Marx uses the term interest-bearing capital to refer to loans made to industrial (and commercial) companies, who will then repay the loan plus interest. However, Marx's wider concept of 'loanable money capital' is also relevant here. This comprises the total mass of funds available for lending, not distinguishing to whom they are lent and whether or not the funds are used productively (Marx, 1974c, Chapters 31 and 32, p. 503, p. 507). The banks have access to such funds, given their privileged position in the monetary system, where they are the sole takers of deposits from the public and can get liquidity from the central bank. However, a notable development from the 1990s was where corporations began to sideline banks as major external providers of long-term investment funds. Instead, the development of

capital markets enabled the corporations to issue bonds to investors to get the required funds; the banks' lending operations could not compete with this (Berlin and Mester, 1996).

Although the bond flotation was done through investment banks, these latter banks earned a fee from the flotation rather than interest on a long-term bank loan. Banks are still called upon by corporations to provide investment funds, but their contemporary role is very different from what Hilferding described. Hence the question of who provides investment finance is answered not only by the banks but also by a range of other providers of money capital – from rich individuals to a variety of non-bank financial institutions.

Banks also create so-called derivative securities that they trade in the market, a special class of security whose price is a complicated function of the price of the underlying security, or of the exchange rate, interest rate or commodity price to which it refers (Norfield, 2012). The economic rationale for derivatives being used by industrial and commercial companies is as a form of price insurance, although the bulk of trading in these instruments is speculative. By providing a market in financial securities and derivatives, banks and other institutions, such as stock exchanges and futures exchanges, increase the liquidity of fictitious capital, or the ability to turn a security into cash with little loss of value. This accentuates the *money-capital* dimension of the process. I would argue that the derivatives relating to equities and bonds should be under the interest-bearing capital heading, since they are essentially transactions in fictitious capital at one remove. The derivatives that relate to money-dealing capital operations, such as derivatives on exchange rates, money market interest rates or commodities, could possibly be seen as having more of a money-dealing capital element. But it would have to be recognised that the bulk of trading by banks is speculative or to manage their own books, not to transact with industrial and commercial companies.

Having examined different aspects of contemporary finance with Marx's theory of value, the next question to examine is the relationship between finance and 'parasitism'. Marx first introduces the term halfway through Volume 3 of *Capital*, when discussing the 'financial aristocracy' – a 'new variety of parasites' (Marx, 1974c, Chapter 27, p. 438). Hence there is a longstanding link in Marxist theory between finance and parasitism, one followed up by Hilferding and Lenin. Given that the financial sector is not productive of value, it obviously makes sense to cast 'finance' as being parasitic on the productive sector of the economy (although it should not be forgotten that the source of the latter's surplus value is the exploitation of productive labourers). However, it may seem surprising that Marx did not discuss the issue earlier when covering the merchant or commercial capitalists, since they buy and sell the commodities of the productive capitalists and take a dealing margin. They produce no value and their costs and profits are deductions from the total social value produced. Are they, therefore, also parasitic?

Marx's view was that merchant/commercial capital was not parasitic. His logic was based on the distinction between commercial and money-dealing capital on one side and interest-bearing capital on the other. The former is unproductive, but intertwined with the industrial circuit and facilitating it. The latter is also unproductive, but it is outside the industrial circuit and instead has a distinctive  $M - M'$  circuit. For example, even though a bank's loan of funds for investment will obviously have an impact upon the accumulation of capital, it is the industrial and commercial capitalists who are doing the production and circulation of commodities and the money-dealing capitalists who are assisting the circulation process. The bank's advance of money-capital as interest-bearing capital is outside that circuit, and the deduction of interest from surplus value is parasitical. The capitalists advancing the money capital in this way are the social stratum of parasites in Marx's sense. Clearly, he is not talking about an individual with some savings in the bank, neither about someone owning a few shares or bonds or having a pension paid from financial revenues, but a 'financial aristocracy'. The large owners and controllers of money capital can be seen as the upper stratum of the aristocracy. In varying degrees of nobility beneath them are the senior executives of banks, brokers, asset managers, insurance companies, pension funds, hedge funds and others.<sup>14</sup>

Marx's analysis precludes identifying *all* forms of finance as being parasitic. They are parasitic only if the capital in financial operations is employed as *interest-bearing capital*, rather than money-dealing capital, although there are many hybrid forms. However, the next section will begin the discussion of how *all* forms of financial operation can assist a transfer of surplus value *from one country to another* and so contribute to an imperialist country's economic power.

## 2.7 Imperialism and finance

A strong theme in Lenin's *Imperialism* is the 'parasitism' of the imperialist countries. For Lenin, parasitism is a defining aspect of imperialism as a stage in capitalist development, but his use of the term is both narrower and broader than Marx's:

'Monopolies, oligarchy, the striving for domination and not for freedom, the exploitation of an increasing number of small or weak nations by a handful of the richest or most powerful nations - all these have given birth to those distinctive characteristics of imperialism which compel us to define it as parasitic or decaying capitalism. More and more prominently there emerges, as one of the tendencies of imperialism, the creation of the "rentier state", the usurer state, in which the bourgeoisie to an ever-increasing degree lives on

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<sup>14</sup> In my personal experience of meeting and discussing with many financial institutions, the relative status of each group was a direct function of the size of the financial institution, but it was always the case that the pure brokers – those who merely matched up the buyers and sellers, taking on no market dealing risk of their own as banks often did – were at the bottom of the hierarchy.

the proceeds of capital exports and by “clipping coupons”.<sup>1</sup> (Lenin, 1976a, Chapter 10, pp. 727-728)

Lenin's focus is on the *international* dimension of parasitism, in the *relationships between countries*, whereas Marx developed the concept in relation to the system as a whole. For Lenin, a distinguishing feature of parasitism is also where an imperialist country's bourgeoisie increasingly 'lives off the proceeds of capital export' *and* the revenues from 'clipping coupons' from investments in other countries. The former proceeds of capital export would include the profits of foreign investments in industrial and commercial enterprises, which would include profit of enterprise, but not the enterprise of the foreign investors. The dividends received are in the form of interest and also imply a separation of ownership from the process of reproduction (Marx, 1974c, pp. 436-437). The latter form of revenue noted by Lenin referred to the interest payment or 'coupon' on the foreign bonds that had been purchased, with interest on foreign loans also included under this heading. This latter form directly corresponds with Marx's concept of parasitism.

For Marx, the concept of parasitism is based upon forms of interest-bearing capital. Lenin, following Hobson, made the further distinction of stressing the growing importance of *foreign* interest payments on the money capital advanced (Hobson, 2011, Part I, Chapter IV).<sup>15</sup> Even if the payments were not all interest payments, they included surplus value produced in *other* countries. It is worth noting that Lenin's argument was neither that the bulk of the interest payments came from foreign countries, nor that *all* the foreign countries were weak and dominated. Importantly, the logic of capital accumulation is that the advance of interest-bearing capital occurs worldwide. A 'rich and powerful' versus 'weak and dominated' country division occurs to the extent that the weaker countries will tend to have smaller, less developed economies and financial systems, with a lower volume of funds to lend, so that they may be more dependent on borrowing funds from elsewhere. However, that does not rule out rich countries lending funds to other rich countries whose financial systems may not provide what their capitalists need (for example, the euromarkets discussed in Chapter 5). Furthermore, an international division of labour is bound to develop in the sphere of financial operations as much as in the industrial and commercial sphere.

This world division of labour in finance includes not only the purely interest-bearing forms of capital but also the money-dealing forms. Extending Marx's assessment of these forms of capital to the *world economy* produces a further key development. The more powerful a country's industrial and commercial relationships in the world economy, the more likely it is that its money-dealing capital operations grow too – with insurance, foreign

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<sup>15</sup> By 1899-1913, the UK had a huge inflow of net investment income averaging 6.8% of GDP (Cain and Hopkins, 2002, Table 5.8, p. 165).

exchange and trade finance. These, in turn, give a spur to the growth of interest-bearing capital, especially as the capitalists in a particular country grow wealthier. The largest financial institutions will tend to be in the richest countries. Pension payments and insurance policies are also far more prevalent than in poorer countries, while the cohort of wealthier people who can invest in funds with asset managers, who can do deals through brokers, or who have significant funds deposited with banks will also be larger.

If companies in a particular country have a competitive advantage in providing financial services, this advantage is also likely to be linked closely to their ability to tie these services together with providing advances of money capital. The early strength of the City of London market in providing long-term investment finance, mainly through the City's flotation of bonds but also its issuance of equities, was very much dependent upon London-based financiers being able to maintain a liquid market in these securities. Stock exchange jobbers could borrow short-term funds to finance their holdings of equities and bonds, and could hope to sell out of their positions when necessary with less risk of capital losses. The Bank of England indirectly supported that market as the cash provider to the banks and discount houses (Michie, 1992, p. 70, pp. 76-78). These operations were principally under the heading of interest-bearing capital, but the overall international dealing mechanism was put in place as a result of the commercial financial operations established by City practice.

Imperialism's relationship to monopoly is often discussed with regard to capital accumulation in industry that benefits larger corporations. The same thing also happens with companies operating in the financial sphere: being bigger can also mean being able to provide services or capital at a lower cost, or at least to be in a more influential market position. One factor important for giving economies of scale to a financial company is that it has fewer incremental costs for delivering a higher volume of business than does an industrial company. It is no more costly to lend \$1000m than to lend \$100m, except as an extra charge for using up the bank's capital. It is no more onerous to do 50 deals per day totalling \$1000m than to do 50 deals with a total value of \$100m. However, for interest-bearing and money-dealing capital operations the revenues can be up to 10 times higher. The extra scale and the extra revenues may justify investing in better management systems and technology, which may involve extra costs, but even then there is negligible extra cost in 'raw materials'. While extravagant salaries in the financial sector are an important element of these companies' expenses, the salary bill is usually invariant to the volume of business in the short term (hiring and firing come later), although bonus payments may have a closer correlation with the scale of business revenues. To that extent, the advantages of the monopolistic financial company would derive from its technical and competitive advantages as discussed in Section 2. However, the ability to get the larger scale of operations depends not only on the national

market, but also on the international market, and then the position and power of the state is a vital factor.

As noted in Section 2.1, the state is important for establishing a monetary and financial system within national borders. As capitalism expands to create a world market, the operations of financial companies expand alongside those of commerce and industry on an international basis. In this, too, they get support from their national base – if only in the national currency to which they have privileged access via the home central bank. Their home currency is commonly chosen as their area of comparative advantage over banks and financial institutions in the other countries.

For example, a US bank setting up in France will do so initially to service US companies that have operations in France. While it will have access to euro currency operations and European Central Bank finance, directly or via the Banque de France, since it is accepted as part of the local monetary system, it will have no advantage in the euro compared to local French banks and may not even be allowed to take euro deposits from non-corporate residents. Normally, it will also have less capacity to fund euro operations than the principal French or euro-based banks, since that is not its home territory, nor the site for the allocation of a large share of its capital. However, the typical US bank will in general be able to offer better (larger-scale and/or cheaper) access to US dollar funding and financing operations than French banks, both to US companies *and* to other companies, because of its links into the US banking system and the funding operations of the US Federal Reserve. In the same way, this will be true for other nationality banks setting up in a foreign country.

Financial companies thus have advantages in expanding their operations when *their countries* have a dominant position in global trade and to the extent that international transactions are denominated in their national currencies. Financial power rests on having privileged access to credit markets and the ability to undertake large-scale transactions. This is obviously a function of the size and operations of particular financial companies, but it is also closely related to the home market from which these companies originate. This brings the discussion back to the second 'imperial set' of features introduced in Section 2.1. Such aspects of economic power are *external* to a particular company in the sense that they do not depend on its productive capabilities. However, they are a function of the economic power of the states to which they belong.

The form of economic power I focus upon here is not that which secures favourable trade and investment deals with other countries – issues more usually discussed under this heading – but one that operates far less overtly and appears to others simply as having to use the prevailing infrastructure for conducting (financial) business. Financial power, or the lack

of it, is most evident in a crisis, as a number of countries in Asia found in 1997-98 and as others have found before and since. However, the mechanism examined in this thesis concerns the more prosaic, day-to-day, regular operations of the financial system, not what can appear to be exceptional crises. The cumulative results of the regular, dull mechanism are striking. Examples of this form of power and privilege are getting access to large-scale funding, whether through the banking system or via the stock market, or to the currency or currencies used for international business transactions. This is part of the broader mechanism by which an imperialist country can appropriate value from other countries through the functioning of the financial system. It is not confined to the narrow definition of parasitism discussed in section 2.6. Chapters 4 and 6 examine this question in detail, showing that the US is far from being the sole beneficiary of this power.

## 2.8 World economic rankings – an index of imperialism

The tendency to monopolisation resulting from the accumulation of capital is a feature of the world economy, and this chapter has argued that the evolution of the financial system should also be seen in this context. While the financial system could be seen as starting from different national bases and then expanding internationally, that view would overlook how there is a hierarchy of power in the world economy into which the different countries must fit. This is exemplified by China, a newer entrant to the list of important powers, but which, until recently, conducted all of its external financial relationships through US dollar transactions. Nevertheless, the financial system is just one dimension of the totality of imperialist relationships. In this section, I will summarise important features of the imperialist world economy today by ranking countries according to their relative scores in five different areas. The areas chosen are loosely related to Lenin's 'five features' of imperialism (see Section 2.3), and they are ones that can be quantified from the data available for some 180 countries. The objective here is to illustrate how the world is far more stratified than is often acknowledged, with a very small group of countries clearly in a dominant position.

The first statistic used in my 'Index of Imperialism' is nominal GDP in 2011, taken from IMF data (IMF, 2012a). This measure of economic output is the most widely used, although it has a number of drawbacks, not least that it is a measure of value attributed to a particular country which is not the same as the value created in that country.<sup>16</sup> However, the degree to which it is boosted by value appropriated from elsewhere, or reduced by value lost, is an advantage when it is used as a measure of global economic power. Of course, countries with a large GDP are not necessarily rich – they might have a very large population with a

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<sup>16</sup> This is not to confuse GDP and GNP, where the latter includes the net income from external sources. The point being made is that GDP data for a particular country may include an element of value created in other countries (Smith, 2012).

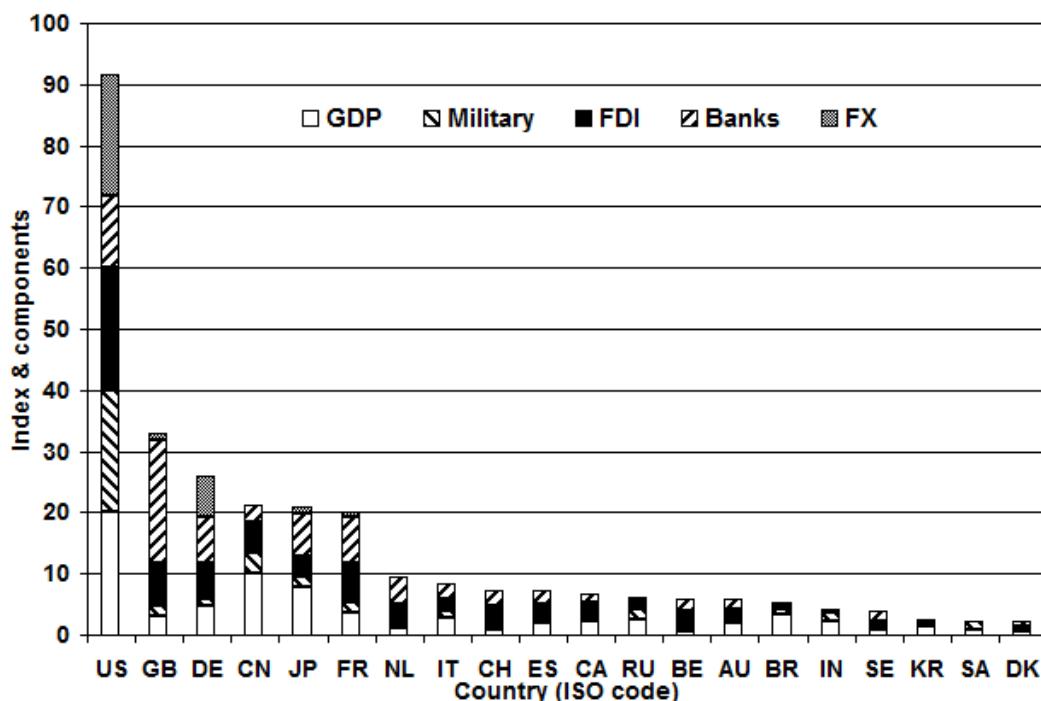
low average income. Nevertheless, a high GDP ranking indicates that the country has weight, and presumably some influence, in the world economy. Nominal GDP in current exchange rate terms seems the most valid of the available measures of national output, not a purchasing power parity measure. The former indicates the value of output in terms of world money; the latter may be a better measure of relative national welfare, but that is not the focus here.

The second index component is the size of military spending by each country in 2010 (SIPRI, 2010). This spending might be for internal repression rather than for external power projection, but it is notable that the five biggest military spenders in the world are also permanent members of the UN Security Council, each with a veto power on UN decisions. It looks like a good measure to use as an indicator of imperial status.

For the third component, I use figures for the stock of outward foreign direct investment owned by each country at the end of 2010 (UNCTAD, 2011, Annex Table 1.2, pp. 191-194). These figures will not fully reflect a country's external economic power. For example, they exclude privileges and benefits that may come from commercial and trading relationships that may have little to do with owning companies and property in other countries. Neither do the FDI numbers reflect the power, influence and revenues that come from owning foreign portfolio assets (equities and bonds). However, the FDI data can be used as a measure of how far companies in one country exploit workers in others.

The final two components of the index are used to reflect the *financial* power of different countries. Data from the Bank for International Settlements for the relative size of international assets and liabilities of banks *operating in* particular countries are used for the first of these (BIS, 2012, Table 2A). Such data cover 19 of the 20 countries in Chart 2.1. The BIS also gives figures for bank assets and liabilities by the *nationality* of the bank. However, the latter are for only nine countries and were not used. In any case, they show a similar rank order to the bank-location data. The second financial measure is the importance of a country's currency in global central bank foreign exchange reserves. This is compiled from data for end-2011 from the IMF's Currency Composition of Official Foreign Exchange Reserves database (IMF, 2012b) and from my own estimates. These two financial measures are far from comprehensive, but they give an indication of how far a country's banks are important on the world stage and how far its currency is accepted internationally. The main dimension of financial power missing from these particular measures is the degree to which a country is able to utilise the financial sector to appropriate value from the world economy when this does not necessarily come from banks operating on its territory, or from the use of its own currency. That issue is discussed both in Chapter 4, which discusses forms of financial privilege for a number of powerful countries, and in Chapter 6 that focuses on Britain.

**Chart 2.1: The global pecking order - an index of imperialism, 2010-12**



Notes: The height of each bar is given by the country's total index value, which is broken down into the respective five components. Two-letter ISO codes identify countries.

Sources: Details are given in Section 2.8.

The index components summarise only particular dimensions of the system. However, the index measure used here is made up from what I would expect to be uncontroversial components. In order to standardise the data for comparison purposes, I set the highest country value under each of the five headings at 20. This means that if a country has the highest GDP then its value is set at 20. Other countries with smaller GDPs will be shown as a proportion of that number, for example, as 10 for a country with half the biggest GDP. The five measures used are given equal weights, and the total index is the sum of the individual values, with a maximum possible value of 100 if a particular country is top in each category. Index results show a small number of countries at the top, towering over the others. If the chart also showed the remaining 160 or so countries in the database, most of their index bars would barely be distinguishable from the x-axis. More than 100 countries have an index value of less than 0.1 compared to over 90 for the US and over 30 for the UK.<sup>17</sup>

The US stands out as the top power by far, but it falls behind the UK into second place as a centre for international banking. In total, the UK remains a distant second behind the US, but it may be surprising that it is in second place, ahead of Germany. This result is

<sup>17</sup> Details of the index number components for the top 20 countries are given in a table in Appendix 2.2 of this chapter.

largely due to Britain's high scores for banks and the stock of its foreign direct investment assets. Each of the longstanding members of the G7 is in the top 11 countries. China (ISO code CN) is in position four, well ahead of the other members of the so-called BRICs – Brazil, Russia, India and the more recently included South Africa (ISO codes BR, RU, IN, ZA, respectively) – and is only partly helped by the inclusion of Hong Kong in China's data.

China's GDP on nominal measures is half the size of that in the US. Its military spending is also the second largest in the world, although still less than 20% of that in the US. The FDI index component for China mainly consists of investments from Hong Kong, and the banking component also comes from Hong Kong. These items may also relate to investments in or exposures to China, so they may incorrectly push China's overall index value a little higher than is valid. However, the leverage that Hong Kong gives China in commerce and finance should not be underestimated. Even though China (excluding Hong Kong) has a position neither in the measure of top banks, nor in that for central bank holdings of its currency, these factors are bound to change in the next few years. China is slowly developing its financial system, its currency is being used more in international trade relationships and Chinese financial institutions are bound to play a bigger international role.<sup>18</sup>

Russia and Belgium offer another interesting comparison, given that they have the same index number of 6.0. Russia's GDP and military spending greatly exceeds that of Belgium, but Belgium offsets that deficit with higher FDI and bank scores. Russia is the more powerful country in the world economy from a political perspective, but Belgium is much richer (per capita) and with a key economic position in Europe.

Saudi Arabia (ISO code SA) is perhaps the surprise country in the top 20, with a score of 2.2. The strong dependence of the Saudi royal family on US imperialism means that it is hard to see this country as an independent player, although Hanieh makes a convincing case for the emergence of a strong Saudi bourgeoisie (Hanieh, 2013, Chapter 6). Saudi Arabia's position in the table is largely due to its military spending that reflects the subsidies it offers to defence contractors in imperialist countries, although it has also played an active role undermining protests in the Middle East, especially in Bahrain, and has funded opposition to the Assad regime in Syria. In general, the position of an individual country can only properly be understood by looking at its relationship to the imperialist system as a whole, not simply by noting its index value. However, these index values provide a useful summary of important features of the contemporary world economy.

## 2.9 Conclusions

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<sup>18</sup> See Chapter 4 for further coverage of China's financial development.

This chapter clarified a number of concepts that underpin the analysis in this thesis, in particular what I mean by the state, imperialism and finance. Monopoly was also shown to be a key feature of the world economy, and it is bound up with all three of these concepts. Tendencies to monopoly result from the accumulation of capital and are often supported by the monopolist's state in the international market. In the literature, monopoly trends are mainly discussed in relation to industrial and commercial companies, but a similar tendency exists for financial companies. For the latter, overt support from the national state in foreign markets can also occur, but there is a more important, implicit support. This is where financial companies, especially banks, can benefit from privileged access to the national, or international, monetary system through having a home base in that country. Such a privilege may not amount to much unless the country concerned has extensive international economic links, so that its currency is in demand for the funding of international investment and trade. However, it was shown that only a few countries have dominant positions in the world economy. This does not automatically translate into prominence in any particular area of industry, commerce or finance, but the division of labour that evolves gives particular privileges to those countries that are strong in the financial sphere. Such privileges benefit not only the companies concerned, but also the economic position of the state and, by offering extra economic resources, potentially to the population in general.

In the discussion of the 'economics of imperialism', the question was asked whether there is anything that distinguishes the economic mechanism of imperialism from that of capitalism. The answer emerged from the discussion of monopoly. While monopolistic tendencies are endemic to capitalism, when the result is viewed from the perspective of the world economy this also becomes the domination of one group of countries over the rest. The methods of domination are not necessarily any different from what a monopolistic company may attempt to do within the national sphere, but they are projected worldwide with the support of that company's state, perhaps directly in terms of the state managing economic deals, or indirectly because of the implicit power that companies enjoy if they are based in that state. The financial dimension of the economics of imperialism is at the same time both more prominent and more hidden than this. More prominent because it is clear that the vast bulk of world trade and investment is conducted in just a few currencies by a relatively small number of major financial institutions, as will be discussed in Chapter 4; more hidden because the structure of the global financial system is accepted without any resort to force on the part of the major powers.

This financial dimension was defined by analysing how different forms of money capital and fictitious capital developed and how their role could be understood using Marx's theory of value. I concluded that working from the concept of fictitious capital was a more

productive approach than using Hilferding's concept of 'finance capital'. The discussion of parasitism showed that this was separate from capitalist exploitation and was derived from Marx's analysis of interest-bearing capital. For this reason, not all financial activities could be put under the heading of parasitism in Marx's strict sense. In Lenin's discussion of imperialism, the concept of parasitism was extended to one where money capitalists in the imperialist countries also lived off the revenues from capital export and foreign interest payments. However, the approach that will be taken in this thesis is to examine not only the parasitism linked to interest-bearing capital, but also to analyse the financial privileges that the major powers enjoy, including those that derive from all kinds of financial transaction. An assessment of these privileges is critical for a fuller understanding of the relationship between finance and imperialism, and the mechanism that produces them will be analysed in more depth in Chapter 4, after next discussing the issue of profit and finance.

## **Appendix 2.1: US and UK Financial Asset Holdings**

The development of fictitious capital, discussed in Sections 2.4 to 2.6, implies the growth of financial assets. This appendix highlights evidence for the US and the UK showing that the owners of these financial assets are not only a small group of wealthy money capitalists but also a surprisingly wide section of the population. The richer financial asset holders own the bulk of equities, or at least have controlling shares, and also the bulk of bonds and other securities. However, millions of others also own bonds and equities, both directly and, more commonly, via savings plans, endowment policies and pension schemes.

US Census Bureau data for 2007 show that the slogan of the Occupy Movement of 2011-2012, '99% versus the 1%', is many percentage points adrift when it comes to economic divisions, at least when it comes to assets owned. These show that for US families in the upper 80-90<sup>th</sup> percentile of the income distribution, the median holding of equities was \$62,000, and for families in the top 10% of the income distribution, the median holding was \$219,000 (US Census Bureau, 2012, Table 1211). By comparison, the median value of equity holdings for families in the 40-60<sup>th</sup> percentile was \$17,700. The families counted were only those owning equities, but half of US households do, directly or indirectly. The top 10% of these families will account for some 15 million people in the US, based on a population of close to 300 million. These figures exclude the large exposure to equities and bonds that individuals have via pension funds.

For the UK, a less detailed report showed that in 2005 there were nine million people owning equities either directly or via mutual funds, which is 15% of the UK population (Grout et al, 2009, Table 1, p. 9). Other data show that UK individuals *directly* owned 11.5% of the value of UK equities, or £204.5bn worth, excluding any holdings via investment funds, etc, at the end of 2010 (ONS, 2012d, Tables A and B, p. 21). Estimates of the net financial wealth of UK households in 2008-10, including cash savings, bond and equity holdings minus financial liabilities (ex-mortgages), showed a mean figure of £44,200. The distribution was skewed dramatically and the median net household wealth was only £6,600. It is instructive to note the details.

Nearly a quarter of all households in Britain had zero or negative net financial wealth, 55% had from zero to £50,000, 9% from £50,000 to £100,000 and nearly 12% of households had more than £100,000 (figures calculated from ONS, 2012a, Table 15, p. 20). Most financial wealth is held in the form of fictitious capital; only a small proportion is in the form of cash deposits (see ONS, 2012a, Table 2, p. 6). These figures exclude equity and bond holdings that individuals have via pension funds. In the UK, pension fund assets make up 39% of total household wealth compared to just 11% for financial wealth. Property wealth makes up another 39%. Although the distribution of pension assets is similarly skewed in

favour of the wealthy, as in the US, and the diversity of pension assets also makes it difficult to give a representative figure,<sup>19</sup> this will nevertheless amount to a further stake in the revenues flowing to financial assets for a significant proportion of the population.

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<sup>19</sup> For example, one must distinguish between the larger 'defined benefit' and the smaller 'defined contribution' pension assets. In the former, a company invests pension contributions in fictitious capital assets, but the pension fund stock of assets attributed to the individual is valued by calculating the sum of assets needed to provide the pension income he or she is contractually due. As yields fall, the size of the required assets rises, and this has resulted in pension fund deficits. The 'defined contribution' assets are valued at market prices.

## Appendix 2.2: Index of Imperialism Components

The component data for the Index of Imperialism shown in Chart 2.1 are given in the following table. Data sources and descriptions are given in Section 2.8 of the main text. An index level of 20 is the maximum value under each of the five component headings, which are unweighted elements of the total index for each country and with a maximum possible value of 100.

**Table 2.1: Index of imperialism components - top 20 countries, 2010-2012**

	<b>Country</b>	<b>ISO code</b>	<b>GDP</b>	<b>Military</b>	<b>FDI</b>	<b>Banks</b>	<b>FX</b>	<b>Total</b>
1	US	US	20.0	20.0	20.0	11.7	20.0	<b>91.7</b>
2	UK	GB	3.2	1.6	7.0	20.0	1.3	<b>33.1</b>
3	Germany	DE	4.7	1.1	5.9	7.6	6.5	<b>25.8</b>
4	China	CN	10.0	3.3	5.1	2.7	0.0	<b>21.2</b>
5	Japan	JP	7.8	1.6	3.4	7.1	1.2	<b>21.1</b>
6	France	FR	3.7	1.7	6.3	7.6	0.8	<b>20.0</b>
7	Netherlands	NL	1.1	0.3	3.7	4.3	0.1	<b>9.6</b>
8	Italy	IT	2.9	1.0	2.0	2.4	0.0	<b>8.3</b>
9	Switzerland	CH	0.8	0.1	3.8	2.6	0.0	<b>7.4</b>
10	Spain	ES	2.0	0.5	2.7	2.0	0.0	<b>7.2</b>
11	Canada	CA	2.3	0.6	2.5	1.4	0.0	<b>6.8</b>
12	Russia	RU	2.5	1.8	1.8	0.0	0.0	<b>6.0</b>
13	Belgium	BE	0.7	0.2	3.0	2.1	0.0	<b>6.0</b>
14	Australia	AU	2.0	0.6	1.7	1.7	0.0	<b>5.9</b>
15	Brazil	BR	3.3	0.8	0.7	0.4	0.0	<b>5.2</b>
16	India	IN	2.2	1.3	0.4	0.2	0.0	<b>4.1</b>
17	Sweden	SE	0.7	0.2	1.4	1.6	0.0	<b>3.9</b>
18	South Korea	KR	1.5	0.0	0.6	0.6	0.0	<b>2.6</b>
19	Saudi Arabia	SA	0.8	1.4	0.1	0.0	0.0	<b>2.2</b>
20	Denmark	DK	0.4	0.1	0.8	0.8	0.0	<b>2.1</b>

Sources: See Section 2.8

## Chapter 3      Profit and Finance

This chapter further develops the analysis of the financial dimension of the capitalist economy. The discussion begins by deriving an expression for the rate of profit including financial operations using Marx's theory of value. In the literature the focus is usually on the profitability of *non-financial* companies (for example, Shaikh, 2011; Basu and Vasudevan, 2011).<sup>1</sup> However, I argue that insofar as financial companies also advance capital for their operations it is necessary to include that advance in the profit calculations. Marx did not do this in *Capital*, Volume 3, but I will argue that this alternative approach has advantages both for understanding the financial sector in the context of the system as a whole and of highlighting the special status of financial companies. In this way, the particular forms taken by financial appropriation in the world economy (discussed in Chapter 4) can be seen both in their relationship to capitalist profitability and as key aspects of the imperialist stage of capitalist development that is dominated by the major powers.

Section 3.1 calculates a formula for the rate of profit that includes the different forms of capital – productive, commercial, money-dealing and interest-bearing – where each has a different relationship to the production of surplus value in the capitalist system. Section 3.2 examines the capital advanced by the financial sector using the example of the balance sheet of UK banks. This highlights the position of derivative assets (and liabilities) for banks and argues that only certain kinds of asset should be included in a profit rate calculation. Section 3.3 discusses questions that arise from different forms of profitability via a common metric for major capitalist corporations: the 'return on equity'. It shows that the return on equity for industrial and commercial capital is positively correlated with the capitalist system's overall profitability, but that this is not necessarily the case for the return on equity for interest-bearing capital operations. In particular, banks can employ high leverage to boost potential returns measured against the capital that they advance because the position of banks in the monetary system puts them in a favourable position to borrow funds and create credit.<sup>2</sup> Section 3.4 discusses different forms of 'financial profit', indicating that while the financial sector creates no new value or surplus value, it can give the impression that new wealth *has* been created. Another important implication of this treatment of finance is that the expansion of the financial sector can be very profitable for a major power if it can appropriate value from *other* countries. This point is indicated theoretically in this chapter, and it is developed further in Chapters 4 to 6.

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<sup>1</sup> The omission of the financial sector in profitability calculations was one reason why Freeman 2012 raised this issue. My disagreements with Freeman's approach relevant to the points discussed here are covered in Section 3.2 below.

<sup>2</sup> These arguments are developed from an earlier publication (see Norfield, 2013b).

### **3.1 The system rate of profit and the financial sector**

Marx's theory of value explains the origin of capitalist profit and how the dynamic of capital accumulation takes particular forms, resulting in a tendency of the rate of profit to fall. This tendency is what Marx termed '*just an expression peculiar to the capitalist mode of production* of the progressive development of the social productivity of labour' (Marx, 1974c, p. 213). Elsewhere, Marx states that it is 'in every respect the most important law of modern political economy, and the most essential for understanding the most difficult relations' (Marx, 1973b, p. 748). It is not my objective here to take part in the debate on the role of the rate of profit in bringing about the world crisis from 2007. Chapter 5 notes some important stages in the historical development of global finance, and other work discusses the question of recent financial trends and profitability (Norfield 2012, 2014). In this section I have the narrower objective of explaining how to include the capitalist financial system in a value-theoretic framework by examining the rate of profit. This is not because I plan to estimate the rate of profit empirically; the point is to discuss the relationships between value production, finance and profitability. The results highlight a dynamic of the financial system, giving a foundation for the later analysis.

I begin with the standard formula for the rate of profit on productive capital and then discuss how this should be modified to include other functional elements of capital. Following the points previously made in Chapter 2, Section 2.2, on productive and unproductive labour, I will not consider state-owned enterprises, state taxation and expenditures or issues related to landed property. Nevertheless, the state as an economic actor is not excluded from this analysis, given both the state's position in the financial system and the role of the state vis-à-vis other countries. One other important issue should also be noted: while the operations of productive capital can be distinguished conceptually from those of commercial capital, money-dealing capital and interest-bearing capital, in practice capitalist companies will often engage in activities that extend beyond one function. For example, industrial companies may also have commercial or money-dealing operations, and banks that should normally be considered under the heading of interest-bearing capital will also usually provide money-dealing capital services. This does not invalidate the theoretical distinctions between the different functions, but the concrete forms taken by capital are liable to involve more than one of them or be hybrids of the two (see Section 2.6 for further discussion of the overlaps).

#### **Productive capital and the rate of profit**

In Marx's analysis, the rate of profit,  $r$ , is expressed as the total surplus value produced ( $S$ ), divided by the advance of both constant ( $C$ ) and variable capital ( $V$ ), or:

$$(i) \quad r = \frac{S}{C+V}$$

This simple formula is the one commonly used to represent the rate of profit on total social capital. However, it leaves out of account two important qualifying factors. The first concerns the period of turnover of the capital advanced, also allowing for what Marx terms 'fixed' and 'circulating' capital (Marx, 1974b, Part 2). In what follows, I discuss an *annual* rate of profit. The second, and more important qualification for these purposes, relates to the advance by *private capitalists* of funds that do *not* produce value and surplus value. Such funds need to be allowed for as extra items in the denominator of the rate profit formula as extra capital advanced. They will also deduct from the numerator because the expenses incurred cannot be recovered from the value added to the social product.

Advances of capital that do not produce value and surplus value fall into two categories. The first is advances of capital for commercial and money-dealing operations; the second is advances of capital for operations that turn money into a 'commodity as capital', ie interest-bearing capital (see Section 2.6). While particular institutions may well perform *both* money-dealing and interest-bearing capital functions, the profitability of each is determined differently in Marx's theory.

The standard rate of profit formula can be amended to allow for these advances of capital. Yet this is rarely done in the literature,<sup>3</sup> even though the majority of Marxist commentators would agree that commercial and other financial activities are unproductive of value and a drain on the productive sector of the capitalist economy. Shaikh, for example, uses a number of profitability calculations, each of which excludes the capital advances of the financial sector (Shaikh, 2011, p. 58). This is acceptable for his focus on *non-financial* corporate profitability, at least insofar as these companies do not engage in financial operations. However, he discusses profit trends in the (US) system as a whole but does not indicate that the financial sector plays a part in the overall calculation except through the impact of interest rate payments taken by the financial sector from non-financial sector profits. Below, I work through the way in which the rate of profit formula for the total capitalist system should be amended. In order to focus on what is important for my argument, I will summarise only the key features of what should be done, leaving other details to Appendix 1 of this chapter.

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<sup>3</sup> Saros 2012 is an exception, and his approach to profitability has some similarities to the one here. However, his analysis fails to deal with bank credit creation and the special position of banks.

## Commercial and money-dealing capital and the rate of profit

Fine was the first scholar to present a rate of profit formula that includes commercial and money-dealing capital, one based on Marx's analysis (Fine, 1975, pp. 62-64).<sup>4</sup> Commercial capitalists are considered as buying commodities from the productive capitalists below value and selling them at value, while achieving the same average rate of profit as the productive capitalists. The advance of money-dealing capital (MDC), to handle other specialised operations for industrial capital such as foreign exchange transactions, also tends to achieve the average rate of profit. In these activities they have to advance cash or other means of payment, and they also need to advance capital to pay for buildings, equipment, the wages of commercial workers, etc. Marx assumes an equal rate of profit between the two types of capital because, in practice, they often overlap and it is considered relatively easy for a producer to move (at least partially) into commerce and money-dealing, or *vice versa*, if the respective rates of profit are significantly different and attractive enough to induce such a change.<sup>5</sup> Here I will show how to derive the formula for the rate of profit including this *non-productive* form of capital in a different way from Fine.

First, consider the value of the output of productive capital in one year and assume this to be equal to  $C + V + S$  in the usual notation. Then, because the commercial and money-dealing capitalists do not add any value to the product (if we exclude necessary transport and packaging, etc), all of their costs in the year, from commercial wages to the depreciation of fixed capital – here represented by  $X$  – must be a deduction from the total surplus value,  $S$ . Hence, the system's total profit available for distribution or further investment is  $S - X$ . Furthermore, if the latter capitalists must advance a total capital of  $Y$ , including their money capital advances for making commodity purchases, their total fixed capital and commercial

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<sup>4</sup> Fine (1985-86) develops the argument further and covers the theory of interest, but his formulae do not represent the rate of profit including interest-bearing capital. In discussion with him on this question, he would disagree with the approach followed here because he views the key rate of profit calculation as that pertaining to industrial and commercial/money-dealing companies. Interest is then a deduction from their mass of profits and their resulting (net) rate of profit is the relevant factor in capital accumulation. The approach here differs because I would stress that capital also needs to be advanced for companies to perform interest-bearing capital operations. This advanced capital will have an impact on the overall rate of profit for the capitalist system. Nevertheless, I do not argue (see below) that there is a tendency for the *same* rate of profit to be received by both industrial and commercial companies and by IBC.

<sup>5</sup> Vertical integration helps industrial companies manage commercial costs internally. Ford Motor Credit is a case where Ford, a manufacturing company, expanded into financing the purchases of the company's products. GE Capital is also chiefly in this *money-dealing* capital area, as defined by Marx, rather than operating as a bank. Commercial capital rarely moves directly into production, but it commonly develops supply-chain links with producers. In recent decades the hold of large retailers from imperialist countries over producers elsewhere (eg Wal-Mart and China-based suppliers) has increased with 'globalisation'. But this is a feature of the imperialist world economy rather than one that, in these cases, indicates an equalisation of profit rates between retailers and producers.

wages, etc, then the total capital advances over which the system profit must be measured are  $C + V + Y$ , not simply the  $C + V$  of the productive capitalists.<sup>6</sup>

Hence, the system rate of profit, including the productive, commercial and money-dealing capitalists is:

$$(ii) \quad r = \frac{S-X}{C+V+Y}$$

The implication is that the rate of profit is lower than implied by the simple calculation of equation (i). A qualifying factor is that commercial capital likely reduces turnover time for industrial producers. This would boost the mass of surplus value produced per year and could also raise the annual rate of profit. Most analysts working on estimates of the rate of profit normally use data from national income accounts that groups together 'industrial and commercial' or 'non-financial' companies when measuring annual profits against advances of fixed capital. In this regard, such estimates would broadly correspond with equation (ii). However, there are still important differences between the formula and empirical estimates. For example circulating capital and the commercial capitalists' advance of money capital are normally excluded from empirical estimates because of the difficulty of getting adequate data. Kliman discusses some of the problems of using national accounts data for value-based estimates of profitability, in addition to other important data-related questions not covered here (Kliman, 2012).

### **Interest-bearing capital and the system rate of profit**

The previous methodology can be extended to incorporate interest-bearing capital (IBC) into the calculation of the system rate of profit. IBC operates outside the sphere of the production and circulation of commodities; hence, one question is whether capitalists in the financial sector should be included in the *equalisation process* for the rate of profit. My analysis argues that IBC should be included in the *calculation* of the capitalist system's general rate of profit, but that its peculiar mode of operation means IBC will not have a tendency to achieve the same rate of profit as the other sections of capital. The important profitability differences between industrial, commercial and money-dealing capital on one side and IBC on the other will be discussed in more detail in Sections 3.2 and 3.3.

The analysis here discusses IBC and the system rate of profit by considering the capital invested in banks. Banks are the institutions that have the broadest and most important financial operations, although these can fall under the headings of both MDC and IBC, as previously noted. Banks act as intermediaries, drawing in pools of spare liquidity in the

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<sup>6</sup> Here and below I assume for simplicity that fixed and circulating capital turns over in one year. The issue of turnover and other factors are considered in more detail in Appendix 1 of this chapter.

economy, especially corporate funds arising from the circuit of capital, to use for loans to industrial and commercial companies. However, their credit operations are far wider than this function would suggest, given their ability to create monetary assets (see Section 3.2). I do not separately consider banks' financial dealings with households, although household deposits will form part of the total funds they can lend to companies.<sup>7</sup> The operations of insurance companies, pension funds and other financial asset managers are included in this analysis to the extent that they also draw upon social money resources to lend to companies by purchasing their bond and equity issues.<sup>8</sup> This will omit some aspects of financial activity, but the dealings that are the most relevant for the key forms of imperialist finance are still included here.

In order to show how IBC can be included in the calculations of system profitability, it is necessary to define some additional variables. I will limit this to the minimum here; Appendix 1 discusses some other details.

Let  $Z$  be the annual costs of capitalist IBC operations, including depreciation and general running costs such as wages and salaries. As in the case of commercial companies, these costs are not recovered by additions to the total value of annual output. Instead, the costs are a deduction from the sum of total surplus value produced, reducing the numerator of the system rate of profit. If  $W$  is the total capital advanced by these capitalists, for their fixed capital, bank equity capital and wages, etc, then this term must also be included in the denominator of the rate of profit for the capitalist system. One final variable needs to be introduced at this stage to reflect the role of IBC in providing funds to industrial and commercial capitalists for investment. Let  $D_2$  be the *borrowed investment funds* that are used for constant and variable capital (in productive operations) and for commercial and money-dealing capital investment. This results in a *general formula for the rate of profit of the total system*, including the productive capitalists and the different forms of non-productive capital:

$$(iii) \quad r = \frac{S - X - Z}{C_1 + V_1 + Y_1 + W + D_2}$$

In equation (iii), the terms  $C$ ,  $V$  and  $Y$  now have a subscript of '1' to indicate that these investment funds are advanced by the capitalists *in these sectors*, while the  $D_2$  term represents *externally-funded* investment from the financial system, via debt or equity issues or

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<sup>7</sup> Here, all the revenues accruing to banks are considered to be a deduction from surplus value, despite the fact that the immediate payers of bank interest and fees might be households or other individuals. In the case where workers might pay interest to banks out of their incomes, that interest is not considered to be a deduction from the value of labour power. Instead, assuming that this is a general, social phenomenon, the wage paid by employers would have to adjust to meet the regular deductions made. (refer back to Chapter 1, Section 1.2).

<sup>8</sup> Asset managers and others in control of advancing money capital will potentially be assisting an accumulation of capital by companies only when they purchase *new* equity and bond issues, not when they buy *existing* securities from previous purchasers.

bank loans. The costs of the borrowed funds may have an impact on capital accumulation, and will have an impact on the distribution of surplus value between different groups of capitalists, but the overall system rate of profit can be expressed independently of the rate of interest or other costs of borrowing investment capital.

Equation (iii) is only a static representation of the system rate of profit. It suggests that the costs of IBC operations by banks and others reduce the total surplus value available for distribution among the different groups of capitalists and also produces a lower rate of profit for the capitalist system taken as a whole. However, while it allows for the impact of borrowed funds on the accumulation of capital ( $D_2$ ), it does not directly show the potential extra surplus value that might result from that accumulation. A key point is emphasised, nevertheless: it is only the productive capitalist operations that create value and surplus value. The unproductive capitalist functions do not even transfer value to commodities: *all their costs* are a burden on the system rate of profit, both reducing the numerator and increasing the denominator.

The previous expression suggests that MDC and IBC activities are negative influences for the capitalist system's overall rate of profit, although there are potentially offsetting factors, in particular that access to investment funds may boost the amount of surplus value exploited. However, one important implication is that a country that specialises in MDC and IBC operations can appropriate (surplus) value from other countries. This point will be followed up in Chapters 4, 5 and 6. In the remainder of this chapter I will consider some other issues that arise when allowing for the role of finance, which I define as encompassing both MDC and IBC operations.

### 3.2 IBC profitability, capital advanced and financial assets

There is little guidance from Marx on how to conceptualise the impact of IBC on the rate of profit. In Volume 3 of *Capital*, there is a long discussion of how the rate of interest is determined, that interest is a deduction from surplus value and that surplus value is split into interest and profit of enterprise (Marx, 1974c, Chapter 23). However, this only relates to interest as a prior claim on the total surplus value that accrues to productive capital, commercial capital and MDC. There is no discussion of how the total surplus value is reduced in order to meet the unproductive costs of banking operations, for example, or what kind of deduction should be made. These omissions possibly arise from the fact that only Volume 1 of *Capital* was fully completed by Marx. For both Volumes 2 and 3, Engels had a struggle

trying to piece together into a coherent presentation the notes that Marx had left.<sup>9</sup> In this section, I review what emerged and also Hilferding's development of that analysis.

Marx's comments on bank capital are contained in Chapters 29 to 32 of Volume 3. He says that bank capital consists of a bank's cash plus its holdings of securities of various kinds. This sum of capital can also be divided in a different way, between the banker's invested capital and his deposits (Marx, 1974c, Chapter 29, p. 463). However, Marx does not analyse these again, except in the context of discussing fictitious capital.

Nowhere in Volume 3 of *Capital* does Marx consider whether, or how, these latter sums of capital enter into the formation of the average rate of profit for the whole system. His analysis also sets aside the fact that banks have fixed assets – buildings, equipment, etc – and personnel and other circulating costs that need to be funded. Marx essentially considers banks only as disembodied bearers of cash to lend (or to invest in securities) as interest-bearing capital. The issue of the rate of profit including banks or other IBC operations is not dealt with, except to argue that interest is a deduction from surplus value.

Marx was well aware that banking operations are very different from those of industrial capital, and not just because banks operate in the 'sphere of circulation', something that is also true for commercial capital and MDC. He may have left bank capital out of the calculation of the capitalist system's rate of profit because banks lie outside the circuit of industrial capital,  $M - C \dots P \dots C' - M'$ , whereas commercial capital and MDC are part of that circuit, and because examining the forms taken by interest-bearing capital was a later stage of the analysis. However, banking capitalists are still private capitalists *advancing capital* for their operations. As will be shown later, closer attention to this when considering profitability can provide some useful insights into the dynamic of the financial sector and also its relationship to imperialism.

Hilferding develops Marx's analysis of the operations of the banking system, and extends Marx's analysis of finance, joint-stock companies, the stock exchange, dividends and fictitious capital (Hilferding, 1981, Chapter 7). This is valuable, but Hilferding makes less progress in dealing with banking capital and profitability, which is the focus here.

'Bank capital', he argues, 'including both the bank's own capital and deposited capital, is nothing but loan capital and as such it is, in reality, only the money form of productive capital' (Hilferding, 1981, p. 173). However, a bank's own capital is not necessarily derived from loan capital. Furthermore, what is deposited in banks is not necessarily the money form

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<sup>9</sup> Engels's preface in Capital Volume 3 noted that for his editing the 'greatest difficulty was presented by Part 5', which is the section that covers the division of profit into interest and profit of enterprise and interest-bearing capital (see Marx, 1974c, p. 4).

of productive capital, and it may not become productive capital when lent out. A bank takes deposits of various kinds from all classes, and its own capital usually comes (initially) from equity issues and the capital of the bank's founders.

Hilferding notes that for capital 'banking is a sphere of investment like any other, and it will only flow into this sphere if it can find the same opportunities for realising profit as in industry or commerce; otherwise it will be withdrawn' (Hilferding, 1981, p. 172). This is part of his analysis of bank profit. While he says that a bank's net revenue is not (industrial) profit – because it derives from the gap between lending and borrowing rates of interest – the 'total revenue, calculated on the basis of the bank's own capital, must equal the average rate of profit' (p. 180). In common with Marx, he does not analyse the impact of banking capital and bank operations on the rate of profit itself. But, whereas Marx does not comment on a rate of profit for banks, Hilferding implies that banking capital will tend to earn the same rate of profit as that accruing to industrial, commercial and money-dealing capital.<sup>10</sup> It is worth considering this question further.

### A tendency to equality for profit rates?

If there is a tendency for the rate of profit recorded by industrial capitalists to converge with that for commercial and money-dealing capitalists, due to the potential migration of capital from one area to another, does it follow that there is a similar tendency for the profitability of capitalists engaged in IBC to converge with the rate of profit elsewhere?<sup>11</sup> I would agree with Fine that there is no such tendency. Fine argues that IBC plays a key role in allocating capital across different sections of industry and commerce, but that there is a 'structural separation between control of money capital and control of productive capital' (Fine, 1985-86, p. 399). Banks are the 'general managers of money capital' and bank lending operations, plus the role of the stock market and the credit system generally, assist the equalisation of profit rates between different sections of industry and commerce. However, there is *no mechanism* for equalising the returns of IBC operations and those of the other capitalists. This can be seen by considering their different nature.<sup>12</sup>

As previously discussed, the rate of profit is calculated according to the return on the advance of capital. For industrial, commercial and money-dealing capitalists, and also for IBC operations, the *return* can be determined. But what is the *advance of capital* from which these returns are derived? Section 3.1 noted the total  $C_1 + V_1 + Y_1 + D_2$  advances of the industrial,

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<sup>10</sup> Saros 2012 also assumes, with Hilferding, that the rate of profit for the financial sector will tend to equal the average rate of profit in the industrial and commercial sectors.

<sup>11</sup> This discussion does not cover the different forms of IBC operation and whether there is a tendency for each of these to have an equal rate of return, but rather the peculiarity of the IBC form of capital.

<sup>12</sup> The points in this section have been developed through several discussions with Ben Fine.

commercial and money-dealing capitalists, including their borrowed funds. Banks advance the sum  $W$ , the remaining element of the divisor in equation (iii). However, this advance of capital is *not* the principal basis on which the banks generate their returns. Banks can also *create their own revenue-earning assets*, and other financial companies are also in the business of attracting external funds for financial investment, something that marks them out from non-financial companies. The accumulation of financial assets by banks is discussed further below, but it immediately raises the question of how their 'capital investment' can be compared with the investments by industrial, commercial and money-dealing capitalists. Comparing profits against *fixed assets* is one method, as used by Duménil and Lévy (2004, p. 104). However, the fixed asset measure ignores the huge role of *financial assets* as the lever for financial sector profits. It means that any version of 'fixed and circulating capital' advanced by the bank will have, at best, only a weak relationship to the bank's ability to generate a profit. This is a structural difference between the two sets of capitalists, based upon the special position of the banks in the monetary system. There is no mechanism for equalising the rate of profit between the two sectors because there is no sensible basis on which to compare the rate of profit of a steel producer or retail company, for example, with that of a bank.

It is interesting that UK official statistics reflect this point. There is no UK 'rate of profit' data published for the financial sector, while there is for the industrial, manufacturing and services sectors, on the basis of 'capital employed' (ONS, 2011).<sup>13</sup> In a discussion with the UK Office for National Statistics (ONS) on getting access to profit and investment data on the same basis for both financial and non-financial companies, an official said: 'Other than Gross Operating Surplus, comparable data for financial companies are not available' (Roberts, 2014). I do not believe this to be a case of the UK ONS not wishing to disclose confidential data. To clarify, this is *not* to argue that bank profits, or some version of a rate of return, *cannot* be calculated, only that the there is no basis on which any measure of 'rate of return' or 'rate of profit' can sensibly be *compared* with that for other capitalist enterprises. The difference between companies involved in the production and merchandising of commodities as compared to those whose relationship to commodity production is an IBC relationship suggests that any empirical results from such an exercise would only measure the accidental coincidence, or otherwise, of profitability. The difference is shown especially by leverage ratios, which are discussed further in Section 3.3.<sup>14</sup>

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<sup>13</sup> The ONS 'capital employed' measure is based on the value of inventories and fixed assets, including buildings, plant, machinery and software.

<sup>14</sup> Between 1970 and 2011, major UK banks had an *average* leverage ratio that moved from a low of around 15 to a peak of just below 50 (see Chart 3.2 in Appendix 2 of this chapter).

One other point is also important for explaining a discrepancy in profit rates, however measured, between banks and other capitalist companies. A banking operation can only be set up if it gets a licence (as a deposit taker) from the central bank, something that helps banks maintain a monopoly position in the money markets. There is also a licensing process for investment banks (although they do not take deposits from the general public), and this helps them to maintain a privileged position in the securities market. Despite the apparent excess profitability of the banking sector in the UK in recent decades, for example, there have been remarkably few new banks set up. Metro Bank, established in 2010, was the first new High Street bank in the UK for 100 years, and it took 18 months for it to be granted a licence to take deposits (Wallop, 2010).

### The accumulation of financial assets and derivatives

Examining the accumulation of financial assets will develop this discussion further. Financial assets are the means through which banks gain profits/interest, but these assets have received less attention than they deserve in the Marxist literature. Most attention has been given to fictitious capital, represented by a financial security whose price is determined by the capitalisation of future (expected) income (Marx, 1974c, p. 467),<sup>15</sup> since the markets in government bonds, corporate bonds and equities, and the derivative contracts based upon them, have expanded rapidly in recent decades. However, one area of the growth of 'fictitious' financial assets has been neglected. This is the one that is at the heart of the special role of the banking system: the creation of deposits.

Marx's discussion of banking and credit recognises the fictitious nature of some bank assets, for example in his comments on how banks could issue notes not backed by capital they actually possessed (Marx, 1974c, pp. 541-542). He also remarks on how a bank can open a credit account for a customer and where cheques, not even bank notes, may be used to settle payments in a clearing house system (p. 457).<sup>16</sup> However, these are incomplete observations, and the impression is given elsewhere that banks play the role of merely gathering up *existing* surplus funds in the system and lending *these* funds out (Marx, 1974a, p. 587). A similar impression is given in Hilferding's work on banks and finance. While he covers fictitious capital in detail, he does not discuss the deposit creation of banks. Yet, this process of deposit creation – and bank lending – is critical for the expansion of financial assets.

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<sup>15</sup> This, Marx's definition, differs from Harvey's: 'If this credit money is loaned out as capital, then it becomes *fictitious capital*' (Harvey, 2006, p. 267). A bank loan to a company only becomes fictitious capital if that loan is securitised; if not, it is just a loan on the bank's books. Here Harvey also mixes up the circulation of money market credit instruments, such as bills of exchange, with fictitious capital.

<sup>16</sup> De Brunhoff has offered the most systematic account of Marx's views on bank credit creation, something rarely discussed by other Marxist writers (De Brunhoff, 1976, especially p. 94).

Banks can create new deposits from an original deposit, based on the reserve ratios they usually need to maintain or on other prudential lending rules. Banking practice differs between countries, but it is easiest to illustrate the potential expansion of deposits using the example of the reserve ratio.<sup>17</sup> If that ratio is 10%, then a deposit of \$1000 at a bank could potentially lead to the creation of an extra \$9000 of *new* deposits.<sup>18</sup> Whether it actually does so depends on the demand for loans; it is far from an automatic process. However, for our purposes the important point is that the extra deposits created are *fictitious*. They are extra liabilities as bank deposits, also extra bank assets as loans to bank customers, but they are multiples of the value of the original deposit and are created by a bank's credit operations. Importantly, this credit creation process is supported by the central bank – the state-backed institution that oversees the operations of and provides liquidity to the private banking system. Credit creation is therefore far from being constrained by the deposits of cash arising from the circuits of industrial and commercial capital. The deposits of funds from individuals can also give a basis for credit creation, but, most importantly, this process is how banks operate and it is also a function of central bank policy.<sup>19</sup>

The accumulation of bank financial assets via deposit creation *may* be loans to industrial and commercial companies for investment purposes, in which case they should be included in the calculations of the system rate of profit that includes IBC given earlier (the D<sub>2</sub> variable in equation (iii), Section 3.1). However, the accumulation of financial assets may have nothing to do with such investment. Instead, the funds created could be used to buy *existing* securities or to make other forms of financial investment.<sup>20</sup> In that case it would be wrong to include these financial assets as part of the invested capital. These assets held by the banks are merely an *accumulation of financial titles*, normally forms of fictitious capital. Although these may still have claims on surplus value in the form of interest or dividend payments, they do not represent any new investment in industry or commerce, nor even any new investment in the financial sector's own business operations. They are not a capital investment, though they may still be considered part of IBC.

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<sup>17</sup> In the case of the UK, the Bank of England has no minimum reserve requirement. However, before this could lead to an unlimited expansion of deposits, other regulations on capital adequacy, etc, are meant to act as constraints.

<sup>18</sup> The 10% reserve ratio is the one most commonly used in examples, for simplicity rather than accuracy. In this case, \$900 of the original \$1000 is lent out first, which, when deposited in another bank, allows the second bank to advance another \$810 in new loans, and so on in a geometric progression. A bank's ability to borrow from the inter-bank money market, and from the central bank, mean that the reserve ratio is not the constraint it otherwise might be.

<sup>19</sup> Note that, for Marx, lending and borrowing in the money market includes *both* credit advanced as money by banks to consumers and companies to buy commodities *and* money capital advanced as IBC for investment purposes.

<sup>20</sup> For example, where banks provide finance for 'private equity' funds or hedge funds that then buy equities, bonds or other financial securities.

Another form of accumulating financial assets occurs when financial companies issue *new* financial securities, but the funds raised are *not* used for extra capital investment in their operations, as they would be if the funds were from issues of new equity capital, for example. In this case, the funds are used for the purpose of advancing *further loan capital* or to buy other financial securities. Hence, neither should these assets be considered as a capital investment.

One striking example of this accumulation of financial assets is the boom in the issuance of Collateralised Debt Obligations (CDOs) by banks from the late 1980s. These were largely based on the payments received by the banks from mortgage loans they had already granted. The advantage of CDOs for banks was that they were a mechanism to boost their earnings and profit potential. They could sell the mortgage-backed securities to investors, receive cash and have fresh capital with which to fund a new round of mortgage business. The interesting thing about CDOs is that they were issued as securities that were claims on the banks' *existing loan assets*. Essentially, this was how banks shortened their own period of circulation, boosting their profitability by not having to wait until the mortgages were fully repaid. From an estimated \$68bn in 2000, annual global CDO *issuance* increased nearly eightfold to a peak of \$521bn in 2006 (SIFMA, 2012). Alongside this, profits reported by the US financial sector, the source of most CDO issuance, more than doubled over the same period – before the collapse that occurred shortly afterwards when mortgage defaults soared.

Other financial securities newly created and issued by banks include derivatives used for hedging and speculative purposes, for example interest rate swaps and futures and options on interest rates and currency values. These may appear on a bank's balance sheet as an asset or liability, and they are also financial products from which they earn dealing margins and other fees. They are part of a bank's business dealings, but they are *not* capital invested in a bank's, or any other company's, operations even though they require that a portion of capital be set aside to cover risks taken on via these instruments. It is wrong to consider these securities as part of the invested capital of a bank.

**Table 3.1: UK monetary financial institutions' financial balance sheet**

(£ billion, end-year)	2005	2007	2009	2011
<b>Financial assets</b>				
Currency and deposits	2210	2565	2934	3150
Loans	2510	3373	3434	3443
Shares and other equity	261	328	255	295
Short-term money market instruments	154	149	120	87
Medium & long-term bonds	570	785	1106	1204
<i>Financial derivatives</i>	<i>1407</i>	<i>2368</i>	<i>4080</i>	<i>5413</i>
<b>Total financial assets</b>	<b>7114</b>	<b>9570</b>	<b>11929</b>	<b>13591</b>
<b>Financial liabilities</b>				
Currency and deposits	4721	5946	6488	6752
Loans	3	3	3	3
Shares and other equity	136	139	159	172
Short-term money market instruments	292	348	360	181
Medium & long-term bonds	314	394	660	652
<i>Financial derivatives</i>	<i>1407</i>	<i>2357</i>	<i>4027</i>	<i>5388</i>
Other	6	8	25	27
<b>Total financial liabilities</b>	<b>6878</b>	<b>9195</b>	<b>11723</b>	<b>13174</b>
<b>Net MFI financial assets</b>	<b>236</b>	<b>375</b>	<b>206</b>	<b>417</b>
<b>Net financial derivatives position</b>	<b>1</b>	<b>11</b>	<b>53</b>	<b>25</b>

Source: ONS, 2012e, Table 4.2.9, pp. 178-9, and author's calculations

Table 3.1 gives an example of UK bank financial assets and liabilities to illustrate these points. The data are taken from the financial balance sheets of UK monetary financial institutions (ie deposit-taking banks). These figures exclude the fixed assets of banks, which are not shown separately in UK data. One can note, however, that the total of fixed assets for all financial companies was 'only' £142bn at the end of 2011. Both the totals of financial assets and liabilities nearly doubled in value in the six years after 2005, helped especially by a big jump in the figures for derivatives. At the end of 2011, derivatives accounted for more than a third of the totals. A bank's creation of and dealing in derivatives results in huge volumes of assets and liabilities, in most cases with the transactions offsetting each other in terms of a bank's risk exposure. This is indicated by the fact that the *net* derivatives position was usually less than 1% of the *gross* derivatives figures. The Bank of England's methodology to record the data also illustrates another problem of using these figures as any indication of 'capital investment'. A derivative 'asset' is simply a derivative position whose market value is positive; if it drops into negative territory, it becomes a derivative 'liability',

and *vice versa*.<sup>21</sup> While this procedure makes sense from an accounting perspective, it also shows how derivatives can confuse the understanding of what is normally considered to be an asset or a liability. It is strange, to say the least, for the value of an 'asset' to fall below zero, or for a 'liability' to have a value that can change so that it is transformed into an asset on a balance sheet.

A different problem occurs if one wanted to use the figures for a bank's loans as a form of capital investment. Firstly, the loan may have nothing to do with any actual invested capital; it may simply be a loan for consumption purposes, an advance of 'loanable money capital' not IBC. Secondly, even if the money were used for capital investment, then that would be counted separately in GDP-based statistics for capital investment. This would lead to double counting the totals of investment in the economy: once as the investment recorded by companies and again as a bank asset. For these reasons, the suggestion made by Freeman to include a bank's financial assets as a factor in total capital investment is mistaken (Freeman, 2012). Freeman suggests that this is *not* double counting because the banks' loans *are* a form of invested money capital. However, this also ignores that the loans are largely the result of bank credit creation processes and so they should not be seen as representing an independent sum of value.

Similar points may be made regarding derivatives traded on financial exchanges. In this case, traders on the exchange, who may work for banks, originate the new derivative contract and the profitability of the exchange is a function of the volume of dealing in such securities. One could measure the value of contracts outstanding, for example by the sum of the face values of each derivative. But this does not reflect any capital invested and it should not be considered as such. It simply reflects the scale of transactions in derivatives!<sup>22</sup>

In the financial assets of UK MFIs detailed in Table 3.1 for end-2011, the £3150 billion in currency and deposits is not a capital investment of the banks. The loans item of £3443 billion is principally made up of business lending, but some 30% is loans secured on dwellings, largely representing residential mortgages. Of the £295 billion of equity investment, only a small proportion is likely to be the banks' purchases of newly issued securities; secondary market purchases do not advance any new funds to the companies concerned. The £87 billion of short-term money market instrument assets are, at most, commercial advances of money to capitalist companies, not an advance of IBC. One-third of the MFIs' bond assets of £1204 billion are investments in UK government bonds; less than half is likely to be in private sector bonds bought in the primary market. Financial derivative

<sup>21</sup> See BoE 2008 (p. 1) for the Bank of England's instructions to banks for completing the statistical returns for financial derivatives positions. These are internationally agreed rules.

<sup>22</sup> See Norfield 2013c for a further discussion of the market valuation of derivatives and their relationship to the underlying financial securities.

assets, a massive £5413 billion, can be excluded as forms of capital investment, for reasons previously noted. This makes the capital investment assets of UK MFIs represent at most around £3500 billion, or just one quarter of their recorded total financial assets.

In summary, my argument is to exclude financial assets from the calculation of the capitalist system's rate of profit, except to the extent that the value of these assets reflects investments in the actual *operations* of industrial, commercial, money-dealing and other financial companies. Even then, one must avoid double counting. Where the assets do reflect the relevant investment they may properly be considered as capital advanced, whether or not the funding goes to productive enterprises or unproductive ones, as in commercial and financial companies. Otherwise, the large volume of assets recorded by financial companies will simply reflect a (potentially huge) sum that includes their holdings of financial securities, derivatives and other irrelevant items.

### **3.3 The rate of profit, borrowing, return on equity and leverage**

Section 3.1 concluded with an equation that represented the rate of profit for the capitalist system as a whole, allowing both for the unproductive costs of commerce, MDC and IBC operations and for the lending of investment capital. This differed from Marx's presentation of the rate of profit, where he only considered IBC from the point of view of it receiving a part of the total surplus value in the form of interest (Marx, 1974c, Chapter 21). In this section, I will examine some important relationships using the previous formulae, showing that once the issue of *borrowed* capital is taken into account, as Marx does in his determination of 'profit of enterprise', the question of capitalist profitability should also be examined in a different context. IBC operations are included in my system rate of profit formula, but, following points made in the previous section, I will argue that this does *not* imply that banks will tend to earn the same rate of profit as the industrial and commercial companies.<sup>23</sup> This will also show that what may look like a comparable measure of profitability only serves to highlight the different status of banks.

#### **Surplus value, profit of enterprise and interest**

Marx divided the total surplus value into 'profit of enterprise' and interest. However, in this analysis he gives the impression that the only deduction to be made from the total surplus value accruing to the productive, commercial and money-dealing capitalists is the *interest* paid to 'the owner and lender of money capital' (Marx, 1974c, Chapter 23, p. 371). As already

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<sup>23</sup> To simplify the exposition, from here on my reference to 'industrial and commercial' capital or companies will include the advance of productive capital, commercial capital *and* MDC.

shown, however, the total surplus value must also cover the costs of commercial capital, MDC and IBC. This implies that the correct formula for the profit of enterprise is:

$$(iv) \quad S - X - Z - D_2 i_A$$

where the final term is the total interest paid on the funds that productive, commercial and MDC companies borrow,  $D_2$ , multiplied by an average interest rate of  $i_A$ . If the former companies lent funds to the banks, then they would also receive a portion of the total deposit interest paid by banks, but that is ignored here.

As shown in Section 3.2, banks are able to create *fictitious deposits* in addition to the 'original' deposits arising from the circuit of industrial and commercial capital or from other sources. Not all of these deposits will be lent to industrial and commercial capitalists, and some of the total bank deposits will also be lent to capitalists who invest in financial assets of various kinds. These factors have an important effect on how profitability appears for industrial and commercial capitalists versus those capitalists advancing IBC, an effect best explained by using a common measure of profitability used by all large, publicly quoted capitalist companies: the *return on equity* (RoE).

Marxist analysis has focused almost exclusively on the simplified expression for the rate of profit in the  $S/(C + V)$  formula. However, it is not often that capitalist companies pay much attention to this kind of measure. Some companies will report a figure for 'return on capital employed', which broadly represents the same concepts, but the overwhelming focus of large capitalist companies quoted on the stock market is the return on equity. This measures the net profit of the company compared to the value of its equity capital (measured according to the value of the equity when issued, plus retained earnings), and so is a good indicator of the return to the owners of the company of the money capital that they have invested in it. The RoE measure is not used in isolation from other indicators, however. For example, a company with a high RoE combined with high levels of debt may not be considered to be in a better position than a company with a lower RoE but much lower debt.

The following analysis shows how the capitalist system's rate of profit is linked directly to the RoE calculation for industrial and commercial capital. However, there is a far more tenuous link between the system rate of profit and the profitability of banks, who are used here as the main representatives of capitalist companies advancing IBC. The exercise will indicate how closely one empirical form of the rate of profit is related to the underlying process of surplus value production.

## **Return on equity: industrial, commercial and financial capitalists**

The owners of capitalist companies must usually advance some of their own capital to begin operations, or to continue to operate. However, they will normally also borrow investment funds (IBC) from the financial system. When this occurs, while they are concerned about the returns they get on the *total* advance of capital, they are more particularly focused on *the return on the investors' ownership stake*, or the RoE.

The return on equity for the industrial and commercial capitalists is their profit of enterprise (leaving aside any deposit interest received from banks), divided by their own advance of capital, or:

$$(v) \quad RoE_{ICC} = \frac{S - X - Z - D_2 i_A}{C_1 + V_1 + Y_1}$$

This return on equity formula indicates how profitability can be boosted from the point of view of equity investors without them necessarily providing any more funds for investment. If they use borrowed funds, then, depending on the interest costs, the numerator may increase while the denominator – their own invested capital – stays the same. Within limits, this means that it is possible for the RoE to rise even if the rate of profit on total investment falls.

Nevertheless, there will be a general, positive correlation between the system rate of profit,  $r$ , and the return on equity for industrial and commercial capitalists. This can be seen by rearranging equation (iii) to make the total capital advanced the subject. The result is:

$$C_1 + V_1 + Y_1 + W + D_2 = \frac{S - X - Z}{r}$$

After moving the  $W$  and  $D_2$  terms to the right hand side, noting that the result is equal to the denominator in equation (v), substituting into equation (v) and then multiplying the top and bottom of the fraction on the right hand side by  $r$ , the RoE formula becomes:

$$RoE_{ICC} = \frac{r(S - X - Z - D_2 i_A)}{S - X - Z - r(W + D_2)}$$

This shows that the return on equity for industrial and commercial companies will tend to decline as  $r$  falls, since the numerator falls *and* the denominator increases. If the rate of interest fell, then there could be a rise in the return on equity despite a fall in  $r$ , but a fall in interest rates (for borrowing) has a limit above zero. The broadly positive correlation will tend to hold.

By contrast, the return on equity for the banks has a far less clear relationship to the system rate of profit. This sector of capital's RoE is its net interest income, after deducting other costs (assumed to be equal to  $Z$ ), divided by the total advance of capital,  $W$ . Making the simplification that the total loans equal total deposits,  $D$ , the net interest income is the total

interest received on assets,  $D_i_A$ , minus the interest rate paid on total deposits,  $D_i_D$ . This gives the following expression for the return on equity for the banks:

$$(vi) \quad RoE_{Banks} = \frac{D(i_A - i_D) - Z}{W}$$

In this case, the trend in the system rate of profit,  $r$ , has a far less direct impact on the RoE for banks. If there is a trend of falling profitability, then  $RoE_{ICC}$  will fall, as previously indicated. This will reduce these companies' ability to meet interest payments on borrowed funds, so there is likely to be downward pressure on  $i_A$  (considered as a percentage return on bank assets, not simply as an interest rate) through a lower demand for investment funds and also due to potential loan losses. That should eventually feed into a lower figure for  $RoE_{Banks}$ . Nevertheless, there are some important degrees of freedom on this measure that could make the banks still look profitable, despite lower returns elsewhere.

Firstly, it is evidently the gap between borrowing and investing (or lending) rates that is critical for the banks. In a 'credit crunch', banks can often charge higher interest rates on their loans, even if the interest rates they pay to depositors fall. Secondly, the banks are able to expand their deposits and loans via credit creation (depending on bank reserve ratios, together with bank credit risk and capital adequacy measures). Hence, the volume of interest earnings, and the return on equity for banks, can move quite differently from the return on equity for other capitalist companies.

The upshot is that *the ability to expand borrowing and assets is a key driver of profitability for the banking system*. This creates a different dynamic for the return on equity for banks compared to that for industrial and commercial companies. There is clearly no direct relationship between the two calculations of return on equity and they are liable to be different.

### **Profit of enterprise and equity dividends**

Before continuing, it is worth commenting on the profit of enterprise equation for industrial and commercial companies – equation (iv). This equation represents the profit available for distribution to the latter group of capitalists. They need have no knowledge that it includes the total surplus value,  $S$ , and deductions  $X$  and  $Z$  for the depreciation and other costs of the commercial and financial capitalists, although they will be aware of the interest paid on borrowing from banks. For them, profit of enterprise is just the residual profit they have left after paying interest. Marx introduced this term to distinguish the functioning capitalist from the mere lender of money capital as interest bearing capital. However, virtually all the capital advanced by today's major industrial and commercial companies is made up from equity

capital issues on the stock market, retained profits, loans from banks and bond issues, with very little originating from the functioning capitalists.

There is probably no 'profit of enterprise' received by capitalist owners as a separate payment from dividends, except in the case of privately owned (not listed) companies and the latter companies account for only a small fraction of the total assets of capitalist corporations. Even retained profits, after payment of interest and dividends, are attributable to *all* the company's equity holders, not to a separate group of owning/functioning capitalists. This makes the RoE-type calculations compelling as alternatives to the traditional rate of profit calculation, in addition to the way they facilitate understanding of the different dynamic for companies in the financial sector. But it also suggests a diminished importance of 'profit of enterprise' as an economic category in modern capitalism. At the same time this reflects the much greater prominence of interest-bearing capital and the form it takes as fictitious capital in equity and debt securities. This point is consistent with Fine's argument that 'financialisation' should be viewed as being 'underpinned by the quantitative expansion of interest-bearing capital and its extension across the economy' (Fine, 2010, p. 113). One area for investigation emerges from this topic, although it is outside the scope of this thesis. This would be to examine whether privileged control of a company, through holding voting shares, and the privileged payment of returns that results from the ownership of certain types of equity, tends to reside with the founding capitalists. In the case of the Facebook IPO, for example, one of the founders, Mark Zuckerberg was reported to own only 18% of the shares but he had 57% of the voting rights (Surowiecki, 2012).

### **Rates of return and leverage: banks and non-financial companies**

Given the previous discussion, it comes as no surprise that industrial and commercial companies borrow far less as a proportion of the equity held by the company's owners than do banks and other financial companies. This ratio of borrowing to shareholders' equity is a common definition of leverage. The ratio will change according to economic conditions, growing rapidly when times look good and falling when times are bad. Nevertheless, at *all* times banks borrow far more than do other capitalist companies compared to the size of their capital or equity base.

As an indication of the divergence, it is considered normal in major capitalist countries for banks to have a leverage ratio of around 20 – in other words, when borrowing is 20 times the size of equity (Haldane, 2011). Industrial and commercial companies, by contrast, are looked upon questioningly by the stock market if their borrowing ratios are high. Data for the aggregate of US manufacturing companies' debt holdings showed that they were *less* than the value of the company's equity capital in each year from 2001 to 2010. Their

average leverage ratio stayed at *less than 1* despite the sharp rise in borrowing elsewhere in the US economy during this period. This was also true for the aggregate measures of mining and wholesale trading companies (US Census Bureau, 2012, Table 794). Another divergence with the banks is that when industrial and commercial companies borrow funds they are very likely to use these funds for investment in their *own* productive and commercial operations. Banks normally borrow funds to lend to *others*, or to invest elsewhere.

Higher leverage usually implies higher volatility of returns on equity. If the investment turns out badly, the interest on the borrowed funds must still be paid, reducing returns further. If investment returns are good, a low cost of borrowed funds relative to the investment returns will magnify the return on equity. Standard portfolio investment theory makes an adjustment for this, deflating the higher returns by the higher volatility when calculating a 'Sharpe ratio' on investment performance (CFA, 2012, pp. 408-409).

Data on the leverage ratios of banks reveal an important dimension of what happened in the run up to the 2007-08 global crisis. From the 1990s, bank profitability had been coming under pressure from narrowing interest rate margins, which had tended to fall in line with the trend of lower money market interest rates.<sup>24</sup> For US banks, net interest margins fell from around 4.0-4.5% in the 1990s to below 3.5% by 2006 (Federal Reserve, 2009, p. A76). This encouraged banks to step up their lending operations in order to compensate with a higher volume of assets. The result was much higher bank leverage. At the same time, the banks also boosted the volume of their trading in foreign exchange, financial securities and derivatives, something that was assisted by their 'financial innovation' and the boom in financial markets.<sup>25</sup> These moves increased both bank interest income *and* their trading income from dealing spreads and commissions.

In the early 2000s, a relatively stable rate of economic growth in major capitalist countries made the higher leverage not seem so risky. Ahead of the crisis, leverage ratios for some major institutions hit levels in excess of 100 in the US and more than 80 in Europe, four or five times 'normal' levels (see Chart 3.1). Once the credit-fuelled bubble burst, however, this gave a particular 'financial' form to the crisis that broke in 2007-2008. The percentage loss incurred on a huge asset base did not have to be high to wipe out the equity capital of

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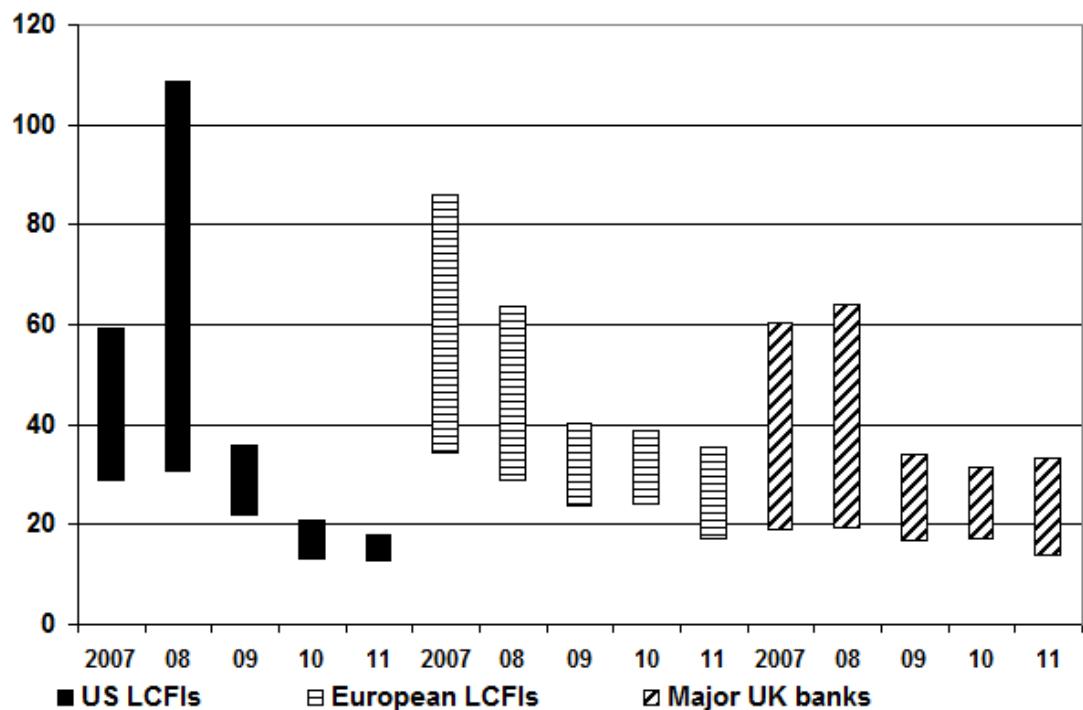
<sup>24</sup> Lower interest rates in major countries were often seen as a result of the success of economic policy in reducing inflation rates. However, this overlooks the impact both from the growing supplies of low-cost imports from China and other producers from the 1990s and of the (mainly Asian) central bank purchases of government bonds in the US, and other major markets, from around 2000.

<sup>25</sup> See Crotty 2007 for an interesting analysis of bank returns and financial innovation. However, he pays too little attention to the broader issue of bank leverage, noting only the implied leverage from credit derivatives and other derivatives.

many institutions, leading to state-supervised mergers and bailouts in the US, the UK and a number of other European countries.<sup>26</sup>

### Chart 3.1: Leverage ratios for major international banks, 2007–2011

(Total assets divided by bank capital. High-low range in each year)



Notes: LCFI stands for 'large complex financial institution'. UK banks are not included in the European LCFI columns. In 2007 and 2008, the weighted average numbers for leverage ratios were about two-thirds down the relevant bars.

Source: Adapted from BoE, 2012, Chart 1.19, p. 14.

The financial system can obviously develop a destructive dynamic in the search for extra profit. This can be looked upon as one consequence of the way in which banks can expand their assets by credit creation. From the perspective of the money-dealing aspects of bank operations, they also have a clear incentive to boost the volume of financial *transactions*. The financial system grows alongside and is intertwined with the accumulation of capital. However, as indicated, weak economic growth and profitability can often prompt accelerated growth of different types of financial business, especially if there is a decline in returns on *financial* investments in an environment of low interest rates. It was this that prompted the extra leverage and the explosion of derivatives markets in the 2000s, as financial institutions could not maintain the returns that they needed from loans or from bond and equity investments (Norfield, 2012). The relationship of these financial returns to the rate

<sup>26</sup> Appendix 2 to this chapter gives the leverage data for major UK banks since 1960, confirming that the 2000s were years of exceptionally high leverage.

of profit is complex. However, the lower is the system rate of profit, the more likely it is that what takes the form of a 'financial' crisis has its roots in weak profitability. In turn, the lower is the system rate of profit, the greater is the economic damage wreaked by a financial crisis.<sup>27</sup>

### 3.4 Financial revenues, surplus value and fictitious capital

Marx's theory of value treats the 'financial sector' (MDC and IBC operations) as unproductive. It neither produces new (surplus) value, nor transfers value to commodities, and all of its costs, not just its profits, are a deduction from the total surplus value produced. Even when financial sector revenues flow directly from workers' wages, as in the case of interest payments on loans, the ultimate source of these payments is from surplus value, given that the regular wage paid would need to adjust to make allowance for such deductions and to maintain a particular value of labour power. However, if one simply stated that financial sector revenues were a redistribution of existing surplus value, this would overlook some important issues. These can be explored by examining the links between surplus value and the price of financial securities or fictitious capital.

Sections 2.4 and 2.5 of Chapter 2 noted the basic mechanism through which the price of financial securities is determined. This price is essentially the discounted value of the *future* cash flows expected - dividends for equities, and coupon and principal repayments for bonds. The security's price therefore does not represent existing value, but there is a minimum price of the security that reflects the taxable capacity (or creditworthiness) of the state or the value of a company's remaining assets. Instead, the price is largely driven by interest rates in the market, influencing the discount rate and, in the case of equities, expectations about future company profits. Therefore the security's price does not have a direct relationship to the surplus value *currently* being exploited from the productive workforce. Its price could rise sharply if interest rates fell or if expectations about *future* coupons/dividends/repayments improved, or its price could slump in the opposite case. The divergence between surplus value production and movements in fictitious capital values means that the underlying conditions for capital accumulation might worsen (bringing a lower rate of profit) but securities' prices could still rise. Such capital gains (or losses) were not included in the rate of profit/RoE measures earlier in this chapter since they reflect changing market calculations about the future.<sup>28</sup> Nevertheless, changes in the prices of financial securities clearly have a big impact on capitalists' wealth, the monetary value it represents for them and how far they can use these securities as collateral for loans or as a means of payment. This is another example of

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<sup>27</sup> For further discussion of relationships between the rate of profit, financial developments and the 2007-08 crisis see Norfield 2014.

<sup>28</sup> Neither do companies normally include a capital gain (loss) in their profit statements before the gain (loss) is actually realised through selling the asset.

how interest-bearing capital can appear to be divorced from the actual production of value and surplus value.

There are some other peculiarities of fictitious capital. Firstly, it is common to think of transactions in the sphere of circulation - where such securities are traded - as being a 'zero sum game': a gain for one party in the transaction must be a loss for the other. However, consider what happens when a company issues its shares at a price of 100 to stock market investors. If the market price rises to 120, then presumably the company has lost (because it could have waited and issued at 120), while the investors have gained. However, although the influx of money capital to the company is less than it might have been, the company's 'market capitalisation' has still risen, based on the higher price of its shares. This gives the company's owners more financial power, and it also improves the potential price for a further issuance of shares. So, it can appear that 'everybody wins' when equity prices are rising. This is similar to the case for a company's issuance of bonds, since the higher bond price (lower yield) will tend to lower the company's future interest rate for bond market borrowing while the investors still have the original coupon payments and a capital gain on the security they purchased. Rising security prices will, though, reduce the return on these financial assets for *new* purchasers.<sup>29</sup>

It is also necessary to consider the revenues that derive from *trading* in financial securities. This is a separate issue from capital gains/losses. These revenues are similar to a bank's (net) interest income, if one considers that it 'buys' or borrows deposits at a lower interest rate than that at which it lends out, or 'sells' money capital, and this item was included in equation (vi) for the RoE for banks. The transactional, or dealing, revenues of banks are usually derived from the spread between buying and selling prices, but revenue from these spreads depend on the size of the deals done, so they are similar to an interest rate spread applied to the amounts of money capital borrowed or lent.<sup>30</sup> The dealing revenues do not depend upon security prices going up or down, as with capital gains and losses, instead they are based upon taking a cut from the price of each transaction (bid-offer spread) and the volume of transactions, both buying and selling (although rising security prices normally ensure a higher volume of deals because they attract more funds into the market). These trading revenues obviously boost the profits of financial companies, from banks to brokers to securities exchanges. However, what is the origin of these revenues from the perspective of Marx's theory of value?

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<sup>29</sup> Lapavitsas makes some useful points on these questions, but from a different perspective and with a view, which I do not share, that 'financial profits' can also be seen as 'ultimately deriving from future wage payments' (Lapavitsas, 2013, Chapter 6, p. 167). Also, he does not properly distinguish transaction revenues from capital gains, as I do in the next paragraphs.

<sup>30</sup> Other forms of financial revenue, including fees and commissions, also usually depend on the size of the transaction undertaken and will not be considered separately here.

The answer comes from considering the formation of the prices of financial securities. This also highlights a fundamental contradiction in the capitalist financial system, one that puts the previous issue of security price *changes* in a different light. As previously noted, the prices of securities are based on market calculations of *future* financial flows, discounted by market interest rates, risk premia, profit expectations, etc. This discounting appears to make the future *a present reality*, but obviously the future has not yet happened! The value has not yet been created from which the dealing revenues can be deducted.<sup>31</sup>

This contradiction does not worry capitalist financial markets. Instead, the financial trading revenues are real enough if they are received as money. *Then* they are a claim on society's resources. The same is true of the value represented by the price of financial securities, whether or not boosted by capital gains, if those securities can be turned into money. A sum of fictitious capital - consisting of bonds, equities, etc - can be valued on a company's balance sheet, or as assets owned by individuals, at current market prices and might represent a significant amount of wealth. This does not appear to be a problem as long as there is little doubt in the market that the recorded prices represent what the wealth is 'really worth'. Such an assessment is made on the view that most holders of financial securities will not attempt to transform their assets into money at the same time. The valuation of fictitious assets at their 'future value' persists until a crisis shatters what is appropriately called 'market confidence': then prices collapse and what was thought to be 'real wealth' disappears.

### 3.5 Conclusions

This chapter has argued that the advance of commercial capital, money-dealing capital and interest-bearing capital by capitalist companies should be taken into account when examining the capitalist system's rate of profit. The commonly used rate of profit formula  $S/(C + V)$  was amended, firstly following work by Fine to include commercial and money-dealing capital. It was adjusted further to allow for the advance of capital by financial institutions, both for their own operations and to represent their advances to other capitalists. This resulted in a formula for the system rate of profit for all capitalist enterprises. My point in doing this was to stress that all of the costs of unproductive capital advances had to be included as negative elements in a rate of profit calculation for the system as whole. Marxist theory has focused only upon the deduction of interest from surplus value to derive the profit of enterprise.

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<sup>31</sup> The argument here concerns financial securities and interest-bearing capital. In the case of the money-dealing aspects of financial operations, as with some foreign exchange dealing, the dealing revenues should be seen as deductions from the surplus value contained in the commodities produced.

However, my argument was not that the rate of profit for interest-bearing capitalist operations would tend to be the same as for the others. Instead, IBC stands outside the operations of productive capital, commercial capital and MDC. Also, banks have a privileged, monopolistic access to the monetary system, one that is endorsed by licensing policies and by access to central bank finance. It was argued that there is no mechanism by which a 'rate of profit' for IBC would converge with that for the other functional forms of capital. Using one standard measure of corporate profitability, the 'return on equity', this was demonstrated by showing that an IBC profit rate had no clear correlation to the capitalist system's overall rate of profit, whereas there would tend to be a more direct positive correlation for other companies.

A key objective of this examination of capitalist profitability and finance was to provide the background theory for the later discussion in Chapters 4, 5 and 6. Here the focus has been on the fact that financial operations are unproductive and represent a deduction from the total surplus value produced, even if they might provide finance for productive accumulation. However, it evidently does not follow that the financial sector is 'unprofitable', in the sense of not managing to accrue income in excess of costs, or that it cannot bring revenues into the country in which it is based. As subsequent chapters will show, the financial sector has grown dramatically, especially in the major imperialist powers, and this has created a global system that assists their appropriation of surplus value *from the rest of the world economy*.

## **Appendix 3.1: Calculations for the System Rate of Profit**

These notes discuss a more detailed method for calculating the overall rate of profit for the capitalist system than is outlined in Sections 3.1 and 3.3 of the main text. Here I allow for the period of turnover of productive capital, and other features that distinguish the different functional sections of capital. Note that in the following, the term 'industrial' is used to mean productive capital; 'commercial' means both commercial and money-dealing capital, while the operations of banks are used to represent interest-bearing capital.

**Start by considering the value of the annual output of industrial capital.** This is the sum of the transferred value of depreciated fixed constant capital, the transferred value of all the constant circulating capital used up, and the new value created by the labour power employed in one year. Let  $FC$  be the total value of the fixed capital advanced, with  $\beta$  the annual proportion of the capital that depreciates in value through being used up. Let  $CC$  be the value of circulating constant capital that is advanced for the next period of production, and let  $n$  be the number of turnovers of circulating capital in the year. Let  $V$  be the value of variable capital advanced to pay wages, but note that this is only the value for *one* period of turnover, and let  $S$  be the total surplus value produced in one turnover period. Then the total value of the product in one year is:<sup>32</sup>

$$(a) \quad \beta FC + n CC + n V + n S$$

**Now consider the commercial capitalists.** Any costs these incur must be recovered from the total value in (a), and essentially will be a deduction from the total surplus value. This is because the total of their wages bill and other circulating costs represent an outlay for which there is no additional value added or transferred to the product. The same is true for the depreciation of their fixed capital. Let  $L$  be the total circulating capital costs advanced by commercial capital for one period of turnover, and let the average period of turnover be  $m$ . Let  $K$  be commercial capital's advance of fixed capital and, for simplicity, assume that the annual rate of depreciation of commercial fixed capital is also  $\beta$ . In addition to these costs, the commercial capitalist must also advance money,  $B$ , to buy the commodities that are sold by the productive capitalists. However, while the advance of money capital  $B$  does not add or transfer any new value, neither is it used up in the process. It returns to the commercial capitalist on the resale of the commodities. The total profit of the system in one year, allowing for the costs of commercial capital, is then equal to:

$$(b) \quad n S - m L - \beta K$$

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<sup>32</sup> This presentation follows Engels's approach (Marx 1974c, Chapter 4, pp. 72-73).

The total capital advanced by industrial *and* commercial capital is  $FC + CC + V + B + L + K$ , and expression (b) can be divided by this sum of capital advanced to give an amended formula for the rate of profit:

$$(c) \quad r = \frac{nS - mL - \beta K}{FC + CC + V + B + L + K}$$

If commercial capital has a faster turnaround of buying/selling that shortens the  $M - C$  or the  $C' - M'$  phases in the standard Marxist notation of  $M - C \dots P \dots C' - M'$ , then there is a reduction of the advanced  $B, K$  or  $L$  compared to the total surplus value produced. Alternatively, one could see this as an increase in the value of  $n$ , the number of turnovers of industrial capital per year, leading to a higher mass of surplus value per year. In this way, commercial capital appears as less of a drain on the surplus value produced and the system rate of profit (per annum) will rise. A smaller negative thus appears to be a productive *increase* of value, although commercial capital creates no new value.

**Now consider the banks.** Let  $D$  be the value of their deposits and other borrowings. These deposits include not only the surplus cash resources of industrial and commercial companies, but also the *banking sector's own creation of money* through its recycling of deposits.<sup>33</sup> These extra, created deposits should be included in  $D$ , since they are deposits in the banking system, deposits that add to the banks' liabilities.

Let  $E$  be the value of bank equity capital, or 'shareholders' equity'. This is equal to the original subscription of equity when the bank (or other financial company) started operations, plus any further share issues, plus retained earnings.<sup>34</sup> This equity capital value does not vary with the bank's share price in the market, but it will be diminished by any losses borne.

The value of  $D$  plus  $E$  is used to fund the bank's total assets,  $A$ . In standard accounting terminology, the bank's total assets equal its liabilities plus its equity capital, so:

$$(d) \quad A = D + E$$

Assume that, of the bank's total assets, a value equivalent to  $E$  covers the bank's fixed and circulating capital costs (buildings, technology, infrastructure and salary costs) and its core reserve capital. This simplification leaves a value equivalent to  $D$  to be the bank's loan, or other investment, assets. The lending, to create assets, can be to industrial and commercial companies, or to other financial companies (including buying any financial assets in the secondary market). This value  $D$  can then be divided into  $D_1$ , where it is lent 'internally' to

<sup>33</sup> Money creation is specifically a banking operation. Non-bank financial companies cannot create deposits. See Hall 1992 for an interesting analysis of the deposit creating process, and a critique of the Marxist literature at the time for ignoring it. Dos Santos 2011 does include this element in his discussion of the credit system and accumulation.

<sup>34</sup> Here I ignore so-called 'Treasury shares', for simplicity.

other financial companies, and  $D_2$ , where it is lent 'externally' to industrial and commercial companies.

If the average interest rate paid on deposits is  $i_D$ , and the average return on bank assets is  $i_A$ , the banks' net interest income can be written as:

$$(e) \quad D(i_A - i_D) \text{ if } i_A \text{ is considered as the return on bank loans.}^{35}$$

The sum  $D_2$  represents the funds for investment that industrial and commercial companies have borrowed from banks. These funds are for their extra investments in constant capital, variable capital, plus a proportion of commercial money capital advanced and a proportion of the fixed and circulating costs of commercial capital. For the total constant fixed capital,  $FC$ , this can be broken down into  $FC_1$ , advanced by the industrial capitalist directly, and  $FC_2$ , that portion borrowed from the bank. Hence

$$(f) \quad FC = FC_1 + FC_2$$

similarly,

$$CC = CC_1 + CC_2$$

$$V = V_1 + V_2$$

and likewise for the commercial capitalist,

$$B = B_1 + B_2$$

$$K = K_1 + K_2$$

$$L = L_1 + L_2$$

By assumption, all the borrowed funds equal one portion of the total deposits of banks, so:

$$(g) \quad D_2 = FC_2 + CC_2 + V_2 + B_2 + K_2 + L_2$$

Now recall that for the commercial capitalists and IBC operations, the depreciation costs of fixed capital and their personnel and other circulating costs are *not* transferred to the values of commodities. They *must be recovered from the total surplus value produced in society*. If we assume that the depreciation of the fixed assets of the banks in one year is equal to  $\gamma E$ , and that the total circulating costs in a year (including wages paid) amount to  $M$ , then the total profit remaining for distribution to the *three* sectors is now:

$$(h) \quad nS - mL - \beta K - M - \gamma E$$

The total capital advanced by all three sectors can be given as the sum of that belonging to the industrial and commercial capitalists, the funds they have borrowed from the banks plus the banking sector's own equity,  $E$  (which, for simplicity, here we assume also

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<sup>35</sup> This assumes that banks only make a return on lending, and excludes the fees and charges they impose on their customers, and any net earnings they derive from financial trading. The latter items could be included, but would unnecessarily complicate the argument here.

covers the advance to meet their circulating costs). Hence the rate of profit on total social capital can now be written as:

$$(i) \quad r = \frac{nS - mL - \beta K - M - \gamma E}{FC_1 + CC_1 + V_1 + B_1 + K_1 + L_1 + D_2 + E}$$

This formula shows how the capitalist system's general rate of profit is impacted not only by commercial but also by the advance of capital for banking operations. (See the main text for the reasons why I exclude purely financial assets from the calculation)

The total surplus value available for distribution among all capitalists is as noted in equation (h) above. This implies that the formula for the 'profit of enterprise' is:

$$(j) \quad nS - mL - \beta K - M - \gamma E - D_2 i_A$$

where the final term is the interest paid on the funds that industrial and commercial companies borrow from the banks,  $D_2$ . If the former also lent funds to the banks, then they would also receive a portion of the total deposit interest of  $D_i_D$ , but for simplicity this is not considered here.

As shown in Section 3, banks are able to create *fictitious deposits* in addition to the 'original' deposits arising from the circuit of industrial and commercial capital or from other sources. This has an important effect on how profitability appears for industrial and commercial capitalists versus the financial capitalists, an effect best explained by examining the *return on equity*, as discussed in Section 3.3.

Using the variables already defined, the return on equity for industrial and commercial companies can be expressed as:

$$(k) \quad RoE_{ICC} = \frac{nS - mL - \beta K - M - \gamma E - D_2 i_A}{FC_1 + CC_1 + V_1 + B_1 + K_1 + L_1}$$

As for equation (v) in the main text, this return on equity expression can be shown to have a direct relationship with the system rate of profit equation (i) above.

The return on equity for the banks can be expressed as:

$$(l) \quad RoE_{Banks} = \frac{D(i_A - i_D) - M - \gamma E}{E}$$

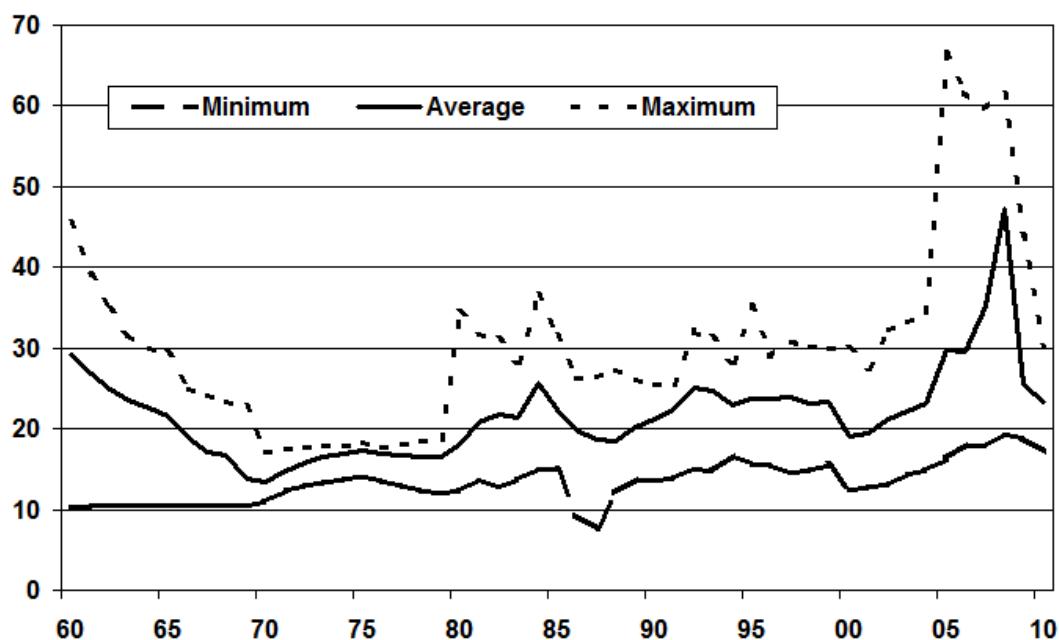
As in the main text, this equation highlights the importance of both the interest rate margin and the banks' ability to expand their assets through the creation of deposits. This expression, and that for industrial and commercial companies, could be further amended to allow for the banks' revenues from financial transactions, another means whereby banks can attempt to raise their returns.

## Appendix 3.2: Leverage Ratios for Major UK Banks, 1960-2010

The data for the following chart are taken from the Bank of England's *Financial Stability Report*, June 2011. Leverage is measured as total bank assets divided by bank capital for the major UK banks, with the maximum, minimum and average (mean) estimates shown in the chart.

The leverage ratio fell steadily through the 1960s, but was then on a modest upward trend from 1970-2000. After settling around the long-term average of close to 20 in 2000, the average leverage ratio jumped to new historical highs in the period leading up to the financial crisis of 2007-08, which then pushed the ratio back down towards the long-term average level. Bank assets fell and bank capital was increased. The big rise in bank leverage was a function of low interest rates impacting bank profitability and an economic environment that encouraged the view that economic risks were lower. The UK economy grew in every single quarter from 1992 to 2007, an extraordinary period of 15 years of continuous growth.

**Chart 3.2: Leverage ratios of major UK banks, 1960-2010**



Source: BoE, 2011, Excel file 3 'Resilience in the financial system', Tab Box 3, Chart A.

## **Chapter 4      Forms of Financial Privilege**

Although capitalist financial companies produce no value, that is not a problem for them since they can claim (surplus) value produced elsewhere and their objective is only to be profitable. They could even argue that they are providing vital financial services or funding other companies' productive investments. Nor is the unproductive nature of financial operations necessarily a problem for other capitalists. If they don't need the financial services then they don't have to take them. One might expect, nevertheless, that being unproductive would tend to put a limit on the growth of the financial sector, since the invested capital, costs and revenues of the financial sector are a drain on total surplus value. However, as Chapter 3 showed, financial operations and financial assets can expand well beyond what the production of value might imply, due to the deposit creation process of banks, leverage and the accumulation of fictitious capital. Furthermore, if one recognises that the financial sector of a *particular country* might be able to draw upon the surplus value produced in the *global* capitalist system, then that offers even more scope for expansion. This is the subject of the present chapter.

Not many countries are in a position to establish a major, domestically based *international* banking and financial operation. The possibilities are limited to those countries that have extensive international trade and investment business. They are usually in a powerful position in the hierarchy of nation states; alternatively, they have strong financial links to the countries that do have such a position. This is the material basis for the expansion of international financial business, one that is also supported by economies of scale. Providing financial services or loans to companies from *all* other countries, not simply to domestic ones, will naturally extend such growth. Today, global finance is dominated by the US and the UK, but there is also a division of labour that gives a role for regional hubs such as Tokyo, Hong Kong and Singapore in Asia, or the fund management businesses of Switzerland and Luxembourg in Europe. In addition, there are many island-based tax havens that play a specific financial role, linked to the major powers.

A key argument of this thesis is that the global financial system is part of the mechanism by which major imperialist powers – especially the US and the UK – sustain their privileges in and appropriate value from the global economy. This chapter will analyse the main features of this mechanism. Section 4.1 examines currency-related financial privileges, ones that can reduce a corporation's or a state's commercial costs and risks, or ones that accrue to a state issuing currency that foreigners both accept in payment and continue to hold. Another, arguably more important, feature of financial privilege is discussed in Section 4.2, that of having ready access to international funds. Section 4.3 examines the financial power

the US gains from being the provider of the main global currency. While the previous sections mainly cover US imperialism, Sections 4.4 and 4.5, on financial services exports and equity markets, respectively, show that financial privileges also accrue to other major countries.

#### **4.1 Currency, international trade and seigniorage**

Within national boundaries, a single, national currency is normally used by all operating businesses. However, for international transactions there is more than one currency from which to choose. Which one is chosen for pricing purchases and sales or for the denomination of loans or other financial deals? Overwhelmingly, it is the US dollar. Even in 2013, more than a decade after the birth of the euro, the dollar was on one side of 87% of all global currency transactions, far beyond the US share of international business and more than twice the share of the euro (BIS 2013c, Table 2, p. 10), whose member countries in aggregate were otherwise not far behind the US in terms of their international economic significance.<sup>1</sup>

Evidently it is simpler, and potentially less costly or risky, for a company to use its own national currency when engaging in foreign trade. Even for multinational companies with a wide range of foreign operations, there is usually one currency that acts as the basis for its accounts, and that is usually the domestic currency of the corporation's headquarters.<sup>2</sup> If a company can use its 'own' currency for pricing its exports and the imports it requires, then that amounts to a significantly lower commercial risk when exchange rates are volatile. Even when it is possible to insure against such risks, for example through currency forward transactions, these usually involve commercial transaction costs. The European Commission cited that avoiding such costs – estimated at 0.3-0.4% of European Union GDP *per year* – was a key economic factor favouring the euro's introduction (European Commission, 2007, p. 17). The more countries that joined the euro, the lower would be such costs, and further reductions would follow from non-euro member countries using the euro as an invoicing currency for international transactions.

The US dollar is used as an invoicing currency for close to 100% of US exports and over 90% of its imports (Goldberg and Tille, 2006, Table 1, p. 15). By comparison, in 2012 the euro was used as an invoicing currency for less than two-thirds of exports outside the euro area, and for just half of imports (ECB, 2013, Table A12, p. 78). The US dollar made up most of the remaining currency share for euro country external trade. In the case of the UK and

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<sup>1</sup> Note that the market shares of all currencies would add up to 200%, since there are two currencies involved in any foreign exchange transaction.

<sup>2</sup> Exceptions occur, as in the case of BP, the UK oil major. Its annual accounts are reported in US dollars, given the dollar pricing of energy products in global markets. However, Vodafone, BAE Systems and GlaxoSmithKline, other big UK corporations, report in terms of sterling.

Japan, over half of their trade is priced in currencies other than their national currency, so they do not benefit as much as the other two currency blocs.

The US gains most from this factor because international commodities, from oil, to metals, agricultural products, pharmaceuticals, plastics, aerospace and defence equipment are priced in terms of US dollars. This means that in competing with foreign companies in international markets, the exchange rate risk falls principally on non-dollar countries. While this can cut both ways – if the US dollar's exchange rate goes up, then other countries might prove to be more competitive in tendering for a contract – it is still a risk that US dollar-based companies are under far less pressure to manage. This is because many contracts will run for more than one year. Even if the initial dollar exchange rate works for a non-dollar company to secure a deal to buy or supply commodities, this may not be true for later years when currency values change. Overall, this way of reducing commercial costs and risks for US international business dealings is likely to be more important than it is for other countries. However, I am not aware of any quantitative estimates of this advantage.

A separate issue under this currency heading is 'seigniorage'. The term describes the benefits to the state of issuing fiat money notes that cost a few cents each to produce but which have a much higher nominal face value, of \$10, \$20 or \$100, etc. Whenever such currency is held and not spent, the national state authorities producing the currency – via the central bank – have gained value because others have accepted the low-cost paper currency in payment for goods and services provided.

All governments printing money that will be accepted within their national boundaries have this advantage, but this can also extend into the international arena for powerful economies. Especially when the national currency is seen as unstable – for example, when there is a very high inflation rate – companies and individuals may also hold on to the currency of another, more stable economy as their 'store of value'. The US has a particular *imperial* advantage in this respect because the dollar is the most widely accepted currency in other countries as a store of value or as a means of payment. In 2012, the IMF listed 43 countries that had the US dollar as a currency anchor, from Ecuador, which has used the US dollar since 2001 as the sole legal tender for notes, to others whose currencies are managed in relation to the dollar through a currency board exchange rate peg or some other method (IMF, 2012c, Table 1, p. 5). The euro was used by 27 countries, and in a similar variety of ways. In Kosovo and Montenegro, the euro replaced the national currency, while Bulgaria has a euro-linked currency board. Denmark is a member of Europe's Exchange Rate Mechanism, keeping the Danish krone within narrow limits to the euro, and 14 countries in Central and West Africa, 12 of which are former French colonies, use the CFA franc, which is pegged to the euro.

If US dollars have entered circulation in another country through the cash payment for that country's exports, then the US has exchanged its green bits of paper for that country's resources. For the non-US company doing the transaction, it has been paid for the goods or services it supplied and it may well use the dollars in a further purchase. However, it still brings a benefit to the US economy because a share of US imports is paid for with US currency that, at some stage in the chain of transactions, does not get spent. In aggregate, the US economy does not exchange its own resources for a portion of its imports and it appropriates value produced elsewhere.

It is difficult to measure with any precision the value to the US economy of international seigniorage. The New York Federal Reserve has estimated that in December 2007 the total stock of notes in circulation was \$829bn, and 'the majority is held outside the United States' – a proportion believed to be close to 60%. In addition, it said that the amount of dollar cash in circulation had 'risen rapidly in recent decades and much of the increase has been caused by demand from abroad' (New York Fed, 2008). Hence, a stock of some \$500bn of US currency is circulating overseas, close to 3% of US GDP. Part of this stock of foreign dollars will be funds taken out of the country by US citizens; part will be money used in drug deals and other illegal activities.

At bottom, this is a transfer of value produced elsewhere to the US state, the printer of the notes. Some foreign suppliers have delivered the commodities and held onto the paper dollar cash. The main risk to the dollar's role in this respect, also true for other currencies, is that the ability to benefit from seigniorage will also depend on market perceptions of the strength of a currency's exchange rate against other major currency alternatives. This was indicated in 2007: as the US dollar's exchange rate was continuing to fall, Brazilian supermodel Gisele Bündchen declared that she wanted to be paid for her services in any major currency except dollars (Nielsen and Brasileiro, 2007).

The benefit for state issuers of other major currencies is much smaller than it is for the US. While the numbers are not insignificant for the euro, the benefits of seigniorage accrue to all the euro member countries, not just to one country. They derive largely from the previous role of the Deutsche mark as the most important European currency of the most powerful economy, but France's CFA franc zone in Africa was also a factor. Ironically, because the Deutsche mark was prominent especially in countries neighbouring Germany that joined the euro area in 1999, there was actually a dip in the 'seigniorage' total for Germany after that point as DM were translated into euros. Nevertheless, with the growing influence of euro area financial markets, to a level well beyond what was feasible on the basis of Germany alone, and despite the financial turmoil in the late 2000s, the scale of euro seigniorage has risen sharply. The European Central Bank estimated the value of euro banknotes held outside

the euro area countries at €36.4 billion in mid-2008 and the figure jumped to €130 billion by end-2012 (ECB, 2005, p. 58; ECB, 2013, p. 23). The latter is about 30-40% of the respective US figure and roughly 1.5% of euro country GDP. There has been speculation about how much foreign circulation of euro banknotes is also due to criminal activity. In 2010, British banks withdrew the high value 500-euro note from circulation after the Serious Organised Crime Agency estimated that 90% were not being used legitimately (Telegraph, 2010).

I have found no contemporary estimates of foreign seigniorage for the UK, Japan or Switzerland. The UK's benefit will have declined with the dissolution of the Sterling Area in the early 1970s. Sterling's very much smaller role in foreign payments compared to the US dollar, and the trend decline in sterling's value, likely mean that seigniorage amounts are negligible in relation to UK GDP. This is not contradicted by the UK's large financial role in the world, since, as Chapter 5 will explain, this financial role is not really based upon sterling. It is probable that the foreign circulation of Swiss francs, and even Japanese yen, are more important in relation to their GDPs. The longer-term trend of appreciation in the value of the latter currencies, and their low interest rates, makes holding cash in the form of notes relatively attractive.<sup>3</sup>

Seigniorage is only a very narrow measure of the potential economic gains from a currency's international role, however. Although the stocks of currency circulating abroad may be large absolute sums, these remain only small shares of GDP. Even in the case of the euro, a newer currency than the other majors, the incremental amounts each year are not significant. The following sections discuss other, economically more important dimensions of financial privilege.

## 4.2 'Exorbitant privilege'

The global role of the US dollar and the linked economic advantages for the US have been discussed in the literature in a different context from seigniorage, usually under the heading of 'exorbitant privilege'.<sup>4</sup> This can mean either the privilege the US gets from being able to fund its external deficits by borrowing at low cost in terms of its own currency, its original meaning, or the ability to earn an 'excess return' on net foreign assets.<sup>5</sup> These are indeed important privileges, ones available only to a select few powers. As noted in Chapter 2, such advantages may accrue directly to capitalist companies or to national governments.

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<sup>3</sup> Holding a bank account (in Swiss francs or Japanese yen, for example) outside the relevant country does not mean that any notes actually leave the national territory and are physically held. Seigniorage refers to holding currency *notes*.

<sup>4</sup> The term originates from French government criticism of the dollar's role in the 1960s, and was coined by De Gaulle's finance minister, Valéry Giscard d'Estaing, who used it to refer to the US ability to fund its current account deficit by issuing dollars at low rates of interest (Eichengreen, 2011, p. 4).

<sup>5</sup> Eichengreen 2011 mainly refers to the former while Habib 2010 focuses on the latter.

Most users of another country's currency for international trade, investment or finance do not hold the physical cash, but a bank account or securities denominated in that currency. With these, the holders may receive interest or dividend payments, so the deposit-liability-holding or security-issuing country does not get the funds for free, as with seigniorage. But a key benefit the US gains from the global role of the US dollar is to get (usually) cheap, low risk finance. This comes about in two ways.

Firstly, the US can draw upon the financial resources of the world economy and it has much easier access to funds than do other countries. One important aspect of this is the dollar's high share – around two-thirds – of official foreign exchange reserves. After the Asian financial crisis of 1997–98, many countries in the region – and elsewhere – built up their currency reserves as a deliberate policy of economic insurance against renewed trouble. The US dollar was the currency of choice for these extra reserves, not only because it was the principal means of payment for trade and finance, but also because many countries had currencies linked to the dollar. Through the 2000s, a growing US current account deficit was funded in this way by huge inflows of finance, especially from Asian central banks that bought US Treasury securities and other US dollar-denominated assets (Higgins and Klitgaard, 2004). From 2000 to 2007, the cumulative US current account deficit was a massive \$4.7 trillion; the annual deficit peaked at 6% of US GDP in 2006. Over the same period, China's foreign exchange reserves, excluding gold, grew by \$1.4 trillion. Assuming that three-quarters of China's reserves were held in US dollars, this implies that China's official reserve accumulation of US dollars *alone* was enough to fund roughly one-fifth of the US current account deficit over that period.<sup>6</sup> The further accumulation of China's FX reserves, from \$1.5 trillion at end-2007 to \$3.8 trillion by end-2013, starkly illustrates the continuing support for US deficits from external finance. Such figures dwarf the seigniorage estimates.

It was not only the *easy* funding of US deficits that stood out in the 2000s. The demand for dollars was so high that, despite the huge deficits that needed financing, US yields *fell*. A variety of factors was responsible for the falling yields, but one study suggested that the impact of foreign purchases of dollar securities was to reduce the borrowing costs of the US government by as much as 150 basis points for 10-year debt (for example, a yield being lowered to 3.5% rather than remaining at 5%), compared to what the cost might otherwise have been (Warnock and Warnock, 2005). Since the foreign purchases of US securities were not only by foreign central banks, and not only of US Treasuries, but also of equities,

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<sup>6</sup> US current account data are from the regular reports of the Bureau of Economic Analysis. China's FX reserve data are taken from Arunachalam 2010 (Table 3, pp. 76-77). The composition of China's FX reserves is not reported, but when discussing with a Japanese finance ministry official in 2005, he told me that 80% or more of China's reserves were held in US dollars in the early part of that decade. The dollar proportion was reduced in later years, but is widely believed in the financial markets to be around 60-65% now.

corporate bonds and 'agency' bonds (asset-backed securities issued by semi-official US institutions, based on mortgages and student loans), lower bond yields and higher security prices spread throughout the US financial markets.<sup>7</sup> Although this was an important factor in the ensuing crisis, it reflected a structural feature of US financial privilege in the world economy. This also indicates that analyses of 'financialisation' must be set in the context of global economic and financial developments and not be confined to individual countries (Christophers, 2013).

Secondly, by issuing debt denominated in US dollars, the US state can avoid taking on foreign currency risk. In a US-centred crisis, the value of the dollar might fall against other major currencies, but the US state has little debt denominated in euros, Japanese yen or sterling, so it will not face much increase in its liabilities from this source. Countries that do not have a privileged position in global finance – those that are not imperialist powers – are in a much worse position. One interesting paper examines this problem for Latin American countries, noting how, even if they have good 'credit ratios', financial markets give such countries a high 'risk premium', making their costs of borrowing higher, because they have little ability to borrow long-term in their domestic currencies (Hausmann, 2002). Often they borrow funds denominated in the major foreign currencies, especially the US dollar, but at interest rates that would appear to be in excess of their underlying credit risk. This would seem to result from the risk of domestic currency depreciation versus the borrowed currency in the event of a crisis.

The interest rate cost for the US of borrowing dollar funds might be higher than the interest rates available on other major currencies. Financial privilege does not necessarily mean lower yields, since these yields will also depend upon domestic inflation and central bank monetary policy. For example, yields on German and Japanese government bonds have usually been below yields on US Treasuries. However, the dollar section of the credit market is the biggest in the world and the easier access to this for the US government, and US companies, together with the absence of any exchange rate risk on borrowing, remain key US financial advantages. The funds borrowed can finance extra consumption of imports or they can offset outflows on the financial accounts for US investments in foreign assets (direct and portfolio investments). Notably, the interest costs on US foreign borrowing have been far less than the returns on US foreign investments. This has enabled the US to maintain a positive net investment income, despite the persistent, large net deficit on its foreign investment position. At end-2012, the US net foreign investment stock position was *minus* \$3,864bn (BEA, 2013a,

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<sup>7</sup> Even if the foreign purchases were only of US *government* securities, the lower yields would have spread throughout the credit system. Other bond and longer-term loan interest rates are based upon the benchmark rate for government securities.

p. 14). However, in 2011-2012 the US gained an annual average net \$236bn from foreign investment income, more than double the amount in 2007 (BEA 2013a, lines 13 and 30, Table 1, p. 73). The higher net income was helped by its ability to pay close to zero interest rates on US government debt owned by foreigners.

Hausmann and Sturzenegger (2006) perform an impressive feat of obfuscation when analysing this issue. The question they ask is why foreign investors accept lower returns on US assets, thus allowing the US to derive a positive income balance from a deficit investment position. Their solution is to assume away the existence of different rates of return and instead to invent *extra* US foreign assets that do not appear in the statistics! This is what they call 'dark matter' and it results in the US having a net *surplus* on its investment position (pp. 3-8). This feat is achieved by capitalising the net income from US foreign investments: 'By capitalizing the income we are redefining the stock of assets in a way that more explicitly shows the value of the underlying services' (p. 8). This sets aside the question of US imperialism's economic and financial power by characterising its ability to appropriate value from the world economy as a payment the rest of the world makes for the 'services' received! In Chapter 6, I will deal with the different way in which the UK usually manages to achieve the same feat.

The foreign investment revenues paid and received result from a wide variety of industrial, commercial and money-capital investments both into and out of the US. Although the US government, corporations, banks and the domestic economy in general must pay for the financial inflows, the privileged financial position of the US means that this cost is relatively cheap compared to the returns that US capitalists earn on foreign investment.

### **4.3 Running the world banking system: US dollar power**

With most of world trade and finance denominated in US dollars, the centre of global financial power is clear. Some authors discuss how the US has the key role in world finance, both effectively being the provider of 'global money' and being able to decide what policies to pursue based both upon its domestic needs and on what is viable for the global monetary system (Panitch and Gindin, 2012). However, the mechanism through which this power is exerted is usually discussed in purely political terms, for example noting that the US has the most influence over financial regulation or on the policies of the IMF. The *economic* mechanism is commonly left to one side. Yet the economic mechanism is what illustrates most clearly how the financial system is a means of exercising such power.

Consider what happens when a company in China needs to pay Venezuela for oil imports. At first sight, no US company, still less the US state, would appear to be involved in this transaction, and neither country is politically friendly with the US. Nevertheless, a US-

based company must be involved in the deal and US state acquiescence is necessary. This is because oil is priced in US dollars, and the payment, for example \$50m, will go through the US banking system. No cash from a bureau de change is posted from Beijing to Caracas in a suitcase! What happens is that the companies in each country will have relationships with their local banks, and will likely have a US dollar account with them. However, these dollar accounts will be *held* in the US monetary system, possibly via a US 'correspondent' bank with which they have dealings or the US branch of the relevant Chinese or Venezuelan bank. The Chinese company will tell its bank to credit the Venezuelan company's dollar account with \$50m, either by deducting the sum from its existing dollar account or by asking its bank to exchange the appropriate amount of its local currency into dollars. In either case, the US-based bank will, on behalf of the Chinese company, then transfer \$50m to the relevant account of the Venezuelan company at a US-based bank. This dollar transfer between banks is done via a payments system based in the US, either the Fedwire Funds Service, which is under the direct supervision of the US Federal Reserve, or, more usually, the Clearing House Interbank Payments System (CHIPS), a privately run international bank-owned system whose US membership is regulated by the US government.

If the respective Chinese and Venezuelan companies did not want to use the US banking system, then they would have to agree on a separate, non-US dollar means of transacting. This could be done, but it would mean agreeing on another currency basis for the deal other than US dollars, for example selling China's renminbi (ISO code CNY) and buying Venezuela's bolivar (VEF). The costs in terms of foreign exchange margins, liquidity and having the relevant currency bank accounts might not be commercially attractive. There would need to be banks making markets in the CNY-VEF exchange rate, otherwise the transaction would probably be done via the US dollar as the intermediary currency (sell CNY and buy USD, then sell USD and buy VEF), which then comes back into the US system. The consequence is that even the opponents of US imperialism tend to fall under its commercial rules. Given the role of the US dollar in world trade and finance, a company planning to do significant and repeated foreign deals will need a bank account in US dollars. Some countries have agreed barter deals to avoid foreign exchange transactions, but this is even less efficient.

This gives the US government an astonishing power to isolate opponents economically, without necessarily doing anything extra in the political or military sphere, although such measures often follow. All that the US government needs to do is declare economic relationships with a particular country *non grata* and that country's economic links with the rest of the world are severely restricted, putting its economy under drastic pressure. The impact, as noted above, does not depend on a country dealing directly with the US, only indirectly with its banking system. Furthermore, even if a country in political conflict with the

US plans to avoid dealing in dollars altogether, thus avoiding these restrictions, the US government can still, in practice, prevent other countries' banks from dealing with the targeted country. As one legal adviser in Dubai, a country with close business relations with Iran, noted in relation to US sanctions:

'The real tipping point was at the end of 2011, with the latest round of US banking sanctions, potentially exposing non-US banks to sanctions by the US ... That was a real wake-up call for banks outside the US still dealing with Iran. They didn't want to run the risk of being cut off from the US banking system.' (Hall, 2012)

Being cut off from the US banking system would severely damage a major company's international business operations, so the real power of this sanction is that it rarely has to be implemented. A number of major international banks in Europe and Japan have escaped this ultimate sanction after paying hundreds of millions of dollars in fines to the US government and doing the necessary penance (Bond, 2013). The US has found it easy to threaten other countries in this way whenever it desires. There has been widespread compliance with US policy, particularly in Europe, which indicates that financial power is a tool that can also be used against other rich countries.

Another dimension of US financial power comes from the fact that the Federal Reserve provides liquidity to global financial markets. All central banks regulate liquidity in the *domestic* monetary system, but the international role of the US dollar makes the US central bank critical for the functioning of the global system. In 'normal' times, the US Fed need play no role, and private banking relationships will service the liquidity needs of the market. However, the financial crisis of recent years has put the US Fed in a key position. It has provided extra funds, for a fee, to the European Central Bank, the Bank of England and other central banks to redistribute to their local banks and support market stability. The *New York Times* reported on why this move was also in US interests:

"In recent days some European banks have faced difficulties in borrowing dollars, whether from other banks or from money market funds in the United States. There was fear that if they could not borrow dollars, they would be forced to cut off loans to American companies or sell dollar-denominated assets, perhaps forcing prices down in already unsteady markets." (Ewing and Castle, 2011)

The vulnerability of European banks was based on much of their business being conducted in US dollars, especially for international trade finance, so that it was (and is) critical for them to be able to access dollar funds. This example illustrates clearly how the US is in a privileged position when it comes to finance, especially in a crisis. However, it did not necessarily profit much from these particular funding operations.

#### **4.4 Financial services exports**

The US is the world's largest exporter of financial services: US-based companies derive the highest revenues from providing financial services to businesses in foreign countries. This is one way that the US appropriates surplus value from the world economy: in dealing revenues, fees and commissions, and the management fees charged by US financial companies to their overseas subsidiaries (which are also included in US statistics).<sup>8</sup> These revenues derive from the global status of US dollar finance, but are separate from and additional to the interest or dividend income on US foreign asset holdings. They also include revenues earned by US financial intermediaries from foreign investment in US government bonds, corporate bonds and equities. So, in addition to the US having privileged access to foreign funding, US-based financial companies – these are principally US-owned – can make money from *incoming* deals. Nevertheless, it is worth noting that these foreign financial services revenues are relatively small compared to the size of the US economy. For example, the 2011 financial services receipts from abroad were \$73bn, but this was barely half a per cent of US GDP (BEA, 2013b, Table G). Overall, however, the activities of the financial services and insurance sector account for close to 8% of US GDP (BEA, 2013c).

By comparison, the UK financial services export revenues of \$59bn in 2011 were 2.5% of GDP, five times higher than for the US, but the share of the financial services and insurance sector in GDP was only a little higher, at 8.4% in 2010 (calculated from ONS, 2012e, Table 1.7.1, p. 87). UK financial services export revenues largely derive from bank dealing spreads and commissions, plus the fees of banks and securities dealers. These data will be discussed in Chapter 6.

Even more than most other areas of global business, financial services export revenues are very highly concentrated in a small number of countries. Table 4.1 shows that the top three countries – the US, UK and Luxembourg – accounted for almost 60% of the world total in 2011, while countries ranked below India, in ninth position, each had a share of less than 2%. The potential for concentration means that, especially for smaller countries, financial services can be a major component of national export earnings and GDP.

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<sup>8</sup> The largest portion of total financial services revenues for the US comes from 'management' fees, which amounted to \$20.6bn in 2011. These fees will include charges for the use of the headquarters' IT systems. Securities lending, electronic funds transfer, and other financial services revenues amounted to another \$15bn, and \$14.2bn came from brokerage fees (BEA, 2013a, Table G).

**Table 4.1: Financial services export revenues, 2000-2011 (\$ billion) \***

	2000	2005	2010	2011	% of 2011 Total
US	22.1	39.9	66.4	73.0	23.5%
UK	22.1	42.6	50.8	59.4	19.1%
Luxembourg **	13.1	24.5	40.5	43.9	14.1%
Switzerland	10.6	14.1	15.8	17.0	5.5%
Hong Kong	4.4	6.3	13.1	15.3	4.9%
Singapore	1.8	4.5	12.2	14.1	4.5%
Germany	3.5	6.6	11.8	13.6	4.4%
Ireland	2.1	6.0	7.9	9.1	2.9%
India	0.3	1.1	6.0	6.4	2.1%
Other	19.8	33.1	51.4	58.4	18.8%
<b>Total</b>	<b>99.8</b>	<b>178.7</b>	<b>275.9</b>	<b>310.3</b>	<b>100.0</b>

Notes: \* Financial services revenues exclude insurance. \*\* Luxembourg's figure for 2000 includes Belgium.

Source: UNCTAD, 2012, Table 5.2, p. 298.

Luxembourg, a country with a population of barely half a million, has a profitable niche in this area. It stands out as what one could call a 'paragon of parasitism', giving an extreme example of how a large financial sector that is unproductive of value can benefit a country if it can appropriate value from *others*. Luxembourg is an important private banking sector for wealthy individuals, helped by its low tax regime, but it stands out as the biggest fund management centre in Europe. It accounted for more than a quarter of European assets under management in 2012, a share that was nearly double that of the next biggest country, France (Luxembourg, 2013). Luxembourg's financial services, including insurance, generated export revenues equivalent to three-quarters of GDP in 2011! These services also made up nearly a quarter of the country's GDP,<sup>9</sup> the highest share in Europe and probably in the world.

Switzerland, Hong Kong, Singapore and Ireland are other relatively small countries with large financial services sectors, both in absolute terms and in relation to GDP.

Switzerland's accounted for 10.3% of its GDP in 2011. This was made up from both the banking sector (6.2% of GDP) and the insurance sector (4.1%). According to the Swiss Bankers' Association, the value attributed to these financial services amounted to CHF 59.4 billion in 2011 – or CHF 260,000 per employee (roughly US\$ 280,000 in 2011) – so that 'productivity is almost two times the Swiss average' (SBA, 2013). This 'productivity' is a

<sup>9</sup> The apparent discrepancy between financial services activity accounting for a quarter of Luxembourg's GDP and financial services export revenues amounting to three-quarters of its GDP is because export revenues are not measured on a 'value-added' basis.

function of Switzerland's role as a tax haven, where it can profit from the small percentage cuts taken from a huge volume of financial business. The tiny lakeside Swiss canton of Zug is reputed to host 27,000 corporations that have registered there for tax purposes – about one for every four inhabitants (Shaxson, 2011, p. 53).

The Hong Kong financial sector's relative size is larger still, making up 15% of GDP in 2010. It also registered a well above average GDP per person employed of HK\$ 1,194,000, roughly US\$ 154,000 (Hong Kong, 2012, pp. FB2-3). Hong Kong was an important Asian trading post of the British Empire, but it has developed its business in the past decade on the back of mainland China's economic prowess being from 1997, when Britain handed over control to China, a 'special administrative region' through which the Chinese state and Chinese companies can engage with world financial markets. As with Switzerland, the bulk of Hong Kong's revenues come from banking rather than from insurance or other financial services. Singapore is also an ex-British colony. Its prominence in regional commercial and financial business developed under British rule, as it was originally established as a trading post of the East India Company in the early 19<sup>th</sup> century. In 2012, the finance and insurance sector made up 11.9% of GDP (MAS, 2013, p. 19). Most of Singapore's financial services export revenues derive from banking, including foreign exchange and derivatives turnover, but its official statistics give few details.

By contrast, Ireland started its foray into financial services in less auspicious circumstances. Having been partitioned in 1921, after several hundred years of British colonial rule, Ireland stagnated economically until it found a means of escape through the economic subsidies that flowed from its 1973 membership of the European Economic Community. Compared to Hong Kong and Singapore, it had no developed financial or commercial services expertise or status, but in the late-1980s the Irish government took a gamble to offer itself as a low-tax venue for international business, especially financial business, in its newly created International Financial Services Centre based in Dublin. Ireland attracted traditional fund managers, hedge funds and the branches of some major global banks. By 2007, financial and insurance services accounted for nearly 11% of GDP (calculated from CSO, 2012, Table 2). However, while financial services export revenues were high and rose steadily, a notable feature of the Irish economy is that its dependence on foreign capital means that a large proportion of GDP ends up transmitted abroad in foreign investment income payments. For this reason, Ireland has possibly the biggest percentage gap between GDP (a measure of its national *output*) and Gross National Income in the world: in 2011, the gap was equivalent to 19% of GDP (calculated from CSO, 2013). This suggests that the value of one day in five worked in the Irish Republic goes to foreign investors!

The Irish data indicate that one needs to be circumspect when interpreting data on the importance of the financial sector. It would be wrong to presume that a large financial sector means a country has financial strength or is prominent in the world economy, still less that it is an imperialist power. The smaller financial hubs, even Switzerland, need to be understood in terms of the role they play in the global financial system.<sup>10</sup> The data on financial services revenues are nevertheless useful for illustrating contemporary capitalism's parasitic features.

#### **4.5 Equity markets, financial power and control**

Equity markets offer a different form of financial privilege and appropriation for the major powers, and one that is more difficult to measure than the benefits accruing from seigniorage, lack of currency risk, lower interest rates or financial services revenues. Equity markets can be defined as the market for a stake in the ownership of publicly listed companies, with consequent rights to the companies' income. They are usually represented by equity trading institutions located in particular countries, although the dealings nowadays are usually transacted electronically and across borders. Fees for dealing on the exchanges, the bid-offer spreads for dealing, etc, are captured in the financial services revenue data discussed in the previous section. However, these markets do not only price the fictitious (equity) capital of companies or act as the places where these assets can be exchanged for money. Two other related functions are just as important.

One is where these markets operate as the institution used by capitalist companies for floating new issues of equity for sale to money capitalists. Yet this should not be exaggerated, since companies derive the bulk of their investment funds from retained profits, from bank borrowing or from issues of corporate bonds. For example, UK gross fixed capital formation in 2011 was £215 billion compared to less than £23 billion raised on the UK stock exchange through new share issues, initial public offerings and further share issues in that year (ONS, 2012e, Table 1.2, p. 58; my calculations from LSE, 2012).

The second, more significant role that equity markets play is as a market for corporate takeover and control. In this case, the market valuation of equity capital is not simply a sign of the sum of money capital that a capitalist *could* have at his command. The equity capital can also act as a *means of payment* for another company's equity. This occurs in a common form of equity market transaction: the 'share swap' or 'stock swap'. Here the acquiring company offers a certain number of its shares in exchange for those of the takeover or merger target company, a ratio that depends on the relative prices of each company's share plus any incentive given to get the transaction accepted by the target company's shareholders. This

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<sup>10</sup> An excellent discussion of Switzerland in this respect, although now somewhat dated, is Ziegler 1978.

kind of deal can avoid the use of cash payment. Even if it did not and some cash were also used, the main factor in the transaction is still the relative attraction of each company's equity. The global size and status of different equity markets is influential here, since the equity capital means of payment has to be sufficiently liquid. An example will illustrate this point.

If company A, listed on the Oslo Stock Exchange in Norway, wanted to buy company B, listed on the New York Stock Exchange for \$10bn, but with its Norwegian-listed shares, then the price demanded by company B's shareholders would be higher than if company A were also listed in the US. The reason is that the takeover would leave the US company's former shareholders owning Norwegian shares. The turnover on the Oslo exchange is barely 5% of the NYSE's turnover, so if they wanted to sell their shareholdings, they would face a greater risk of the price falling as they sold. Furthermore, apart from the price risk in a less liquid equity market, they would also have a significant exchange rate risk given that the trading volume of the US dollar versus the Norwegian krone is very small, only around 1% of the daily trading volume of the US dollar versus the UK pound sterling, and less still for the US dollar versus the euro. These things are not attractive to money capitalists! Although this is perhaps an extreme example, it shows the advantages of equity markets that are bigger and priced in major global currencies, especially the US dollar, but also the euro, the Japanese yen and sterling. The latter three currencies trading against the US dollar accounted for 51% of total currency turnover in 2010 (BIS, 2010a, Table B.6, p. 15).

Not surprisingly, if they originate from smaller countries, major global corporations will also tend to list their equities in the bigger equity markets, ones that are based in the major capitalist powers. This builds on the fact that companies will tend initially to float their equity on their domestic markets, so that the major powers, with often the biggest companies, will also tend to have the biggest equity markets. However, countries with prominence in the financial sphere can further punch above their domestic economic weight by attracting foreign companies to their equity markets. To refer back to the previous Norwegian example, Statoil ASA, Norway's largest company, two-thirds owned by the Norwegian government and the 11<sup>th</sup> biggest global oil and gas producer, is listed on the New York Stock Exchange as well as in Oslo. This was to assist Statoil's foreign acquisitions. This kind of development means that the US equity market, in both capitalisation and turnover, is bigger compared to other centres than a simple GDP metric might suggest. The same is true for the UK. In stock exchange terms, the US is more than five times bigger than Japan, and the UK is roughly twice as big as Germany, as Table 4.2 details.

**Table 4.2: Equity market capitalisation and turnover, 2012 (\$ billion)**

Country	Exchanges	Capitalisation *	Turnover **
US	NYSE Euronext (US) plus NASDAQ	17,503	12,588
China	Shanghai plus Shenzhen plus Hong Kong Exchanges	5,936	3,703
Japan	Tokyo Stock Exchange	3,385	1,810
UK	London Stock Exchange	3,332	1,190
Belgium, France, Netherlands, Portugal	NYSE Euronext (Europe)	2,460	853
Canada	TMX Group	1,860	672
Germany	Deutsche Börse	1,212	698

Notes: \* Market capitalisation for end-June 2012.

\*\* Electronic order book volume of trades for first half of 2012. Turnover data for Hong Kong estimated by the author.

Source: WFE, 2012, and author's calculations.

The ups and downs of share prices affect the data shown in Table 4.2, but the relative size of each exchange does not tend to change much. The exception is for China, which has risen to prominence in more recent years. I have added together the two mainland exchanges to the more established Hong Kong exchange to give a total for China. But, even without Hong Kong, China would have the second rank in terms of global market capitalisation. US markets are head and shoulders above the others, assisted by the market's greater size that attracts foreign company listings more readily. The London Stock Exchange ranks behind Tokyo's, despite London's foreign constituents, but it is far bigger than the exchanges for other European countries, including the combined Euronext exchange figures for Belgium, France, the Netherlands and Portugal.

Stock exchange equity price indices are the most widely reported part of financial markets in the general news media, from regular television news bulletins to daily newspapers and Internet sites. The attention paid to these indices reflects the importance of fictitious capital, and of financial wealth, in capitalist society today.

A company listed on a major equity market will have access to funds, being able to raise new capital. In addition, having a listing on a major stock market gives the company extra business influence because its equity capital now acts as *real* money in the market for the ownership and control of *other* companies worldwide. Such an advantage can apply to any major corporation that lists on a major exchange, from whichever country. Owing to this, one

might question whether there are really any particular *imperialist* advantages involved. If a Norwegian oil and gas corporation can list in the US, or if a component company of the FTSE100 index in the UK is Kazakhmys, a mining company based in Kazakhstan whose majority shareholders are Kazakh capitalists, then it may seem to be just a question of big corporations *anywhere* taking advantage of the best, not necessarily national, financial markets in which to deal. However, this would fail to recognise that the principal monopolistic corporations are also based in the major imperialist powers.

A study cited in Chapter 2's discussion of monopoly (Section 2.3) showed that only a small number of corporations control a large share of global corporate assets. Just 50 corporations were estimated to control 40% of the assets of more than 43,000 international companies (Vitali et al, 2011). The 50 corporations are separate companies that are unlikely to act as one entity, but the countries in which the companies are based are the usual suspects: a small number of powerful capitalist states, with the UK second in importance behind the US. The companies were distributed as follows: US (24), UK (8), France (5), Japan (4), Switzerland (2), Germany (2), Netherlands (2), Canada (1), China (1) and Italy (1).<sup>11</sup> These countries are also in the top 10 of Chapter 2's 'Index of imperialism' (Section 2.8), which gives further support to that index's validity as a measure of economic power. However, it is important to note for the purposes of this discussion that the corporate control feature is a direct consequence of the growth of cross-shareholdings, mergers and takeovers that are made possible by global equity markets. This is another sign that the equity markets do not simply offer a means of turning a 'long-term' investment in a company's assets into a form of tradable money capital, they also show another way in which fictitious capital is the pre-eminent form of value characterising the economics of imperialism.

#### 4.6 Conclusions

This chapter has examined the principal forms of international financial privilege today. As the examples have shown, the US is, to use a phrase of military strategists, the closest to 'full spectrum dominance' in global finance, given the key role of the US dollar and the power of the US economy. A wide range of financial privileges accrues to the US from this position. Not all of these can be easily quantified, and those that can, such as export revenues from financial services, might appear to be an insignificant percentage of US GDP. However, these examples should be considered as a package, one that extends beyond the activities of banks and other financial institutions. The financial 'package' is part of the mechanism by which the US relates to the world economy, as in the case where the relatively easy funding of the US current account deficit assists the financing of foreign direct investment by US corporations.

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<sup>11</sup> The companies concerned are listed in Appendix 4.1 of this chapter.

Some of these privileges and the related economic benefits can accrue to US-based companies or to the US government simply because those trading with the US, or using the dollar, are accepting the existing infrastructure of payments. These privileges do not only depend on the more direct appropriation of surplus value from the world economy that comes from foreign investments and exporting financial services. Nor do these privileges - or financial power in general - only come to the fore when there is a debt crisis. They are part of the regular, daily mechanism of imperialist finance.

As this chapter has indicated, the US is not the only country involved in this process. The varied forms international finance - bank lending, dealing in currencies, interest rates, bond and equity securities, asset management, etc - have seen a division of labour emerge in the financial dimensions of the world economy. This includes a number of smaller powers that have their own niche, such as Switzerland and Luxembourg, and other, essentially subordinate countries, that play the role of tax havens to service the major powers (a topic discussed further in Chapter 6). US-based international financial operations are not necessarily the world's biggest in every area, and such operations are often more important for other economies than they are for the US economy. As Chapter 6 will show, UK-based international banking and many areas of UK financial services are bigger than those in the US. To set the scene for that analysis, Chapter 5 covers the relevant history of the UK financial sector, especially the post-1945 links with the US.

## **Appendix 4.1: Corporate Control by Controlling Company**

The following table lists the top 50 corporations at the centre of global ownership networks. The listing is in order of implied controlling share of a group of 43,060 companies from 116 countries, with the respective controlling companies noted according to their 'home' country as indicated by that country's two-letter ISO code. Most, but not all, of the top 50 are financial corporations.

**Table 4.3: Corporate control by controlling company, 2007**

<b>Rank</b>	<b>Company name</b>	<b>Country</b>	<b>Cumulative % network control</b>
1	Barclays Plc	GB	4.1
2	Capital Group Companies, Inc	US	6.7
3	FMR Corp	US	8.9
4	Axa	FR	11.2
5	State Street Corp	US	13.0
6	JP Morgan Chase & Co	US	14.6
7	Legal & General Group Plc	GB	16.0
8	Vanguard Group Inc	US	17.3
9	UBS AG	CH	18.5
10	Merrill Lynch & Co	US	19.5
11	Wellington Management Co LLP	US	20.3
12	Deutsche Bank AG	DE	21.2
13	Franklin Resources Inc	US	22.0
14	Credit Suisse Group	CH	22.8
15	Walton Enterprises LLC	US	23.6
16	Bank Of New York Mellon Corp	US	24.3
17	Natixis	FR	25.0
18	Goldman Sachs Group Inc	US	25.6
19	T Rowe Price Group Inc	US	26.3
20	Legg Mason Inc	US	26.9
21	Morgan Stanley	US	27.6
22	Mitsubishi UFJ Financial Group Inc	JP	28.2
23	Northern Trust Corp	US	28.7
24	Société Générale	FR	29.3
25	Bank Of America Corp	US	29.8
26	Lloyds TSB Group Plc	GB	30.3
27	Invesco Plc	GB	30.8
28	Allianz Se	DE	31.3
29	TIAA	US	32.2
30	Old Mutual Plc	GB	32.7
31	Aviva Plc	GB	33.1

**Table 4.3: Corporate control by controlling company, 2007**

Rank	Company name	Country	Cumulative % network control
32	Schroders Plc	GB	33.6
33	Dodge & Cox	US	34.0
34	Lehman Brothers Holdings Inc	US	34.4
35	Sun Life Financial Inc	CA	34.8
36	Standard Life Plc	GB	35.2
37	CNCE	FR	35.6
38	Nomura Holdings Inc	JP	35.9
39	The Depository Trust Company	US	36.3
40	Massachusetts Mutual Life Insurance	US	36.6
41	ING Groep NV	NL	37.0
42	Brandes Investment Partners LP	US	37.3
43	Unicredito Italiano Spa	IT	37.6
44	Deposit Insurance Corporation, Japan	JP	37.9
45	Vereniging Aegon	NL	38.3
46	BNP Paribas	FR	38.6
47	Affiliated Managers Group Inc	US	38.9
48	Resona Holdings Inc	JP	39.2
49	Capital Group International Inc	US	39.5
50	China Petrochemical Group Co	CN	39.8

Source: Vitali et al, 2011, Table S1, based on analysis of 2007 corporate data.

Since the previous table was compiled, the position of Barclays Plc as number one would be reduced by the 2009 sale of its Barclays Global Investors unit to BlackRock of the US. However, Barclays' 2008 purchase of parts of the North American business of Lehman Brothers would likely still leave it in first place today.

The ranking for 2007 in terms of how many companies in the top 50 are based in particular countries is as follows:

US	24
GB	8
France	5
Japan	4
Switzerland	2
Germany	2
Netherlands	2
Canada	1
China	1
Italy	1
<b>Total</b>	<b>50</b>

## **Chapter 5      British Imperialism, Finance and the Major Powers**

This chapter reviews events in the post-1945 development of the global financial system that throw light on British imperialism's position today. It will show firstly how Britain's dominant position in global financial markets before the Second World War could not be replicated post-war. British economic power was greatly reduced, so the orientation of British finance also had to change. Secondly, it will show that the way in which this position changed reflected developments in the world economy, in particular by coming to a *modus vivendi* with the power of US capital. There is a wide literature on the evolution of international financial markets in Britain that covers similar ground (for example Burn, 2006; Cain and Hopkins, 2002; Michie, 1992), so I will note only briefly the relevant points. However, my focus on Britain's position in the world helps to explain the persistent political debates in Britain on the relationship with Europe, dating back at least to the 1960s. Coming to terms with developments in Europe has been almost as important for the UK as its relationship with the US. They are two key dimensions that determine Britain's status as an imperialist power.

There can be no dispute that the UK is in a subordinate position in its relationship with the US. That became clear to UK policymakers from the 1940s, when US governments made concerted efforts to undo the British Empire's protectionist policy and influence as a *quid pro quo* for US financial aid. It was particularly clear in the 1956 Suez fiasco, when US opposition stymied the Anglo-French adventure against Egypt (Kyle, 1991). But I argue that it is a mistake to understand UK-based international financial market operations as simply being a 'satellite' of the US (Panitch & Gindin, 2012, p. 12; Gowan, 1999, p. 26). A better conception is that UK markets adapted to the changes in the political and economic realities of the post-1945 world in ways that built on their prior strength. While this meant recognising US financial power, especially as UK financial dealing came to be focused on the US dollar, this also reaped new benefits for British imperialism. The Anglo-American relationship is an example of the complex system of cooperation and rivalry between the major powers. One important consequence is that the City of London remained a major world financial centre - in many respects, though not all, ahead of New York or elsewhere in the US - despite the post-1945 weakness of the British economy and despite sterling no longer being the principal currency for international trade and finance. I discuss the main ways in which this came about, and how both historical factors and the interaction between the activities of financial companies and new developments in state policy gave advantages to London-based international finance.

The focus of this thesis is, nevertheless, on British imperialism and finance from around 1979 to 2012. This later period was characterised by a greater importance of financial

transactions than in the three decades after 1945. Booming international financial *transactions*, with the City acting as an intermediary, rather than a boom in the *provision of finance*, was the reason why the operations of the 'City' were also able to expand very rapidly from the mid-1980s. The City did not become much more important for the UK economy in the immediate aftermath of the growth of the euromarkets from the late 1950s. Even the breakdown of the Bretton Woods exchange rate system in the early 1970s only gave a marginal boost to the City's prominence. Instead, it was only after the Conservative Government's 1979-86 financial reforms that City expansion became more significant for British imperialism (this will be covered more fully in Chapter 6).

Relationships between capitalist companies, state policy and the evolution of the global market are the key themes of this chapter. All three factors jointly determine the form taken by global financial markets and are necessary to explain the evolution of British imperialism's position today. The chapter begins with a review of the changed relationship between the UK and the US after 1945, in which British policy came to terms not only with a reduced status but also with the reduced economic value of the Empire compared to the opportunities that beckoned elsewhere, particularly in Europe. The way in which British imperialism had interacted with the rest of the world had peculiarly strong financial dimensions, however, especially in trade finance and other dealing operations. So, despite strict UK government limits on the use of sterling for foreign investment, the City had the expertise to develop a business largely on the basis of using the new world currency, the US dollar. This put London in a strong position, especially compared to a US-based financial system that not only had a large domestic market as a focus for its business, but which was also more constrained by different forms of regulation. Section 5.2 discusses the key development here: 'euromarkets'. The development of these markets was consequent upon the international expansion of capital, enabling major corporations to access large-scale funds, often in a size that was not available in their domestic financial markets. The euromarkets grew outside the control of individual governments, but the British authorities fostered that growth.

Section 5.3 examines the critical turning point decade, the 1970s, which changed the economic and financial relationships between the major powers following the collapse of Bretton Woods, and which also saw the foundation laid for the subsequent rise to prominence of *global* financial market activity. In Section 5.4, I pinpoint some of the problems that the UK had in coming to terms with the rest of Europe as an economic trading partner, especially when a reunified Germany was an even more important power and when the logic of European political developments was for 'ever closer union'. Section 5.5 notes how the abolition of exchange controls by the Conservative Government in 1979 was not so much

'free market' ideology as a desire to increase income from foreign investments. The 'Big Bang' of 1986 was another policy measure to boost the international position of City dealing operations, even though this meant that many traditional City firms were sold to foreign investors. Section 5.6 discusses how power relationships between the major capitalist countries are subject to change and notes that economic weight does not necessarily translate into financial power. An Appendix to the chapter discusses a relevant historical incident, the UK's 1925 return to the gold standard, and how this financial decision was based on Britain's imperial interests. This illustrates how it is a mistake to try to understand British financial markets, and government policy towards these markets, from the perspective of the national economy alone, or, similarly, in terms of a split between 'finance' and 'industry'.

### **5.1 Anglo-American financial relationships in transition**

Britain's role in the post-1945 world economy has been closely shaped by its relationship with the US, one that, especially in the early period, was far from being the 'special relationship' of amicable, mutual support that Churchill had invoked.<sup>1</sup> Instead, especially from the 1930s and into the Second World War, the US used its economic and financial prowess to force political and economic concessions from Britain in return for delivering it much needed credit. The US made a determined effort to supplant Britain from its key global economic position. Britain's dependence on US goodwill had already led it to end its alliance with Japan in the early 1920s, a power that the US saw as a threat to its interests in the Pacific region, despite Britain's gratitude to Japan for monitoring Britain's Asian colonies during the First World War.<sup>2</sup> By the early 1940s, Britain's economic resources had been stretched to the limit as a result of prolonged war against three opponents in three theatres at the same time: Germany and Italy in Europe, the Mediterranean and North Africa, and Japan in Asia. Britain became heavily indebted to the US via Lend-Lease and was forced to liquidate foreign assets, trading these for desperately needed US funds, while also offering the US military bases in Newfoundland and the Caribbean (Ponting, 1990, pp. 202-04). By 1944, when discussions about establishing the International Monetary Fund and the World Bank culminated in the Bretton Woods agreements, the US had determined that its own interests implied a post-war trade and financial system with the dollar at its centre, one that would further undermine the international position of sterling and the commercial power of British imperialism. US

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<sup>1</sup> Churchill used the 'special relationship' phrase on a number of occasions, most notably in his 'Iron Curtain' speech in 1946 in Fulton, Missouri. The main thrust of that speech was not so much to attack the Soviet Union in front of an American audience as to promote a joint Anglo-American domination of the world, with their power projected by a wide range of military bases and nuclear weapons (Ponting, 1994, p. 734).

<sup>2</sup> Britain's concern about rising US power was an important factor in the government's decision to return to the Gold Standard in 1925 as a means of trying to restore Britain's pre-1914 status at the centre of international finance, as the Appendix to this chapter discusses.

officials rejected out of hand Keynes's pro-British proposal of inventing a new international currency, 'bancor', which would have limited the power of American finance (Steil, 2013).

The US Treasury Secretary at the time of the Bretton Woods negotiations, Henry Morgenthau, was one of the many US politicians who wanted to displace Britain as the major world financial power. One way to indicate that this was happening was to site the new International Monetary Fund in the US. In 1944, he told his team: 'Now, to me it boils down to this ... that the financial centre of the world is going to be New York and we don't want to postpone this thing until another day where we may not be in as advantageous a position and maybe have them [the British] to get in a horse-trading position and maybe end up by having it in London' (cited in Steil, 2013, p. 224). However, the paradox was that, despite being bankrupt and heavily dependent on US credit, Britain's financial position in the world economy was far from being fatally damaged. In the remainder of this section I will outline the factors that helped sustain Britain's key financial role.

### **Building beyond the Empire**

Britain's status as the leading international power had clearly come to an end by 1945. Nevertheless, that did not stop British government attempts to shore up the Empire and to use its resources for domestic purposes. This met with US disapproval because Empire protectionism limited the markets for US capitalists and the US was projecting itself to the world as being anti-colonial. However, in the immediate post-1945 period, the US became more concerned with the 'threat of communism' and the position of the Soviet Union in Eastern Europe and Asia. Hence, the US did not oppose Britain's efforts to restore its hold over its colonial possessions in Asia in the wake of the defeat of Japan. Neither was there any US opposition to Britain's post-1945 wars to revive Dutch and French colonial positions in Asia as part of its attempt to rebuild the *status quo ante* (Bayly and Harper, 2007).<sup>3</sup> As Cain and Hopkins note:

'with the onset of the Cold War, American attitudes to colonialism softened. The British Empire finally ceased to be an obstacle on the road to progress and became instead a bulwark against the Communist menace.' (Cain and Hopkins, 2002, p. 625)

The changed political situation also amended the initial US policy view at Bretton Woods that the British government had to restore sterling's convertibility as soon as possible. The US came to realise that this was not feasible without leading to a collapse of sterling's exchange value against the US dollar, and financial repercussions elsewhere given sterling's

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<sup>3</sup> Despite the UK-Japan conflict during the Second World War, Britain used Japanese troops in the immediate post-war period in its colony-restoration projects in Asia, along with Indian troops - something that angered Indian nationalists.

ties to a wide range of other currencies. Sterling devaluation eventually occurred in 1949, in the wake of the failed attempt at convertibility in 1947, when sterling's exchange rate was reduced from \$4.03 (a rate set in 1940, after having been cut from \$4.86) to just \$2.80.<sup>4</sup> However, the evident weakness of the UK economy meant that sterling convertibility was delayed until 1958.<sup>5</sup>

By that time, developments in the international economy had also begun to alter the British perspective on the value of the Empire and this had implications for British finance. The most important thing was the rapid recovery of the economies of Western Europe, Germany in particular. This made the orientation of British trade and finance towards its Empire and the Dominions - now called the 'Commonwealth of Nations' - look somewhat *passé*. Maintaining a protectionist system to facilitate the former arrangement and to give Britain privileges in these markets was not a sufficient strategy when the rest of the world was growing faster. Britain had benefited from the pooling of financial resources in the Sterling Area - formally created in 1940, but informally in place from the early 1930s - when other members had surplus US dollar funds that were deposited in London. However, in the 1950s 'an increasing number of Britain's colonies began to run deficits with the United States' (Cain and Hopkins, 2002, p. 636).<sup>6</sup> This worsened in the 1960s. The Sterling Area's current account deficit with the rest of the world rose from an average annual £508m in 1958-61 to £754m in 1962-65 (Perkins, 1970, Table 6.1, p. 62), deficit figures that were a little over 2.0% of UK GDP, while the UK itself had a modest current account *surplus* over this period.

The UK's current account surplus was usually insufficient, in any case, to offset the outflow of long-term investment capital from Britain, and also insufficient to help build up adequate foreign exchange reserves to offset any short-term outflows from sterling (Radcliffe, 1959, para. 633, p. 233). So these deficits added to Britain's own financing troubles, and were a factor in shifting the perspective of British policymakers closer towards trade with Europe. However, this was not enough to encourage Britain to take part in the European Economic Community (EEC) with the 1957 Treaty of Rome's founding six members. That alliance would have conflicted with its existing economic relationships with Commonwealth countries.

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<sup>4</sup> Although the \$4.03 rate applied only for a relatively short period, in the UK until the 1960s the sum of five shillings in the pre-decimal currency (now equal to 25p) was commonly referred to as a 'dollar'.

<sup>5</sup> Note that this 1958 sterling convertibility (into US dollars, etc) was for sterling held by *non-UK* residents, and only for banks acting on their behalf, which usually meant the 'British Overseas and Commonwealth Banks' and foreign banks that, in practice, were mainly US banks. Other foreign exchange transactions were still restricted. Only in 1979 were all UK exchange controls abolished.

<sup>6</sup> Given the contemporary focus of this thesis, I will not deal with Britain's financial relationships with the colonies, decolonisation and the operations of the Sterling Area. A valuable study of the international role of British finance to the end of the 1960s is Strange 1971.

In 1960, Britain brought together a group of non-EEC countries to form the more loosely structured European Free Trade Association (EFTA), where members were free to establish individual customs duties in trade with non-EFTA countries. This was the first step in a series of developments that eventually culminated in Britain joining the EEC in 1973. However, Britain's first application to join in 1961 was rejected by French President De Gaulle's veto in January 1963. Notably, this was the month after UK Prime Minister Macmillan had secured a nuclear deal with President Kennedy on the supply of US Polaris missiles to the UK at a US-UK meeting in Nassau, capital of the British colony of the Bahamas. For De Gaulle, but he was not alone in this view among European political leaders, this was a signal that Britain's political stance was not consistent with an independent European project. British policymakers were to continue having difficulties negotiating a relationship with Europe while protecting the wider interests of British imperialism.

The financial position of British imperialism by the 1950s is in dramatic contrast to its position half a century earlier. Before the First World War, the City of London was the main hub for the issuance of international loans, bonds and other securities, but by the 1950s, the City's role had shrunk markedly. Between 1899 and 1913, Britain had a current account surplus averaging 5% of GDP per annum: its large trade deficit in goods was offset by even larger revenues from services and the investment income from foreign assets (Cain and Hopkins, 2002, Table 5.8, p. 165). This financial strength enabled the City to act as a base for extending credit to the world economy, both via the funds accruing to wealthy families and domestic capitalists and by intermediating the funds placed in London by foreign capitalists. The sale of foreign assets, the setbacks in world trade and finance resulting from two world wars and the imposition of controls on financial flows to protect Britain's balances had more or less destroyed that comfortable position. Michie notes that in 1910 'around one third of all securities issued in the world were quoted on the London Stock Exchange, and foreign securities comprised around 60 per cent of all the securities listed in London' (Michie, 1992, p. 134). However, the 'sale of UK-held foreign securities during the war, and the restrictions imposed on overseas investment afterwards, limited the volume of international business emanating from British investors, while the maintenance of strict exchange controls until 1958 prevented non-British investors gaining easy access to the London securities market' (p.137).

By the 1950s, it was clear that Britain's previous central role in the mechanism of global finance could not be restored. The weakness of the British economy, the reduced economic importance of Empire markets - a protectionist mainstay since the 1930s - and the pre-eminent position of the US in the world economy had put paid to that prospect. Controls on the operations of financial companies based in Britain flowing from these economic

conditions suggest that 'financial capitalists' were far from being in charge of British state policy, as some writers suggest. However, the previous successful history of Britain as a financial centre still meant both that financial service revenues were important for the economy and that this expertise could potentially be used in a different way to suit the new, post-1945 environment.

In this respect, a comment in the 1959 Radcliffe Report on the UK monetary system is of interest. The Report briefly discussed the declining role of sterling in international trade and payments, and that the US dollar had become more important, particularly in official foreign exchange reserves (Radcliffe, 1959, para. 626, p. 230). However, there was little concern about the future role of the City's 'substantial' invisible earnings if sterling were to become convertible. While this was thought likely to weaken financial ties between Sterling Area members, it did 'not demonstrate that these earnings would be perceptibly less if the settlements that now take place in sterling came to be made, under a different system of payments, in some international currency such as "bancor"' (Radcliffe, 1959, para. 659, p. 241).<sup>7</sup> To refer in 1959 to Keynes's 1944 bancor proposal instead of the US dollar was disingenuous, but the point being made was that the City was still a leading centre of international finance, one that was not confined simply to Commonwealth or Sterling Area business.

### New York versus London

Morgenthau's 1944 ambition to make New York the financial centre of the world in place of London was not so audacious. Wars had greatly weakened British imperialism's finances, as was clear in Britain's extensive Lend-Lease debts and other obligations to the US. From before 1945 it was also evident that the US was the world's major economic power, and the Bretton Woods financial framework now formalised its financial power, with the US dollar as the numéraire of the system and the currency that was convertible into gold (between central banks). The importance of the US as a key provider of foreign credit had been felt since the First World War, and this position had become even more prominent after 1945. The surprising thing, however, was not that the US overtook Britain as the world's provider of capital, but that it did *not* overtake Britain as the world's centre for international banking. This point is worth dwelling on because it helps explain both the later relationship between the British and American financial systems and the basis for the renewed growth of British finance in the 1980s.

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<sup>7</sup> The Radcliffe Report was prepared over the period from May 1957 to August 1959, and these comments would have been made either before, or just after sterling was made convertible in 1958.

In 1945, and for several decades afterwards, US banks faced many legal restrictions on their activities following from the experience of the inter-war slump. These included limits on inter-state banking by bank corporations and the Glass-Steagall legislation dating from 1933 that limited affiliations between commercial banks and securities firms. This meant that despite the dominance of the US economy, the US financial system was in a far less strong position to overtake London's international role than it might have appeared to be. As one author noted:

'Given widespread perceptions of a direct link between the [1929] Crash and the severe depression that followed, revulsion at speculative financial excess was common and was voiced by the leading politicians of the Roosevelt administration ... Based on their considerable social and political power, isolationist American farmers, organised labour and industrialists ensured that New York could not be a WFC [world financial centre] at the heart of a reconstituted orthodox liberal world financial order during the 1930s.'

(Langley, 2002, p. 66)

This impeded the development of New York as a rival to London. Despite the greater ability of US capitalism to provide funding for foreign investments after 1945, many of these flows to other countries were in the form of direct investments by US industrial corporations and bank loans to foreign governments (influenced by the US state), rather than the shorter-term credit in which London specialised or London's focus on issuing foreign bonds and other securities (Langley, 2002, pp. 66-67). London's international banking operations also had a wider geographical scope than those of the US, given sterling's previous international role and the continued UK links with Empire and Dominion countries. Post-1945, US moves into international markets were also restricted by Cold War political considerations. In 1957, sterling was still a major international currency and was used for financing some 40% of world trade (Burn, 2006, p. 26).

Factors that favoured London as a leading financial centre are commonly taken to be the importance of English as a business language, English law as being particularly suited to commerce, the availability of a workforce with the relevant skills, a good communications infrastructure and even the 'economies of scale' that arise from the concentration of financial business in one location (see, for example, Burn, 2006, p. 101; BoE, 1989, pp. 521-23). Yet none of these seems to be a particularly strong argument for London over New York, although there was some split of financial business in the US between New York, Chicago and other centres. Another important factor often cited, one that *is* significant, is the geographical location of London, lying both on the western edge of Europe, a major base for capitalist business, and between the Americas and Asia. This is a clear advantage for London over New York, especially when one considers the regular business day, during which most business decisions and communications are made. New York is cut off from Tokyo's and

Singapore's regular business days and misses the European morning, whereas London can communicate with Asia in the morning, North and South America in the afternoon and Europe all day. Working hours can, of course, be changed or extended in any location. But in order to neutralise the time zone effect on international business, the hours would have to be changed not only for bankers in that location, but also for government and central bank officials, lawyers, accountants and corporate executives. This was, and remains, a disadvantage for New York's international financial business.

One would have expected London's purely 'historical' advantages to diminish over time, even if the geographical ones were less open to change. However, while New York's financial operations had grown rapidly by the early 1960s, with increasing volumes of foreign loans and issues of securities, its ability to become the pre-eminent international banking centre was hindered by US government policies implemented both for domestic economic reasons and because of a concern to limit the outflow of capital from the US. Although still much bigger and more powerful than any of its rivals, the US was beginning to see its lead reduced as others recovered, particularly in Europe and Japan. Capital flows from the US began to outstrip its trade surplus and, by the early 1960s, the US dollar shortage earlier feared by analysts of the Bretton Woods payments system had been transformed into a dollar glut, one that fuelled the growth of an offshore pool of dollar funds held by foreign governments and companies. As Konings notes:

'Concern regarding the stability of the dollar was widespread by the early 1960s, but the [US] Treasury opposed any proposals for fundamental reforms to the financial system and instead adopted capital controls. The latter, however, did little to reduce the outflows of capital associated with foreign direct investment by American companies.' (Konings, 2009, pp. 58-59)

By 1960, and more evidently in the early 1960s, foreign holdings of US dollar assets had begun to exceed US government holdings of gold at the official price of \$35 (Eichengreen, 2011, p.50). This was a harbinger of the eventual demise of the Bretton Woods exchange rate system in 1971.<sup>8</sup> However, in the early 1960s the US authorities did not worry much about foreign *private sector* holdings of dollars because only central banks could request an exchange of dollar assets for gold from US reserves, something that later in the decade led to conflicts with the French government.

'Regulation Q' and the Interest Equalisation Tax were the most important of the US financial market regulations for the discussion here. Regulation Q was enacted in 1933 and

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<sup>8</sup> After a series of increasingly desperate international attempts to shore up the system from the mid-1960s, including the devaluation of sterling and the French franc and the revaluation of the Deutsche mark versus the US dollar in 1967-68, it collapsed in 1971 when the US government unilaterally ended gold convertibility for the dollar. These developments will not be discussed here. Eichengreen 2011 gives a concise summary.

remained in force until the 1980s. It prohibited banks from paying interest on demand deposits and also restricted the interest rates banks paid on other types of account. The objective was to prevent banks' excessive competition for funds weakening their finances, but it had the effect not only of encouraging US banks to develop other modes of competing for business - from expanding branch networks and services to developing new financial instruments - but also of encouraging US funds to be invested in non-US locations that offered higher rates. The London-based financial market was in a position to attract such funds. The Interest Equalisation Tax of July 1963 was another US government measure restricting US financial markets. It aimed to discourage foreign issuance of dollar bonds in the US, and so to reduce long-term capital outflows (Schenk, 2002, p. 90). These factors boosted London's business at the expense of New York because they were the principal spurs to the growth of the 'euromarket' in London from the late 1950s.

One other issue behind the advantage of London-based banking over New York is rarely noted: the structure of the US money markets. Although the US economy was several times the size of the UK, its banking system was fragmented, both along state lines and whether or not banks even belonged to the Federal Reserve System that, from 1913, acted as a lender of last resort. This led to some odd developments. For example, when the burden of the Federal Reserve's bank reserve requirements began to rise in the 1960s, banks began to leave the system. From nearly 85% in the late 1950s, 'the share of transaction deposits held by member banks had fallen below 75%' by the early 1970s (Feinman, 1993, p. 576). This would have limited the role that many US banks could play even in the national banking system, or in their connections with New York banks, let alone in the international system.

## 5.2 The Anglo-American euromarket

Since their inception in the late 1950s, the euromarkets have been analysed extensively in the academic literature (for example, Burn, 2006; Schenk, 1998 and 2002) and have been the subject of many articles in central bank publications and in business literature. The detailed operations of these markets need not concern us here, but there are some issues that should be covered in order to understand the background to the expansion of London's financial markets from the 1970s. The euromarkets developed in two stages, firstly as a eurocurrency bank deposit and loan market from the late 1950s and then, from 1963, as a eurobond market.

The term 'euromarket' refers not to the *location* of the market for transactions in bank funds or in financial securities, but to the legal fact that this market normally lies outside the regulation of any particular state authority. So banks operating in the euromarkets can do so from London or elsewhere, if the national state authorities allow it, when their business is deemed to be 'outside' the regulatory territory, which usually means business done with non-

residents. For example, eurodollars are dollar-denominated deposit accounts held outside US Federal Reserve jurisdiction, originally in European banks, especially in London. The transfer of dollar deposits between banks would still, however, have to be done through a bank *inside* the domestic US payments system (He and McCauley, 2012, review the mechanisms involved). The special status of the euromarkets does not mean that banks operating in them can do anything they like, and central bank authorities in the relevant locations will supervise them to some degree. However, because their operations are considered to be with non-residents, their lending and borrowing with non-resident counterparties, and the issuance of securities for and the sale of such securities to non-residents, will usually fall outside the domestic monetary, banking or tax regulations that apply to residents. As a result, interest paid on euro deposits or coupons paid on euro bonds will normally be paid gross to the non-resident investor, with no deduction of tax at source (note: *inter-bank* deposit interest is always paid gross). Similarly, a bank's eurocurrency exposures will not be subject to central bank credit restrictions that apply to dealings with residents. A US-based bank's eurocurrency deposits have also been free from any Federal Deposit Insurance Corporation charge on the bank, because the deposits are not repayable to customers resident in the US.

It might appear that these markets are *never* touched by state regulation, but this is not the case. Every government can take a policy view on these markets, whether to encourage them or to restrict the participation of local banks in their activities, and on what impact these markets might have on the domestic economy. In the early years, the euromarkets developed 'spontaneously', one might say, and sometimes the monetary authorities were only dimly aware of what was going on. As the markets grew, they became too big to ignore and government policy often responded. For example, eurodollar deposits held by US banks did not initially attract reserve requirements from the US central bank. As a result, US banks could accept such deposits at a lower net cost because they did not have to place a portion of these deposits (as reserves) with the central bank at a zero interest rate, as they did with domestic deposits. This helped boost both eurodollar deposits and loans. However, in October 1969, the US Federal Reserve did impose reserve requirements at 10% (on *extra* eurodollar borrowings) as a means of limiting this new source of funds for US banks (Feinman, 1993, p. 575; Federal Reserve, 2013). Burn does not mention this in his otherwise thorough analysis (Burn, 2006), although that may be due to his focus on the market's origins. Since the euromarket continued to grow very rapidly after 1969, however, this suggests that reserve requirements were not a significant restraining factor, even if the earlier lack of reserve requirements might have been a spur to their growth at that point.<sup>9</sup>

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<sup>9</sup> The removal of controls on capital movements by major capitalist countries in recent decades, and a reduction of the differences in bank regulation, means that there is now little distinction that can be

The euromarkets clearly created room for 'regulatory arbitrage', but it was an arbitrage business in which only those working in a developed financial market could engage, one where dealing costs were not so high as to eliminate the benefit of doing transactions that avoided other costs. London had such a market, one also used to dealing in the large-scale funds that characterised the euromarkets. This also suggests that the origin of these markets was related to the development of monopoly capitalism in the post-1945 period. In the US, credit restrictions had made it more difficult for companies to obtain the needed investment funds from banks, so they looked overseas for other sources. In particular, US corporations had been expanding their foreign operations and that required financing. In the early 1960s, US foreign direct investment ran at a little below \$3bn per year; it had doubled to a rate of \$6bn per year by the end of the 1960s, rising still further into the 1970s (BEA, 2011, Table 1, line 51). The expansion of foreign direct investment was also happening from other major countries, albeit on a smaller scale. This link between the growth of the euromarkets and the needs of large companies was made clear by the Governor of the Bank of England in a speech to bankers in Chicago in 1971:

'New procedures have been developed for meeting the needs of euro-market customers, typically big international corporations whose global credit needs cannot always be met from purely domestic banking systems. Among these are roll-over credits, floating rate notes and, more recently, an infant market in eurodollar commercial paper.' (BoE, 1971b, pp. 224-5)

He went on to add that 'the eurodollar market is now equal in size to the money supply of France'. The US dollar accounted for around 90% of all currencies available in the euromarket in the 1960s (BoE, 1970, p. 37); its share fell later as the size of the international pool of funds rose dramatically. Burn notes that total deposits in the euromarket 'are thought to have grown from about \$1bn in 1960 to \$19bn in 1967, \$57bn in 1970, \$215bn in 1975 and \$1050bn in 1983' (Burn, 2006, p. 17). This expansion was based on the ability of banks operating in the euromarket to create credit in the same way as banks in the national credit system. Eurobanks did not have to wait for new incoming funds to expand their lending.

The euromarkets developed on the back of the demand for funding from large corporations and the flows of money capital from big business and the wealthy. For this reason, I disagree with Burn's view that the 'creation of the euromarkets and an unregulated international financial structure was simply the reassertion of the interests of financial, as opposed to manufacturing, capital' (Burn 2006, p. 187). This ignores that major international corporations seeking domination in the world market, usually with the assistance of their

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made between 'euro' and domestic currencies. Where there are still controls on the movement of capital or significant differences in regulation, as in Brazil or China, the terms 'onshore' and 'offshore' are most commonly used now to describe the different markets in which funds are borrowed or lent.

states, represent the imperialist form of 'manufacturing capital'. As earlier chapters have shown, British corporations loom large amongst these, so it is particularly inappropriate to suggest an economic gulf between 'the City' and 'manufacturing'. Such corporations were the ones that needed the euromarkets to assist their global expansion when domestic money markets were not able to provide them with the funds required. Burn is more correct in saying that 'this market also allowed the City's financiers to issue dollar liabilities and thereby share in the denomination rents and the privileges of seigniorage that had that previously accrued exclusively to the US' (p. 10). However, even this comment ignores the benefits for British capitalism as a whole through the balance of payments, a topic to be covered in detail in Chapter 6. Benefits were not only accruing to the financiers.

The euromarkets were, not surprisingly, lauded by the Governor of the Bank of England as a 'useful addition to our invisible earnings' (BoE, 1971a, p. 83). Editions of the UK *Pink Book* on the balance of payments for the 1960s and 1970s show that the annual net foreign invisible earnings from UK financial services more than quadrupled between 1958 and 1970, to £439m, and they doubled from 0.4% to 0.8% of GDP.<sup>10</sup> These revenues were indeed useful in helping to offset the persistent visible trade deficit, something that was a key factor in the UK's 'stop-go' economic policies at the time. Such revenues – they grew to greater prominence in later decades – and the broader benefits of City finance are a more solid foundation for explaining British government policy towards the financial markets than the political-sociological concept of the 'City-Bank-Treasury' nexus supported by a number of authors (Ingham, 1984; Helleiner, 1996; Burn, 2006).

Some other features of the euromarket are important to discuss in order to get a fuller picture. Firstly, the City's ability to use the dollar and develop this new financial market depended on at least the passive acquiescence of the US and UK authorities. While the US Federal Reserve had shown some concern about the new market and the impact it might have on the Fed's ability to control credit in the US economy, the 1969 imposition of reserve requirements on extra US bank eurodollar deposits was the only real limitation on the market's growth that it came up with. Even these were eliminated by 1990. As for the UK, the Bank of England looked upon the market with great enthusiasm and was not opposed in this stance by the UK government. This market's development expanded the international role of the City and encouraged an increasing number of foreign banks to locate there, even when Britain's economic travails and balance of payments problems limited the international role of sterling. The Governor of the Bank of England's speech cited earlier went on to note:

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<sup>10</sup> These early editions of the annual Pink Book are not available on the UK ONS website, and the author consulted original copies from 1963 in London's Guildhall Library.

'Absence of the latter [restrictions] has been a feature of banking in London, though London is by no means unique in this respect. But London has provided freedom of establishment and banks of good repute have been welcomed - one result of which has been that the number of US banks with branches in London has risen from nine in 1963 to 31 today, not counting those multinational banks in which there are US interests. Such restrictions as we have found it necessary to operate have concerned the use of sterling - either domestically, or for use overseas, or for conversion into other currencies. Banking conducted wholly in other currencies has been free from restrictions, and in that sense the market has been extra-territorial.' (BoE, 1971, pp. 225-6)

The euromarkets allowed the growth of City business outside of its previous focus on sterling, a focus that had become a dead end. The new market was one step on from the City profiting from the use of other people's money – it was now specialising in using other countries' currencies too, particularly the US dollar.

The financial institutions involved in the new euromarket business were not only British, as it was attracting a wider range of foreign banks, in particular from the US. A Bank of England report noted that in 1963, 'three groups of banks together accounted for two thirds of the business done in the London market; these were the American banks and the British overseas and Commonwealth banks (each accounting for about 25% of the total) and the accepting houses (rather less than 20%)' (BoE, 1970, p. 36). US banks were the biggest foreign players in London, accounting for nearly half of the liabilities of foreign banks in the late 1960s (BoE, 1968, p. 156). By 1971, London had attracted some 160 banks from 48 countries (BoE, 1971a, p. 83). The main role of the US banks in London was to service their international corporate clients with funds that were not so easily, or cheaply, available from the domestic US credit market. This did not appear to contradict US domestic economic policy, since the funds were available for investment *outside* the US.

London was the international banking centre of choice not only because of the lack of 'restrictions', including no reserve requirements on euromarket business, but also because London's money markets were highly developed and able to offer active trading in unsecured loans between banks. A wholesale interbank market was established in London in the 1950s and there was no equivalent in the US (Burn, 2006, p. 24), where bank funding was usually very short-term, largely based on secured 'repo' borrowing or on overnight transactions in Federal funds held at the central bank. One study of the evolution of the London money markets claims that while the sterling money market developed initially through local authorities dealing with banks, it was the US banks in London that spurred the growth of the interbank market in the context of the new euromarket (Shaw, 1981, Chapter 7, especially pp. 104-05). I have no evidence to the contrary, but this author does not discuss the important issue of how the US interbank money market was very short-term and did not have anything

to compare with the 1-month, 3-month, 6-month, etc, standard period loans and deposits, and hence interest rate quotations, of the euromarket in London. While the bulk of eurocurrency business was very short-term, some 30% of bank deposits and 40% of loans in the 1970s, for example, were for longer than 3-months (Shaw, 1981, Table 29, pp. 138-139). Although further investigation is beyond the scope of this thesis, I would argue that this was because the London market had (and has) a large number of banks performing these wholesale market operations. This is basically why there is a LIBOR for London, reflecting the existence of an active interbank market in unsecured term loans, and why there is no such thing as a 'NYIBOR' for New York.<sup>11</sup>

Banking centres in Europe that might have become rivals to London, such as Paris, were eclipsed by strong Anglo-American economic and political links, and by political events and policy decisions in those countries (Schenk, 2002, pp. 86-97; Michie, 2006, pp. 249-50). Above all, there was the more consistent promotion of international financial business by the British authorities, which included an implicit promise not to disturb financial interests with any changes in legislation. These points were made clear to foreign financial businesses in direct discussion with Bank of England officials, and clear to everyone in the Bank's published statements. For example, after noting the usual features favouring London, a 1989 Bank review of London as a financial centre also said that there was 'a degree of confidence among firms that regulations will not be altered without good reason and appropriate consultation' (BoE, 1989, p. 521). In 1996, the Governor of the Bank of England also spelled out that, apart from the usual functions of a central bank, its role 'concerning the effectiveness of the United Kingdom's financial services - is more unusual, *and perhaps peculiar to the Bank of England* which has a long-established tradition of encouraging the financial services industry in this country to meet the needs of the wider economy both domestically and as the world's major international financial centre' (BoE 1996, p. 92, emphasis added).

### **Eurobonds and London's international intermediation**

The stability of capitalist property relations in the UK was a critical factor in the revival of the City, something that the Bank of England could build upon in its promotion as a base for international financial services. There were no *événements* in London to rival those in Paris in 1968, notwithstanding student demonstrations against the Vietnam War. This meant that the City's eurocurrency operations could also be put to use in funding another new business, in eurobonds, that began in 1963, the opening for which had been provided for by the Bank's

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<sup>11</sup> The *official* UK LIBOR fixing dates from 1986. There are '-IBORs' in many countries where there is an active interbank unsecured loan market. PIBOR (Paris) and others disappeared with the birth of the euro, to be replaced by a system-wide EURIBOR. However, there is a CIBOR (Copenhagen), a TIBOR (Tokyo) and now even a SHIBOR (Shanghai). In this respect, the US money market is an anomaly.

1962 decision to allow foreign securities denominated in foreign currencies to be issued in London (Helleiner, 1996, p. 84). The funds that go into such bonds will usually come from other investors, but it is important not to ignore banks' own investments in eurobonds. Banks acting as dealers in particular issues, often as part of a syndicate, have to maintain a certain inventory for selling on to investors and will normally be committed to ensuring a two-way market in the securities. This means that banks will require short-term funding to run their positions, and funds from the eurocurrency market were the most suitable – being subject to the same non-regulation as the bonds themselves. This funding requirement was also true for other securities issued in the euromarkets, including floating-rate notes.

So London's role as the major eurocurrency banking centre also supported its position as the principal location for issuing eurobonds and other securities in the offshore market. While Regulation Q acted as a spur to the first market, the US government's Interest Equalisation Tax of July 1963 is generally considered to have been the major element in the growth of the second (Helleiner, 1996, pp. 85-86). This tax was on US residents' purchases of foreign securities and was intended to reduce the US capital outflows into portfolio securities (direct investment, or a portfolio investment in 10% or more of a company's equity, was exempt). The effect was to make it more expensive for foreign borrowers to issue securities in New York, and the business was attracted instead to London and other euromarket centres. The UK also had its tax disadvantages at this point for foreign borrowers in the *sterling* domestic market - stamp duty - and Schenk notes that in 1962 there had already been a discussion at the UK Treasury to allow foreign (government) loans in US dollars to be issued in London which would act to 'make the facilities of the London capital market more widely available and to mop up some of the very volatile eurodollars at present in London' (Schenk 2002, p. 87). The avoidance of tax is a key element of eurobonds: they are usually 'bearer' securities, where the coupon is paid to the holder of the security without any tax deduction.

It is important to recognise that the euromarket business for the City developed despite the continued, weak position of Britain's balance of payments. British capitalism was not the lender to the world it had been in the period up to the First World War. Instead, the City's new markets were more based upon it playing the role of an intermediary. As Michie notes, the City acted 'as a bridge between short- and long-term funds and as a conduit for international lending' (Michie, 1992, p. 146). However, he fails to notice that the City's ability to attract money capital from the rest of the world also enabled it to help finance Britain's foreign investments, a point that will be discussed in Chapter 6. In the case of the eurobond market, some of the money capital to which the City had access will also have gone to buy eurobonds issued by British companies. In any case, banks based in London, British or not, still earned fees from the flotation and this boosted the overseas earnings of the City.

Michie notes that by 1968 'it was estimated that 60% of the trading in eurocurrency bonds was in London, totalling \$15 million per day and handled by a growing number of European banks and US brokerage houses' (Michie, 2006, p. 247). That should not be understood to mean that London was the centre of the global bond market, since most bonds, especially government securities, are issued, bought and sold on a domestic basis. This made financial centres such as New York and Tokyo central to the global bond market and the UK could not compete with these much bigger economies as centres for raising capital. However, London still had a leading position for *international* issues and especially for cross-border trading. The international bond trading business grew dramatically over the next decades, and 70% of the total trading took place in London (Michie, 2006, p. 310). The international bond market figures include both eurobonds and foreign bonds, the latter being issued in the domestic market by a foreign issuer. In London, three-quarters of international bonds are eurobonds. In 2010, the UK accounted for 13% of total international bonds outstanding, second to the US with 24%, but it was the location for 70% of *global* secondary market *trading* in international bonds (City, 2011, p. 2).<sup>12</sup>

This review of London's position as the world's leading financial dealer should not be taken to presume that this position is, or was, secure, despite London's historical and political advantages and despite a number of potential rival centres limiting their financial business with restrictive legislation. A good example of the risks to London's status in the global economy is given by Japan's development from the 1970s.

In 1975, the UK was by far the biggest international banking centre, with 27% of global business, twice the size of the next biggest, the US. Japan was only in seventh place among the major countries, with less than 5% of the market (calculated from BoE, 1989, Table E, p. 518). However, Japan later emerged as the main threat to London's position, given that country's continued, large current account surpluses and growing foreign investments. There had been no international banking market in Japan up to 1972, and Japan's Ministry of Finance had restricted Japanese bank business. From 1972, it allowed Japanese banks 'to lend to non-Japanese entities and to participate in the international syndicated credit market' (BoE, 1987, p. 518). These measures, together with subsequent policies, led Japanese banks to account for more than 35% of London's international banking business by 1987! Alongside this, Japan's surplus funds also began to be lent directly from Tokyo, helping to make it the biggest international banking centre by 1988, with 21.0% of total lending, just ahead of

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<sup>12</sup> Figures for 2010 give an indication of the relative sizes of the main components of the global bond market (measured by the value of bonds outstanding). The total market was valued at \$95 trillion, of which government bonds accounted for 43%. The international bond market makes up 30% of the total. The global bond market is much bigger than the global equity market, largely due to government debt issues. In 2010, the global equity market had a capitalisation value of \$55 trillion (City, 2011, p. 2).

London's share. This was not an overnight development, but it indicates how one imperialist power's position of market dominance could be threatened by another.<sup>13</sup>

Japan's potential to become not only the world's major creditor country but also its major dealer and one of the leading financial powers was undermined by its own financial implosion, however. From the late 1980s, under pressure from the US, Japan guided the value of the Japanese yen stronger in the foreign exchange markets and operated a very loose monetary policy to counteract the impact this had on domestic industry. Together with financial market deregulation, this led to a prolonged credit boom and a build up of bad debts, particularly from real estate. These debts undermined the capital ratios of its banks. From being big creditors, the banks began to be seen as big credit risks and ended up paying premium rates to borrow in the money markets.<sup>14</sup> Despite Japan's own endorsement of International Banking Facilities, its share of international banking fell to just 7% by 2012, putting it in fifth position, well behind the UK in first place with a 20% share (BIS, 2012, Table 2A).

Britain's position as an international banking centre therefore grew more prominent into the 1970s on the back of the expanding euromarkets, before falling back as the new rival, Japan, increased its business into the 1980s. The subsequent setback for Japan helped London regain its leading rank. However, it is interesting to note other dimensions of the City's position rather than simply the one based on the share of total international lending or borrowing. One study of banking centres in 2007 analysed the *networks* between banks in different BIS-reporting countries and found that the UK's score was well ahead of all the others on its five measures of 'network centrality' (von Peter, 2007, p. 37). For example, banks in the UK took deposits from 382 other locations (including bank and non-bank locations), 90% of the total, and the UK was the location for 337 BIS-reporting banks.<sup>15</sup> These factors indicate that the City's status as a major dealing centre is solidly based on its connections with the rest of the world and its ability to act as an intermediary for global flows of money-capital and credit. London's status led banks from other European centres that were potential rivals, such as Frankfurt, to make London their principal location for dealing, even if they had taken

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<sup>13</sup> The latest BIS database does *not* indicate that Japan-based international banking business overtook the UK at any point, although that was an observation and a widespread belief in the 1980s. However, Japan-based international lending did grow much more quickly than the UK's in the 1980s. Offshore banking centres, as a group, also became much more important in the 1980s. The links of these centres to the UK and US will be examined in Chapter 6.

<sup>14</sup> Japanese banks regularly paid a premium over interbank lending rates in all major currencies compared to their counterparts from other major countries, so much so that they came to be excluded from panels to determine LIBOR fixings. The author witnessed at first hand the operations of Japanese banks in the City and in Tokyo, having worked for a major Japanese bank in 1989-1990 and observed their retrenchment in subsequent years, where they cut back on loans and securities transactions.

<sup>15</sup> Von Peter's 2007 article also indicated that the UK, like the US, was also a large net borrower of international funds (p. 34). This issue is discussed further in Chapter 6.

over London-based banks and were clearly in a strong financial position, and even if their move to London had gone against national political sentiment (Rodgers, 1996).<sup>16</sup>

The international expansion of capital was the fundamental dynamic behind the expansion of the euromarkets. The euromarkets, in turn, helped to undermine the Bretton Woods system of fixed exchange rates. A changing balance of competitive power between the major countries put pressure on the system, and at the same time the scale of financial flows now possible provided the ammunition to destroy it. In the next sections I note the key developments from the 1970s and how these set a new environment for UK financial policy and for UK-based financial markets.

### 5.3 The 1970s interregnum

The 1970s was an extraordinary decade, both for the global economy and for changes in the financial relationships between the major powers. A steep fall in growth rates signalled the end of the post-war boom, with higher unemployment, inflation and fiscal deficits. Capitalist profitability had slumped in all major countries (Armstrong et al, 1984, p. 320). While the causes of the crisis were in dispute, the outcome was that economic policy had to change. Everywhere, the state moved to restrict the rights of trade unions and to push the burden of the crisis onto working class living standards. That was the expected capitalist policy reaction to crisis. The new development of relevance to this thesis was the final collapse of the Bretton Woods system and the start of a new phase in global financial markets.

In August 1971, the US formally abandoned its obligation to convert US dollars into gold at the fixed \$35 parity. US gold reserves had fallen to low levels compared to official foreign dollar holdings; a trend exacerbated by US military spending on the Vietnam War and continuing outflows of capital. The dollar began to depreciate against gold and against other currencies, producing turmoil in financial markets. However, despite flows of international investment funds out of the dollar, it remained the numéraire of the new, unstable system. US financial power actually increased once the US had abandoned gold because no other major country was in a position to offer a serious challenge to it, or to establish an alternative to the dollar-based global financial system. In 1973, nearly 85% of central bank foreign exchange reserves were denominated in US dollars (Eichengreen, 2005, Table 2, p. 29), the bulk of international trade was denominated in dollars and the US still had by far the largest capital markets in the world for issuing bonds and equities.

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<sup>16</sup> In the author's experience of working for the largest Dutch bank, that bank's decision to have London as the centre for its European securities operations was diluted by keeping the centre of European foreign exchange dealing operations in Amsterdam.

The continued financial power of the US - and the relationship of financial power to imperial power more generally - was exemplified by the international flow of funds after the OPEC oil price increases in 1973. Although the price hikes are often discussed in the context of the 1973 Arab-Israeli War, a key economic backdrop was the previous weakening of the dollar, the currency in which the oil price was denominated. Oil prices had been little changed for many years, despite rising world inflation and large rises in other commodity prices in the previous decade (Karlsson, 1986, p. 249). The price hikes gave the OPEC countries massive trade surpluses, while the US, Europe and Japan (and other countries) moved into bigger trade deficits. This was not such a problem for the US, since OPEC held its surplus revenues in US dollars - 'petrodollars'. However, these had been largely held in dollar bank deposits, which the US government now feared were liable to be liquidated and moved into other currencies, putting more pressure on the US balance of payments. Although currency values were no longer fixed and did not have to be defended in the previous ways, there would still be a problem for US economic policy if the dollar's value collapsed. So US Treasury Secretary William Simon visited the Saudi Arabian Monetary Authority in July 1974 to do a deal to sell them US Treasuries (Spiro, 1999, pp. 107-109). This was part of a more general deal announced by US State Department with Saudi Arabia, the key OPEC producer, including lucrative weapons contracts for US companies and a US promise to give Saudi Arabia security protection (Spiro, 1999, p. 148).<sup>17</sup> By the end of 1977, Saudi Arabia accounted for 20% of all Treasury notes and bonds held by foreign central banks. Following a Commerce Department trip to Saudi Arabia, Saudi money was also invested in government-backed mortgage securities (Spiro, 1999, pp. 112-113).

Political and economic negotiations with the Saudis, and with other Middle Eastern OPEC states, also kept the price of oil denominated in US dollars, despite a June 1975 OPEC consensus to peg oil prices to a basket of major currencies. The US supported Saudi Arabia's political ambition to get a larger IMF quota (and so IMF voting rights) at the same time as plans to shift from the dollar were dropped (Spiro, 1999, pp. 104-105).

Rising oil prices, and the increased deficits of oil importers versus the OPEC surpluses, were one element in the greater volume of international financial flows in the 1970s. Between 1973 and 1974 OPEC's current account surplus rose from \$6bn to \$67bn, despite a rapid increase of imports by OPEC countries. World recession helped reduce the surplus to zero in subsequent years, but by 1979 another round of price increases raised the surplus again to \$74bn (BoE, 1980, p. 154). The IMF attempted to manage a recycling of

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<sup>17</sup> This 'special relationship' between the US and Saudi Arabia - and the US military role in the Gulf - increased 'after Britain announced that its protective role in the Gulf would end in 1971' (Karlsson, 1986, p. 256).

OPEC surpluses with limited success, and many countries instead obtained deficit financing through the euromarkets. A Bank of England study noted that the bulk of the new OPEC surpluses were largely put into bank deposits and loans to developing countries, either directly or via the IMF. Between 1974 and 1979, OPEC countries had put a cumulative \$84bn into eurocurrency bank deposits, providing further fuel for the expansion of the international credit system. By 1979, a little over half the eurocurrency deposits were held in UK-based banks and nearly half of OPEC's total surplus from 1974-79 was invested in the UK and the US, roughly equally (BoE, 1980, Table D and p. 159). The UK could not attract OPEC money into its securities as easily as could the US, but the UK-based international banking system was a natural recipient of these funds.

The other European powers had none of these advantages and received only a small share of OPEC surpluses. However, in response to the financial turmoil of the early 1970s, the original six signatories of the Treaty of Rome - West Germany, France, Italy, the Netherlands, Belgium and Luxembourg - tried to build a regional financial system as a shelter from the dollar's volatility. Subsequent policies resulted in 1979's Exchange Rate Mechanism (ERM), a system that aimed to limit fluctuations in European currencies against each other to avoid disrupting important trading and investment relationships. Even the strongest country in economic terms, West Germany, was buffeted by large financial flows out of US dollars that pushed the Deutsche mark stronger against the currencies of Germany's other European trading partners. The ERM was essentially a Deutsche mark bloc, with that currency the numéraire and with the Bundesbank giving its principal direction. It did not do much to diminish monetary instability, but it was an early incarnation of the later euro system that began in 1999.

In 1972, Britain successfully applied for a second time to join the EEC, with membership beginning on 1 January 1973. However, Britain remained at one remove from the European project. The British government's policy rationale for membership was the importance of the EEC as a faster-growing trade bloc, a closer alliance with which, through lower tariffs and the removal of other trade restrictions, would also exert some competitive pressure on British industry.<sup>18</sup> There was little intention to take part in other moves towards European integration, particularly in the financial and political spheres. In Britain during the 1970s, and for a long time afterwards, the EEC was called the 'Common Market'. This indicated the difference of perspective from that of the founding members, in whose view the EEC was not just an 'economic community' but also one that, as in the words of the preamble to the Treaty of Rome, was 'DETERMINED to lay the foundations of an ever closer union

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<sup>18</sup> This is not the place to discuss the industrial policy of the Heath Government, but its initial view of letting 'lame ducks' go to the wall was consistent with this objective for joining the EEC.

among the peoples of Europe' (no emphasis added). Even the moves towards closer trading relations were opposed by a significant, although minority, section of British public and political opinion because of the threat to relationships with the Commonwealth. However, the UK's membership went ahead. Membership was inconsistent with the operation of the Sterling Area, but the latter's benefits for British imperialism had by then become questionable, not least from the threat of 'sterling balances' being sold for other currencies. The Sterling Area was dissolved in the 1970s, and a UK referendum in 1975 endorsed EEC membership by 67% to 33%.

EEC membership was one sign that British policymakers recognised that things could not go on as before. UK economic problems had resulted in a sharp rise of inflation, a record current account deficit of 4% of GDP in 1974, a slump in the value of sterling on foreign exchange markets and the need to negotiate a series of loans from the IMF. In September 1976, Chancellor Denis Healey had to abandon a trip to a finance ministers' meeting and return from Heathrow airport to apply for another loan. The IMF granted \$3.9bn on condition of £2.5bn cuts in government spending (Healey, 1990, pp. 428-432; Moran, 2010). While spending cuts were in line with changes in government policy that were already under way, the political embarrassment of being humbled so publicly was something that no UK government would want to risk again.

#### **5.4 British imperial strategy and the pound**

Britain's relatively weak economic position compared to other major powers conditioned its policy responses and set the context for the development of British financial markets from the 1970s. In this section, I examine the relationship of Britain to Europe to explain why Britain did not take part in the euro project.

At first sight, the economic case for British membership of Europe's Economic and Monetary Union (EMU) would appear to be compelling. Continental Europe is clearly a major trading partner for the UK and the location of much British overseas investment. However, Britain also has a much wider range of *non-European* interests than do the main continental European powers, in particular the strong British political link with the US. That relationship is one means that Britain has relied upon to protect these interests, even at the expense of having to concede ground where it was not in a powerful enough position to act on its own, as in the 1953 Anglo-American coup against Mosaddegh in Iran. Britain has

depended on the US connection for its nuclear weapons systems since the Polaris deal in 1962 and it has a close cooperation with the US in military policy and spying activities.<sup>19</sup>

British policymakers came to realise that they did not have the power to operate as they wished in the international arena. That is always true, to the extent that it is necessary for any power to judge the potential response of others to its actions. Yet, post-Suez it became clear that any major initiatives with international repercussions could not succeed if the US opposed them. A possible alternative for Britain would have been to establish closer links with other European powers. But, until the late 1950s, British policymakers saw little reason to get involved more closely in European affairs, given Britain's Empire and its other interests in the world. This had been most clearly expressed by Churchill, who called for a 'United States of Europe' but one that did not include the UK! In later years, the decision was a little more evenly balanced, but British policy decisions still came down firmly on the side of an alliance with US imperialism. Its former 'Dominions', Canada, Australia and New Zealand, also being in the US sphere of influence reinforced this point.<sup>20</sup> These factors have meant that a succession of British governments of different political parties did not see a strategic advantage in joining the European project beyond getting involved in the narrower economic dimensions.

One simple measure of the difference between the UK's perspective and, for example, those of Germany and France, can be seen in the different geographical patterns of trade, as illustrated in Table 5.1. Exports to the rest of the EEC/EU have been important for the UK, but less important than for Germany and France. UK exports to the US and Canada, and to Japan and other non-European developed country destinations, have also tended to be more important for the UK than for Germany and France. However, the UK and France have a similar share of exports going to developing countries, one that is bigger than Germany's. This is largely explained by the ties that the former two powers still have to their previous colonies, which also receive significant exports in the form of military equipment from these major weapons producers. The data for 1980 and 1990 indicate the trade patterns before discussion of closer European financial ties really got under way in the 1990s. Cyclical economic factors have an impact on these numbers, but the relative importance of the different geographical areas for the UK, Germany and France stays much the same.

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<sup>19</sup> In 2013, this cooperation between the US and UK became more widely known following the revelations of Edward Snowden, a former US National Security Agency official. Much of the media furore concerned access to personal communications, but the interceptions by the US and UK were clearly focused on business and political targets.

<sup>20</sup> See Darwin 2009 for an interesting historical study of Britain's links with the 'Anglo-Saxon' world.

**Table 5.1: UK, Germany and France – patterns of trade, 1980-90 (% of total) \***

	<b>1980</b>	<b>1990</b>
<b>UK, merchandise exports</b>		
European Union	51.8	57.5
US and Canada	11.2	14.4
Japan	1.3	2.5
Other non-European developed countries	4.9	3.6
Developing countries	23.4	16.1
<b>Germany, merchandise exports</b>		
European Union	60.6	62.6
US and Canada	6.8	7.8
Japan	1.1	2.6
Other non-European developed countries	2.4	1.8
Developing countries	16.9	12.5
<b>France, merchandise exports</b>		
European Union	55.7	63.3
US and Canada	4.8	6.8
Japan	0.9	1.9
Other non-European developed countries	1.3	1.0
Developing countries	23.6	17.6

Note: \* Selected regions only, so that the percentages shown sum to less than 100.

Source: UNCTAD, 2002, Table 3.1A, pp. 57, 58, 68.

The political divergence between the UK and the core European powers became clear in the meetings on the inter-governmental Maastricht Treaty in 1992, the Treaty that also changed the EEC into the 'European Union'. British strategy was to avoid the dimensions of the 'ever closer union' that would restrict its freedom of manoeuvre. Prime Minister Major negotiated an opt-out from the commitment to join the future EMU and from the social and employment chapters of Europe-wide legislation. The latter gave British capital a freer hand to downgrade employment conditions. In addition, EU foreign and defence policies were made matters of inter-governmental cooperation and agreement.

In addition to Britain's stronger ties into the non-European world system, the rejection of EMU membership can also be seen as a response to the crisis that occurred after Britain joined the ERM in 1990. That 1990 decision was largely a tactical policy move by the Conservative government, designed to allow a reduction of UK interest rates while maintaining some stability for sterling's value in the foreign exchange markets. However, it all came to grief when German re-unification led the Bundesbank to raise domestic interest

rates, with knock on effects for other ERM countries in weak cyclical positions. Britain exited the ERM two years after joining, and after spending many billions from the foreign exchange reserves in a futile attempt to defend sterling's value against the Deutsche mark. The lesson the UK political class learned from this event was that their previous policy of handling European issues in a tactical, piecemeal manner had undermined support from the major European powers - Germany, in particular. The lack of British loyalty towards the 'European project' would result in little appetite to support Britain's position if it got into trouble and the Bundesbank saw no reason to go out on a limb to back up sterling's position within the ERM.<sup>21</sup> The ERM fiasco led the Bank of England to raise interest rates twice in one day to defend sterling and then to reduce them again once the game was up and sterling exited the system. It was a political humiliation, but the UK economic recovery after 1992's collapse of sterling's value endorsed the view that Britain's economic prospects were better off outside the European project.

In Britain, the decision on potential EMU membership is often considered only in terms of whether there would be an advantage in being part of a single currency system dominated by the decisions of other countries, given that Britain would then have much less direct control over its currency and monetary policy. However, that assessment is one-dimensional and too focused on national economic policy issues. The decision is better understood by considering Britain's interests in the imperialist world system, not by judging only what might be better for the domestic British economy. One book published in 1997 by a Conservative ex-minister, entitled 'Our Currency, Our Country', was more to the point (Redwood, 1997). It focused on the risk of political pressure from the two major European powers, Germany and France, who could undermine the flexibility of UK policy. Once inside EMU, Britain's degrees of freedom would clearly be constrained.<sup>22</sup>

British policymakers' reluctance to board the euro train was based on these concerns, especially about the position of Germany at the centre of the system. The Benelux countries plus Austria and Finland, as fellow creditors, were in the Germany-aligned group, while others depended on Germany's role as the paymaster of the European system, providing the biggest contributions to the EU budget. British worries grew following German re-unification in 1990, and were shared by France. While France had been a long-term ally of Germany in European policy, it had seen its position being undermined with the spread of capitalism into what it feared was to be a German-dominated Eastern Europe after the fall of the Berlin Wall

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<sup>21</sup> At this time, the author had regular discussions with a Bundesbank official at the German Embassy in London, and it was made clear that he thought sterling was significantly overvalued at the ERM central rate of DM2.95, a rate that had *not* been agreed with Germany in 1990. See Connolly 1995 for a depiction of the politics of European monetary relations during this period.

<sup>22</sup> The Maastricht rules for EMU membership do not even have a procedure for exiting the system after a country becomes a member.

in November 1989. A UK Cabinet Office report of a meeting on 20 January 1990 between UK Prime Minister Thatcher and French President Mitterand (released in 2010) brought the point home sharply. It described the concerns each leader had with a Germany on the verge of re-unification:

'President Mitterrand said that he shared the Prime Minister's concerns about the Germans' so-called mission in central Europe. The Germans seemed determined to use their influence to dominate Czechoslovakia, Poland and Hungary. That left only Rumania and Bulgaria for the rest of us.' (Cabinet Office, 1990)

It is in such confidential meetings that imperial interests and concerns are more openly admitted. In the plan to open up a wider range of countries to exploitation within the orbit of the EU's major capitalist powers, those receiving the less attractive cuts were not happy.

These factors help explain the proposal by the 1997 Labour government of '5 Economic Tests' for deciding on whether and when the UK should join EMU. In principle, the five conditions made the decision not to join look like an economic one, based upon cyclical and structural differences between the UK economy and the euro area, differences that might be overcome at some stage. More realistically, they should be interpreted as deliberately sidestepping the bigger policy issue of whether the UK was politically aligned with Europe or with the US.<sup>23</sup> 'Leaving Europe', or distancing Britain further from any influence over European policy, would not have been a sensible decision as it would put Britain in a weaker position with the US, not least by losing its role as an interlocutor between the US and Europe. However, joining in the political-economic project of EMU would have implied sacrificing what for British imperialism were important aspects of its political and economic flexibility, including the close links with the US. Prime Minister Tony Blair, as well as most other UK political leaders in recent decades, had a clear conception of the need for an alliance with *both* the US and Europe (Blair, 2011, pp. 318-19). This middling position may appear to be unstable, merely tactical or even an unprincipled political stance, but it reflects a strategic reality in which British imperialism is placed and which it must manage.

The key issue relevant for this thesis, however, is that EMU would threaten the *financial* dimensions of British power, since these might not be reproduced within a euro-based monetary system that was dominated by Germany. While I would question whether one should take the 1997 Labour Government's '5 Economic Tests' as a serious economic

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<sup>23</sup> Ed Balls, who was then a Treasury adviser to Labour Chancellor Gordon Brown, constructed the five tests in 1997. Scepticism as to whether they should be taken as the result of a profound economic analysis is reinforced by the story that they were written on the back of an envelope while Balls was travelling in a taxi to a political meeting. The tests are no longer UK Government policy and are not on the UK Treasury's website, but they are listed at Europa 2006.

assessment, it is notable that the fourth test, listed just before one on 'Growth, stability and jobs' was a strong defence of the City. Test 4 read as follows:

'Financial services - EMU must improve the competitive position of the UK's financial services industry, particularly in London'. (Europa, 2006)

This reflected a contemporary concern that EMU might undermine the City's business if Frankfurt, the home of the European Central Bank (ECB), became more important as a financial centre. That did not transpire, but the City's well being - still more, its *improved* well being - was a major issue for the Labour Government, and this shows how much financial business was, and remains, central to the economics of British imperialism. Chapter 6 will discuss that issue in depth. To conclude on this point, it is worth noting that by being outside EMU the UK government was in a position to decide its own rescue operations in the recent financial crisis. The Bank of England could operate a policy of 'quantitative easing' independently of any decision of the ECB. For example, between 2009 and 2012 it bought a massive £375bn of UK government bonds and pushed official interest rates down towards zero (BoE, 2012). While the ECB also cut interest rates and bought huge sums of government bonds from weaker countries in crisis, including Greece and Spain, this was done with economic policy measures being imposed upon the latter.

## 5.5 State policy on financial markets from 1979

From the previous discussion it should be clear that state policy has an important influence on the development of the financial sector. Different forms of finance emerge from the underlying logic of capital accumulation, but these forms, particularly their international locations and connections, will be affected by state policy. Such policies had a big impact in the years after 1979, when key changes occurred following the elections of Margaret Thatcher in the UK and Ronald Reagan in the US. This section will focus on the post-1979 period, but it is an exaggeration to see the policy changes in this period as qualitatively different from before. By 1979, the euromarkets had already passed their teenage years and the collapse of Bretton Woods in the early 1970s had already brought about a boom in financial market activity. For example, the value of outstanding international bank loans rose by two-thirds between 1977 and 1979 to exceed \$1000bn, and it was in 1972 and 1975 that major financial futures exchanges had been set up in Chicago. Also, by 1974 the US had removed almost all the controls on international capital outflows, partly given the 'freedom' of not having to defend the dollar's value and partly on the expectation that OPEC oil revenues would flow into the US securities markets (Helleiner, 1996, p. 111). Before 1979, several other countries (ones that usually had current account surpluses) had followed suit, including Canada and Germany. Nevertheless, 1979 is a useful starting point for the discussion of two significant

policies relating to UK financial markets: the abolition of foreign exchange controls and the 'Big Bang' reform of the London Stock Exchange.

The new Conservative Government from 1979 did not like the existing controls on the foreign exchange markets, and one of its first moves was to abolish them. It was able to do this with little risk of a collapse of sterling's exchange value through a flight of capital, since UK North Sea oil production and net exports had begun to increase sharply. Removing exchange controls was seen as a way of enabling *more* capital outflow from the UK, partly in order to limit the likely upward pressure on sterling's exchange rate from the oil revenues, but principally to derive more revenues from foreign investment. Geoffrey Howe, the Chancellor of the Exchequer at the time, explains this in his memoirs:

'[Exchange controls] had cost us dear. Our overseas assets and investment income had fallen as a proportion of national capital and gross national product very sharply. Overseas investment income in the 1970s was down to under 1% of GNP. The invisibles account looked like going into deficit. The financial markets were being stifled. Competition was stunted. Pension funds and institutions were being prevented from getting the best return on capital.'

(Howe, 1995, pp. 140-41)

Evidently, the best return on capital was from overseas. A boom in foreign direct and portfolio investment followed abolition of exchange controls, with net outflows rising from an annual rate of close to 1% of GDP in 1978-80 to nearly 4% in 1984-86.

This deregulation by the UK was part of a more general move by governments in the leading capitalist powers to come to terms with new developments in financial markets. Many tried new ways of managing domestic monetary policy, including controlling consumer credit, but they all had to deal with the financial relationships with other countries. Not all chose the same policy initially. France tried a version of 'Keynesianism in one country' under President Mitterand in 1981, but was forced within a short time to abandon these plans, having failed to get support from other European powers (Helleiner, 1996, pp. 142-43). France's retreat reflected not so much the importance of global financial markets as the very limited ability of any country to operate in isolation from the world economy. Stringent controls on the movement of capital and on financial markets may have been a policy option for France, but not one that could be used if it needed to borrow from capital markets and if it wanted to have some political influence over the developing European Monetary System. Furthermore, its companies would have faced restricted access to sources of foreign capital, something that the growing euromarkets were providing.

There was a general move towards deregulation of financial flows between major capitalist countries in the 1980s. For the US, the UK and Japan, a key motivation was to boost their own financial markets and gain a share of this financial trading business. By 1981, the

US authorities had become more favourably disposed towards getting a bigger share of euromarket operations, passing laws to establish 'offshore' International Banking Facilities that were physically in the US but, by running a separate set of accounts, would be free from most national banking regulations (New York Fed, 2007). Japan also set up its own 'Japanese Offshore Market' from 1985. By the end of the 1980s, major capitalist countries had eliminated most forms of capital control. One indication of this was shown by the narrowing gap, to zero in most cases, between the interest rates paid for 'onshore' versus 'offshore' interbank deposits (see Blundell-Wignall, 1991, Chart 1, p. 36).

Financial business boomed as a result, not only in the volume of eurocurrency lending and borrowing, but also in eurobond issuance and trading and in the large-scale buying by foreign investors of government bonds and equities (Michie, 2006, pp. 292-294). The access of the key financial centres to foreign capital was not without its problems, however. In the US, for example, despite a growing current account deficit, by 1985 a large influx of funds into US securities led to a strong rise in the value of the dollar on the foreign exchange markets. It took official guidance by the 'Group of 5' powers (the US, Japan, West Germany, the UK and France) in the Plaza Accord to help prompt a reversal. The much stronger link between national financial markets also found a striking reflection in the 1987 *global* stock market crash, an event triggered by a dispute between the US and West Germany over monetary policy.

With other countries developing their own international financial markets, the City's leading position was not secure, as noted in Section 5.2. So a key UK government concern in the early 1980s was to improve the competitiveness of London, especially vis-à-vis the New York stock market. This meant overcoming the cosy cartel in London that had been in place for decades. Far from the Thatcher government being 'pro-City' and backing a clique of wealthy financiers, its objective was to promote the City as an expanding business area. So it considered the previous insular forms of protection to be unviable. This led to the 'Big Bang' reforms of 1986, which consisted of liberalised entry of financial companies to the London Stock Exchange, the abolition of fixed commissions and ending the established division of labour between brokers and jobbers (Coakley and Harris, 1992, p. 45). The relatively small size of the London-based brokers and jobbers was a problem for a market that wanted to compete internationally (Michie, 2006, p. 277). Big Bang led to the influx of an even larger number of foreign financial companies into London, especially those restricted by their own government's rules on the scope of their activities, as was still the case even in the US and Japan. The result was that more of the City's operations were taken over by foreign financial companies, but that was consistent with boosting London as a profitable base for doing business and one that was able more easily to attract inflows of foreign money capital.

Some critics of the Thatcher Government's policies on finance suggested that it had a short-sighted view that ignored the importance of domestic manufacturing industry, and that it had, in any case, failed to boost the role of the City or to increase net income from foreign investments (Coakley and Harris, 1992). Especially in the years immediately after Big Bang, it was not clear how selling off UK financial companies to foreign investors could be counted as a major policy success. However, this kind of critique misses the point about what was going on. Even with the build-up of North Sea oil and gas revenues and a domestic recession, the UK's current account position had only briefly moved from deficit to surplus in the early 1980s. One could argue that a policy to boost industry would have been more sensible, but the failures of previous policies by Labour and Conservative Governments from the late 1960s did not set a precedent for success in the 1980s. Furthermore, a national Keynesian policy had been attempted by France in 1981 and was abandoned, replicating in many ways the previous turn in policy of the 1974-79 Labour Government. This is not to argue that the Thatcher Government's policies were inevitable or unavoidable, but it is to put them in a context where they made more sense for capitalist strategy than critics often allow. By making moves to boost the City's business – and to boost earnings from foreign investment – they were placing a bet that looked like having better odds of a payoff than the others on offer, given the international status of the City.<sup>24</sup>

A point worth reiterating is that most other major capitalist powers were following similar policies. This was especially clear within the European Union. In 1986, all member governments of the EU signed the Single European Act, the first major revision of the Treaty of Rome and one that aimed to create a 'single market' by 1992. The scope of this single market was not restricted to the products of industry and regular services. It also included the removal of capital controls and a 'free market' in financial services within the EU. A number of these policies had already been under way since 1977 (Chrystal, 1992). By 2012, the impact of such policies, and an indication of the growth of parasitic economic activities within the EU, is seen in the fact that 5.3% of total employment was in financial and related professional services in EU member states, and that 5.5% of EU GDP was accounted for by financial services (City, 2013a, p. 11, p. 13). The UK was well above the EU average on each measure, at 7.0% for employment - 2.1 million people - and 7.9% for GDP. There were exceptional figures for some smaller, financial service-oriented EU countries such as Luxembourg (17.9% and 23.5%, respectively).

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<sup>24</sup> These comments refer only to the international finance aspects of UK policy relevant to this thesis.

## 5.6 Global finance and the major powers

As noted at the beginning of this chapter, UK financial markets remained in a strong global position after 1945, despite Britain being nearly bankrupt and with fundamental balance of payments problems. This may be seen partly as a result of inertia. It would have taken time before other centres could have overtaken the UK. But it was also due to pro-active policy measures - including a policy of *not* imposing restrictions - that assisted, among other things, the development of the euromarkets. That policy stance can hardly be explained by arguing, as does Helleiner, that Britain supported liberalisation because of 'its "lagging" hegemonic commitment to London's position as an international financial centre' or that it was 'locked into a policy of openness that dates from its hegemonic days' (Helleiner, 1996, p. 167, p. 202). The policy clearly had a forward-looking objective of boosting revenues from overseas via expanded City operations. It was not based on nostalgia.

Table 5.2 sets out some key data for comparing the position of UK financial markets with those of other major powers (the top five of the 'G7') in the 1980s and 1990s. Comprehensive data for global financial markets do not exist for the whole period from the 1970s and, before the mid-1980s, surveys were very patchy, perhaps with details for one market location but none for other important centres. However, the overall message is both that UK-based markets 'punched above their weight' *and* that their position was under threat from developments elsewhere.

Firstly, consider the data for international banking, namely giving loans to and taking deposits from outside the national territory. The UK consistently had the highest share of this market, but its lead fell back after 1980. This was partly due to the BIS data including offshore tax havens in its data for the first time from 1983. This was not necessarily much of a setback for the UK's banking operations, because, as Chapter 6 will show, there are strong British financial links with these areas that attract vast sums of international money capital. In addition, the UK's share at 20% in 2000 was still twice as big as that for the second place power, the US. However, the rapid expansion of Japanese banking was a competitive threat around 1990, before Japan's financial crisis. Germany's position in international banking also increased, and did so more persistently than Japan's. Eventually Germany overtook Japan's share of business and came closer to the US position, one more indication of Germany's potential threat to UK-based financial business.

Other data in Table 5.2 relate to the foreign exchange market. From the 1980s, the share of global FX trading in London increased steadily and remained well ahead of all other financial centres. This was despite the volume of trading in sterling (GBP in the table) being the fourth largest in the global markets, well behind the US dollar and also behind the

Deutsche mark (DEM, later the euro) and the Japanese yen (JPY). This was another sign of how the City had consolidated its position as the main international centre of financial dealing, one that did not necessarily relate to the UK domestic economy nor depend upon the use of sterling, and one in which the main institutions doing the deals were as likely as not to be owned by foreign banks.

**Table 5.2: Financial market shares of major powers, 1980-2001 (% of total) \***

	1980	1985	1990	1995	2000
<b>Banking - % of international global assets/liabilities outstanding by location *</b>					
UK	27.0	23.7	17.8	17.6	20.1
US	13.4	15.3	9.6	9.2	10.0
Japan	5.0	7.3	14.9	12.3	8.3
Germany	5.5	3.4	4.7	6.9	9.1
France	10.8	6.9	7.1	7.8	6.3
<b>FX market - % turnover by location (April)</b>					
UK	-	-	26.0	29.3	31.8
US	-	-	16.0	16.3	16.0
Japan	-	-	15.0	10.3	9.0
Germany	-	-	-	4.8	5.4
France	-	-	3.0	3.8	2.9
<b>FX market - % turnover by currency traded (April) **</b>					
GBP	-	-	15	10	13
USD	-	-	90	83	90
JPY	-	-	27	24	23
DEM (EUR in 2001)	-	-	27	37	38

Notes: \* Global financial market data is very patchy before 1989. For example, in 1986 only four central banks took part in a measure of FX market activity. \*\* There are two currencies involved in every FX deal, so the sum of the shares for all currencies is 200%.

Sources: Various Bank of England and BIS reports, with author's calculations.

The rising importance of the euro in global foreign exchange - and other financial markets, including bonds, equities and derivatives - was a possible threat to the UK. Yet, in many respects, the euro financial system, although developing apace after the single market reforms, showed little sign of establishing a rival financial centre to London. Greater unification of the financial services sector within the EU and a common currency for euro member states encouraged banks to centralise their dealing operations. Nevertheless, despite the establishment of the European Central Bank in Frankfurt, it was commonly the case that these operations were centralised in London. Where it was not London, it would be in the

home country's business centre, and not in Frankfurt unless the bank was German.<sup>25</sup> National and political differences within the euro area meant that there was far less of a trend than one might have expected to bring about a dominant centre of financial market activity. There is a single currency, but a multiplicity of states, something that politically and economically makes the euro less than the sum of its components. Notably, in the aftermath of the 2007-08 crisis and the ensuing problems with Greece and other member countries, there have been reports that the previous integration of euro banking markets was beginning to be reversed: if a bank had euro assets in France and euro liabilities in Spain, it did not have complete confidence that the assets and liabilities would be treated in the same way by their respective governments, or by any supra-national authority. As the crisis developed, European banks began to match their assets and liabilities on a *national* basis (Tett, 2012).

## 5.7 Conclusions

This chapter has outlined the main developments in global financial markets from 1945 to the 1990s as they relate to the position of British imperialism. One conclusion is that while the UK has clearly been subordinate to the US, it would be a mistake to see UK financial markets as simply being a 'satellite' of US markets. To use a more accurate astronomical metaphor, this particular relationship is better described as a 'double planet' system. Instead of the UK simply orbiting the US, each country has a significant 'gravitational' pull on the other, even if the US is the larger. More than that, the centre of gravity for the overall system is determined by the balance of power among *all* the major capitalist countries, a balance that changes over time. Reckoning on its position within the global hierarchy, the UK will accommodate US demands, but it will also pay close attention to its own interests. The UK's dependence on the US in military and security matters does not mean that British policy is determined by the wishes of the US administration. There have even been occasions when US policy had appeared to shift in favour of the UK joining in more closely with European developments, and where US administration officials have sidestepped Britain to negotiate with other European leaders directly, but the UK has persisted with a 'mid-Atlantic' policy.

The authority of the British state, not only over its national territory, but also in relation to other powers and, in particular, over the rules for managing financial obligations in the City, has been critical for the City's international role. It was this that assisted the renewed role of the City in the post-1945 world. Britain was no longer in a position to be the world's major creditor as before 1914. Its commercial empire and the Sterling Area came under attack

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<sup>25</sup> In the author's experience, even after the euro's introduction, German banks, like others, did most of their securities business in London, which remained the key financial centre. A bank's sales force would need to be located close to the dealing operation to get market information. Communication links to European clients were good from London, so this often meant that the main sales teams were also in London.

from US policy as well as being undermined by world economic trends. But the City's financial infrastructure and international links were largely intact and these formed the basis on which it was able to build new forms of financial dealing, this time mainly in US dollars.

The British state did not build these markets, neither the government nor the Bank of England. The operations were clearly initiated by private capitalist companies. To that extent, I would agree with Burn's thesis. However, Burn's argument that the City represents a pre-industrial financial clique restored to power (Burn, 2006, p. 9) ignores both the impressive coherence, unity and inter-mingling of the British ruling class and the realities of post-colonial economic competition in the harsher world market with which successive UK governments had to deal. These issues led the Bank of England, a part of the British state, to endorse the expansion of financial business and led the Thatcher Government from 1979 to enact financial reforms to expand it further, policies which have not been reversed by any later administration. While many European politicians were, at least rhetorically, promoting the idea of a 'Tobin tax' on financial transactions in the wake of the 2007-08 financial crisis, the British government was resolute in opposition. In the next chapter, I shall examine more closely the contemporary dimensions of how the City of London enhances the economic power of British imperialism.

## Appendix 5.1: Imperial Status and Britain's Return to Gold in 1925

Britain's return to the gold standard in 1925 was a decision condemned in J M Keynes's pamphlet of that year, 'The economic consequences of Mr Churchill'. However, it is interesting to note that Keynes only argued against the *particular rate* chosen for sterling – one that was the same as in 1914 at the start of the First World War, when the gold standard had been suspended – *not* the decision itself. Furthermore, the rate was only claimed by Keynes to be about 10% too high, although this was significant for some of Britain's industries, such as coal mining. But what is striking about Keynes's pamphlet is that it *completely ignores* the reasons the Government, with Winston Churchill as Chancellor of the Exchequer, took the decision.

Far from potential economic problems with the new gold parity not being taken into account, these were anticipated, but were thought to be worth paying in order to get the benefits of the decision to return to gold at the pre-war level. The prevailing view, even of many industrialists, was that a return to gold in 1925 would have stabilised business conditions after the period of turmoil post-1918, and this would help to boost international trade and investment.<sup>26</sup> However, my focus here is on the imperial rationale for Britain's policy.

Keynes's biographer, Skidelsky, notes the imperial dimension, even though his subject does not. Skidelsky quotes from Churchill's budget speech on 28 April 1925, when the decision to return to the gold standard at the pre-war rate was announced:

'If we had not taken this action, the whole of the rest of the British Empire would have taken it without us, and it would have come to a gold standard, not on the basis of the pound sterling, but a gold standard of the dollar.'  
(Skidelsky, 1992, p. 200)

Wars are expensive, and Britain's armed forces had previously been deployed mainly to put down small-scale threats in troublesome colonies and from countries not making their coupon payments, not from rival powers that would take far more resources to subdue as in the First World War. Britain's economic interests were also severely damaged by that war as commercial and financial relations were disrupted. It was clear that Britain was in a weak position after 1918 and that its previous hegemony was endangered.

Despite the setbacks, British policymakers had reason to believe that the previous position could be restored, given the desolation elsewhere in Europe, and despite the new worry about Soviet Russia. But their problem was that the First World War was largely a European war; the US had emerged both unscathed and in a stronger international position.

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<sup>26</sup> See R S Sayers 1970 for an enlightening analysis of this event.

So there was a debate in British policy circles: should the government restore sterling as the currency underpinning global financial relationships – at the old rate against gold, in order to stress both that nothing had really changed and that holders of sterling would not be damaged - or recognise that the *status quo ante* was no longer attainable? In 1925, the former path was risky, but it looked far less of a threat to Britain's imperial position and privileges than the latter.

This is what Churchill had to say that is relevant to my argument here when he made his April 1925 budget speech announcing the return to gold:

'We are convinced that our financial position warrants a return to the gold standard under the conditions that I have described. We have accumulated a gold reserve of £153,000,000. That is the amount considered necessary by the Cunliffe Committee, and that gold reserve we shall use without hesitation, if necessary with the Bank Rate, in order to defend and sustain our new position.'

...

'I have only one observation to make on the merits. In our policy of returning to the gold standard we do not move alone. Indeed, I think we could not have afforded to remain stationary while so many others moved. The two greatest manufacturing countries in the world on either side of us, the United States and Germany, are in different ways either on or related to an international gold exchange. Sweden is on the gold exchange. Austria and Hungary are already based on gold, or on sterling, which is now the equivalent of gold. I have reason to know that Holland and the Dutch East Indies – very important factors in world finance – will act simultaneously with us today. As far as the British Empire is concerned – the self-governing Dominions – there will be complete unity of action. The Dominion of Canada is already on the gold standard. The Dominion of South Africa has given notice of her intention to revert to the old standard as from 1st July. I am authorised to inform the Committee that the Commonwealth of Australia, synchronising its action with ours, proposes from today to abolish the existing restrictions on the free export of gold, and that the Dominion of New Zealand will from today adopt the same course as ourselves in freely licensing the export of gold.'

...

'Thus over the wide area of the British Empire and over a very wide and important area of the world there has been established at once one uniform standard of value to which all international transactions are related and can be referred. That standard may, of course, vary in itself from time to time, but the position of all the countries related to it will vary together, like ships in a harbour whose gangways are joined and who rise and fall together with the tide. I believe that the establishment of this great area of common arrangement will facilitate the revival of international trade and of inter-Imperial trade. Such a revival and such a foundation is important to all countries and to no country is it more important than to this island, whose population is larger than its agriculture or its industry can sustain, which is the centre of a wide Empire, and which, in spite of all its burdens, has still retained, if not the primacy, at any rate the central position, in the financial systems of the world.' (Hansard, 1925)

The important lesson from this historical episode is that big events cannot be understood if we do not take into account the position of different powers within the imperialist world economy. It was a particularly narrow and misleading analysis by Keynes in his pamphlet to judge the decision to go back onto gold at the previous parity only in terms of whether that exchange rate was thought to be suitable for the domestic economy.

Britain's renewed application of the gold standard lasted only until 1931, when large outflows of gold and pressure on sterling led to its abandonment. British policymakers had planned to use the gold standard as a means of re-establishing Britain's role in world finance. After 1931, there were instead more direct sterling-based financial links with the Empire and Dominions, ones that eventually resulted in the Sterling Area from 1940 until the 1970s.

## Chapter 6      The Role of Finance for British Imperialism

The City of London is the pre-eminent *international* financial centre for global capitalism. While the policy of the US Federal Reserve is critical for international financial markets and New York and Chicago have the biggest trading exchanges for financial securities, London is by far the largest hub for foreign exchange trading, for 'over-the-counter' derivatives deals (between banks and their customers) and for international bank lending and borrowing. Earlier chapters have covered the historical background to this status and how these financial activities should be understood in terms of Marx's theory of value. Here I will explain the contemporary economic role of UK-based finance and the economic benefits provided for British imperialism. To talk of benefits from finance might seem perverse in the wake of a huge financial crisis. However, this chapter will demonstrate the continuing importance of this role through examining the UK's international balance of payments. My focus will be on the years from the late-1980s up to 2012-13. This is mainly because the 'Big Bang' City financial reforms date from the late-1980s and international finance became more important thereafter. But the statistical information for earlier years is also far less detailed, with some data only starting in 1987, and does not show as clearly how the mechanism works.

Balance of payments data for the UK have some unusual features that highlight important aspects of British capitalism. This is not surprising, since a country's external accounts will tend to reflect its relative strengths and weaknesses in the world economy. However, Britain has a unique position when it comes to financial transactions with the rest of the world, and there is no substantial analysis of that position in the contemporary literature, Marxist or otherwise.<sup>1</sup> The City does not simply earn significant foreign revenues; the UK-based financial sector is part of the broader mechanism by which British imperialism appropriates surplus value from the world economy. The data I use in this chapter are from the UK Office for National Statistics (ONS), the Bank of England (BoE) and the Bank for International Settlements (BIS). While these sources discuss trends in the figures for financial revenues, transactions, positions, assets and liabilities, they treat different categories of statistics under independent headings and do not discuss the key *relationships* that are examined here.

In summary, my argument is that the financial sector of the UK economy ('the City') plays three important and related roles for British imperialism. Firstly, the *revenues* provided from this sector's international transactions are an important surplus element of the current

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<sup>1</sup> The relevant literature is reviewed in Chapter 1 and will not be discussed further here.

account of the UK balance of payments, helping offset the chronic visible trade deficit.<sup>2</sup> Secondly, the City's operations provide a means by which any deficit on the current account, or outflows on other elements of the total balance of payments, may be readily *financed*, often at relatively low cost. This allows the UK economy, taken as a whole, a great deal of flexibility. There may be a deficit on the current account and also net outflows of foreign direct investment, for example, but these negative balances can be offset with funds borrowed from external sources. The relative ease with which UK foreign investments can be financed also enables the British economy to benefit from the international revenues that derive from those investments. These add to the surplus revenues from financial transactions. Thirdly, the City's role as a key market for global finance gives British-based companies *access to capital* with which they can extend their influence and operations worldwide. This final point is linked to the operations of the banks and the London Stock Exchange, but illustrates the way in which fictitious capital can be used as a means of payment. This follows from the discussion in Chapters 2, 3 and 4 of the role of fictitious capital in contemporary imperialism.

Section 6.1 discusses issues that arise when analysing balance of payments statistics and the approach used in this chapter. Section 6.2 sets out the key features of the current account of the UK balance of payments. It highlights the components relating to finance and shows that these surpluses do much to offset the deficit in goods trade. The next section looks more closely at UK-based international financial services, banking operations and trading, which are usually the largest in the world. Section 6.4 pays attention to the financial account of the balance of payments, detailing that net inflows of money capital into portfolio assets and the UK banking system effectively fund both the UK current account deficit *and* the net outflows on direct investment. Section 6.5 analyses the UK's outstanding foreign investment *position*, rather than the annual flows. The analysis shows that the returns on the net *surplus* position on direct investment are higher than the yields paid on the *deficit* positions on portfolio investment and banking flows. This is how the UK was able to maintain a net surplus of investment income for the past decade or so, a fact helped especially by lower global interest rates. That income surplus has nevertheless diminished in recent years, turning to a deficit in 2012, and this is one indication that the UK's future financial position is far from secure. Section 6.6 examines the City's financial links with the rest of the world, paying particular attention to the UK relationships with tax havens. This dimension has been absent from the academic literature, or, indeed, from any discussion that has not focused *solely* on tax issues. The discussion brings out the importance of these tax havens, both for the funding

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<sup>2</sup> The City's operations are principally in non-sterling currencies, but the net revenues from these operations mean that there is a smaller rise in net UK foreign liabilities via the financial accounts of the balance of payments.

of the City and for the international flows of finance today. Section 6.7 rounds off with a discussion of 'financial privilege', bringing together the different themes of the chapter.

## 6.1 Data issues and methodology

My analysis in this chapter is taken from an examination of the data for the period from around 1986 to 2012, an important quarter century in the history of British finance. For UK balance of payments data, different categories of data get revised at different times. In order to avoid possible problems with inconsistent sets of figures, I have principally used the ONS online database for the UK *Pink Book* 2013 which gives a set of annual data to 2012.

In the case of the balance of payments data, I will focus on *net* figures showing the balance of transactions or investment positions between the UK and other countries, rather than the gross flows or positions. For example, I will look at the net trade figure, not exports and imports separately. The net figures are the simplest way of expressing the position of the British economy vis-à-vis the rest of the world and they relate to an important concept for this thesis: British imperialism's *privileged* appropriation of surplus value. While the gross inflow of such revenues might be larger than the net inflow, I would argue that the net figure is a better measure of such a privilege. If inflows of revenues were £100bn, for example, while outflows were £90bn, then the net figure of £10bn is a better measure of the privilege since it is a better sign of the *relative* position of Britain in the world economy compared to other powers.

However, clearly the net figures do not tell the whole story, even if they are a more concise way of presenting it. If the net balance for an item is close to zero that does not necessarily mean that nothing is happening. Instead, it could be that there is a large outflow balanced by a large inflow. For example, a net balance of +1 results both from a value of 1 for exports and zero for imports, and from 101 for exports and 100 for imports. The gross figures might reveal a significant two-way volume of business operations or transactions that shed a different light on international flows than the net figures.

Yet even the gross international figures might understate the significance of the sector measured. Consider where domestic demand for the output of that sector is 50 and where the domestic sector supplies 80% of demand (40), with the other 20% (10) being supplied by imports. If the domestic sector did not exist then, in addition to the loss of any exports from that domestic sector, domestic demand (50, if there were no reduction) would have to be supplied by imports. This suggests that both the net and gross international inflow figures for an economic sector could *understate* its value to the domestic economy. To be more specific, if the British financial sector did not exist, this would not only eliminate the surplus on the balance of financial services payments; the result would also be a deficit as more of these

services would then be imported. While it is probable that a large proportion of the financial services currently imported are imported by the financial sector itself, this point is still valid. My focus will be on the net position of the UK financial sector vis-à-vis the rest of the world, but these points indicate that this is likely to underestimate its true economic value to the UK economy.

The next data issue to consider is one that commonly plagues these investigations: do the data accurately measure the object of analysis? There are two problems here - data revisions and how the data are constructed. Economic data are often revised as statistical organisations receive further information or as the method of estimation is changed. In the case of data relating to the financial sector, this can be particularly frustrating when positive balances become negative or when the magnitude of the data is revised substantially. I have made an effort only to draw conclusions from those items and relationships that appear to be relatively immune from significant revision.

Even if the data are not revised, it may still be the case that the data do not measure what they appear to be measuring. This can result from a company or individual seeking to classify an international business deal in a more tax- or regulation-favoured category, from ambiguities as to what is the correct statistical category or simply from the deal being omitted altogether. These things demand that one must be circumspect when interpreting data and focus more upon trends than upon particular data points to judge what is really going on.

A related issue concerns the method of 'indirectly' measuring the value of the output of the financial sector, including its international balances. This method was adopted post-2007 in UK statistical publications. The 'financial intermediation services indirectly measured' (FISIM) method applies only to bank loans and deposits, but it has the effect of raising the value of the financial services provided by banks, including export values. In recent years this has boosted the value of financial services net exports by £4-5bn per annum, or by some 15%. Discussion of this methodology is beyond the scope of this thesis, but its most egregious outcome is when it is used for GDP-related income data. In 2008, for example, UK banks as a group recorded a huge loss, but the FISIM-method data gave a 'value added' that appeared as *higher* operating profits than in 2007!<sup>3</sup> Christophers has made a definitive critique of the FISIM methodology from a value perspective (Christophers, 2011), while there has also been a mainstream critique from a senior Bank of England official (Haldane, 2010). In the discussion below, I note which data set is used but, luckily, inclusion of the FISIM-based data does not have a material effect upon the international data.

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<sup>3</sup> The figures in the Blue Book for UK national accounts are in Table 4.2.2, series code NHBX (ONS, 2012d). They relate to *gross* operating profits, but the rise from 2007 to 2008 is still bizarre. The author discussed this issue with an ONS official and was told that the rise was due to FISIM methodology (Wisniewski, 2011). Bank of England data for the major UK banks showed a *drop* in pre-tax profits of nearly £80bn between 2007 and 2008 (see BoE, 2010a, Chart 4.3, p. 37).

Another point concerns the balance of payments accounting identities. The balance of payments always sums to zero, but it is important to take a view on which elements are the 'drivers' and which are the passive 'residuals' balancing the flows. This may change with the situation being discussed. For example, deals to borrow funds or engage in financial transactions are often motivated by other, 'underlying' transactions. A company may borrow funds from a foreign bank in order to import goods, for example. The borrowing is for the purpose of importing. The foreign bank may have wanted to lend the funds, but that loan would not have been made apart from the company's decision to import. In other cases, a financial deal may be the underlying motivation itself, for example when investors in one country decide to buy portfolio assets or companies in another. Typically, banking transactions are intermediary flows, while portfolio or direct investment deals are the driving or 'underlying' flows. Even here there may be exceptions. Overall, however, a country with a strong financial sector, like the UK, is in a very flexible position when it comes to financing the 'underlying' flows in the balance of payments.

Finally, this chapter's discussion of the role of finance only examines the international relationships. If I did include the UK's many highly paid professional jobs in law and accounting, and in a range of other business services strongly related to the City, then that would undoubtedly further raise the City's value for British imperialism, especially as these services are also exported. For the domestic British economy there is also a benefit that extends to the demand for goods and services from the more than one million employees, a demand that provides jobs for other groups of workers. Rather than the financial sector being a semi-detached appendage of the domestic UK economy, it is a key contribution to it, and one whose growth was, and remains, vital to the economic interests of the British state, not least by providing important tax revenues.<sup>4</sup> Alistair Darling, a Chancellor in the recent Labour Government, gave an indication of this in his comment on the booming 2000s:

'we mistakenly assumed that the revenue that rolled in from the financial services sector and from stamp duty would keep on coming. Our spending was based on that assumption and, when it came to an end, borrowing rose.'

(Darling, 2011, p. 310)

Discussing the value of the financial sector for British imperialism may look perverse when the government has bailed out the banking system with taxpayer-backed funds in the many tens of billions of pounds. However, as the following sections will show, the UK-based financial system is a critical part of the economy and this is why successive UK governments have defended it.

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<sup>4</sup> The City of London lobby group CityUK provides comprehensive data on the revenues from, employment in, and activities of financial and related professional services. In 2011/12, UK financial services contributed £63bn of tax revenues, 12% of the total. Just over 2 million people in the UK are employed by the finance and related services sector, 7% of the total, with 1.07 million in banking and insurance. See City 2013a and 2013b.

## 6.2 UK current account: surplus from City dealing

One feature of the current account data sets the UK apart from all other major powers: a chronic deficit in goods trade that is largely offset by a surplus in services revenues and (usually) investment income. This was also true when the UK was the 'workshop of the world' in the nineteenth century, but then Britain's commercial and financial supremacy meant that the deficit of some 4% of GDP in goods was much more than counter-balanced by revenues from shipping and insurance, and from the huge income from Britain's rapidly growing foreign investments, so the country had current account surpluses. In more recent decades, current account surpluses have been rare - the last one was in 1983 - but the deficits on goods have remained,<sup>5</sup> reaching record levels of nearly 7% of GDP in 2010-12. This raises the question of how the UK trade gap is financed today. European countries with large external deficits - Greece, Ireland, Portugal, and Spain - have been faced with severe austerity resulting from the economic crisis post-2007. While living standards in the UK have fallen for the bulk of the population, there has been nothing on that scale. This is because British capitalism has found other ways to make money to help pay the bills.

**Table 6.1: UK current account balance and components, 1986-2012 \***

	1986-89	1990-99	2000-07	2008-12	2012 (£bn)
<b>Visible trade</b>	-3.6%	-2.1%	-4.8%	-6.5%	-107.9
<b>Financial services</b>	0.9%	1.0%	1.6%	2.5%	34.7
<b>Insurance services</b>	0.5%	0.6%	0.5%	0.8%	11.6
<b>Investment income</b>	-0.2%	-0.3%	1.1%	1.2%	-2.1
<b>Other items</b>	-0.3%	-0.6%	-0.7%	0.5%	4.5
<b>Current account</b>	-2.8%	-1.3%	-2.3%	-1.5%	-59.2

Note: \* All figures are the average annual % of GDP, except in the last column.

Source: ONS, 2013, and author's calculations

A country's trade in goods can stay in deficit with little problem if the gap in payments is easily balanced by other funds flowing into the country. In Britain's case, the key item of its international dealing that brings in surpluses is the trade in financial services, usually with help from insurance services and the income from British investments overseas. In 2011, the surpluses on these items covered two-thirds of the huge trade deficit. A wider trade gap in 2012, with a lower surplus on financial services and a deficit on investment income saw a much wider current account deficit of 3.8% of GDP, up from 1.5% in 2011. However, the current account gap was easily funded by inflows on Britain's financial accounts, as indicated by the Bank of England's trade-weighted sterling exchange rate index being nearly 4% higher in 2012 than in 2011. This again suggests something unusual about

<sup>5</sup> The last annual UK trade surplus was in 1982, helped by rising North Sea oil and gas exports and a domestic economic recession.

Britain's external position. In this and the next section, I will note the current account features; later I will examine the financial accounts.

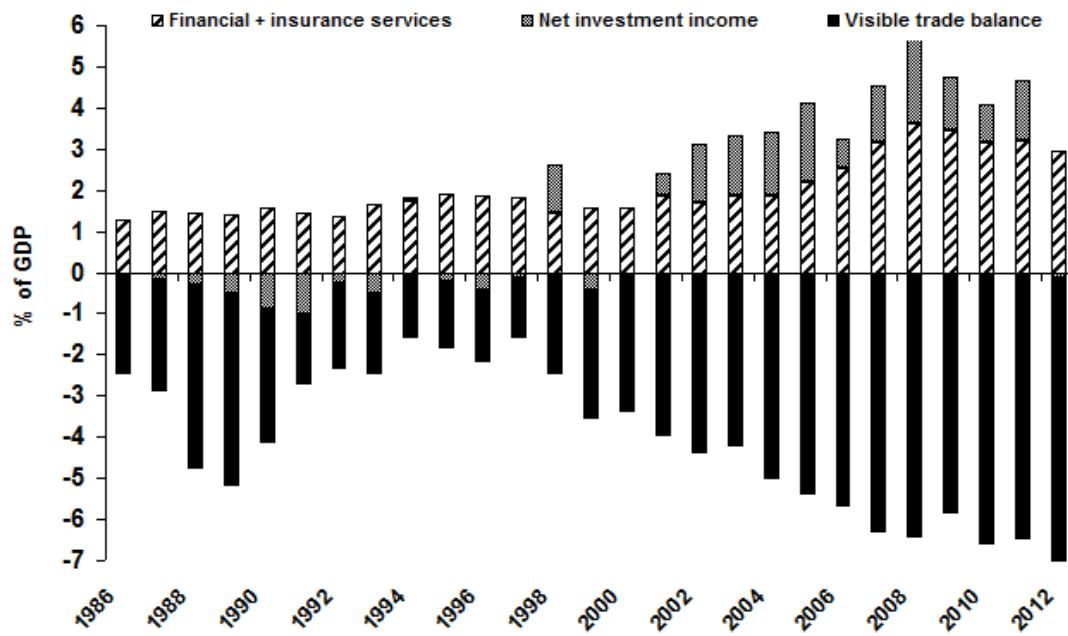
Table 6.1 gives the key numbers for the current account breakdown over the past quarter-century. The visible trade deficit has tended to move with the UK economic cycle, but it trended higher as a percentage of GDP even into 2008-2012, despite the recession in domestic demand after 2007. The net surplus revenues from financial services have grown fairly steadily, however, supplemented by relatively stable, though smaller, net service revenues from insurance. Investment income moved from deficit to surplus in the past two decades, reaching an average 1.2% of GDP in 2008-2012. Any positive income figure remains a surprise, nevertheless, given that the UK has a large net *deficit* on its overseas investment position, a deficit that has steadily grown since 1995. The reasons behind the (potential) net income surplus on a net deficit position will be examined in section 6.5. The 'other items' in Table 6.1 include other business services (a surplus), tourism (a deficit), net EU payments and net military grants (deficits). Chart 6.1 shows the key data from 1986 to 2012.

A striking feature of Table 6.1 is that, despite the sharp rise in the UK trade deficit from the 1990s into the 2000s, the current account gap as a share of GDP was little changed. This can be interpreted as a sign that the policies of successive governments to back the expansion of the UK financial sector worked, although critics of government policy will bemoan the failure of UK-based industry to remain competitive in world markets. At the very least, it has allowed an important share of an otherwise disastrous trade deficit to be funded by revenues from the expanding financial services sector. Net income from foreign investments has also been an important contributor in the 2000s, but in the previous decade that figure was negative. In the next section I will look more closely at the UK's financial services revenues and how its financial activities compare with other countries, before moving on to examining the UK's external assets and liabilities.

### **6.3 Britain as the financial broker for global capitalism**

A wide range of financial services is based in the City, but the principal activities, those that bring the largest net revenues, are those of the banks, or, in official terminology, the 'monetary financial institutions'. The operations of banks as part of the monetary system are distinguished in official UK statistics from the operations of fund managers and securities dealers, although bank corporations may also have divisions that also take on these latter roles. Financial services are also treated separately from insurance services, and this analysis will pay little attention to the insurance sector since my focus is mainly on financial transactions such as bank lending/borrowing and trading in securities.

**Chart 6.1: Key components of the UK current account, 1986-2012**



Source: ONS, 2013, database and author's calculations.

Table 6.2 details the UK's net earnings from financial services. As with Table 6.1, the columns are divided up into periods that reflect different phases, from the first years after the 1986 'Big Bang', then the 1990s, then 2000-07, the period before the onset of the financial crisis, then the later years. Here I present the figures in nominal amounts, rather than as a share of GDP. Although this means that the data are no longer deflated by the growth of the economy, the main constituents have grown far more rapidly than nominal GDP.

The UK has the second biggest surplus on financial services in the world, usually just behind that of the US. If insurance services are added to the reckoning on this account, then the UK surplus is the highest, given that the UK has steady net revenues on insurance (shown as one of the addenda to Table 6.2) while the US has a large deficit. Apart from highlighting the UK's role as the world's key centre for international banking and financial trading, these net revenues are one measure of the UK's net appropriation of global surplus value from the world economy. The second addendum to Table 6.2 shows the value of the 'FISIM' additions to the recorded value of net financial services exports. Whatever may be one's view of the validity of this adjustment (see Section 6.1 for my own), its impact is less than 20% of the 2000-12 totals, so it does not have a substantial effect.

**Table 6.2: UK net earnings from financial services, 1986-2012 (£ billion) \***

	1986-89	1990-99	2000-07	2008-12	2012
<b>Monetary financial institutions</b>	n/a	4.3	12.8	28.2	26.7
<b>Fund managers</b>	n/a	0.5	1.7	3.6	4.1
<b>Securities dealers</b>	n/a	2.2	6.0	6.0	3.8
<b>Baltic Exchange</b>	n/a	0.3	0.5	0.7	0.4
<b>Other institutions</b>	n/a	-0.3	-1.2	-1.8	-0.2
<b>Total net earnings</b>	4.1	7.5	19.8	36.8	34.7
<b>Addenda:</b>					
Insurance services	2.3	4.5	5.6	12.0	11.6
FISIM addition **	2.2	1.9	2.6	5.9	4.1

Notes: \* Average net earnings per annum. \*\* The value of 'financial intermediation services indirectly measured' that is included in the total net earnings of financial services.

Source: ONS, 2013, and author's calculations

Monetary financial institutions account for the bulk of the revenues. In 2012, the banks' net interest income on loans made up less than a third of their foreign income, with fees and commissions accounting for about a quarter. Nearly half of their earnings, £13.2bn, came from *dealing spreads* (ONS, 2013, Table 3.6). The revenue from dealing spreads should come from the difference between bid and offer prices, but, since prices change, it is difficult, if not impossible, to separate this revenue from that which dealers make in profitable bets on a move up or down in market prices. Securities dealing operations, considered separately from banking, gained almost all of their income from commissions and fees, rather than from such dealing margins. Fund managers based in the UK are usually less important in the totals, as is the Baltic Exchange, which is linked to dealing in freight futures, and is the main international broker for dry cargo and tanker fixtures, including the sale and purchase of merchant vessels.

It is significant that the earnings data on financial services have shown little sign of being affected by the post-2007 crisis. In the immediate pre-crisis years 2006 and 2007, total UK net earnings were some £25bn and £35bn, respectively, and significantly higher than previous years, led by higher volumes of dealing. In 2011 and 2012, the total net revenues from financial services averaged close to £35bn. Such figures indicate the continued importance of financial market trading.

The UK's position in global financial services is reflected in the data for the geographical locations of the main financial markets. The evidence presented in the remainder of this section shows both the prominence of the UK and the highly centralised nature of modern global finance.

Table 6.3 details the UK's international banking position compared to other countries. The totals in the table are for 44 countries that report to the principal body that collates these figures, the Bank for International Settlements (BIS) based in Basel, Switzerland. Notably, the UK has by far the largest total of claims on (loans to) and liabilities to (deposits from) other countries. The data are for banks located in a particular country, including these countries' 'international' banking facilities which, as in the case of the US and Japan, are located in the respective national territories but operate under a different set of financial legislation. There is no such distinction for the UK, and at the end of 2012 the UK had nearly 19% of the total outstanding global business. The US was in second place with a 12% share. Japan's share was a little over 8%. While this increased from 5% in 2007, it remained well below levels seen before 2000.

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**Table 6.3: International positions of banks, end-2012 (\$ billion)**

Country	Claims + Liabilities	Share of Total
UK	10,162	18.8%
US	6,716	12.4%
Japan	4,623	8.5%
France	4,411	8.1%
Germany	3,688	6.8%
Cayman Islands	2,805	5.2%
Netherlands	2,314	4.3%
Hong Kong	1,709	3.2%
Singapore	1,415	2.6%
Italy	1,314	2.4%
Luxembourg	1,271	2.3%
Belgium	1,169	2.2%
Other *	12,534	23.2%
Total	54,130	100.0%

Note: \* Each of the remaining countries has a share that is less than 2% of the total.

Source: BIS, 2013b, Table 2A, and author's calculations

UK-owned banks do not do all this UK-based business, of course; foreign banks in the City do a large share. However, a separate table compiled by the BIS on the business done by banks according to the *nationality of the bank's head office* still shows that British banks have a larger volume of *international* business than the banks of other countries. In December 2012, British-owned banks had \$9.1 trillion of claims plus liabilities compared to the US

banks' figure of \$8.5 trillion, the second biggest.<sup>6</sup> This was only a small leading margin, but it shows that a common cliché that City business is like the Wimbledon tennis tournament – a UK *location* where *foreign* players overwhelmingly dominate proceedings - does not allow for the powerful international role of UK banks.

The UK figures in Table 6.3 exclude the separate banking business of tax havens outside the UK, including the Cayman Islands, the Bahamas, Bermuda, Jersey, Guernsey and the Isle of Man. While these islands are not technically parts of UK territory, they all sing 'God Save the Queen' as their national anthem and the British authorities give them a special status. Together they would rank fifth in the table, ahead of Germany, making up 8% of international bank business at end-2012. The role of these offshore centres in UK finance is analysed in section 6.6.

Table 6.4 details another dimension of global finance: the foreign exchange markets. Banks in the UK (overwhelmingly London) have a clear and persistent lead in terms of market share, one that has grown over the past two decades. Foreign exchange dealing is not bank lending or borrowing, but exchanging one currency for another, and banks make money on these deals by taking a dealing margin. The margin can look very small – for example, one or two hundredths of a percent of the value of the deal for widely traded currencies. However, given the gigantic volume of global dealing – \$5.3 trillion *daily* in 2013 – this can still add up to big earnings! London has by far the biggest share in all segments of the global FX market, in spot, forward, swaps and options transactions. This might not seem surprising, given London's historical primacy in international commerce. However, Britain has more than twice the volume of currency dealing of the US despite being only in sixth position in world trade in goods and services, compared to the US's top position in trade. The size of London's foreign exchange market is the clearest indication of British imperialism's role as the broker for global capitalism, taking a cut from deals that account for two-fifths of all foreign exchange transactions in the world economy. This was despite sterling being on one side of *only 16%* of the total \$2.7 trillion of deals done in 2013 (BoE, 2013c, Table A, p. 397).

London's dominant position has remained in place despite the advent of the euro and initial fears of the UK authorities that Frankfurt or Paris might erode its market share. Neither has the boom in electronic trading undermined London, nor has it led to a shift of business away to cheaper, alternative locations. As discussed in Chapter 5, the UK has a number of advantages that are difficult to replicate elsewhere – language, a convenient time zone location between Asia and the Americas, a skilled workforce, commercial and employment legislation favourable to capital and a regulatory oversight that is both strong in defence of the

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<sup>6</sup> Figures calculated from BIS data (2013a, Table 1B, page A4, Statistical Appendix), For comparison, note that the next biggest banking countries, Japan, France and Germany, each had total claim and liability figures around 70-73% of the UK total, with Switzerland at just over half the UK number.

property rights of capitalists and also friendly to finance. This has meant that London's historical position at the centre of British Empire finance was able successfully to evolve into its key role in today's global financial business.

**Table 6.4: Foreign exchange turnover, 1995-2013 (daily average, April, \$bn) \***

	1995	2001	2007	2013	% of 2013 Total
UK	479	542	1,483	2,726	40.9
% of total	29.3%	31.8%	34.6%	40.9%	-
US	266	273	745	1,263	18.9
Singapore	107	104	242	383	5.7
Japan	168	153	250	374	5.6
Hong Kong	91	68	181	275	4.1
Switzerland	88	76	254	216	3.2
France	62	50	127	190	2.8
Australia	41	54	176	182	2.7
Netherlands	27	31	25	112	1.7
Other	304	355	798	951	14.2
<b>Total</b>	<b>1,633</b>	<b>1,705</b>	<b>4,281</b>	<b>6,671</b>	<b>100.0</b>

Note: \* These figures adjust for local double counting, but not cross-border double counting; if they did, the world total in 2013 would be lower at \$5.3 trillion.

Source: BIS, 2013c, Table 6, and author's calculations

Table 6.5 shows an even stronger picture of London dominance in the 'over-the-counter' (OTC) interest rate derivatives market, comprising direct deals between banks and their customers, with nearly half of global business. This market only began in the 1980s, but OTC trading is the biggest part of the derivatives market, principally made up from the trading of interest rate swaps. Other trading of derivatives takes place on exchanges, and the US is home to the biggest exchanges for these, mainly based in Chicago. However, the volume of trading on exchanges is a small fraction of that in the OTC market.<sup>7</sup> UK and US financial centres together account for 70% of the world market in interest rate derivatives, illustrating once more the extreme concentration of global trading. The US and the UK are also the leading issuers of international debt securities (to which a lot of this derivatives trading is linked), giving them easy access to investment funds from across the world.

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<sup>7</sup> Government regulators have made efforts to put OTC derivatives onto more tightly regulated electronic systems, to make pricing and exposures more transparent.

**Table 6.5: OTC interest rate derivatives turnover, April 2013 (\$ billion) \***

	FRAs	Swaps	Options	Other	Total	% World Total
UK	472.7	795.8	76.5	2.7	1347.7	48.9%
US	141.6	382.5	102.1	1.9	628.2	22.8%
France	56.6	141.7	3.9	-	202.2	7.3%
Germany	77.2	23.0	1.2	-	101.3	3.7%
Japan	2.7	55.9	8.6	-	67.1	2.4%
Australia	18.2	46.7	1.3	-	66.2	2.4%
Denmark	18.8	39.5	0.9	0.1	59.4	2.2%
Singapore	13.5	22.8	0.9	-	37.1	1.3%
Canada	6.8	25.2	2.0	-	34.0	1.2%
Switzerland	13.7	18.9	0.0	-	32.6	1.2%
Netherlands	13.6	14.9	0.2	-	28.7	1.0%
Hong Kong	2.0	23.7	2.0	0.1	27.9	1.0%
Other	45.2	75.3	5.5	0.1	126.1	4.6%
<b>Total</b>	<b>882.4</b>	<b>1,665.7</b>	<b>205.4</b>	<b>5.1</b>	<b>2,758.6</b>	<b>100.0%</b>

Note: \* Single currency derivatives, daily average turnover. Components may not add exactly to totals due to rounding.

Source: BIS, 2013d, and author's calculations

There are other dimensions of global financial dealing than those noted above, including commodities trading and pricing, fund management and insurance. However, I will not open up a further torrent of data and just note that the UK ranks at the top end of these global tables too, usually second only to the US as a base for these operations. Table 4.2 in Chapter 4 has already detailed the main locations for global equity markets, with the UK in fourth place, behind the US, China and Japan.

#### 6.4 UK financial account: FDI, portfolio flows and bank funding

An examination of the financial account of the UK balance of payments throws further light on the role of the City for British imperialism.<sup>8</sup> This account is divided into five sections: the flows of foreign direct investment, portfolio investment, financial derivatives investment, official reserves and 'other'. Foreign direct investment (FDI) and portfolio investment are normally seen as the key elements. Portfolio investment relates to the investment in bonds (or related money market and debt securities) and equities. Direct investment, however, occurs

<sup>8</sup> The standard divisions of the balance of payments are the current account, discussed in section 6.2, the financial account, the 'capital' account and 'errors and omissions'. The latter two will not be of concern here. The capital account includes 'capital transfers and the net acquisition or disposal of non-produced, non-financial assets'. The largest single item, one that largely accounts for the steady net surplus of around £1bn to £4bn in the past decade, is net migrants' transfers into the UK. These figures are too small to warrant further investigation here.

when the investor owns more than 10% of the equity capital of a company. In that case, the investment is considered to be a direct, not a portfolio, investment flow. The distinction between the two categories can appear to be somewhat arbitrary, but ownership of a larger share of equity capital in a company generally implies more control over the investment and less likelihood that it will be traded on the market. There is also a marked difference in the recorded rates of return on the two types of investment, as shown in section 6.5.

Transactions in financial derivatives 'are treated as separate transactions, rather than being included as integral parts of underlying transactions to which they may be linked as hedges' (ONS, 2012b, p. 15). In other words, these flows have far less of an independent role than will appear to be the case from their separate listing. It is only from 1992 that UK balance of payments data have recorded transactions in financial derivatives, and only from 2004 that they record the outstanding 'stock' of assets and liabilities in derivatives. Until 2006, the net annual flows on derivatives were also much smaller in absolute terms than the other components, at less than £10bn. The official reserves data relate to transactions by the UK Treasury and Bank of England for the foreign exchange reserves. The latter numbers are only included here to complete the financial accounts total; they are relatively small and have no role to play in my analysis. The last item in the financial accounts under the heading of 'other' may appear to be just an assortment of items that does not fit into the previous categories. But it is far from being just a bag of residuals. It is important because it is principally made up from banking flows.

Inflows and outflows on the financial account work very differently from the way they do in the current account. In the current account, if a good is imported or exported, it will generally not be re-exported or re-imported, except for those countries heavily engaged in entrepôt trade. By contrast, such additional buying and selling is very common for the transactions in financial contracts and titles. A flow of funds into a country may occur from a foreign investor newly buying equities, bonds or other investment assets in that country. However, an *inflow* on this account may also come from the *domestic investor selling* a foreign asset previously owned. Or an outflow may result from foreign investors selling back assets that they had previously bought. This phenomenon can have a dramatic impact during periods of financial market instability. In 2008, for example, the financial crisis was reflected in data showing huge flows of funds. It is useful to examine these to illustrate the linkages between different parts of the financial accounts.

In 2008, the net balance on the total financial account was in a surplus of £10bn, less than the surpluses of previous years, but not by itself indicating any disturbance. However, in that year UK banks *brought back* £147bn of their deposits abroad and £123bn of their short-

term loans.<sup>9</sup> In addition, securities dealers in the UK reversed £338bn of their deposits with foreign banks. This development added up to a net reversal of some £607bn in outflows, reflecting the panic in financial markets and the fears of bank insolvency. Each of these flows was recorded in the 'other' category of the financial accounts; however they did not lead to a net *inflow* of 'other' funds into the UK because there were even larger disinvestments in the UK by foreign players! The usual trend of foreign loans *to* UK-based securities dealers turned into a reversal of £262bn and foreign deposits held in UK-based banks fell by a massive £459bn. However, these withdrawals did not lead to a net outflow of funds in the *total* financial account. In 2008, UK-based banks sold an extraordinary £243bn of their foreign *portfolio assets* – including £161bn in bonds and £67bn in equities. This was a result of the rush to whatever liquidity could be found as bank lending collapsed and market prices tumbled. As Marx commented on an earlier crisis:

'But now the cry is everywhere: money alone is a commodity! As the hart pants after fresh water, so pants his soul after money, the only wealth' (Marx, 1974a, Chapter 3, p. 138).

Cross-border company takeovers offer an example of another complication when interpreting the financial accounts. If a domestic company buys a foreign company, this will normally result in an outflow of funds being recorded in the foreign direct investment category. But it may pay for the acquisition with its own equity capital in a 'share swap'. Then, the equity owners of the foreign takeover target will be recorded as *purchasing the equity* of the domestic company and this will appear in the *portfolio* accounts as an *inflow* of funds to buy equities. This illustrates that the different line items in the financial accounts are often closely linked and that an economic interpretation of the data can be misleading if one interprets the numbers independently of such links. However, as noted in section 6.1, I will in general assume that banking flows are the facilitators of other 'underlying' transactions, whatever they may be, rather than being desired for their own sake.

A final point re-emphasise before examining the financial account data is that the numbers get revised. This happens with all economic statistics, but the huge scale of the numbers in the financial accounts can also make the revisions very large, sometimes up to £100bn or more on annual data, especially in the case of the portfolio, derivatives and other categories. Yet, the effect of these revisions is more to shift the balance of components in the accounts – which may result from reclassifying existing data – rather than to change the overall financial account balance by very much. Insofar as the data still reflect the scale of underlying transactions, at least approximately, the broader trends will hopefully remain

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<sup>9</sup> These inflows can result from not rolling over a deposit or loan once it has matured. The data cited in this paragraph are from ONS 2013 (Tables 7.1 to 7.7).

valid. With these caveats in mind, I will continue with the analysis of the international financial account data.

**Table 6.6: UK financial account balances, 1987-2012 (£ billion) \***

	<b>1987-89</b>	<b>1990-99</b>	<b>2000-07</b>	<b>2008-12</b>	<b>2012</b>
<b>Direct investment</b>	-6.9	-15.4	-14.0	-12.9	-8.9
<b>Portfolio investment</b>	13.0	-1.8	53.7	15.6	-211.2
<b>Derivatives</b>	0.0	0.7	-0.2	-7.2	26.8
<b>Other</b>	10.8	25.3	-9.4	31.7	249.2
<b>Official reserves</b>	-3.1	0.1	-0.1	-4.6	-7.6
<b>Financial account</b>	<b>13.7</b>	<b>9.0</b>	<b>30.0</b>	<b>22.6</b>	<b>48.2</b>

Note: \* All figures are average annual numbers. Positive means inflow into the UK, negative means outflow from the UK.

Source: ONS, 2013, database, and author's calculations

The total UK financial account is almost always in surplus, offsetting the trend of current account deficits. Its components are volatile on a year-to-year basis, reflecting financial turmoil and crises as much as the whim behind the investment flows between countries. However, they still have some distinctive features Table 6.6 gives the annual average flows in order to highlight these.

One persistent trend is the net *outflow* of foreign direct investment from the UK, averaging nearly £15bn per annum in the past two decades. This has tended to be offset by net portfolio investment inflows into UK equities and bonds, although during the 1990s such flows were also (modestly) negative. Another usually positive element of the financial flows has been in the 'other' category. Taken together, these portfolio flows and the net inflows from the banking sector have more than accounted for the surplus numbers on the total financial account.

The data for 2012 have unusually big flows on the portfolio accounts and on the 'other' account. There was a large net *outflow* of portfolio investment, made up from foreign investors selling UK equities and bonds while UK-based investors bought foreign equities and bonds. Offsetting this outflow - and directly funding it - was a huge net *inflow* of 'other' funds, principally from UK financial institutions and other residents cutting back their deposits abroad. Financial market developments around the time when most of these flows took place, the third quarter of 2012, included falls in European bond yields and a rise in foreign equity markets. The 2012 figures will likely have reflected shifts of funds out of foreign deposits and into foreign portfolio assets, apart from the usual function played by the 'other' account in balancing the total balance of payments flows.

The overall picture for the UK balance of payments in recent decades can be summed up as follows: the chronic and large visible trade gap is paid for by net financial services revenues, plus portfolio and banking inflows. The latter provide surpluses that also allow the UK to maintain a net outflow of foreign direct investment. The advantage to the UK of this particular structure of the balance of payments flows becomes clear when the returns on the resulting international investment assets and liabilities are analysed.

## 6.5 UK investment position: low cost liabilities, high return assets

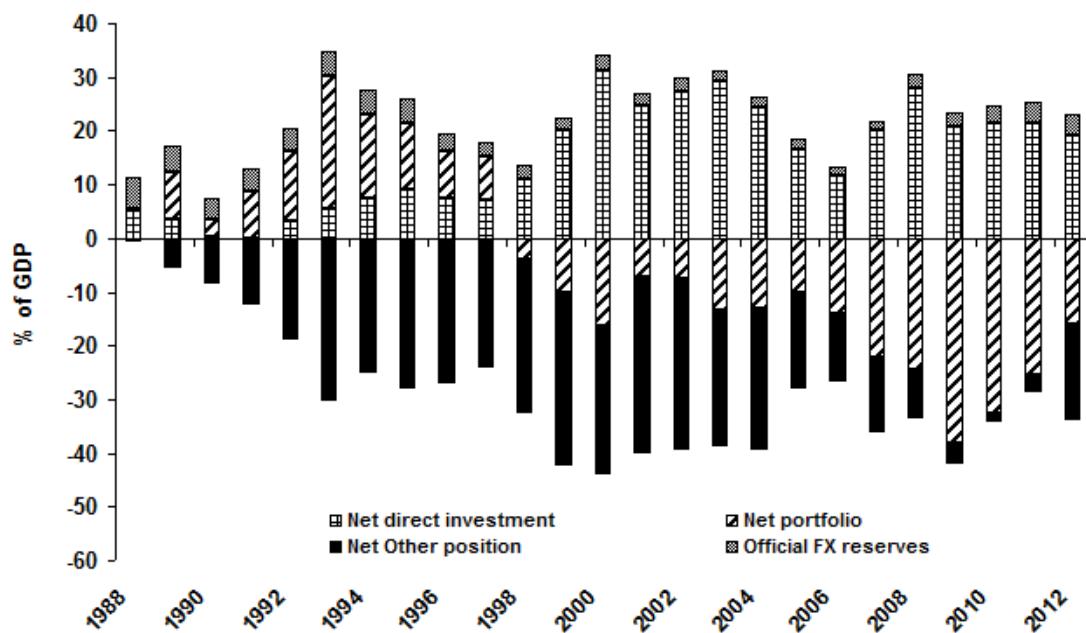
The flows on the financial accounts are closely related to the accumulation of UK foreign assets and liabilities. One would expect that the persistent current account deficit should eventually result in a deficit on the UK's net international investment position. That first happened on a sustained basis from 1995.<sup>10</sup> The deficit reached a trough at the end of 2009, with the value of foreign investment assets in the UK £264bn higher than the value of UK assets abroad. However, the UK net foreign investment position is also impacted by moves in the value of sterling on foreign exchange markets and by moves in asset prices. These factors helped a reduction of the recorded stock position deficit to £169bn by end-2012, despite a continued current account deficit.

A question arises from these data: how has the UK in recent years generally maintained net investment *earnings* on a large *deficit* investment position? The UK had positive net international investment income in every year from 2000 to 2011, with the annual average net income amounting to 1.2% of GDP. Only in 2012 did the income balance turn modestly negative. How was this previous surplus possible with a net investment *deficit* position that was anywhere up to 20% of GDP over this period? It may seem as if I am belabouring a point to make an issue about earning a relatively small net investment income, one that was much lower as a share of GDP than in the heyday of the British Empire. But it is something special, given the UK's large net foreign liabilities. This income number represents a significant privilege, one that the UK has shared with the US, another power in the world with net investment income *and* a net deficit position in foreign investment.

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<sup>10</sup> When discussing the UK's total net asset position here and below, the calculation excludes derivative assets and liabilities, for reasons discussed later in the text.

**Chart 6.2: UK net foreign investment stock position, 1988-2012**



Source: ONS, 2013, database, and author's calculations.

The answer must obviously lie in the UK's higher rate of return on its assets abroad than it pays on its liabilities. In what follows, I examine the structure of these assets and liabilities and estimate their respective investment returns. To the best of my knowledge, this exercise has not been conducted in the literature, and nor have the returns on all the different components been tabulated in official publications from the ONS or elsewhere.

Discussion of the financial account flows in the previous section gave an implicit prediction of the results for the UK international investment position: a large positive net foreign direct investment position (based on the annual outflows) offset by a deficit on portfolio and 'other' assets (based on the annual inflows). For the post-1987 period, these positions are shown in Chart 6.2. Over the past decade or so, a surplus on foreign direct investment has built up alongside a large deficit on the banking ('other') and portfolio accounts. In the 1990s, the banking account was the only one in deficit. The data are shown as a percentage of GDP, but note that the asset/liability components have risen sharply in nominal terms over the period shown.

Following from the analysis of the balance of payments *flows* in the previous section, one can view the deficit items in the investment *stock* positions as having funded the surplus items. Table 6.7 shows the data for the asset and liability positions in each of the main categories. I have included financial derivatives only as an addendum to this table, and excluded them from Chart 6.2 and from the later discussion. This is for two reasons. Firstly,

as noted in Chapter 3, Section 3.2, a high proportion of derivatives positions are offsetting or matching trades which boost the asset *and* liability totals, often without changing the net position by very much. Secondly, I wish to examine the investment returns on assets and liabilities, and no investment income is recorded as coming from derivatives positions.<sup>11</sup>

**Table 6.7: UK international investment position (end-year, £ billion)**

	2006	2008	2010	2012
Total assets *	5204	6,917	6,912	7,162
Total liabilities *	5385	6,966	7,052	7,332
<b>Total net investment stock position *</b>	<b>-181</b>	<b>-49</b>	<b>-140</b>	<b>-169</b>
<b>Of which:</b>				
Direct investment assets	733	1,069	1,045	1,137
Direct investment liabilities	577	660	726	839
<b>Net foreign direct investment position</b>	<b>156</b>	<b>408</b>	<b>319</b>	<b>297</b>
Portfolio assets (equities and bonds)	1531	1,664	2,070	2,251
Portfolio liabilities (equities and bonds)	1722	2,023	2,554	2,503
<b>Net foreign portfolio position</b>	<b>-191</b>	<b>-358</b>	<b>-484</b>	<b>-252</b>
Other assets	2917	4,148	3,747	3,713
Other liabilities	3086	4,283	3,772	3,989
<b>Net 'Other' investment position</b>	<b>-168</b>	<b>-135</b>	<b>-25</b>	<b>-277</b>
<b>Official reserves</b>	<b>23</b>	<b>36</b>	<b>50</b>	<b>62</b>
<b>Addendum</b>				
Financial derivatives assets	854	4,040	2,963	3,060
Financial derivatives liabilities	890	3,915	2,895	3,033
<b>Net financial derivatives position</b>	<b>-37</b>	<b>125</b>	<b>68</b>	<b>28</b>

Note: \* Total investment positions in this part of the table exclude derivatives.

Source: ONS, 2013, Chapter 8, and author's calculations

Turning now to the issue of investment *returns*, Table 6.8 shows the pattern of results from the more detailed asset/liability data available from 1987. These show a strongly rising trend of net income from foreign direct investment that more than counterbalances the rising deficits from portfolio and other (banking) payments. It is worth noting that the deficit on *portfolio* income includes UK central government payments to foreign investors – for their holdings of gilts and other UK government debt. This is a significant element and is detailed

<sup>11</sup> See ONS 2012a (p. 182). The gains/losses from derivatives positions are reflected in current account financial transactions commission and spread income, and in the valuation of the derivatives positions.

separately. The official reserves number (not counted in the previous central government item) is small, and it stays positive since only reserve assets are included.

Table 6.8 also shows the investment rate of return, calculated as the net income in a year divided by the average stock position of each category. In total, the rates of return on assets and liabilities have moved in the UK's favour since the late 1980s, and enough to allow a deficit net investment position to bring about a positive net income balance after the deficit income balances seen in the 1980s and 1990s. By the 2000s, the return on assets was some 0.5% higher than that on liabilities. Although the returns on all assets and liabilities trended lower compared to the late 1980s, there was a shift towards a higher net positive return, or a lower net negative return, for each category, especially for the portfolio and other accounts.

**Table 6.8: Income and returns on UK international investments \***

All data are annual averages	1987-89	1990-99	2000-07	2008-12	2012
<b>Net investment income (£bn)</b>	-1.8	-1.7	13.4	16.9	-2.3
<b>Of which:</b>					
Net FDI income	4.9	11.7	33.6	49.1	37.5
Net Portfolio investment income					
<i>of which, net central government</i>	-5.1	-2.5	-1.8	-15.0	-25.1
<i>    of which, net central government</i>	-2.7	-4.7	-5.4	-12.7	-14.8
Net Other investment income	-2.8	-12.4	-18.8	-17.6	-15.2
Official FX reserves	1.4	1.5	0.8	0.7	0.7
<b>Details of rates of return (%)</b>					
Total assets	7.5%	6.0%	4.4%	2.8%	2.2%
Total liabilities	8.3%	6.1%	3.9%	2.5%	2.2%
<b>Total difference</b>	-0.9%	-0.1%	0.5%	0.3%	0.0%
<b>Of which:</b>					
Direct investment assets	14.4%	11.6%	9.5%	7.7%	7.2%
Direct investment liabilities	12.6%	7.3%	7.5%	4.2%	5.4%
<b>FDI difference</b>	1.8%	4.2%	2.0%	3.5%	1.8%
Portfolio assets					
Portfolio liabilities	5.4%	4.0%	3.8%	2.8%	2.2%
<b>Portfolio difference</b>	9.8%	5.6%	3.5%	3.0%	2.9%
<b>Portfolio difference</b>	-4.4%	-1.6%	0.3%	-0.1%	-0.7%
Other assets					
Other liabilities	7.4%	5.6%	3.0%	1.4%	0.8%
<b>Other difference</b>	10.2%	6.2%	3.5%	1.8%	1.2%
<b>Other difference</b>	-2.9%	-0.5%	-0.5%	-0.4%	-0.3%

Note: \* The rate of return is income for the year divided by the average stock of investment at the end of that year and the one before. This is a standard method of approximation.

Source: ONS, 2013, database, and author's calculations

Such return calculations can only give a broad indication of the relevant magnitudes, since the value of the stock of investment to which the income applies is not known exactly and, in any case, the data get revised. I have found a similar pattern of returns when doing this exercise with different data in recent years, but it is possible that there are systematic biases in the data, for example, ones that overestimate net income flows or underestimate the stock of foreign assets, whether for tax-related or other reasons. Nevertheless, the financial account *flow* data do appear to be broadly consistent with the resulting stocks of assets and liabilities. Furthermore, the rates of return on the portfolio and 'other' categories of asset and liability have also moved in line with the trend of financial market yields. I would therefore take these results as reasonably good indications of the underlying situation, and the results for the different categories of investment are divergent enough to make some observations. In particular, direct investment returns have been persistently higher than those on the portfolio or other items in the past quarter century, and the data also show that the UK earns a significantly higher rate on its foreign direct investment assets than is paid on FDI in the UK. In reference to the discussion of profitability in Chapter 3, it is useful to note some points about the nature of these returns.

The rate of return on direct investment can be considered as broadly similar to the return on industrial and commercial capital (only a small share of FDI is by financial companies), while the return on 'other' investment is linked to levels of interest rates. The returns on portfolio investment stand somewhere in between, since they are a function of coupon payments on notes and bonds and dividend payments on equities. One important development from the late 1980s to 2008-12 was the fall in returns on *all* categories of investment, for both UK assets and liabilities. This dramatically reduced the yield on the UK's portfolio and other *liabilities*, from 9.8% to some 3% and from 10.2% to less than 2%, respectively. The drop in yields paid was some 2 to 4 percentage points more than the fall in the yields received on the UK's portfolio and other *assets*.

Analysis of the pattern of returns shows that the boom in financial market activity since the late 1980s has paid off for British imperialism! It has not only been the extra revenues registered on the current account of the balance of payments in financial services, as discussed in section 6.3. There has also been a much better investment income balance than might have been expected, given the UK's deficit investment position. Developments in the UK financial sector have allowed the easy financing of higher-yielding outflows of FDI with lower-cost inflows on the portfolio and other (banking flows) accounts. Banks in the City did not necessarily provide *direct* funding for particular foreign investments. The investing companies may have had their own resources and may not have depended on bank loans, or debt and equity issues, to finance foreign investment or acquisitions. The key mechanism is one where the City provides funding for the *whole* balance of payments. This shows how the

City's financial operations underpin the Britain's economic relationships with the rest of the world.

The division between higher yielding assets and lower yielding liabilities can be seen as a natural capitalist response to the pattern of yields. Yet maintaining such a division depends on having access to investment assets in foreign markets and on having the ability to raise funds relatively cheaply. Britain's status as an imperial power and the efforts it has made, along with the US, to open up foreign capital markets help ensure that it can find destinations for its foreign investment. However, being able to borrow 'cheaply' is a far more contingent proposition, one that is not under the control of any individual power in the world economy. Given that the UK's net investment position is in deficit, it is not simply the relative yields on assets and liabilities that count, but also the absolute level of yields.

The reduction of global yields from the late 1980s, and especially the reduction of the high nominal yields on UK liabilities, including on government debt, was a big benefit for the UK's net investment returns.<sup>12</sup> This initially reduced the net income deficit and then boosted the surplus. With money market interest rates close to zero in 2012-13 in most major financial markets, and with government bond yields already at historic lows, the potential for any further net income benefits from this development will be very limited. As Table 6.8 indicates, the returns on assets and liabilities had turned against the UK in 2012, producing a net deficit on the investment income balance for the first time since 2000. Data for 2013 show that this income deficit has continued.

Given this sensitivity to the funding cost of liabilities, it is no wonder that the UK government has been concerned to maintain a high national credit rating. The top 'Triple A' status was nevertheless lost in early 2013 when two of the three major ratings agencies, Moody's and then Fitch, cut the UK's sovereign rating by one notch (BBC News, 2013a). Each agency cited rising debt levels, although their focus was on domestic debt and the government's own liabilities. This particular reduction in credit status was not significant, but it highlights a continuing vulnerability and one of the reasons behind the UK government's domestic austerity measures.

## 6.6 The City's links with other countries

In this section I will discuss the financial connections of the UK with the rest of the world, firstly by examining the location of direct investment assets from the UK financial services sector and then by analysing the geographical pattern of financing for UK-based banks. This

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<sup>12</sup> In the early 1980s, following the tightening of UK monetary policy, the yield on total UK foreign assets was 1.8% *less* than that on total UK foreign liabilities. The negative gap had declined to 0.9% by 1987-89, as shown in Table 6.8.

will bring out some important dimensions that did not emerge from the previous analysis of the summary balance of payments data.

Britain is far from being just a financial player in the world economy, and the data for UK direct investments overseas show that in 2011 only some 20% of UK foreign direct investment was in financial services. Commercial and industrial investments are far more important. However, Britain's position as the main base for global financial trading means that it does not need to have huge direct investments in financial companies based overseas. Instead, it mainly requires operations in the foreign centres that operate as financial hubs. These investments increase the power of UK-based financial companies because the UK head office can facilitate deals via foreign branches and also get easier access to foreign money capital.

At the end of 2011, 53% of UK's foreign financial services assets were located in Europe, 31% in North America and 8% in Asia.<sup>13</sup> This distribution is not surprising, since one would expect that the more economically advanced countries would also tend to have the bigger financial systems. However, the details within the regional totals are interesting. Almost all of the UK-owned financial assets in Europe are located in countries with big financial centres, even if their economies are not so big: the Netherlands (20%), Ireland (8%), and Luxembourg and Switzerland, each with 5% of the world total. Germany and France, the largest European economies, account only for a little over 1% each. More pertinent to the discussion later in this section, the statistical authorities also identify another European location: *UK offshore centres* – meaning Jersey, Guernsey and the Isle of Man – that account for 10% of total foreign financial services assets! These centres are considered to be outside UK territory, despite the evidently strong political and economic links to the UK. The links are just distant enough to allow the UK authorities to deny responsibility for the business conducted in these centres and their status as tax havens (Shaxson, 2011, Chapter 6).

The largest single foreign location for UK financial services assets is the US, making up 27% of the total at the end of 2011. This obviously reflects the US position as a major economic and financial power. Asia accounts for only a small 8% share of UK assets, but Hong Kong and Singapore each account for 1.5%. These former British colonies are important hubs for regional financial business, and the Hong Kong figure would have been more like 10% on its own, were it not for some unexplained disinvestments, especially in 2010.<sup>14</sup>

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<sup>13</sup> Data here and below are calculated from ONS 2012c (Table 3.3).

<sup>14</sup> I can find no evidence, apart from these data, that UK banks in Hong Kong divested anything like the reported £15bn of assets between 2008 and 2011. The reported drop may have been due to a revaluation of bank assets, but no data are available to clarify this.

**Table 6.9: Net external position of UK MFIs by location (end-year, \$ bn) \***

	1997	2002	2007	2012
<b>Total net position</b>	-87	-252	-808	-491
Of which				
<b>Offshore financial centres</b>	<b>-97</b>	<b>-209</b>	<b>-529</b>	<b>-160</b>
Of which				
<b>UK Offshore</b>	-117	-155	-374	-257
<b>Cayman Islands</b>	17	20	56	106
<b>Developed countries – total</b>	<b>n/a</b>	<b>352</b>	<b>992</b>	<b>595</b>
Of which				
<b>Europe</b>	n/a	157	467	428
<b>US</b>	109	79	413	-29
<b>Developing countries – total</b>	<b>n/a</b>	<b>-82</b>	<b>-247</b>	<b>-6</b>
Of which				
<b>Europe</b>	n/a	-10	-40	60
<b>Africa &amp; Middle East</b>	n/a	-64	-181	-117
<b>Saudi Arabia</b>	-16	-13	-79	-83
<b>Asia &amp; Pacific</b>	n/a	-17	-33	20
<b>Latin America</b>	n/a	8	7	31
<b>Addenda for UK MFI liabilities</b>				
<b>International issue of securities</b>	-58	-128	-396	-530
<b>Unallocated liabilities</b>	-105	-227	-709	-507

Note: \* MFI means 'monetary financial institution' or bank. Net figures are for UK-based MFI assets minus liabilities, including loans, deposits, bonds and money market instruments. Negative numbers show net borrowing by UK MFIs, and *vice versa*. Some 18% of liabilities and 2% of assets are unallocated by country.

Source: BoE, 2013a, Table C3.2, and author's calculations

The major flows of finance in the form of deposits, loans and the purchase and sale of securities between UK-based banks and the rest of the world are intermediated by banks outside the UK, especially UK-linked banks. Sections 6.4 and 6.5 covered the aggregate balance of payments and investment position data, highlighting the portfolio and, especially, the 'other' categories. In order to examine the picture more closely, however, it is necessary to switch from the UK Office for National Statistics (ONS) data to the Bank of England's (BoE) data. The BoE gives much more detailed coverage of flows and positions by geographical location than does the ONS, and the BoE also provides the ONS with the figures for UK banks. These BoE data are presented in terms of US dollars because most financial flows to/from the UK are in terms of foreign currency, especially the US dollar.<sup>15</sup> They also include the asset and liability positions of UK-based MFIs in deposits and loans, their issuance and purchase of bonds, notes and various money market instruments. Each of these items is a

<sup>15</sup> A discussion of the differences between ONS and BoE data is given in the Appendix to this chapter.

means of providing or of getting finance that is dependent on their operations as monetary institutions. However, the BoE data do not include a bank's equity assets or liabilities. Neither are securities dealers included in these BoE figures, unless they are also licensed as deposit takers and thus part of the UK banking system. While this will omit an important dimension of UK financial business, it will also highlight the more specific role of the banking system for British imperialism. To my knowledge, such data have not been analysed before in the literature.

Before examining the geographical pattern of the UK MFI assets and liabilities with the rest of the world, one should note that the figures here only measure the *outstanding valuations* of each. However, while a liability of \$100bn, for example, may be unchanged from one year to the next, this does not mean there has been no underlying *flow* of funds. At least part of the borrowing through fixed term loans or deposits, or the sale of securities, may have to be renewed when the terms are for less than one year. Hence a continued liability of the UK to a particular country, even if it shrinks, will most likely still reflect a continued flow of funding. The same is true for assets, where the outstanding amounts will result from a myriad of underlying flows of lending or depositing abroad, or investing in foreign assets. Table 6.7 and Chart 6.2 showed that the UK has had a persistent net deficit position on both the portfolio and the 'other' accounts. In the BoE data discussed next, the net liability position of UK MFIs covers their external positions in loans, deposits, money market instruments and bonds – everything except their FDI, equity portfolio and derivatives positions. Hence, the BoE data include all of MFI-related data in the ONS 'other' account plus the MFI positions in the debt and money market instrument part of the ONS portfolio account.

Table 6.9 gives the main geographical details of the UK MFI sector's external positions taken from the BoE data. A weakness in the available data is that nearly one-fifth of outstanding liabilities is not allocated by location. This is made up from UK MFI securities purchased by international investors and deposits placed in the UK by non-UK residents who are not allocated to a particular country or region. If the domicile of these investors were known, then this might alter the relative importance of each area for which details are given. However, the unallocated lenders to the UK MFIs are likely to be principally from developed countries, since most of the world's wealth and income is in developed countries. Given that the UK MFIs also *lend* vast sums to the same countries, this would indicate that the UK MFIs act as important financial intermediaries for the major capitalist countries. In other words, they help to fund the balance of payments of other rich countries, even if this is only by recycling funds back to them that were previously sent to the UK.

Overall, the UK-based MFIs are net borrowers from the rest of the world. This is a persistent deficit and one that grew dramatically in the 2000s, peaking around 2007 before the full onset of the latest financial crisis. The deficit fell in subsequent years with the financial

squeeze, but it was still close to \$500bn at the end of 2012. Within the total deficit, there is a large net borrowing from offshore financial centres and a smaller net borrowing from developing countries. Within the developing country total is a notable volume of net borrowing from Africa and the Middle East, especially from Saudi Arabia. The latter is a function both of Saudi oil revenues and of the continuing political and security links between the British state and the Saudi regime. In other words, UK MFIs receive global savings in the form of net flows from offshore financial centres, from developing countries and (via securities issues) from developed countries. These borrowing positions are partly offset by a large net asset (lending) position with developed countries, but they are also used to bridge the gap in the UK balance of payments, as noted in Sections 6.4 and 6.5.

The country location data for the external positions of the UK MFIs reveal some interesting details. Firstly, the largest proportion of the offshore financing comes from the UK offshore centres – Jersey, Guernsey and the Isle of Man. In 2011-12, UK MFIs had lent some \$30bn to these centres, but borrowed some \$300bn, 10 times more!<sup>16</sup> The significance of 'UK offshore' as a source of funds has rarely been noted in the literature. Shaxson is one exception, although he mentions the figures only briefly, and he has no analysis of what role these centres play in the mechanism of financing the UK balance of payments (Shaxson, 2011, p. 252). His book is an illuminating discussion of the history of and the operations in offshore centres, but his coverage is mainly limited to the question of tax avoidance by companies and individuals via these centres. Palan examines offshore financial centres in detail, and from a more theoretical perspective, noting the flows of funds between different locations and into the UK, using BIS data and reports from *The Economist* (Palan, 2003, p. 84 and pp. 137-139). Yet his thesis tends to elevate offshore centres as something separate from, and opposed to, the system of nation states in the world economy. This means that, while he recognises that there are major powers that dominate the world, he argues that offshore centres are leading to the 'demise of the nation state' and that capitalism is becoming more 'nomadic' (Palan, 2003, especially Chapters 6 and 7). Such a thesis fails to appreciate the role offshore centres play for the major financial powers, the UK especially. By the same token, it also greatly exaggerates the political and economic independence of these centres.

Unfortunately, details of the interest rate costs to UK MFIs for obtaining funds from offshore centres are not available from either the BoE or from the ONS. This makes it impossible to derive good estimates of the breakdown of income flows or the implied cost of funds from different regions. However, my experience of working in London bank dealing rooms for nearly 20 years, including several business trips to Jersey, suggests that these

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<sup>16</sup> These centres have been included in BoE offshore data only from September 1997, having previously been included in the UK data totals. The effect of this move was to switch the UK's total offshore funding balance from a small surplus (lending) in the previous 10 years to a significant deficit (borrowing).

centres are seen as a valuable line of business, although relatively small compared to total City operations. This explains why many UK-based banks have operations in the UK offshore havens, despite their extremely provincial and unfashionably retro ambience.<sup>17</sup> My strong impression is that the interest rate cost of funds from these centres is significantly less than from the 'onshore', more heavily taxed and regulated financial locations, and that this is a key reason behind their role for the major financial centres – especially London – as a source of funds. Compared to the UK offshore centres, other locations are much less important as persistent net suppliers of funds to the UK-based financial system, although Hong Kong and Singapore also stood out in the 2000s and the Bahamas were important after 2006.

The exception is the Cayman Islands. As Table 6.9 shows, there has been a steady net *lending to* this location from UK MFIs. If cheap funding were the function of tax havens for the UK, then that would not explain this relationship. The rationale for these particular flows is that the Caymans are a major centre for the legal domicile of international corporations, especially for those engaged in fund management and insurance, although their physical presence may be little more than a nameplate on a wall. It might seem odd for the UK banking system to be funding operations in the Cayman Islands until one recognises the other financial links. Those funds are, in turn, routed into the Americas, and especially into the US equity and bond markets. Confirming this, US balance of payments data indicate that investors registered in the Caymans hold very large volumes of US securities: at end-2011 these amounted to \$128bn of US Treasury securities, \$377bn of corporate and agency bonds and \$381bn of corporate equities (BEA, 2012, Tables K, L and M, pp.14-15). This would be a surprising accumulation of wealth if one were naive enough to think it belonged to the 60,000 local inhabitants!

The net asset-liability numbers in Table 6.9 show that the UK banking system usually has a net lending of funds directly to the US, although the figure reversed by end-2012. From 1991 to 2009, there was a persistent net position of UK-based lending that reached a peak of more than \$400bn in 2007. The volume of net lending to developed European countries has been even higher; it exceeded \$700bn during 2010 and remained above \$400bn in 2012.

These data for the City's international connections spell out its major role in global finance, not only in funding the UK balance of payments. By being the key intermediary for international flows of money capital and fictitious capital, the City also keeps the global financial system ticking over and, as the figures for transaction revenues indicate, takes a cut from all of the deals passing through it.

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<sup>17</sup> Funds from these tax havens are in addition to those received from a variety of criminals more directly by the City, and presumably also at relatively low cost. Talani 2012 (Chapter 6) has a useful review of London as a money-laundering centre.

## 6.7 UK financial privileges

The UK-based financial sector is an important part of the mechanism by which British imperialism appropriates surplus value from the world economy. The previous sections have detailed the different aspects of this mechanism. Based upon the evidence presented in this and in earlier chapters, here I will sum up the key privileges British imperialism gains from the financial sector.

The term 'privilege' implies a special advantage, one not shared by everyone else. *Financial privilege* can be broken down into two related factors: access to funds and the yields for borrowing or investing. British capitalists are certainly privileged in the sense of having greater *access* to these markets than capitalists from countries outside the imperialist orbit: London's equity and bond markets are amongst the largest in the world. Access to these markets also means access to whatever forms of finance they offer. Such access to international sources of capital can also keep borrowing costs lower - both for companies and for the government - by reducing the demands on the domestic financial market. Here the role of the City is exceptional in facilitating the international reach of British capitalists, although its business is open to capitalists from anywhere, not just from the UK.

For example, the huge international money and foreign exchange market in the City allows a company to transform its own funds into, or borrow funds in, any currency needed. Sterling can be changed not only into US dollars, euros and Japanese yen, but also into a very wide range of other currencies, where specialist dealers can usually find ways around any capital controls that a foreign government might impose. UK-based banks obviously have a relative advantage in obtaining sterling funds, both from the domestic market, including from the Bank of England, and from overseas. However, they also have access to vast pools of other global funds. They can translate these funds into whatever currency, or offer loans for whatever time period, is required. From 2000 to 2011, only some 12-16% of the external assets and liabilities of UK-based banks were denominated in sterling (calculated from ONS, 2013, Table 8.7), with BoE data suggesting that most of the remainder was in US dollars and euros. This prominent position of the UK financial markets is closely bound up with Britain's status in the world economy as an imperialist power. The development of the euromarkets and other changes up to and beyond 'Big Bang' in 1986, assisted by government and Bank of England policy (see Chapter 5), show that this is far from being a hangover from the days of Empire.

The advantage in finance goes well beyond bank funding, however. Chapter 2's discussion of fictitious capital (Sections 2.4 and 2.5) pointed out that this form of capital was a defining feature of the financial system, one that grows to particular importance under imperialism. Fictitious capital in the form of equity can also act as a form of money, or means

of payment, for those companies whose shares are quoted on one of the major stock exchanges, such as the London Stock Exchange. This is because money-capitalists worldwide are far more likely to accept payment in the form of securities that are easy to transact in a liquid market in a major currency than they will from a smaller, less liquid market denominated in a minor currency. As a result, major companies listed on the London Stock Exchange will be in a more powerful position to use their own 'paper' as a means of doing deals with or securing control of rivals in mergers and acquisitions. While the UK may rank sixth or seventh in terms of GDP, Chapter 4 noted that the position of the stock exchange in world rankings of market capitalisation and turnover was fourth, after the US, China and Japan.

Many non-UK companies also list their shares in London, just as UK companies also list in other markets such as New York. Nevertheless, a London listing is a badge of privileged access to finance, one that is also reflected in the figures for monopolisation of the world market in most goods and services (cited in Chapter 3, section 3.4). A striking example to illustrate this process, one that also shows how such a facility can be used in the competition between imperialist companies, is Vodafone's takeover of the German mobile company Mannesmann in February 2000. The deal worth £112bn was at that time the world's biggest 'hostile' (not mutually agreed) takeover. While Mannesmann had been an 'alliance partner' of Vodafone, it had bought another UK company, Orange, in October 1999. This had 'contravened a gentleman's agreement not to compete on each other's territory', according to the head of Vodafone, Chris Gent. Upset that its own monopolistic plans were under threat as the industry was in a merger boom, Vodafone launched a hostile bid for Mannesmann in November 1999. When the deal was completed, Mannesmann shareholders were given close to 59 shares in Vodafone for each (higher priced) share they held in the German group (BBC News, 2000). No cash changed hands to execute the deal in this 'share swap', and it directly involved no bank borrowing or cash transaction. The combined company's value was estimated at £228bn on completion.

It is arguable that Germany's Mannesmann could also have bid for Vodafone, however the greater prominence of the London Stock Exchange compared to Frankfurt's, on which Mannesmann was listed, plus the strong links between British and US money-capitalists as Vodafone's shareholders put the balance of power with Vodafone. Even if the takeover had been done in reverse, this would still support the point that corporations based in the imperialist financial centres have the privilege of being able to use their own equity valuation as a means of payment.

The second aspect of financial privilege, the yields for borrowing and investing, does not necessarily imply that a country has a superior yield on its assets compared to its liabilities

in all categories, or in any one category, of investment. This thesis has shown how the operations of the UK financial sector support the economics of British imperialism *as a whole*. Capitalist companies will have positions in the FDI, portfolio and 'other' categories of the financial accounts, and they may be using foreign funds for domestic investment or domestic funds for foreign investment. All that is required is that *their* assets yield more than *their* liabilities. Examining only the international asset-liability positions and returns, Table 6.8 showed that from the late-1980s relative yields moved in favour of the UK. While this was largely a result of developments in the world economy, the expansion of the UK financial system allowed British imperialism to benefit from it. More specifically, lower yielding portfolio and other liabilities funded higher yielding FDI assets. In addition, it is important to recall that the financial sector earns large net revenues on payments for *financial services*.

## 6.8 Conclusions

This chapter has examined the details of the UK balance of payments and the international flows of finance to illustrate the role of finance for British imperialism. The data pinpoint Britain's position within the world economic system. UK-based financial operations are principally in the area of transactions and dealing, with financial companies mainly acting as intermediaries using other people's money and currencies other than sterling. But the evidence shows that these operations bring revenues into the UK economy and play a key role for British imperialism. This explains why a succession of British governments has backed the financial sector. In April 2004, the then UK Chancellor, Gordon Brown, officially opened the new Lehman Brothers European headquarters in London with the words:

I would like to pay tribute to the contribution you and your company make to the prosperity of Britain. During its one hundred and fifty year history, Lehman Brothers has always been an innovator, financing new ideas and inventions before many others even began to realise their potential. And it is part of the greatness not just of Lehman Brothers but of the City of London, that as the world economy has opened up, you have succeeded not by sheltering your share of a small protected national market but always by striving for a greater and greater share of the growing global market.  
(Lehman, 2004)

Coming some four years before the ignominious collapse of Lehman in September 2008, this political perspective is not so different from Prime Minister Cameron's more recent defence of City bonuses against threats of interference from the EU (Wolf, 2013a).

The City of London's operations are an important dimension of British imperialism's relationships with the rest of the world. They fund, at relatively low cost, both the deficit in goods trade and the continued outflow of FDI. UK data suggest that the yield on FDI assets has been persistently higher than that on the liabilities incurred in their financing, while financial services net export revenues - not to mention the related legal, accounting and other

business service revenues - have reduced the current account deficit. Furthermore, as detailed in Section 6.6, UK-based financial flows with the tax havens, especially the 'UK offshore' centres, are part of the mechanism for financing Britain's balance of payments. Previous literature has analysed the offshore tax havens only in the context of tax avoidance by the wealthy or as a function of some 'international' form of finance, with little or no attention paid to the relationships with the major powers. However, the City's relationships with the tax havens are another means by which it facilitates the flows of finance globally - for example, by channelling funds into the US via the Cayman Islands - quite apart from the City being the location for a large share of the international banking, foreign exchange and derivatives deals undertaken in the global system.

In conclusion, it is worth drawing out the links between the data presented in this chapter and the value categories of Marxist theory discussed in Chapters 2 and 3 (especially in Sections 2.6, 2.7 and 3.4). Section 6.1 noted that the data might not reflect accurately the real transactions or the flows of revenue. Nevertheless, broad trends in the data were thought to reflect underlying developments. However, simply to note that the City is responsible for a huge volume of international financial dealing and that it brings important revenues into the UK would ignore key economic characteristics of this business and of those revenues, ones that are highlighted by Marxist theory. The point made here is not that value relationships are not immediately reflected in market prices, something that is clear even from the formation of 'prices of production' in Marxist theory, leaving aside issues of how monopolistic features of the market, state intervention, landed property and rent also have an influence on price relationships domestically and internationally, and hence on any data that is drawn from those prices (issues that are not discussed in this thesis). The point is rather that financial operations should not be seen just as a business in which the UK happens to be competitive. It is a business that underpins the transfer of surplus value, in different ways and in different forms, from the world economy into the UK.

Firstly, as argued in Chapter 3, *all* financial revenues, not simply the net revenues or profits, are deductions of surplus value from the productive sector of the capitalist economy. More than this, the City's *international* business is a mechanism for regularly deducting value from what is produced in the rest of the world economy. In this chapter, I have focused on the *net* international balances, in order to highlight the relative position of British imperialism: how much revenue is derived from overseas minus how much is paid to foreign residents. In this sense, the data given earlier in the chapter do indicate the scale of the *net* surplus value derived from the world economy - eg, in data for net financial services export revenues.

Secondly, City financial business includes both money-dealing and interest-bearing capital operations. However, as discussed in Chapter 2, Section 2.6, the City's focus on

dealing rather than advancing money capital does not imply that its activities can be characterised as being principally under the heading of money-dealing capital in Marx's sense. For example, in the case of the UK foreign exchange business, a key financial transaction service that banks provide, only a minuscule 4% of the \$2.7 trillion daily total of business in 2013 was done with non-financial companies, 43% being with other dealers and 53% with financial institutions (BoE, 2013c, Table C, p. 403). There is a clear case for putting the bulk of foreign exchange business under an interest-bearing capital heading, since it has little to do with providing currency for industrial and commercial companies and is much more engaged with the operations of financial companies. An interest-bearing capital-related focus of City business is still more evident for its dealings in bonds, equities and derivatives.

Thirdly, this thesis has discussed how fictitious capital is a key form of value in contemporary imperialism. The UK is far from being the biggest issuer of bonds and equities in the world, but the City plays a very large part in the international transactions in fictitious capital. It is an important conduit for the access of UK-based non-financial corporations as well as pension funds, insurance companies, hedge funds and other asset managers to securities issued in foreign markets. Its dealing in equity securities is a means for centralising the ownership of capital. The interest or dividend payments from securities may have little relationship to the *current* production of surplus value, since these usually take the form of regular payments. Also, as explained in Chapter 3, Section 3.4, the revenues from dealing in fictitious capital or from capital gains/losses have a more complex relationship to surplus value produced, since they are dependent on the formation of fictitious capital prices. Hence, it is more accurate to say that the revenues deriving from these financial deals are claims both on the surplus value produced and to be produced in the world economy.

The City's activities are *parasitic* on the operations of productive capitalists both in the UK and overseas. However, one should note that companies in the industrial and commercial sectors themselves also engage in interest-bearing capital operations with the assistance of City firms. Recall, for example, that the definition of foreign direct investment is based upon the arbitrary rule of having more than 10% of a foreign company's equity. This means that non-financial corporations might have little involvement in their FDI acquisitions and might act more like portfolio investors in allocating their money capital. The City's parasitism might also be at several removes from the production of value as its dealers transact with other banks, financial companies and governments in a wide range of countries. It is impossible to untangle fully this web of value relationships and the ultimate origin of City revenues, but the end result is that the City's dealings are an effective mechanism for appropriating surplus value, and, as the empirical results suggest, there is a significant net transfer of value from the world economy into the UK.

## Appendix 6.1: BoE and ONS International Financial UK Data

The Bank of England provides the data published by the UK Office for National Statistics for UK-based banks (monetary financial institutions, or MFIs), including that for their international flows of funds, foreign assets and liabilities. However, the two organisations present the data in different ways and with different degrees of detail. A fuller picture of the UK financial sector is obtained by analysing the two types of data, as was done in this chapter. The following table gives an example of how far it is possible to match up the respective ONS and BoE numbers for the banking sector's outstanding foreign assets and liabilities using figures for 2008-2012 and giving details of the respective series codes.

**Table 6.10: Comparison of data for UK MFI assets and liabilities, 2008-2012**

Data are for end-year	Code *	2008	2009	2010	2011	2012
<b>UK MFI foreign assets</b>						
Loans/deposits	VTXD	2673	3225	2687	2852	3078
Bonds, notes	HPCO	550	562	493	469	462
Money market instruments	HHZV	54	57	65	65	59
<b>ONS-based total assets, £bn</b>		<b>3277</b>	<b>3844</b>	<b>3245</b>	<b>3386</b>	<b>3599</b>
<i>End-year GBP-USD FX rate</i>		1.4376	1.6148	1.5655	1.5461	1.6168
<b>ONS-based total assets, \$bn</b>		<b>5526</b>	<b>5241</b>	<b>5302</b>	<b>5564</b>	<b>5342</b>
<b>BoE's MFI assets, \$bn</b>	B348	<b>5499</b>	<b>5236</b>	<b>5299</b>	<b>5564</b>	<b>5331</b>
ONS-BoE gap, \$bn		27	5	3	0	11
% gap		0.5%	0.1%	0.0%	0.0%	0.2%
<b>UK MFI foreign liabilities</b>						
Loans/deposits	CGHB	3599	2928	3020	3226	2979
Bonds, notes	HMBF	409	426	445	461	417
Certificates of deposit	HHGM	149	206	163	99	101
Commercial paper	HHGP	53	61	41	25	27
<b>ONS-based total assets, £bn</b>		<b>4210</b>	<b>3622</b>	<b>3670</b>	<b>3811</b>	<b>3525</b>
<b>ONS-based total assets, \$bn</b>		<b>6052</b>	<b>5848</b>	<b>5746</b>	<b>5893</b>	<b>5699</b>
<b>BoE's MFI assets, \$bn</b>	B293	<b>6141</b>	<b>5992</b>	<b>5899</b>	<b>6039</b>	<b>5822</b>
ONS-BoE gap, \$bn		-89	-144	-153	-146	-123
% gap		-1.5%	-2.4%	-2.6%	-2.4%	-2.1%

Note: \* 'Code' gives the 4 character series codes used by the BoE and the ONS.

Sources: ONS, 2013; BoE, 2013a, and author's calculations

Frustratingly, the numbers do not completely tally. Following discussion with the ONS on this matter (Harrington, 2013), this was explained as largely due to differences in procedures for handling revisions to the data. This is a plausible explanation for the data on

assets, where the discrepancies are small, at usually less than half of one percent. However, the data for liabilities show bigger gaps, more like 1-3%, and this is unlikely to be a result simply of data revisions, especially for data that are more than a few years old. If one assumes that the BoE data are the 'correct' numbers, then the published ONS data overstate the value of assets by up to half a percent and underestimate the value of liabilities by up to 3%.

Given that the sign of the discrepancy in each case is consistent, this suggests a missing element of data, especially for ONS-reported liabilities compared to those for the BoE. However, I have not found it possible to explain the remaining gaps, either from discussions with the ONS or from details of data coverage on the BoE and ONS websites. Nevertheless, this is not a serious problem because the magnitude and trend of the positions is very similar for each set of data.

There are two main differences between the ONS and BoE methods of presentation. Firstly, the BoE's international financial data used in this chapter are reported in terms of US dollars; the ONS reports the figures in pounds sterling. However, this problem is resolved simply by using the BoE website data for the end-year GBP-USD exchange rate, as shown in the table. Secondly, the ONS divides up UK MFI data on foreign investment positions into FDI-related, equity-related, bond and money market security-related and the 'other' data for loans and deposits. The BoE reports MFI data *excluding* the equity and FDI flows and positions. In order to compare MFI assets and liabilities figures for the two organisations, it is therefore necessary to make the relevant adjustments, selecting only the ONS bond and money market instrument portfolio data and the 'other' data for loans and deposits. This is done in the table from the available published data but, as noted, there remains a gap of 1-3% each year between the two measures for liabilities.

## Chapter 7      Results and Prospects

My analysis of British imperialism's position in the world economy has examined the key financial relationships of recent decades using Marx's theory of value. The thesis has focused on explaining how the financial system provides economic benefits for British capital, although it also reviewed the broader picture including other countries. An objective was to contribute to an understanding of how the economic mechanism of contemporary imperialism works by analysing one of its principal agents.

There are a number of original points in the thesis, both at the level of theoretical development and in the presentation and analysis of empirical evidence:

- Imperialism, as a stage in the development of capitalism, has a particular economic content. It is based not only on the trend towards monopoly under capitalism, but also on the hierarchy in a world economy that is dominated by a small number of powers. This hierarchy is especially seen in the sphere of finance. Economic privileges accruing to those powers from financial operations were detailed. While monopoly, economic and political power are features often used in the description of imperialism, I believe that this is an original analysis of the range of privileges that arise from the regular, day-to-day operations of the financial system (Chapters 4 and 6, especially).
- Marx's concept of fictitious capital is more suitable than Hilferding's concept of finance capital for explaining 'finance' as an expression of capitalist power under imperialism (Chapter 2). This was shown in the material presented on the role of the US dollar in global finance and on how corporate shareholdings reflect capitalist power via the ownership of fictitious (equity) capital (Chapter 4).
- 'Fictitious' deposit creation by banks is another key part of the financial mechanism, one that has largely been ignored in Marxist analysis (Chapter 3). How banks accumulate financial assets and the important part played by leverage as a variable in bank profits and financial crisis are also innovations for Marxist discussion.
- The City of London as a global financial centre is far from being a 'satellite' of New York, although it developed a *modus vivendi* with US capital (Chapter 5). Chapter 5 also mapped out the reasons why British governments decided against joining Economic and Monetary Union in Europe, despite close ties between the UK and European economies.
- The structure of the UK balance of payments reveals the key role of finance for British imperialism, both via the revenues from financial services exports and the way

in which banking and portfolio flows fund relatively high return foreign direct investments (Chapter 6). This analysis has not been done before.

- To the best of my knowledge, this is also the first analysis of Bank of England data on financial flows between UK-based banks and the rest of the world, including the offshore tax havens (Chapter 6). This analysis uncovered the role of the tax havens both for the UK and the US. It also demonstrated how the UK-based banking system intermediates global financial flows, providing finance *from* developing countries (especially Africa and the Middle East) *to* other major powers, particularly the US.

These points show that the development of the financial systems in different countries can only be understood when placed in a global context, something that is especially true for the US and the UK, the world's major financial powers. These are arguments against the tendency in the literature to analyse 'financialisation' on a national basis, and arguments that stress how 'finance' is better understood as a general form of capitalist economic power, not as a means of separating 'good' productive capitalists from 'bad' financiers.

My assessment of the economic benefits that British imperialism gains from the financial system based in the UK is that these are a combination of: earnings from financial services; the relatively easy funding of balance of payments outflows, in particular for imported goods and services and for foreign direct investment, and the (usual) net income from foreign assets that follow from this, despite the large UK net debt position. In addition, there are other, more general benefits that flow from being the central hub of global finance. These include a wide range of factors that have not been discussed at any length in this thesis, but which are worthy of note as supplementing the picture already presented.

Firstly, there is the large number of well-paid jobs in finance and allied services, such as law and accounting, together with the tax revenues that flow to the UK Treasury from these (City, 2013a and 2013b). In addition, one must add the other businesses that depend on the demands of the financial sector, from cleaning services, to restaurants and bars, to job agencies, to telecommunication and information technology providers, to construction. Secondly, beyond this domestic economic reach is the international status of the City of London, and the UK in general, as a welcoming haven for foreign finance and financiers, one where the tax laws are favourable to 'non-domiciled' residents and where their dealings and other activities get a more objective, predictable treatment from the British legal system than they might face in the country that was the source of their wealth.

Systematic data on the latter aspect of financial influence are not available, but there are many news reports of purchases of residential property, UK football teams, newspapers and other trophy items by Russian and East European oligarchs, Middle Eastern plutocrats

and others (for example, Hollingsworth, 2010). Notably, in the wake of Russia's incursion into Crimea at the end of February 2014, a UK government policy briefing made it clear that it would seek to exempt the City of London from any EU or US sanctions against Russia. Britain should not 'close London's financial centre to Russians' (Watt, 2014). The value of the economic-political-social connections between the UK and foreign financiers to Britain is indicated also by the £7bn-plus crisis-related injection of capital into Barclays Bank in October 2008 from Abu Dhabi and Qatar's sovereign wealth fund (Jenkins, 2013a).

That the British financial sector is in a prominent position in both the domestic UK economy and the world economy is in no doubt. However, as the historical developments discussed in Chapter 5 suggest, what might look like a secure position can be undermined by developments in the world economy. There are several risks to the pre-eminence and future growth of British-based finance, but also some options for expansion that are being pursued. In this final chapter, I note those that would appear, at the time of writing, to be the main issues.

### **Political and economic risks to UK-based finance**

In the wake of the financial crisis, many European politicians, 'think tanks' and government agencies recommended a tax on financial transactions or other means of limiting banking and financial activity, for example via higher capital requirements on banks.<sup>1</sup> They hope that these measures will limit both the size of the financial sector and the risk of further crises. A further benefit for the proponents of a transactions tax is, obviously, the potential tax revenues. If there were new transactions taxes, or other measures to constrain the expansion of bank assets (on balance sheet, or off balance sheet as with derivatives), this would curb the growth of the financial sector in the countries to which the measures apply. However, it is unclear whether a ruling at the EU level would necessarily apply to countries that were against the new tax. In early 2014, it appeared that the tax might be implemented only by the euro group of countries, in which case the business of UK-based banks could be boosted as financial business migrated to the UK since any UK government will be opposed to it. Yet, with some versions of the proposed EU legislation, the tax would apply on any transaction if one of the counter parties were a bank based in the country that agreed to the tax. In that case it would apply if Deutsche Bank, for example, did a deal in London and the German government agreed the new transactions tax. The UK government would then have to act as tax collector (Richter, 2013). Nevertheless, one must recognise that these transactions are also performed by the

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<sup>1</sup> Other examples include new Basel rules for the required levels of bank capital and proposals from the UK's Vickers Commission on Banking to 'ring fence' retail banking from what was considered to be more risky wholesale market activities, among other things (see BIS, 2010c; Jenkins, 2013b; Vickers, 2013).

politically favoured 'industrial' companies who would bear the costs of such a tax, not simply by the banks. My view is that there is only a small probability that governments would do much to restrict the activities of their major corporations and banks in this regard.

It is clear that the UK authorities will not sign up to any international regulation measures that disadvantage UK-based banks. Nevertheless, the international policy climate in the wake of the financial crisis could limit the future growth of financial markets, and possibly even lead to a reversal, something that is a risk to the large financial services revenues earned by the UK. Financial scandals, such as those over the fixing of benchmarks for money market interest rates (LIBOR) or exchange rates might also damage UK business, but these do not look likely to have much effect. For example, while the rate-setting process for interest rates has been changed and is now run by a New York-based company, NYSE Euronext, the market remains in London (Stafford, 2013).

Other threats to the UK-based financial markets would occur if the UK decides to leave the European Union,<sup>2</sup> or if Scotland decides to separate from the UK in the September 2014 referendum. The first might lead to renewed efforts to promote a continental European centre of finance, and the risk that trade and investment relationships between the UK and the rest of the EU might be affected could also have knock on effects for the City's business. Scotland's independence, cutting the economic size of the UK, and possibly implying a separate currency from sterling and the loss of major asset managers based in Glasgow and Edinburgh (assuming they do not relocate to England/London), would also be a risk to UK financial power and influence. Investigation of these issues is, however, beyond the scope of this thesis.

There are also more direct economic risks to the way in which the mechanism of finance has operated for the UK in the past three decades. One is a higher cost of funds. As an official commentary noted when discussing the investment income balance on the 'other', or banking flows, account:

'As the UK has an excess of other investment liabilities over assets, there is generally a deficit on other investment income, with rising interest rates leading to a rising deficit and falling interest rates to a falling deficit.' (ONS, 2012, p. 67)

Chapter 6 noted that in 2012 the total investment income balance had already moved into deficit. Since 2007, the world's major central banks have implemented extraordinary policies to push market interest rates lower in an effort to mitigate the effects of crippling levels of debt. But interest rates close to zero are unlikely to persist longer-term. When

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<sup>2</sup> A referendum is planned on EU membership by 2017 if there is then a Conservative government, but one is not likely under a Labour government, unless there is 'a new transfer of power to Brussels' (Parker, 2014).

interest rates do rise again, that would further damage the UK's balance of investment income unless higher returns on direct investment and portfolio assets can compensate.

Apart from a general rise in global interest rates, another possible factor that could worsen the UK's deficit on interest income is a sovereign credit downgrade. Only Standard & Poor's among the three major agencies retains the UK's triple-A status at the time of writing, but it has a 'negative outlook'. So far, this is a negligible concern, because it is only a small downgrade from the top status, but further downgrades could raise the cost of foreign borrowing. The UK's financial sector is anomalously large, with assets around five times GDP. So even modest doubts that the state is not considered able fully to meet its obligations could have an effect not only on the position of the UK government, but also on the banking system that is underpinned by that government. This would be a serious issue for a country that is a big debtor and which relies on privileged access to financial markets. The credit ratings agencies have a reputation for being slow, if not negligent, in their assessments of credit risk. Yet they still act as a means of focusing market attention.

### **The City 'open for business': China and Islamic finance**

The previous comments suggest that the future may not be as bright for British-based finance, but the world economy has not ground to a halt and financial companies, assisted by the government and the Bank of England, have sought new markets for expansion. Two stand out and they reflect relatively new developments in the pattern of global finance: the growth of Chinese renminbi financial markets and so-called Islamic finance. I will make some brief remarks on these to round off the analysis.

The first is Britain's attempt to build up its role in the offshore trading of China's currency and to get access to China's financial markets. Outside China and Hong Kong, the City already manages some 60% of offshore currency trading, with the US at just 15% and France at 10%.<sup>3</sup> However, it took a while before the People's Bank of China gave the Bank of England the currency swap line for CNY versus sterling that it wanted, and which is needed to provide an important financial backstop for banks engaged in currency trading and other financial business. Even then, the swap line opened in June 2013 was only around half the figure that had been mooted, at CNY 200bn, the same size as the one for Australia and much less than the CNY 350bn agreed with the European Central Bank (Noble, 2013). After an agreement with China, in October 2013 the UK Treasury announced the opening up of direct trading of China's currency with sterling and that it had gained for the City's financial institutions a (relatively small CNY80bn, roughly £8bn) quota for buying domestic Chinese

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<sup>3</sup> The 'offshore' Chinese renminbi currency has the ISO code CNH. However, for consistency with previous references, I will use CNY here.

equities and bonds with their CNY funds (Hornby, 2013). Another dimension of CNY business for London is the issuance of so-called dim sum bonds, which are debt securities issued by non-Chinese companies in renminbi. Up to the end of 2013, London had lagged Luxembourg in this market and in some other areas of CNY finance. This led the UK Treasury to make it easier for Chinese banks to set up in London in October 2013, lifting some regulatory hurdles (Rabinovitch, 2013). These developments will increase the potential for City dealing, but they are also of interest for revealing that China is in a strong position to determine the limits in an area that is outside the normal purview of Anglo-American finance.

The second growth prospect, Islamic finance, might also appear to be outside the regular orbit of British finance, but that view would ignore British imperialism's continued strong links with Islamic countries, especially in the Middle East. For example, Chapter 6, Section 6.6, noted the large inflow of funds to the UK from Saudi Arabia. Nevertheless, it was a surprise to many that UK Prime Minister David Cameron, political leader of an imperialist power that has attacked a number of Muslim countries in the past decade, declared in October 2013 that:

'I don't just want London to be a great capital of Islamic finance in the Western world, I want London to stand alongside Dubai as one of the great capitals of Islamic finance anywhere in the world.' (BBC News, 2013b)

He was addressing a conference of the World Islamic Economic Forum in London and his presentation outlined a plan for the UK Treasury to launch an 'Islamic bond' worth £200m in 2014, believed to be the first Islamic bond issued outside the Muslim world.

The reason for this attention is that 'global Islamic finance assets' - namely those that are 'Sharia compliant' - are estimated to amount to some \$1.5 trillion and are growing fast, with \$139bn of bonds issued in 2012, some two-thirds higher than in the previous year (City, 2013c). To build on the existing business from the 22 Islamic banks in the UK, more than in all other western countries combined, and the \$34bn of sukuk (Islamic bonds) already listed on the London Stock Exchange, the UK government has established an Islamic Finance Task Force, although this task force is not weaponised. Cameron's planned Sharia bond is minuscule in terms of state finance, but it is a signal that the government and the City is willing to do whatever is necessary to attract more business. Best of all, Britain's financial policy makes it easy for rich foreign investors to put money in and take it out at will, with little fear of political moves against them. Well, perhaps less confidence these days, since the wife of Syria's president no longer shops at Harrods and Libya's Gaddafi family no longer have a residence in Hampstead.

As if the direction of British policy needed further emphasis, the new Governor of the Bank of England, Mark Carney, in an address to a *Financial Times* 125th anniversary event

declared that: 'Five simple words describe our approach: we are open for business' (BoE, 2013b, p. 7). He outlined an increased willingness to provide banks with liquidity, and noted that financial services directly accounted for a tenth of UK GDP, one million jobs and a large share of exports. Just as important, he said that British finance being 'at the heart of the global financial system also broadens the investment opportunities for the institutions that look after British savings, and reinforces the ability of UK manufacturing and creative industries to compete globally' (p. 3). In some neat sidestepping of the recent financial crisis, he also added:

'It is not for the Bank of England to decide how big the financial sector should be. Our job is to ensure that it is safe. The UK can host a large and expanding financial sector safely, if we implement a reform agenda that extends well beyond domestic banking.' (BoE, 2013b, p. 4)

The 'reform' agenda will be consistent with proposals discussed at the Bank for International Settlements in Basel to try and limit the scope for financial meltdown by increasing bank capital (he is also the chair of the BIS Financial Stability Board!). However, the prospect of such reforms did not prevent him from suggesting that by 2050 UK banks' assets could grow much further to reach *nine* times GDP, assuming that the UK's share of global banking activity remained constant (p. 3). The Governor's remarks were so much in favour of expanding finance - safely, of course! - that even his hosts were taken aback. Martin Wolf, senior *Financial Times* columnist, wrote that Carney had placed a 'big bet on finance' and while he admired his 'bravura' he doubted his 'wisdom' (Wolf, 2013b).

## Conclusions

The promotion of British finance is not surprising from a Governor of the Bank of England. However, this thesis has shown that finance is such an integral part of the economics of British imperialism that it has also been promoted by a succession of governments that would otherwise claim to have different economic priorities. While Britain has slipped down the global rankings in many other areas of business, it has made a successful business out of financial parasitism to boost its income, especially from financial transactions, and with revenues coming from all areas of the world. Marx famously summed up capital as 'dead labour, that, vampire-like, only lives by sucking living labour, and lives the more, the more labour it sucks' (Marx, 1974a, Chapter 10, p. 224). To pursue the metaphor further, British imperialism has developed a financial system that acts like a blood bank for the surplus value produced *worldwide*. It facilitates the flows of many forms of finance, especially of fictitious capital, a form of value that is more unborn than dead, and represents the power of global capital while, at the same time, taking a sip from every value that flows through it.

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