A. D. BAIN

The Economics of the Financial System

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TO ANNE

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PREFACE

Students of economics often reach the end of their courses with only the most basic knowledge of the financial system. The macro-economic models they meet concentrate on saving, investment, money and 'the' rate of interest. The entire range of non-monetary financial instruments is represented by long-term securities. The only financial institutions worthy of detailed attention are banks, some of whose liabilities happen to be money, with other institutions considered only in so far as their activities complicate the tasks of the monetary authorities. While bond-holders' attitudes have a crucial influence in the Keynesian model, the financial system itself is down-graded – it is the level of income, rather than the interest rate, which brings saving and investment into balance, and the rate of interest depends only on the demand and supply of money.

This comparative neglect of the internal workings of the financial system contrasts with a high level of public concern. Financial institutions have always been in the public eye and frequently attract politicians' attention. The availability of finance, the terms which lenders demand before parting with their funds, and the economic power wielded by large financial institutions are matters for controversy. Public debate, however, is seldom founded on a deep understanding of how the financial system works, partly due to the complex nature of the system itself and partly to the reticence of its practitioners.

The evidence submitted to the Wilson Committee (Committee to Review the Functioning of Financial Institutions) did much to overcome this reticence, and the Committee's report contained an authoritative account of many important aspects of the UK financial system in 1980. While some people will disagree with the Committee's recommendations, there is now less excuse for ignorance and misunderstanding. Nevertheless the report does not pretend to go into the theory of the system in any detail, and the treatment is selective, linked to the questions the Committee was asked to consider, rather than comprehensive.

My object in this book has been to provide a complete account of the working of the financial system in the UK at a level which is suitable both for students with only a basic course in economics behind them and for informed laymen or people embarking on a career in the financial sector. I have tried to put the emphasis on *behaviour* – what motivates the actors in the financial system, why they behave as they do, what constraints influence the decisions they take – rather than on detailed descriptions; these can be found elsewhere, as for example in Jack Revell's excellent book, *The British Financial System*. I have also attempted to provide an evaluation of the efficiency of the financial system in Britain, and to consider some issues of current interest.

The framework around which the book is organized is the flow-of-funds table. This is introduced in Part I in the context of a brief overall view of finance in the UK. The sectors are discussed in Part III and the institutions and markets in Part IV.

Part II, which precedes the institutional material, deals with the theory of financial systems. It is the most technical section of the book; readers who are prepared to take on trust the important part played by financial institutions and markets in mobilizing saving and stimulating productive investment may choose to skip the indifference curve analysis in Chapter 3. Chapter 4 deals with asset transformation in a non-technical fashion and Chapter 5 contains a loanable funds model of interest rate determination. I have not entered into the debate concerning stocks and flows, nor attempted to reconcile loanable funds with Keynesian interest theory – though the possibility that interest rates may fail to balance saving and investment at a high level of income is discussed later.

Parts III and IV draw upon this theory to explain the behaviour of the participants in the financial system. The importance of structural and legislative factors is emphasized, as well as the market considerations, which are usually more central to economic models. Some issues concerning the needs of particular sectors or the facilities provided by the financial institutions are discussed in the relevant chapters.

Part V contains three chapters on broader issues: first, the efficiency of the system as a whole and its success in meeting the demands which fall upon it; secondly, the effects of inflation and possible remedies for the difficulties it causes; thirdly, the thorny questions of whether, and if so what, changes in the financial system are needed in order to promote industrial investment in the UK.

Some, but not all, of these issues were considered in the report of the Wilson Committee. My work on the book has arisen naturally

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out of my service on that Committee, and I acknowledge my debt to my colleagues – not least to those with whom I frequently disagreed. I am also indebted to colleagues at the University of Strathclyde, particularly John Harvey for the many helpful suggestions he made, and Dick Davies who cast an informed eye over a key chapter. Neither is responsible for any heresies or errors that remain. My greatest debt, however, is to my secretary, Jean Paterson, who worked tirelessly at successive drafts and without whose dedication the book could not have been completed at this time.

A.D.B.
May 1981

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1 THE FINANCIAL SYSTEM

Everyone has some contact with the financial system. We are all aware of financial institutions like banks, building societies, and insurance companies, each providing in its own way for some of our everyday needs – for example, payments facilities through banks, convenient savings and access to home loans by building societies, and car, house, or life insurance. Other financial institutions, such as investment trusts, development capital companies, and the National Enterprise Board – to name only a few – are less well known and carry out more specialized functions. Most people also know something about financial markets, like the Stock Exchange where securities are bought and sold, though comparatively few are directly concerned with their activities. Again, there are other important but less familiar financial markets, like the money market in which large sums are borrowed and lent for very short periods, and the foreign exchange market in which dealings in foreign currencies take place. All these financial institutions and markets fit together into a network which comprises the financial system.

The quality of the services provided by the financial system affects the performance of the economy as a whole. The most basic function of any financial system is to facilitate payments in the economy. Normally the responsibility for providing the necessary facilities falls on the note-issuing authority – the government or the central bank – and the commercial banking system. Satisfactory payments facilities are something which we are inclined nowadays to take for granted, but productive economic acitivity is dependent on their existence, and indeed on traders having reasonable access to short-term credit facilities.

Important as payments facilities are, they will receive relatively slight consideration here, because a properly developed and smooth-running financial system can do much more for the economy. It raises the levels of saving and investment and provides incentives for

PART I INTRODUCTION

This Part is intended to provide the reader with the background knowledge required for the more detailed discussion which follows in the rest of the book. The first chapter is an introduction to the functions of financial systems in economies, their importance, and the ways in which they perform their tasks. The second provides a bird's-eye view of the UK financial system, focusing on the salient features. Attention is drawn to the sizes and importance of the major institutions, the levels of saving and investment in the economy and the sectors in which they are found, and the financial channels through which savings flow on their way to investors. The flow-of-funds framework is introduced as a means of providing a coherent description of financial activity, and as the organizing framework for later chapters.

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the allocation of the available resources to those uses where they are likely to give the highest returns. The financial system thus facilitates effective capital accumulation, one of the major engines of economic growth, and it is the saving/investment aspect which will be the focus of our attention.

How well the financial system of a country satisfies the needs of users is a matter for public concern. By their very nature financial institutions attract criticism: bankers would not be doing their jobs if they did not turn down some requests for loans, and those who are denied funds sometimes feel hard done by and are vociferous in their complaints. The control which financial institutions wield over very substantial sums of money also attracts the attention of governments, partly because they may see irresistible opportunities to secure cheap finance for favoured borrowers (notably governments themselves), and partly in view of the economic power attached to control of finance. Official enquiries into the financial system are therefore not uncommon. The most recent British enquiry was the Wilson Committee on The Functioning of Financial Institutions, which reported in 1980.[1] It had broad terms of reference, with special attention being given to the finance of industry and trade. In Australia, the Campbell Committee[2] is conducting a similar investigation, though its main thrust is on the extent of government regulation in the system. In Germany the Gessler Committee[3] recently examined the structure and activities of the banking system, with a particular concern for the influence which the banks' central position in the financial system gave them over industrial companies. There are many other examples. But whatever the particular slant of each enquiry, the objects are generally to ascertain whether the organization of the financial system and the practices of its institutions are in accordance with the current needs of society, and to make recommendations for improvements.

Any evaluation of the financial system should be founded on an understanding of its functions within the economic system as a whole, and the means by which these can be carried out. This must be complemented by a knowledge of users' requirements, of the behaviour of institutions, and of the market practices. Moreover, institutions and markets cannot be viewed in isolation, for it may not be important that one category of financial institution makes no provision for certain needs if these can be satisfied elsewhere in the system. What matters is not the shapes of the individual pieces, but how well the jigsaw fits together and the quality of the picture that emerges.

THE PARTICIPANTS IN THE SYSTEM

The participants in the financial system can be classified into five broad groups: savers, investors and other borrowers, financial intermediaries, brokers and advisers, and regulators. At one edge of the financial system are the *savers*, i.e. those whose current spending is less than their income and who have money available to lend to others. Opposite them are the *investors*, who want to borrow money in order to buy capital goods or increase the scale of their business, and other borrowers who want to spend more than their incomes. In between lie the financial institutions and markets. Ensuring that money flows smoothly from savers through institutions and/or markets to investors is an important function of the financial system. It is the ultimate savers and ultimate borrowers who are, as it were, on the periphery of the financial system, whose needs it serves and who provide the rationale for its existence.

Nevertheless, a good deal of the business of financial institutions and activity in financial markets is generated, not by new saving and investment, but by rearrangements of existing savings or changes in the form of existing borrowings. People shift money from bank accounts to building societies or vice versa, and firms raise new long-term capital in order to pay off short-term debts. Moreover, investors do not always need to borrow in order to finance expenditure; they may choose instead to run down savings accumulated from earnings previously, or they may use balances obtained by borrowing on other occasions. By permitting economic agents to organize their financing in a flexible manner, the financial system helps to make all this possible.

Financial intermediaries are institutions which attempt to serve the needs of both lenders and borrowers. As we shall see later the forms in which savers wish to hold their savings, for example bank deposits, frequently differ from the ways in which borrowers would like to obtain their funds, for example long-term loans. Financial intermediaries are often able to reconcile these divergent requirements. In addition they provide a variety of specific services which savers and borrowers value in their own right. Examples are money transmission facilities and advice on corporate finance in the case of banks, and life assurance cover in the case of insurance companies. Moreover, while there is nothing to prevent savers and investors from dealing directly with each other if they wish, the existence of financial institutions makes direct contact unnecessary, since both groups can deal with the intermediating institutions.

In a competitive financial system (like that in Britain) institutions compete for business in broadly construed 'markets' for saving and lending business; they seek to attract funds from savers and supply funds to borrowers. But there are also *organized* markets, which provide facilities for economic agents to borrow and lend or to buy or sell securities. The main role of *brokers and advisers* is to help these organized markets to function properly. Brokers and advisers provide information to participants in the markets, and attempt to ensure that lenders and borrowers, buyers and sellers, have the facts they need to strike a fair bargain. They also perform the vital task of putting actual lenders and borrowers in touch with each other – for example, the money-market broker brings together the lender who has money to spare with the borrower who wants it temporarily. By obviating the need for individual borrowers or lenders to search out counterparts themselves the brokers substantially reduce the transactions costs involved in borrowing and lending. In some markets there are also professional dealers, whose function is to ensure that lenders and borrowers are always able to find a counterpart for their deals.

Historical experience in many countries has shown that where large sums of money are involved in financial markets there is a considerable danger of fraud or other malpractices. Most countries therefore need *regulators*, who control their financial institutions and regulate dealings in securities markets with the objects of ensuring that the financial institutions are able to honour their commitments, that people have access to relevant information before they enter into contracts, and that dealing in securities is fair. These rules come under the general heading of *prudential* regulations. But more general *economic* controls are also needed. Sharp expansions or contractions of activity in financial markets are often associated with booms and slumps in the economy at large, and the intimate connection between money, credit and economic stability compels countries to curb the expansion of credit in some periods and to stimulate it in others. Economic controls may also be required to guard against monopolistic structures or practices in the financial system.

FINANCIAL INSTRUMENTS

The financial system deals in financial instruments or claims. These are all more or less sophisticated forms of IOUs – they are an asset of one party and a liability of another. In most instances the former

party is entitled to repayment at a specified time, and also receives a promise of some interest, share of profits, or other service as compensation for his loan. For example, deposits are liabilities of banks or other institutions, are generally repayable on demand or in the fairly near future, and usually bear interest. Loans are often liabilities of ultimate borrowers, are usually repayable by the end of some predetermined period, and carry an obligation to pay interest. And ordinary shares are liabilities of firms, which confer on their owners the right to a share of the profits earned but, in contrast with loans, do not have to be repaid. Although a wide variety of financial instruments exists, differing significantly in detail, the major distinctions rest on three characteristics – risk, liquidity and susceptibility to loss of value due to inflation.

A distinction can be drawn between on the one hand deposits and loans, which are generally made only if repayment of capital and interest is confidently expected, and on the other company shares, which are claims to a share of the surplus incomes after prior claims have been met. People think of their deposits with financial institutions as safe,[4] and loans are usually secured on assets or made conditional on the borrower's financial performance, to give the lender added confidence in the safety of his funds, though there is usually some small chance of partial or total loss. The *risk* of loss, and conversely the possibility of gain, is heavily concentrated on equity assets, mainly the ordinary shares of companies. The shareholder is entitled to his share of the company's profits but must also accept the chance of experiencing some loss. Indeed, for reasons discussed in Chapter 7, the effects on the shareholder of success or failure of a company are magnified if the company has loans outstanding as well as ordinary shares.

Liquidity refers to the ease and speed with which savings in non-monetary form can be turned into cash, and reflects both the *maturity* of financial instruments and their *marketability*. By maturity we mean the time which elapses before a deposit or loan is due to be repaid. Deposits which are repayable on demand have a short maturity, mortgage loans due for repayment after 25 years a long one. Thus maturity covers a very wide range, and the shorter is the maturity of a deposit or loan the greater is its liquidity. But assets which are marketable may also be liquid, even if they are not automatically repayable in the near future. For example, ordinary shares in many companies can be sold at short notice and their value turned into cash, though at a price which is uncertain. Not all assets are marketable – fixed-term deposits are an example – and in other

cases the ease of selling and ability to obtain a reasonable price may be in doubt. A house may be for sale for many months and the price received will be a matter for negotiation. The existence of an organized market for an asset and the ability to deal at short notice therefore adds to the asset's liquidity.

The third distinguishing characteristic of financial instruments is their susceptibility to loss of value due to a rise in the general price level – *real value certainty*. Neither deposits nor loans, whose values are fixed in money (or *nominal*) terms, provide their holders with protection against price-level changes. Ordinary shares stand a good chance of doing better on this score, because profits can be expected in the end to rise roughly in line with the general price level, though there may be prolonged periods when this does not hold good. Indeed, over a long period, probably the safest asset to hold in real terms is a physical asset, property, rather than any form of financial instrument.

SAVERS AND INVESTORS

In developed economies decisions to invest are often taken separately from decisions to save. The investor may be a company manager who wishes to expand the activities of the firm by which he is employed, while the saver may be a private individual who wishes to put some money aside for his retirement. Even when saving and investment are carried out by the same economic agent, the timing is usually different, with saving either preceding the investment which is to take place, or occurring afterwards as debts are gradually repaid. Moreover, the acts of saving and investment are also often far apart in space. British savings in the nineteenth century helped to finance the construction of the US railroads, just as in more recent times US saving has helped to pay for the development of North Sea oil, and saving by oil-rich countries in the Middle East is currently being used to finance investment in many other countries.

There are of course important exceptions. The businessman who ploughs his profits back into the business is saving and investing simultaneously, and the same is true of the large company which holds down its dividends in order to retain profits for investment. A substantial part of company investment is in fact financed in this way, with funds put aside for depreciation being used to replace capital equipment as it wears out or to finance new investment. Nevertheless, a high proportion of saving is not employed directly

or immediately by the saver himself, and is made available to investors elsewhere.

Savers' objectives are varied. Some people save for short periods merely as a means of levelling out their income and consumption patterns, or they save up for some specially heavy expenditures, such as presents at Christmas or a holiday. Others have motives directed to longer-term needs, of which the most important is saving for retirement. Firms save to finance future investment or to provide a cushion against the possibility of adverse business conditions. Governments may add to saving through the tax system if they anticipate that there will be a shortage of saving in the economy as a whole and decide to compel people to save more (through the fiscal system) rather than curtail investment.

Their motives for saving have a bearing on the characteristics of the financial instruments which people wish to hold. First and foremost people look for *safety*: they wish to be sure that their savings will not be lost. Security of money value is important for many asset holders, and it is comparatively easy to ensure that savings will not lose their value in this sense; but the objective of securing the real value of saving is difficult to attain in periods of inflation, when the real value of monetary savings is eroded by rising prices.

Secondly, most firms and many individuals want a large part of their savings to be readily available. This means that *liquidity* is vitally important – the maturity of the assets which they hold must be short or good markets must exist in which assets can be sold so that cash can be raised if necessary. In consequence, savers have a strong demand for deposits and short-term loans. There are, however, very important exceptions to this preference for liquidity: savings built up for retirement, for example, will often not be required until many years have elapsed, and do not need to be held in a liquid form. Long-term loans, and assets which provide some protection against inflation, may be suitable for this purpose.

Thirdly, savers seek a *yield* (income) on their assets. For most, this ranks well behind safety and liquidity. But in choosing between financial claims which are similar in other respects savers can generally be expected to select that which offers the higher yield. Some savers are also prepared to hold risky financial assets, like ordinary shares, if the return[5] they hope to earn is sufficient to compensate them for the risk of loss.

Investors' needs are very different. The bulk of physical investment is durable, generating a flow of earnings which permits its value to be recovered gradually and over a long period. Much of it is

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