Regional Development in an Era of Slow Global Economic Growth

Gordon L Clark. Smith School of Enterprise and the Environment, Oxford University, South Parks Rd., Oxford OX1 3QY, UK and Department of Banking and Finance, Monash University, Caulfield VIC 3145, Australia.

Contact. gordon.clark@ouce.ox.ac.uk

Abstract. By convention, the responsibility for framing pension fund investment strategy lies with boards and their investment subcommittees, outsourcing the major part of the implementation of chosen investment strategies to various asset managers. In recent years, some pension funds have begun to outsource the investment strategy and implementation thereby locating authority and responsibility with external providers. In this paper, we focus upon the Outsourced Chief Investment Officer (OCIO) model of management emphasising the forces driving the adoption of this type of arrangement, its characteristics and what defines success. This model of management has the merit of replacing multiple providers with one contract on a fee-for-performance basis. For this model to be effective, it is shown that it must be well-governed. This includes clarity of mandate and delegation as noted in prior research on pension fund governance. In addition, any governance regime must address the principal-agent problem if the OCIO model is to realise clients’ ambitions. This may require high-level Board competence, investment advisory services, and performance assessment processes that are sensitive to the unseen forces that influence success.

Keywords. Banks, finance, intermediation, urban and regional development

JEL Codes. G23, H26, R10

Acknowledgements. This paper was prepared for presentation at the Annual Meeting of the Association of American Geographers, Boston 2017 at the invitation of the Regional Studies Association and the editors of Area Development and Policy. The author is grateful for the invitation to present this paper as a Lecture. It draws upon research in collaboration with a number of scholars and institutions, notably Ashby Monk at Stanford University. I am grateful for the research assistance provided by Micol Chiesa and the editorial advice provided by Sarah McGill and Selina Cohen. None of the above should be held responsible for the views and opinions expressed herein.
Introduction
The prospects for economic growth over the next decade appear subdued compared to the confident claims of unending global prosperity made during the first decade of the 21st-century. Not only do nations and trading blocs such as the EU have to rethink their place in a new era of contested globalisation at home and abroad, cities and regions have also to reconsider development plans and commonplace assumptions made about reaching beyond their host nations to a growing global economy. Recognising the new ‘uncertainties’ emerging out of the economic, political, and social disruption triggered by the global financial crisis, it has been suggested that those cities and regions that will prosper in the future will be those that are, in some sense, resilient – that is, have the capacity to adapt in ways consistent with long-term growth.

Regional resilience depends on many factors including the ability of the local workforce to adapt to new circumstances, the flexibility of local organisations and institutions, and the capacity of firms and related financial institutions to invest in a future which is subject to both risk and uncertainty. It is widely recognised that risk is the lifeblood of market-based economies being both the object of investment strategy as well as being, on the downside, an ever-present threat given the possibility of not realising intended outcomes. When risk is tamed or managed, investors can look forward and place their bets accordingly. When uncertainty dominates, decisions to invest are postponed, even abandoned. Notwithstanding attempts to colonise uncertainty by risk metrics, the past decade or so has brought theorists and practitioners alike back to the costs and consequences of uncertainty.

The past decade has also revealed systemic faults with many countries’ financial systems. These have become the focus of academic research across the social sciences with criticism and comment from financial theorists well as economists, economic geographers, sociologists and political scientists (amongst others). A veritable industry has developed around finance as ‘ontology’ and as an important sector of many countries’ economies. Furthermore, the fact that the global financial crisis was triggered by the systematic mispricing of risk in US housing markets has given life to research programmes that link the performance of local housing markets to failures of public policy and financial institutions. As Smith (2013, 72) has observed, notwithstanding the sophistication of financial derivatives “housing market dynamics ... are still quite poorly understood.”

There have been many attempts to diagnose the causes of the global financial crisis focusing, for example, on issues such as the behaviour of traders, the incentives driving financial institutions, the culture of finance – of companies and the industry – and the moral hazard apparent when financial institutions reap the benefits of the upside of the market and society (by default) covers the downside costs of speculative behaviour. I have contributed to this debate in a variety of ways including papers on the space-time characteristics of finance, behaviour and institutions, and the culture of finance.

Here, I suggest that the global financial crisis and its aftermath taken together is evidence of a profound failure of intermediation. At one level, intermediation has been successful in the sense that every minute of every day savings are placed into investment vehicles of many kinds. At another level, however, intermediation has stripped cities and regions, even whole nations, of their financial assets and has not repaid clients with sustainable long-term financial returns. One reason for this is the fact that the enormous flow of assets has forced financial institutions into public markets which, in sum, are losing propositions (net of transaction costs). I also argue that the source of savings matters just as the organisational form of intermediation matters a great deal in mitigating or accelerating the spatial-temporal concentration of financial assets in selected markets around the world.
Along the way, I suggest that a key ingredient in understanding of the genesis and aftermath of the financial crisis is the existence of a global savings glut or “surplus of savings” (Bernanke 2009). Having discussed the theory and practice of intermediation, in the section that follows I distinguish between its functions and its organisational forms. This discussion is augmented by my contention that the global savings glut drove investors away from conventional forms of intermediation like banks, mutual societies, and savings and loan organisations that had their roots in cities and regions. Reinforcing this process, I argue that as different forms of savings became available those able and willing to save switched away from traditional savings vehicles to new forms of finance including pension funds, mutual funds and even certain types of insurance companies.

The first part of the paper explains how and why many cities and regions were the losers in the transformation of industrial capitalism into financial capitalism. In the second part of the paper, I argue that the challenges facing many financial institutions are such that the search for superior risk-adjusted rates of return has prompted a shift in investment strategy towards opportunities either at the margin of public markets or are located in untraded commitments. Investors are returning to the value to be had in cities and regions that have distinctive attributes which can be realised via new forms of financial intermediation. In the penultimate section, I identify some of the key building blocks underpinning these new kinds of financial organisations noting the value attributed to information internal and external to the relationships that underpin investment process.

**Theory of Intermediation**

For argument sake, assume that our economy is comprised of households, companies, and government. As such, it could be a city-state. Let’s assume that households work for companies that sell products to households and government. And let’s assume that government taxes households and companies. We can assume that households use their wages and salaries to purchase products made by companies and save a fixed proportion of earned income (Friedman 1957). Likewise, we can assume that companies use the income generated by the sale of products to pay households for work and save the residual for investment in working capital. To complete the story, it is assumed that government uses taxes to produce services for households and companies and saves a portion of those taxes to invest in infrastructure.

Notice two implications from our simple model. First, it is inefficient for households, companies, and government to separately hold small parcels of savings when they would be better-off if savings were pooled together thereby reaping the benefits associated with a common savings institution. Second, in any event, households, companies, and government might wish to invest their savings such that they secure their separate and collective long-term welfare. Some economic agents may be able to do so, but many would not. Without regard to the particular form that the city state’s savings institution takes, to be effective this institution would have to have three attributes: it would have to have integrity in the sense that it is trusted by those that rely upon its activities; it would have to be more efficient than alternative forms of saving, and; it would have to be transparent in that households, companies, and government would have sufficient information to judge integrity and efficiency (against the alternatives).

Herein is a rationale for intermediation – that is, an explanation for the existence of an institution or set of institutions that collects, holds, and distributes savings within and between sectors and investment opportunities. It is an explanation which emphasises the functions of the financial sector matching, in part, recent theoretical frameworks of the structure and performance of modern financial systems (Crane et al 1994; Merton and Bodie 2005). Historically, there have been many kinds of organisations that have fulfilled this institutional function. For example, in 19th-century English cities not-for-profit mutual societies were created to collect if not invest workers’ savings largely for the purpose of holding and protecting those assets. Likewise, in agricultural communities
in Western Canada credit unions provided similar functions collecting, holding, and dispersing financial assets to fellow depositors for both personal and commercial uses. In some localities, a distinction is made in law between savings trusts and commercial banks (as in Massachusetts).

Mutual societies, credit unions, savings trusts and commercial banks typically began life at the local level. Specialisation by function and by geography reinforced their dependence upon specific constituencies and localities. Remnants of these organisations still exist. However, through the first half of the 20th century and then accelerating over the second half of the 20th century larger multifunctional banks were formed crossing over, where possible, constituencies and localities to emerge as provincial and national financial institutions. Even so, the history and geography of the process of scaling-up is fundamentally important if we are to understand the US map of banking against the German and UK maps of banking (Clark and Wojcik 2007). In this regard, it is reasonable to suggest that the development of these organisations and their scaling-up over the 20th century fuelled local, regional, and national development in ways consistent with King and Levine’s (1993, 1995) theory of financial intermediation and economic development.

However, the literature on financial intermediation has posed important questions as to the efficiency of banks and bank-like organisations. It is reasonable to ask whether these types of organisations can provide on a cost-effective basis even the simplest of functions such as collecting and holding depositors’ savings. In circumstances where these types of organisation have a monopoly or near-monopoly position in the local market, depositors may be trapped in organisations which do not provide a level of service consistent with those organisations that are able to reap economies of scale and scope by virtue of their regional or national significance. For example, local organisations may find themselves undercapitalised in the face of innovations in service provision led by larger banks that have the resources to invest in sophisticated information technology across their branch networks.

Likewise, small organisations embedded in their local communities may lack the liquidity available to larger organisations with access to diverse constituencies with different levels of savings and different preferences for immediate and long term access to funds. Smaller organisations with limited liquidity are likely to be highly risk adverse in terms of their lending strategies and preferences. This explains why many local credit unions prefer to collect and hold deposits rather than make investments with those deposits extending lines of credit to depositors subject to immediate recall if necessary. Notwithstanding their closeness to the community, these types of organisations tend to be conservative in all aspects of their business given the risks associated with taking a significant forward position without adequate capitalisation.

A related issue concerns whether banks large and small are able to be effective monitors of investors. This topic has been widely discussed in the literature and deals with issues such as the existence of information asymmetries, adverse selection and moral hazard. Nonetheless, it is also observed that banks and similar organisations that offer bank-type functions can often count upon the loyalty of their customers to maintain deposits over the long term. Here, then, is a paradox. On one hand, having a loyal customer base provides a predictable flow of assets allowing banks of sufficient size to undertake significant investment programs. On the other hand, given their inability to effectively monitor chosen investments means that they are likely to be more risk averse than organisations that are much closer to ‘the action’ (Allen 1993).

Community savings organisations and banks are not always risk adverse. As the Savings and Loan debacle demonstrated, these types of organisations can readily get out of their depth when led by senior officers whose risk appetite is inconsistent with the best interests of these organisations.
**Finance, Intermediation and Markets**

In this section, we complicate the model of intermediation so as to better understand the status of bank-like organisations and other kinds of intermediaries in the modern economy. I do so by complicating the story about what are, in fact, savings and investments. This allows us to see how and why these types of intermediaries are less important than was widely assumed 25 years ago. Note, by using the phrase ‘modern intermediation’ I mean to distinguish the past (up to about 1985) from the present rather than signifying profound differences of mentalité and society.

**Saving behaviour**

As suggested above, saving was represented as a form of retained earnings deposited in a bank or similar organisation for safekeeping. Reference was made in passing to the seminal work by Friedman (1957) and others to the relationship between saving and consumption wherein it is assumed that over a person’s life course savings underwrite consumption. As such, it is obviously important that savings be held in secure deposit accounts and invested in low-risk financial instruments (such as government bonds). However, recent research on individual long-term savings behaviour has revealed two important qualifications to this story. First, the propensity to save depends upon the level of earned income and its predictability. Second, high income earners not only save more (as a proportion of their income) but also hold a variety of savings instruments.

Lower income earners tend to save proportionally less and rely upon their savings to cover short-term commitments. In these circumstances savings accounts like checking accounts are dominated by short-term transactions. Banks and community-based savings organisations that service these clients face continuous calls on their liquidity. By contrast, high income earners tend to carry a range of savings instruments some of which are provided by banks but many, in fact, are provided by organisations like insurance companies, mutual funds, pension funds and property investment companies. These types of earners ‘park’ a small proportion of their retained earnings with banks for safekeeping and look to other kinds of organisations that offer a premium on the long-term rate of interest. Whereas home mortgages are treated by lower income earners as an ongoing call on their monthly earnings, higher income earners often treat mortgages as a long-term investment.

**Savings and financial institutions**

As above, the savings process was represented as a set of individual choices including the proportion of earned income saved, the purpose of saving, and the type of organisation chosen to hold and invest those savings. In fact, in many OECD countries pension savings have been the single largest component of individual savings – most people do not choose the proportion of income saved in these vehicles, nor the purpose of saving, and nor the organisation and its investment strategy. During the second half of the 20th century most developed economies institutionalised the pension savings process using statute and regulations to oversee the performance of these organisations. Whether voluntary or compulsory, the growth and the volume of financial assets in these organisations eclipsed the volume and growth of financial assets in banks and similar types of organisations (accelerating from the 1980s through to the current day).

[Insert Figure 1 About Here]

In Figure 1, the growth in pension assets for the UK and Australia over the period 1980 – 2015 is briefly summarised. In both countries, the growth in assets has been extraordinary. It begins earlier in the UK reflecting the post-war industrial and corporate structure of the economy. Large corporations dominated within nationalised industries along with the significance of London as the stand-out global financial centre. For Australia, the take-off phase was in the early 1990s, accompanied by a federal government policy regime that provided surety about the growth and development of pension funds as single-purpose financial institutions. Twenty-five years later, it is
believed that Australian pension fund assets amount to AUS$2 trillion with expectations of about AUS$10 trillion at maturity. Whereas banks remain important in the UK economy largely because of their international market, questions have been raised in Australia about the future of the ‘big 4’.

*Saving, globalisation and finance*

Other forms of national saving have emerged over the past three decades. As globalisation gathered momentum, resource-rich countries have, often times, earned a premium on energy resources (fossil fuel rich countries) and those resources related to industrialisation and commodity production. These developments have added to the earnings of local workers. Most importantly, however, a significant portion of these earnings have been held by governments through the medium of national banks and sovereign wealth funds (SWFs). Whereas national banks would have once been the intermediaries through which these assets were collected, held and invested, SWFs have become the favoured financial institution bridging the gap between the rudimentary financial capacities of nation-states and the services provided by the global asset management industry. It is believed that these institutions account for approximately US$10–15 trillion.

Much has been written about the emergence and significance of these organisations and the ways in which they function (see Clark et al 2013). Perhaps less important in terms of the total volume of financial assets held are the large private corporations that have also been the beneficiaries of globalisation and economic growth over the past few decades. It is believed that large US corporations hold something in the order of US$1 – 2 trillion. While this sum is small in relation to the assets held by sovereign wealth funds and the global pension fund sector, it is significant in another sense: these corporations have become financial organisations as much as being production platforms, seeking a return on retained earnings through financial markets rather than holding these assets in banks. The volume of retained earnings is so significant that it discounts the earned income and savings of their own employees.

*Markets as intermediation*

If the simple model of intermediation presented in the previous section once represented the financial structure of cities and regions and national economies, it does not do justice to the complex structure of the global financial services industry. Then again, the simple model was not meant to describe in the organisations involved in converting savings into investments so much as represent the function of intermediation. As debate in the social sciences has developed around the distinguishing features of different models of economy and society, it has become apparent that some countries have also relied upon other kinds of market-based organisations for the intermediation process. For a time, the contrast drawn was between Anglo-Saxon economies and continental European economies (Dore 2000).

Bypassing intermediaries like banks and similar organisations over past 30 years or so has resulted in the enormous growth in the asset management industry. In response, intermediation has become a complex web of inter-related organisations that sustain the collection, management, and investment of financial assets. Historically speaking, these organisations are very different from banks. Indeed, growth in the asset management sector has been so significant that commercial and savings banks have had to build their own asset management businesses to keep pace with the growth of clients such as pension funds, sovereign wealth funds, and large corporations. In this world, risk management and allocation have become very important functions, produced and distributed through markets rather than through the closely-held relationships between banks. The conventional functions of associated with being a savings bank have been consigned to the margins of many banks with much reduced significance and responsibility.
Financial Intermediation - Success and Failure

There are various ways of judging the success and failure of financial intermediation. We could focus upon the growth of the sector in advanced economies and around the world in terms of employment and earned incomes. Likewise, we could focus upon the renewed prominence given to financial centres such as London and New York. Given their success, a number of countries have sought to develop their own financial centres combining the goal of global financial status with finance-led urban and regional economic development. Here, I focus upon three indicators of success and failure that relate to the global economy. In doing so, I also bring the issues to ground – the consequences of financial intermediation for urban and regional economic growth.

Indicators of success

The remarkable growth in savings over the past 30 to 40 years has both prompted the development of financial intermediation and has relied upon intermediaries to manage these financial assets in ways consistent with the goals and objectives of clients. As noted above, this also prompted the growth and development of various types of intermediaries based in established financial centres and markets with global reach. As financial organisations came to market with ever-increasing financial assets to be managed, asset managers began to look beyond opportunities in established financial centres to opportunities in the rest of the world. Perhaps the most well-known example of such a geographically-extensive investment strategy is the Goldman Sachs’ investment programme focused upon the BRICS (Clark 2015).

As international financial centres accumulated vast financial capacity, market liquidity deepened (in terms of its absorptive capacity) and broadened in scope (in terms of the nature of risks that could be accommodated). Depth and scope allowed large corporations to come to market and raise money for investment in mergers and acquisitions, global expansion, and corporate restructuring. Indeed, the reliance of these types of corporations on “local markets” is indicative of a broader issue – that these organisations have relied upon their relationships with home-based financial institutions to sustain global expansion strategies. Moreover, governments, development banks, and multilateral organisations also benefited from the growth in market liquidity which, in turn, fuelled regional and global economic integration.

It is also arguable that financial market liquidity – depth and scope – in leading international financial centres enabled the launch of the European single currency (Euro) and the remarkable surge in European financial integration over the first decade of the 20th century. After the launch of the Euro and through to the global financial crisis, many European companies, governments, and financial institutions were able to gain access to investment resources at reduced rates compared to the rates obtaining in each country over the previous 20 years. In effect, financial market intermediaries priced risk and return expectations at the European periphery referencing European institutions rather than continuing with the normal practice of pricing risk against country-specific factors including the likelihood (or not) of government default.

Indicators of failure

One of the consequences of the dominance of financial markets over financial institutions like banks and related savings organisations has been the consolidation of the banking industry. This has been accompanied by the assessment of lending via automated credit scoring systems which use ‘gates’ to exclude those deemed not creditworthy. In some countries, savings organisations like building societies have been driven out of the market. Inevitably, these developments have had significant urban and regional consequences producing, in some cases, lending deserts and in other cases saturating individuals and companies that qualify with multiple offers. In this vein, Beaumeister et al (2015) suggest that the concentration of the French banking system has adversely affected the funding of innovation whereas the continuing importance of regional banks in Germany has
sustained small and medium enterprises even if they have been adversely affected by solvency issues arising from the Euro crisis.

While this issue is obviously very important, it is arguable that the global financial system has been subject to a set of related systemic failures that have undercut the coherence and stability of the whole. In what follows, I refer principally to the fundamentals of global financial markets centred on London and New York. There are three ways of illustrating this argument.

The First systemic failure is to be found in the rewards for opportunism over long-term investment. In figure 2, the annual returns on investment are presented for two iconic US investment groups: one is Renaissance technologies, a well-known quantitative hedge fund which specialises in reaping the benefits of market-based mispricing, and the other is Berkshire Hathaway, the long-term institutional investor led by Warren Buffett. Over the nearly 30 years of investment returns presented, Renaissance Technologies almost always outperformed Berkshire Hathaway. Furthermore, Renaissance Technologies recorded a number of years of remarkable outperformance while, unlike Berkshire Hathaway, not recording any years of negative performance. There is an incentive to focus on the short-term rather than the long term.

Second, in Figure 3 UK bond government rates are displayed for the period 1980 – 2016. Whereas bond rates were in double digits early in the period, over time there has been a systematic decline in bond rates such that, in the current era of low or negative interest rates, the current UK government bond rate is about 3.5% over 30 years. In other words, the cost of capital has systematically declined over this period such that the expected rate of return on a balanced portfolio has continued to decline. At one level, this could be interpreted as having social and economic benefits. However, it is arguable that it reflects the costs and consequences of a global surplus of savings. One response to this phenomenon has been to seek out investment strategies that can compensate for the long-term secular decline in expected returns. This is one reason why hedge funds such as Renaissance Technologies have been so successful (in terms of market share).

A third systemic element in the failure of global financial markets has been the emergence of uncertainty in developed financial markets. Historically, shocks to developed financial markets arose from the periphery of the global economy and flowed to London and New York disrupting global investment and economic growth. So, for example, investment in Argentine railroads, investment in emerging Asian economies, and investment in commodities and resources have all contributed to market instability at home and abroad. However, many commentators including some from the Bank of England have concluded that the global financial crisis was precipitated by the so-called irrationalities and self-defeating incentives apparent in the market activities of major investment houses located in London and New York. In this respect, the global financial crisis was home-grown and has flowed out to the periphery taking with it the stability of the Euro and the prosperity of most ‘southern’ countries of the Eurozone.

Low expected financial market returns, lower than expected rates of regional and global economic growth, and the premium on opportunism in financial markets has discounted the value of long-term commitments and investment strategies. It is little wonder, then, that major corporations flush with liquidity from the past decade tend to buy-back shares rather than invest in capital and technology. This is, quite obviously, a self-fulfilling prophesy.
Paradox and Response
Commentary on current modes of financial intermediation and market performance tends to go in one of two directions. There are those that believe that financial intermediaries and markets are self-adjusting and adaptive organisations that respond to signals positive and negative – the implication being that current circumstances are an opportunity for innovation. There are other commentators who argue that the hegemony of finance is such that the dysfunctional nature of financial intermediation and markets has closed-off opportunities for growth. Paul Krugman (2015) argues that current conditions in the West are more consistent with being in an economic depression than they are consistent with an ongoing process of rebalancing and development. He also suggests that as Chinese economic growth falters under the weight of home-grown constraints and protectionism in the West, economic growth will remain modest.

While there are reasons to be sympathetic with Krugman’s argument, it is also apparent that the map of economic stagnation and growth is highly differentiated both within countries and between countries. Much of southern Europe is in either economic depression or is caught in a stagnation trap not of its making. Figure 4 displays current (2016) rates of youth unemployment amongst OECD and European countries. This is a good indicator of economic conditions, representing the presence and absence of economic growth as well as the systemic nature of these circumstances. Those countries with the highest unemployment rates are on the left of the figure, and those countries with the lowest rates are on the right of the figure. The differences between are remarkable. Likewise, differences with countries are also pronounced – witness the problems facing southern Italy. At issue, is how economic agents and organisations have responded to these conditions.

[Insert Figure 4 About Here]

We have shown elsewhere that many European small and medium enterprises have had, in any event, limited access to finance (Clark et al 2004, 2005). These types of organisations, like similar types of organisations around the world, have had to rely upon cash flow and retained earnings to finance their operational expenses from one period to the next and their investment in capital equipment and technology. While some small and medium enterprises have been very successful and have used banks and similar types of organisations as the mediums through which to smooth the flows of revenue and expenditure, in many cases, these intermediaries have simply acted as portals for transactions. As such, one response to the Euro crisis and the withdrawal of liquidity in many European cities and regions has been to return to self-financing and the benefits of trade beyond the immediate environment.

Often times, enterprises have sought to bypass financial intermediaries and markets so as to sustain trading relationships. At the same time, in some countries, urban and regional investment clubs have been formed outside of local and national banking systems so as to provide capital for operating expenses and short-term investment. These clubs are, in effect, networks of individuals and organisations that rely upon direct placement rather than regulated systems of intermediation. Being network based, these clubs tend to be relationship-intensive substituting governing devices such as incomplete contracts, norms and conventions for market exchange. Again, this type of response is enabled by the persistence of past practices often particular to cities and regions and not easily transferred from one region to another (Storper 1993). Nonetheless, social media has been one way of going beyond the financial resources of existing relationships to the rest of the world.

At the other end of the spectrum, large pension funds and similar types of organisations have sought to discount their reliance upon public markets and seek investment opportunities in conjunction with like-minded collaborators. Again, these types of partnerships are more often informal and governed by letters of agreement than they are governed by explicit contracts that have lock-in
clauses which reduce flexibility and harden commitment (Clark and Monk 2017). In part, these types of organisations have sought ways of learning about alternative opportunities and models of management notwithstanding their continuing reliance upon public markets to absorb a large proportion of their financial assets on hand. In part, this type of response to the systemic problems of financial intermediation and markets trades-off institutions’ liquidity apportioning a portion of their flow of funds to these opportunities. When successful, these initiatives allow for a rebalancing of investment portfolios away from conventional asset classes and modes of management thereby discounting the effects of public markets on long-term performance.

Another response to the systemic problems of financial intermediation and markets has been the development of special-purpose investment organisations including development banks and initiatives such as the UK Green Investment Bank. Through much of the 1990s and first decade of the 21st-century, development banks such as the EBRD were overshadowed by rapid growth of the global financial services industry. However, in the current Europe, these types of development banks along with banks that have responsibility for infrastructure and environment have benefited from the surplus of savings and the search for different ways of organising the investment process along with an expected rate of return underwritten by long-term economic and environmental responsibilities that can reap the superior (if not exceptional) and predictable rate of return. Indeed, recognising the value of the product, these types of organisations have built up their marketing capacities to reach out to global portfolio investors.

Yet another response to the problems of public markets and intermediaries has been the transformation of some sovereign wealth funds into sovereign development funds. Instead of investing in global portfolios of publicly traded stocks in ways consistent with global asset managers and the large banks which have significant trading functions, sovereign wealth funds have begun to build up their long-term investment capacities in national resources and opportunities. In some cases, the development functions of sovereign wealth funds have been spun out into stand-alone organisations. In other cases, sovereign wealth funds have been willing to forego the liquidity associated with tradable assets to invest in infrastructure projects through each phase of the development process. These types of initiative take advantage of the enormous flows of financial assets through these organisations to bypass public markets in favour of direct control.

**Innovation in Intermediation**

Is widely recognised that infrastructure is one of the key building blocks underpinning urban and regional economic development. High quality transport systems, communication links, and space-time integrated platforms allow small and medium enterprises to reach beyond local circumstances to national and international markets. A cell phone with an international network is just as much a form of infrastructure as is a road system, railway network, and airport. Whereas third-party provision of infrastructure is fundamental to small and medium enterprises, for larger corporations able to select sites of production according to the nature and scope of available infrastructure, the financing of infrastructure provision is often an important factor in their business strategies. More broadly, it is widely observed that infrastructure is a key ingredient of economic growth.

Infrastructure is often assumed to be a public good. Nonetheless, three issues have conspired to discount these assumptions in favour of the market provision of infrastructure. Just as financial intermediaries and markets have become skilled at valuing companies in terms of their debt and expected value, these organisations have also become skilled at valuing governments in terms of their debt load and capacity to service debt over the long term. As government indebtedness has risen around the world, governments have looked to financial intermediaries and markets to finance infrastructure directly or indirectly. Just as importantly, many governments have sought to reduce the significance of long dated obligations relative to short-term revenue and expenditure while some
governments have found it difficult to raise long-term investment at a price comparable with financial intermediaries. The sale of existing infrastructure facilities to market intermediaries has also prompted the entry of many institutional investors seeking a safe haven for investment.

Investment banks were first type of financial intermediary to enter the market for the financing and provision of infrastructure. These banks combined expertise in the valuation of infrastructure facilities with the capacities of asset managers to design and sell portfolios of infrastructure facilities according to accepted norms and conventions regarding expected risks and returns. These portfolios rarely provided direct access to the infrastructure facilities – more often than not, parcelled-up in the portfolios and sold to investors were the revenue streams from those facilities. Like other kinds of investment portfolios, the risk and return characteristics of these infrastructure-based financial products could be compared to similar types of products and across whole asset classes. As the industry matured, investors could switch in and out of these products just as they would switch in and out of traded equities and bonds.

Characteristically, these products sacrificed the geographical specificity of the infrastructure facilities in favour of the option for investors to trade in and out of these portfolios as desired. That is, short-term liquidity was deemed the priority, reinforcing the design of these products around diverse streams of revenue rather than the management of the infrastructure facilities themselves. For large institutional investors, seeking alternative ways of investing without the skills and expertise to judge the quality of the underlying infrastructure facilities and projects, this was a way of economising on the investment process.

Recognising the premium paid by investors for the parcelling-up of infrastructure revenues, recognising the premium paid for liquidity, and recognising the premium paid for a relatively low but predictable rate of return, more sophisticated institutional investors have looked for alternative ways of intermediation. In reaction, a new kind of intermediary has entered the market. This type of intermediary is, in effect, a market-maker. That is, it has deep knowledge of both sides of the market including those entities including governments that would offer infrastructure facilities for investment and those entities including insurance companies, pension funds, and sovereign wealth funds that would invest infrastructure facilities. In some cases, whole infrastructure facilities are available for sale. More often, infrastructure facilities are offered to investors on long-term leases with certain conditions as to maintenance and investment in capacity according to market conditions. In effect, investors not only take a share of revenue and also take a share of the responsibility for the integrity of the infrastructure facilities.

Characteristically, the intermediaries that manage this segment of infrastructure investment bring together both sides of the market around specific types of facilities (e.g. airports), in specific jurisdictions (e.g. the UK), over the long term (e.g. 20 years). Moreover, instead offering easy routes for entry and exit, these types of financial intermediaries require the long-term commitment of investors with few avenues for exit. Normally, these types of investment are governed via purpose-specific private companies where investors are co-owners even if some investors may have larger shares than other investors. Market-makers are rewarded in three different ways. They are rewarded for bringing parties together; they are rewarded for the type of facilities, their risk and return profiles, et cetera, and; they are rewarded for managing the investment vehicles.

Market makers are successful in circumstances where neither side of the market for infrastructure investment know enough about the nature and scope of opportunities available on a global basis, and where neither side of the market have the resources and capabilities to supplant market-makers. However, as institutional investors have grown in size and as they have diversified their investment strategies so as to be less reliant upon public markets, these types of institutions have
established their own infrastructure investment teams. In some cases, these teams are particularly skilled at identifying opportunities and carrying through transactions alongside third parties such as market-makers. But, in other cases, these teams have become skilled at project development, construction, and infrastructure management. That is, they have sought to reap the benefits of each phase of an infrastructure development programme including its public use and the revenue generated thereof. As these groups of become more sophisticated, have sought partnerships with other investors with access to different geographies, different types of facilities et cetera.

This type of infrastructure investor is often anchored in a specific locality or region, has certain advantages including deeper knowledge of the long-term value or otherwise of an infrastructure project, close relationships with public officials, and close relationships with other commercial entities integral to the development of a significant infrastructure facility. Furthermore, in some cases, this type of initiative is related to the insourcing of the asset management process thereby replacing market intermediaries with internal capabilities and resources. This process is underway around the world and is especially notable in Australia, Canada, the Netherlands, and some regions of the United States. As such, it is a deliberate attempt to move away from financial intermediation via markets to the process of intermediation that internalises the market for financial services. While not all elements of intermediation can be or need be internalised, through their size and significance, these types of organisations seek to impose on the market for intermediation terms and conditions consistent with their long-term investment objectives.

Characteristically, this is a form of long-term investment on four dimensions. It is, quite obviously, an investment in organisational capacities and resources whereby the market for financial services is either avoided or highly discounted. It is a form of investment which crosses-over conventional asset classes so as to join-up the skills and expertise needed to reap the value of an integrated approach to investment management. It is also a commitment to a theory of investment which values being embedded in long-term urban and regional economic development rather than the short-term liquidity of financial markets. And it is an expression of path dependence with the benefits and costs of long-term commitment is the object of investment management.

Implications and Conclusions

Urban and regional development depends upon many factors including access to capital for both investment and for trade and exchange over time and space. It also depends upon community or shared resources such as infrastructure – including facilities that provide predictable resources for production and facilities that allow local enterprises to reach markets near and far. For many years, banks and related savings organisations were the first port of call when local enterprises sought capital to underwrite their production and development strategies. However, in many developed economies over the past 20 to 30 years these types of financial intermediaries have either drawn from these types of activities at the local level due to successive waves of consolidation or have been eclipsed by other kinds of financial intermediaries which have been more successful in growing national and global financial markets.

In this paper, I begin with a conventional account of the role of financial intermediaries in facilitating economic activity. Unlike some theorists that suppose that the particular form that intermediation takes is less important than the functions provided by different kinds of organisations including markets, I have argued that the spatial and institutional consolidation of many countries’ banking industries has often produced financing deserts – in these circumstances, credit is either severely rationed or not available at all. These tendencies have been exacerbated by series of financial crises over the past 20 years which have driven the process of consolidation so as to maintain and protect national (rather than local) banking systems. In any event, these types of organisations have not had
the national and global scope of the financial institutions created out of very different mechanisms for individual, enterprise, and government saving.

In many ways, small and medium enterprises located in cities and regions suffering from the outflow of financial assets to national and international markets have had to rely upon alternative forms of saving – most often the use of retained earnings to finance production. In these circumstances, many small and medium enterprises have seen their development potential choked-off rather than enabled by regional national banking systems. Even so, I suggest that there is a paradox of the heart of the financial systems of many developed economies. This paradox has two sides: on one side, there appears to be a global surplus of savings. This is either the product of the institutionalisation of many countries’ systems of saving and/or the product of economic growth and the growth in capital markets from the early to mid-1980s through to the global financial crisis of 2007 – 2008. Krugman has a related explanation, arguing that many developed economies particularly those in Europe are in depression. On the other side of the paradox, is the search for investment returns outside of financial markets and established financial practices.

Implications of my argument are threefold. First, if small and medium enterprises are to prosper and play their roles in generating long-term growth through production and trade new forms of intermediation will be needed to replace banks and related savings organisations that have either retreated or are, in some sense, mere shadows of their former selves. A second implication is that economic depression and financial repression have accelerated capital flight to financial intermediaries and markets that promise a rate of return over and above that available in many economies. Capital flight has been facilitated by banks and other savings organisations that have, in effect, mimicked other types of financial intermediaries in global financial markets. Third, if urban and regional growth is to be sustained in many economies, new kinds of intermediaries will have to be created using inventive ways of self-organisation and institutional innovation.

This argument is illustrated by reference to different forms of adaptation to these new realities. For example, it is noted that some countries sovereign wealth funds are being reconceived in terms of a development agenda aimed at providing financial resources and expertise at the local level in cities and regions that have the potential to participate in the global economy. This shift in focus and responsibility has been prompted by recognition by some policymakers that global financial markets carry with them considerable risks of systemic failure. Indeed, one of the contributions of this paper is the articulation of those risks noting, for example, the risks due to the apparent superior returns found in short-term arbitrage as opposed to long-term commitment. Equally, it is noted that the search for superior rates of return over and above those found in conventional markets has prompted successive waves of market speculation as well as waves of asset switching and herding on the latest new idea. Property market speculation has little to do with urban and regional development but is a favourite target of institutional investors seeking geographic specific returns.

At the same time, I suggest that new kinds of intermediaries have come to market so as to reap the opportunities found in long-term commitment (illiquidity). This argument is illustrated by reference to the various ways in which institutional investors have sought exposure to infrastructure investment. But this process of adjustment and innovation can be illustrated in a number of ways. For example, in early 2017 it was announced that one of the UK’s largest pension funds have made a deal with a Swiss investment bank to take on its portfolio of loans and loan commitments stretching over 5 to 7 to 10 years. In effect, the pension fund is able to make such a forward commitment course it does not need as much liquidity as the investment bank and can afford to hold loans to medium-sized businesses because of the size of its asset base and diversity of asset holdings. While unusual, this development does illustrate the significance of alternative forms of financial intermediation for long-term economic development.
Just as large pension funds can be patient investors, they can also hold concentrated portfolios of geographic-specific assets thereby trading on the long-term development of major economic centres around the world. Just as there are cities and regions that are effectively financial deserts, there are cities and regions flush with financial resources and development programs. Note, however, and implied but significant implication: when these types of financial intermediaries make big bets on the long-term development of certain cities and regions they do so in the context of the host nation-state and the place of the nation-state in the global economy. So, for example, investing major cities of southern Europe would seem to be a significant risk given the economic and political fragility of these nation-states and long-term doubts about the integrity of the Euro.

Ultimately, I argue that long-term regional development in the 21st-century global economy depends upon innovation in the forms and functions of financial intermediaries. The past few decades have seen conventional financial intermediaries like banks and other savings organisations virtually driven out of their original cities and regions. By mimicking the activities of other kinds of financial intermediaries, these types of organisations have contributed to what Krugman refers to as the ongoing depression in much of the West. The challenge, of course, is to create new kinds of intermediaries that have the funding and the responsibility to make-up the gap between economic potential and financial reality. I have identified certain ways forward. But there is much to be done.