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Back to the Basics – What Are the Flaws in the Financial System?*

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Vedat Akgiray:
Good Finance: Why We Need a New Concept of Finance
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Pallas Athéné Könyvkiadó, Budapest, 2020, p. 155
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The primary task of the financial system should be to serve the real economy. Opinions vary as to how well it does in this regard. According to Mariana *Mazzucato* (*2017*), a renowned contemporary economist, it extracts value rather than creates it, and Vedat Akgiray's book is based on a similar premise.

Why does finance appear detached from the real economy, seemingly becoming an end unto itself? What are the flaws of the financial system and what remedies are there? One inevitable legacy of the crisis is reflection. In an environment where the global economy struggled to recover from the 2008 meltdown and now once again finds itself in crisis, where there are fresh memories of prominent players of the global financial system being bailed out using taxpayer's money, where the top executives of international banks often earn over a hundred times more than the average employee as income inequalities widen, the popularity of the topic should come as no surprise. Yet Akgiray's book is not merely one of the many touching on the topic. It is noteworthy for several reasons.

The author poses fundamental questions, without assuming extensive prior knowledge of the readers about the financial system. Supporting material is provided throughout, with carefully chosen, telling statistics. The book was written by someone who is not only an academic and a former university teacher, but also a hands-on expert: he headed Turkey's Capital Markets Board and became a go-to

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figure at an international organisation during the 2008 crisis. The book, therefore, offers a nice blend of theory and practical experience. Last but not least, although the author is intimately familiar with the financial processes of the developed world – not least because of his work at the IOSCO (International Organisation of Securities Commissions) – he is strongly linked to a developing country, Turkey. Perhaps the perspective of a less mature financial system lent him some courage to question the value added of the large and complex world of finance in order to complement the multitude of internationally-acclaimed books – most of which were written by authors from advanced economies.

The book starts with the aim of finance, underlining that it connects various stakeholders in time and space, enabling flows of money and risk. This is followed by a brief historical overview documenting that the countries with more efficient financial systems have developed more rapidly. In high-income countries, financial markets are much larger relative to GDP than in middle- or low-income countries. Financial markets in high-income countries have experienced a spectacular expansion since the 1980s, related to deregulation measures, the rise of global free trade, technological progress and the credit boom driven by both the consumer society and the growth needs of developing countries. While earlier crises were typically isolated in space, the operation of the global financial system has led to widespread contagion. Although the author does not blame the financial system alone for the 2008 global economic crisis, he notes – consistent with several studies – that financial crises compound real economy crises.

After the historical introduction, Akgiray takes stock of what he views as the most crucial problems with the financial system. First, he believes that the financial sector is too large. Since the 1980s its growth has far exceeded that of the volume of trade or the global economy. Also, the trading of derivatives – a type of financial instrument – takes place overwhelmingly among financial institutions, which Akgiray – somewhat questionably – cites as evidence towards finance serving itself. Do we see economies of scale in the (now) larger financial sector? The author's answer is a definite no, stressing that the sector's productivity has diminished as it increased in size. One only needs to think of an equity fund that determines its asset management fee as a share of the assets managed: in a bull market, the asset management fee rises, although it is unclear why asset management or advisory services would cost more in such a situation. Technological innovations and the synergies arising from globalisation should have reduced the unit cost of intermediation.

An oversized financial system is also detrimental to the real economy because it can lead to excessive lending, partly to less profitable and risky projects and borrowers. Moreover, the high salaries paid in the sector could divert the best workers from other, more productive sectors. To cite James Tobin, one of the most influential economists of his time, '*we are throwing more and more of our resources, including the cream of our youth, into financial activities remote from the production of goods and services'* (*Tobin 1984:14*).

Closely linked to the oversized financial system is the high level of credit and debt. The world has become even more indebted since the crisis (including relative to GDP). Although in Europe and the United Kingdom the volume of bank lending decreased, this was more than offset by the rise in bank lending in China. And government securities and corporate bond holdings have expanded globally. Few economists dispute the potential of high indebtedness to increase vulnerability with a potential to curb economic growth. Why is it then that regulation is unable to rein in the growth of credit and debt? The author maintains that this is the result of the institution-based regulatory approach. The shift towards market-based lending is partly the result of the fact that, in response to demand, the market creates new credit that is not constrained by existing regulations.

At an aggregate level, the high level of debt is coupled with little equity. There are fewer and fewer initial public offerings (IPOs). What is even more surprising is that in Western countries, the number of publicly listed firms continues to decline. Conversion back into a private company has become popular, often by buying back shares using debt finance. Alongside questions about share prices derived from stock market trading as well as the role of long-term factors, the author notes the oft-cited tax environment as a hindrance. While interest payments on loans reduce corporate tax, dividend payments on stocks do not. In fact, in OECD countries the effective tax rate on capital is, on average, 10 per cent higher than in the case of debt financing.

Akgiray argues that the ecosystem of finance has become unnecessarily complex. With so many profit-maximising players it is no wonder that economies of scale are lacking. While prior to the 1980s the overwhelming majority of publicly-traded shares in the US were held by households, nowadays the majority are owned by institutional investors. Of course, ultimately even today most capital owners are households. Nonetheless, the remuneration structure of fund managers and corporate executives incentivises measures that contribute to short-term stock price increases, which do not necessarily serve the long-term interest of these households. Also, the regulatory authority has responded to the complex system with complex regulation, with increasing compliance costs further reducing productivity.

Akgiray believes that macroeconomists, financial economists and central banks are resistant to change. Financial regulation is still fragmented both geographically and in terms of substance, and central banks have little wiggle room. The most unfortunate legacy of the 2008 crisis is that people have no confidence in the financial system.

The world desperately needs a paradigm shift in finance. With this in mind, the author outlines a number of proposals to address the aforementioned problems. Unsustainable borrowing needs to be limited and corporate tax rules need to be changed, phasing out the incentives for borrowing. Share issues should be promoted by transforming the stock exchange model and revisiting regulatory burdens, with special attention to small firms. Although borrowing induced by the consumer society is difficult to curb, the 'skin in the game' approach should be strengthened at lenders.

Financial regulation should be structured by function rather than on an institutional basis, and this view is becoming increasingly popular as fintechs appear. Accordingly, banking and securities market supervisors should merge, and cross-border cooperation should be enhanced, reflecting the global nature of financial markets. The system has to be simplified. *'It is absurd to spend valuable resources on managing the risks manufactured by self-inflicted complexity'* (p. 129).

Promoting overall financial literacy is a popular goal all over the world. According to the *OECD* (*2017*), at least 55 countries have advanced plans or have already started implementing the national strategy of financial education. Nevertheless, Akgiray does not focus on educating the wider society. He believes that it is especially important to lay new foundations for the education of the limited number of future financial experts, because theoretical finance as taught today is far removed from the real world.

In his book, Akgiray does not intend to examine a single issue in meticulous detail by comparing and contrasting arguments on both sides. Instead, he focuses on the big picture to spark a debate using straightforward reasoning and encouraging dialogue. He is a disillusioned author, who believed for decades that finance served 'economic prosperity and social progress'. In Akgiray's words, he wishes to provoke 'wiser people' to think about the flaws of the financial system and how they can be fixed. With its approach questioning the very fundamentals, its clear questions and the statistics presented not only does the book serve this purpose perfectly but it also makes for an easy read. Enjoy!

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