The function of the financial services sector

July 2012 saw the publication of the final report of 'The Kay Review of UK Equity Markets and Long-Term Decision Making'.[1] At a British Academy Forum in January 2012, ***Professor John Kay FBA*** *queried the effectiveness of the financial services sector in satisfying the needs of the wider economy*

Production vs 'rent-seeking'

Economic progress everywhere depends on the extent to which entrepreneurial energy goes into production and innovation, rather than to wealth appropriation and 'rent-seeking'. How much effort do people devote to growing their own crops and managing their own livestock? And how much to stealing other people's crops and livestock, or taking a share in the produce that other people cultivate? This is one of the oldest questions in economic history. The effective support of productive activity over rent-seeking is the most important measure of the quality of economic institutions.

It is quite difficult to maintain the balance in favour of productive and innovative activity, and most countries through most of history have not been very successful. If the robber barons who built castles on the Rhine to collect tolls from passing river traffic had devoted the same enterpreneurial energy to seeking out new trading opportunities, the industrial revolution might have happened earlier than it did. The modern problem of rent-seeking takes different forms in different parts of the world. It takes one guise in China, with the curious role of the institutionalised Communist Party; a different version is found in sub-Saharan Africa, largely characterised by essentially kleptocratic states, and much the same structure of political organisation is found in Russia and several other parts of the former Soviet Union. In south-east Asia there is crony capitalism, and a different variant of crony capitalism created economic meltdown in Iceland and Ireland. These are all versions of the same problem: failure to manage the balance between rent-seeking and productive activity.

The economic success of western Europe and North America has come through relative success in controlling rent-seeking. In modern western economies there have been two main channels for rent-seeking. One is the use of large corporations to exercise economic and political power for the aggrandisement of individuals who control them. The second is engagement with the mechanisms of democracy by concentrated producer interests or by groups of organised workers to subvert the mechanics of the state in order to extract rents for the benefit of those particular groups.

Financial sector

The economic history of the last 30 years has been the story of a moderately effective drive against the second kind of rent-seeking, Britain has been at the forefront of attacks on the power of regionally concentrated producers to secure subsidy or protection for uncompetitive industries, and the ability of organised labour, especially in the public sector, to achieve pay, conditions and staffing levels well above the rates needed to attract capable employees. Simultaneously, there has been a rise, or perhaps revival, of the first type of rent-seeking, the use of large corporations as vehicles for wealth abstraction by controlling individuals and their supporters. The financial sector has become the principal focus of the most aggressive rent-seeking behaviour in modern economies. People who have the entrepreneurial drive and selfish character to be effective rent-seekers have tended to congregate in the City of London and on Wall Street, and the scale of rewards that are derived there has attracted many more.

The crash of 2007-8 was a direct consequence. As the financial sector has expanded in the western world, a series of crises has followed. These crises have all been very different in proximate form, while all having similar fundamental underlying causes. There is a common character to the Asian market debt crisis of the mid to late 1990s, the new economy bubble at the turn of the century, and the growth and subsequent collapse of the securitisation of credit from 2003 to 2008. Some asset mispricing occurs in particular markets. Herding behaviour exaggerates that mispricing, as capital and traders are attracted to the profits created by asset

[1] www.bis.gov.uk/kayreview

overvaluation. Then the mispricing is abruptly corrected, imposing large collateral losses not just in the financial sector but in the non-financial economy, and governments have intervened to mitigate these consequences by providing large amounts of public money to the financial system. That public money has essentially provided the fuel for the next market crisis. That is what we did after 2008, with inevitably the same results, and the next version of the same cycle may not be far off.

Regulation

It is understandable that people should react to these developments by saying that what we need is more regulation. But the problem we had in the years before 2007 was not that we did not have regulation – financial services is a heavily regulated industry. The problem was that the regulation we had was useless, or worse. One of the principal drivers of the creation of complex financial instruments was regulatory arbitrage – the construction of securities which have the same economic substance but more favourable regulatory treatment, while many of the problems emerged in vehicles which had been constructed to fall outside the scope of any regulatory supervision.

Responses to the crisis are characterised by a dual form of regulatory capture. There is the familiar form of such capture: regulators come to see the health of the industry through the eyes of established firms in the industry. It is difficult for regulators to see things in any other way, because that is where industry-specific expertise lies.

In financial services we have a second, and in some ways graver, form of regulatory capture: the growth of a very large regulation industry. This consists of regulatory agencies themselves, of people in regulated firms who are employed in compliance activities, and a large intermediate group of advisors and consultants. This industry has become large, and its interest, as with most industries, is expanding the scale and profitability of its own activities. The outcome is a regulatory activity that is at once extensive and intrusive, growing in scope and intensity, and yet largely ineffective, as repeated scandals demonstrate.

Secondary markets

In my view what we need is not more regulation. In many areas we probably need less regulation. What we have currently is a financial services sector that supports large volumes of secondary market trading, but which is not very good at meeting the rather modest needs of capital for new businesses and new investment of a modern economy. Non-financial business is now much less capital-intensive than it was when the institutions of the modern market economy were developed. But the mechanism we have is still bad, particularly in western Europe, at generating funds for early stage businesses, the main area in which fresh capital is required to support productive and innovative activity.

Instead we observe an almost unbelievable volume of trading in secondary markets, and a payments system that is far inside the frontiers of what is technologically possible. The needs of the non-financial economy for financial services, although real and important, are modest: a certain amount of seedcorn financing, and a cheap and efficient and quick payment system – there is not much more to it than that. That is not what we are providing, nor is it the direction in which we are travelling. A financial system far larger than we need has created business cycles of increasing amplitude. We face the danger – familiar whenever society loses control of a group of rent-seekers – that the oligarchy which benefits from rent accumulation goes on entrenching its own power and scale, until the point at which it provokes a crisis that is social and political as well as economic. That is the depressing outlook which we face following the ineffectual political responses to the crash.

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On 26 January 2012, a British Academy Forum, held in association with the Social Market Foundation, considered 'The Politics of the Market after the Crash'.