

How the financial system helps society innovate and develop
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It is easy to be gloomy about the contribution of the financial system to society in the aftermath of the 2008 global financial crisis and the subsequent eurozone sovereign debt crisis. Governments wrote very large cheques to ensure that the financial system did not freeze up. Some countries' financial systems, indeed their state finances as a whole, buckled. Quantitative easing and other unconventional monetary policies were adopted, to try to get economies working more productively. These policies have brought new challenges, such as negative interest rates, which have the potential to disrupt the financial health of life insurers, pension funds and other parts of the financial system that weren't initially too affected by the global financial crisis.

However, a different picture emerges if we adopt a longer term perspective. In this note I want to present the positives that the financial system has brought to society, and the innovations and developments it has fostered.

It seems to me that the invention of money, several thousand years ago, itself ranks as one of humanity's more important inventions. Money makes practical the effective division and specialisation of labour and of other factors of economic production. It allows us to borrow or save depending on whether our current productive activities are less than or greater than our immediate consumption needs.

Niall Ferguson very effectively argues in his 2009 book *The Ascent of Money* that the extent to which a society adopts modern financial practices (such as those underpinning modern capital markets, banking and insurance) strongly links to its overall competitiveness. It is probably impolite for me, an Englishman writing for an audience who are mainly French, to point out one of the arguments he advances to support this thesis.

He argues that the English beat the French to global domination for much of the 1700s and 1800s not because England had a larger population or even initially a larger economy but because England had a better developed financial system (a better functioning central bank and stock exchange etc.) that was better able to raise the funds needed to wage wars at the time. These were financial innovations that the English had incidentally copied from the Dutch, proving that first mover advantage isn't always necessary for success. The success of the USA in the 20th century (including it coming out on the winning side in both World Wars) was also partly due to it being better at marshalling its capital and financial resources than other countries.

My own profession, the actuarial profession, has been significantly involved in several major financial innovations through time. These include the development of life insurance from its roots in the 1700s and the more recent development of pension scheme financing structures. It is easy in the glitz of modern finance to ignore the social innovations that the financial system has helped to bring about and nurture. The development of modern welfare states and of methodologies to channel savings into investments so that we are not all destitute in our old age is a major achievement.

These developments also highlight another aspect of the financial system. It has a symbiotic relationship with the rest of society. Pension funds and other long term aspects of finance cease to be practical if the economy and society in which they exist break down. Countries that have suffered revolution or the collapse of political structures often also suffer financial meltdowns such as

hyperinflation, and vice-versa. Ultimately the financial system is sustained by social contracts and societal norms of 'fairness' that humans collectively decide should guide their day-to-day lives. We (i.e. all of us forming human society) think that there should be some 'fair' distribution of rewards to individuals who have supported these rewards, whether their contribution comes from their labour, their savings or their intellectual ingenuity. The modern financial system provides a mechanism for sharing out these rewards. Granted, it is far from perfect and does not always divide up rewards in ways that we collectively consider are 'fair'. But despite its complexities and short-comings it still arguably gets closer to the 'right' answer than any other way of ordering society we can think of, particularly since we can override its end outputs via taxes, welfare systems and other redistributive mechanisms if we so wish.

As society has industrialised and left its old agrarian roots, society has also had to develop mechanisms to foster economic cooperation involving large projects and sometimes large distances. Financial innovations that were radical at the time but which we now take for granted, like the development of the joint stock company, originally played crucial roles in developing trade across large distances (like the English and Dutch East India Companies). Corporations now form the bedrock of most economies.

In more recent years, the financial system in the form of venture capital funds has been extraordinarily supportive of new ideas, innovation and entrepreneurship. Much of the money these funds have deployed has come from pension funds and endowments, themselves products of and parts of the financial system. Some larger corporations, including the tech titans but by no means limited to them, have also been extremely innovative, and not just within seed capital units akin to internal venture capital funds that they have set up to invest in other organisations.

Frank Knight in his seminal 1921 work *Risk, Uncertainty and Profit* highlights the strong link between entrepreneurship and 'uncertainty' (of a form that is nearly impossible to quantify with much precision, in contrast to 'risk'). Humans are supposedly typically risk averse, so what is it that predisposes some of us to dream up and try to implement new business ideas, when the statistics indicate that most of them will fail? Much of this is no doubt down to temperament, our creative instinct, our social drives and lots of other aspects that form part of the human psyche. But I think that the financial system also plays a part, whether it be venture capital funds, modern capital markets that provide an 'exit route' or modern institutional investors who recycle savings in the pursuit of profitable investment opportunities.

More difficult to say is whether some of the innovations that the financial system has applied to itself are always as socially useful. This was certainly an accusation levied against some more complex financial structures during the depths of the 2008 global financial crisis. Those who work within the financial sector tend to see it as fairly Darwinian in nature, with poorer ideas fairly rapidly falling by the wayside but more helpful ideas having a longer lifespan. But few would disagree with a desire to limit the adverse impact on the public purse when some of these innovations go wrong. This partly explains the increased emphasis on systemic risk and macroprudential policy in today's regulatory environment, and the increasing regulatory burdens placed on firms in the financial sector. Financial firms too often these days seem to be mentioned in the press because of conduct-related fines they are being required to pay for past misdemeanours. The financial system is still a work in progress. Structures and incentives within it need further refinement to make the system as helpful as possible to the wider needs of society.

But please take the longer view. Society would be unrecognisable and a lot worse today if past financial innovations hadn't happened and the financial system hadn't channelled our productive efforts into supporting innovation and development. For sure, there are weaknesses and flaws in the

edifice that financiers have built and the rest of us have contributed to. The trick is to recognise these weaknesses, address them and modify the outputs of the financial system so that it better meets society's needs, rather than scrap it and return to a barter based stone age existence.