What Finance Is For

And How It Veered Off Course

By John Kay
stock prices, and when news about output, employment, or products is released, the media turn to Wall Street for an assessment of its significance.

Business policy is likewise conducted with an amount of attention to Wall Street that would have been inconceivable two generations ago, and the chief executives of modern companies proclaim allegiance to the promotion of “shareholder value.” Economic policy, too, is conducted with a view to what “the markets” think, and households are increasingly forced to rely on those same markets for their retirement security. Finance is the career of choice for a high proportion of the top graduates of the top schools and universities.

A country can only be prosperous if it has a well-functioning financial system, but that does not imply that the larger the financial system a country has, the more prosperous it is likely to be. Financial innovation was critical to the creation of an industrial society; it does not follow that every modern financial innovation contributes to economic growth. Many good ideas become bad ideas when pursued to excess.
The central characteristic of the recent process of financialization in Western economies has been a shift from relationships to transactions. The traditional bank manager—whether he (it was always he) was a titan of finance, such as JP Morgan, or a community figure of the kind epitomized by George Bailey in *It’s a Wonderful Life*—would base his decisions on his personal knowledge of his clients. The stockbrokers of yesterday would be personally familiar with the companies they recommended to customers they knew. Investment banks maintained long-term relationships with large companies. They would have similar connections with institutions, such as the insurance companies that channelled the capital of small savers into infrastructure and business investment.

The world of finance today is dominated instead by trading, and trading is a principal source of pay and profits. Fifty years ago, there was one large speculative financial market—the stock
government bonds were bought and sold, but the bond market was sleepy in the extreme. Thirty years ago, activity was shifting to the trading floor of investment banks. Today, the screen is the source of information and the basis of trading: an increasing fraction of trade is conducted by computers silently transacting with each other.

Anonymous markets have thus replaced personal relationships. The rise of the trading culture has no single explanation. It is the product of a series of developments, interrelated in origin and cumulative in impact. The globalization of financial markets was part of the story, and so was the breakdown of the post-war Bretton Woods system of fixed exchange rates. The creation of new markets in derivative securities, and the development of the mathematics of financial markets needed to analyze them, was another factor. Regulation and deregulation played a large, but partly accidental, role: few of the consequences of regulatory policy changes were intended. Institutional reorganization played a part as well; traditional forms of business structure, such as the partnership and the mutual, were folded into public limited companies. After the elections of Margaret Thatcher in the United Kingdom and Ronald Reagan in the United States, the political consensus was increasingly that markets were good and more markets were better.

The list of factors contributing to the change is long, and has one striking feature: it had little to do with any change in the needs of the real economy. These needs remain much the same.
face in our economic lives. Some aspects of these services are better, many are not. Information technology has changed the ways in which financial services are delivered. But there has been no transformation in the services provided to customers comparable to the transformation in the nature and political and economic role of the industry that provides them. The process of financialization, in other words, had its own internal dynamic.

The finance sector has always operated by establishing claims against assets—the operating assets and future profits of a company, or the physical property and prospective earnings of an individual—and almost any such claim can be turned into a tradable security. If securities are claims on assets, derivative
securities, you can create further layers of derivative securities whose values are dependent on the values of other derivative securities—and so on. In this way, a vast superstructure of financial claims, its scale and interactive complexity both costly and fragile has grown from a narrow foundation of economic activity.

The value of derivative contracts outstanding is three times the value of all the physical assets in the world. World trade has grown rapidly, but trading in foreign exchange has grown much faster. The value of daily foreign exchange transactions is almost a hundred times the value of daily international trade in goods and services. High-frequency trading is undertaken by computers which are constantly offering to buy and sell securities. The interval for which such securities are held by their owner may be quite literally shorter than the blink of an eye. Spread Networks, a telecoms provider, has recently built a link through the Appalachian Mountains to reduce the time taken to transmit data between New York and Chicago by a little less than one millisecond just to facilitate even faster blinks.

What is it all for? And why is trading so profitable? Common sense suggests that if a closed circle of people continuously exchange bits of paper with each other, the total value of these bits of paper will not change much, if at all. If some members of that closed circle make extraordinary profits, these profits can only be made at the expense of other members of the same circle. Common sense suggests that this activity leaves the value
Not much. The events of 2008 demonstrated that much of the reported profitability of the finance sector had been illusory; it was money borrowed from the future, but distributed in the present to the senior employees of financial institutions. Shareholders and taxpayers were in due course called on to repay. The broader costs to governments and global growth are evident to all.

The world economy is gradually recovering from the crisis of 2008. But the fundamental sources of instability, and the divorce between the activities of the finance sector and the needs of the non-financial economy are largely unchanged. We need a finance sector to manage our payments, finance our housing stock, restore our infrastructure, fund our retirement, and support new business. But very little of the expertise that exists in the finance industry today relates to the facilitation of payments, the provision of housing, the management of large construction projects, the needs of the elderly, or the nurturing of small businesses. The process of financial intermediation has become an end in itself.
that already exist. High salaries and bonuses are awarded, not for fine appreciation of the needs of users of financial services, but for outwitting competing market participants. In the most extreme manifestation of a sector which has lost sight of its purposes, some of the finest mathematical and scientific minds on the planet are employed to devise algorithms for computerized trading in securities that exploit the weaknesses of other algorithms for computerized trading in securities.

Solutions to these problems are not to be found in more regulation. Financial regulation is today an industry in its own right, encompassing the staff of agencies, compliance personnel in financial institutions, and consultants and lawyers who mediate between them. That industry not only failed to anticipate, far less prevent, the crisis; it had no coherent strategy of response. Like all industries, it has a vested interest in its own expansion, and took advantage of the global financial crisis to achieve that growth; it was barely possible to keep up with the plethora of acronyms describing new agencies, committees and supervisory bodies. And, whatever the rhetoric, none of this activity was aimed at fundamental reform: rather, it was to make better, or at least more extensive, use of the skills and expertise regulators and their associates already have.
Financial regulation suffers not only from the institutional capture resulting from the political influence of large financial firms, but cognitive capture, in which the activities of the industry are viewed through the lenses of those who work in it and its performance judged by criteria it has itself determined. The regulatory obsessions with the promotion of liquidity—interpreted as high volumes of trading—and the creation of a chimerical level playing field, an environment safe for anonymous traders, are preoccupations that serve the needs of
which focuses on the structure of the industry and the incentives of individuals and firms within it, rather than the creation of ever more complex prescriptive rulebooks. A modernised Glass-Steagall rule, which mandates the separation of investment and retail banking, is only the beginning of the necessary structural reform. The combination of functions that characterizes the modern investment bank—corporate advice, securities issuance, market making, asset management, and own account trading— is riddled with inevitable conflicts of interest, and the resulting informational advantages are a significant source of industry profitability.

We need a smaller, simpler, financial services system better adapted to the purposes of the non-financial economy—an efficient payment system, effective capital allocation, greater economic stability, security in planning and managing our personal finances, and justified confidence in the people who advise us. One in which focused businesses, which deal directly with savers, borrowers and businesses, rather than each other, earn profits directly related to the value of the services they provide to users. And one in which the influence of the finance sector on political activity has been reduced to its rightful place.
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