THE FUTURE OF FINANCE

And the theory that underpins it

Preface

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Preface

The financial crash of 2008-9 has been the most damaging economic event since the Great Depression – affecting the lives of hundreds of millions of people. The most immediate problem now is to prevent a repeat performance.

Much has been written about reforming the world financial system. But it is rarely based on a searching in-depth analysis of the underlying weaknesses within the system. Nor does it usually tackle the key question of what a financial system is for.

To correct this omission, we invited eighteen leading British thinkers on these issues to form a Future of Finance Group.[1] They included journalists, academics, financiers and officials from the Financial Services Authority, the Bank of England and the Treasury. We have met twelve times, for what many of those present described as the best and most searching discussions they had ever participated in. The result is this book.

The issues at stake are extraordinarily difficult and profound. The central question is what the financial system is for? Standard texts list five main functions – channelling savings into real investment, transferring risk, maturity transformation (including smoothing of life-cycle consumption), effecting payments and making markets. But if we study how financial companies make their money, it is extraordinarily difficult to see how closely this corresponds to the stated functions, and it is often difficult to explain why the rewards are often so high. Any explanation must also explain why the system is so prone to boom and bust.

Chapters 1, 2 and 3 in the book deal with these fundamental issues: the ideal functions of the system; the way the system has actually operated; and the sources of boom and bust. To answer these questions much of the abstract theory of finance has to be abandoned in favour of a more realistic model of how the different agents actually behave. Central to this is opacity and asymmetric information, combined with short-term performance-related pay. For example, the asset price momentum which accompanies booms occurs because the owners of giant funds expect fund managers to shift into the fastest rising stocks. (They would do better to invest on a longer-term basis.)

The opacity of the system has increased enormously with the growth of derivatives. Did this contribute to high long-term growth? The issue remains open. On one side, people point to the high real growth in 1950-1973 (an era of financial repression) and the real cost of the present downturn. On the other side, many studies, discussed in Chapter 4, point to real benefits from financial deepening. But apart from this Chapter, all others in the book invoke the need for a radically simplified and slimmer financial system

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[1] Other regular members of the group (apart from the authors) were Alastair Clark, Arnab Das, Howard Davies, Will Hutton, Martin Jacomb, Jonathan Taylor, Dimitri Vayanos and David Webb.

There are four aims of such a reform. The first is to prevent the financial system destabilising the real economy, as it has in the recent past. The second (closely related) is to protect tax-payers against the possible cost of bailouts. The third is to reduce the share of real national income which accrues as income to the financial sector and its employees for reasons not related to the benefits it confers – thus absorbing into the sector talent that could be more usefully used elsewhere. And all of this has to be done in a way that works.

There are two main lines of approach. The first is **regulation –** higher capitalisation of all financial institutions, and levels of required capital that rise in a boom and fall in a slump. These are discussed in Chapters 5, 6 and 7. Chapter 5 points to some of the difficulties involved in any such regulation; Chapter 6 shows that asset price booms can be identified, at least sometimes; and Chapter 7 discusses how such information could be used, if there were an independent Committee specifically charged with "macroprudential regulation". (Chapter 4 argues by contrast that financial booms should be mainly controlled via interest rates.)

The second main approach to a more stable system is **institutional reform.** Chapter 8 argues strongly for the introduction of narrow banking. In such a system, only deposit-taking institutions could expect to be insured through the state, and they would not be allowed to build up a balance sheet of risky assets. This is a version of the so-called Volcker Rule.

Faced with these two possible lines of approach, Chapter 9 comes down in favour of strong regulation, linked perhaps to some institutional reform, aimed especially at greater competition. It argues that the state would in fact bail out any major financial institution threatened with bankruptcy, whether deposit-taking or not; it must therefore regulate all institutions.

Moreover managers must face totally different incentives and pay. In particular Chapter 9 suggest the managers should be liable to repay a substantial proportion of their pay if their institution requires state assistance or goes bankrupt within 10 years of their getting that pay.

All these proposals would directly reduce the profitability of banks and the pay of bankers. Do they have a chance? Chapter 10 documents the huge influence that banks exert in the political sphere worldwide. And it argues strongly that only a worldwide system of regulation embodied in a worldwide treaty organisation, like the WTO, could have a chance. In this context it is encouraging that the Working Party of the G20 Financial Stability Board which will deliver proposals to the G20 Summit this November is chaired by our first author, Adair Turner.

It has been an extraordinary privilege to chair the discussion of these chapters. The book was discussed at a major conference at Savoy Place, London, on July 14th 2010. Both the Conference and the work of the Group have been funded by The Paul Woolley Centre for Capital Market Dysfunctionality at LSE. We are extremely grateful to Paul Woolley for his financial support and for his foresight in establishing his Centre well before the crash.

The Group and the Conference have been jointly planned by Paul Woolley in his Centre and by myself in the Centre for Economic Performance. The Group has been superbly organised by Harriet Ogborn, and the Conference likewise by Jo Cantlay.

Richard Layard
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