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## From speculative to sustainable finance - can markets do good?

“We know that markets can do harm, but even under these most adverse circumstances, is there a way to fix the markets in order to promote social good?” This is the opening question posed by Professor Emiliios Avgouleas in the penultimate lecture of Murray Edwards’ two-year programme, Capitalism on the Edge.

The inaugural holder of the Chair in International Banking, Law and Finance at the University of Edinburgh is an acknowledged expert in financial regulation. Avgouleas is also acutely aware of the social functions that financial markets should perform.

Firing off more questions, he asks: “If there *is* a way, do I have an idea how that can be done? Is it all doom and gloom? Is our fate to be hostages to the forces of speculation or to the anti-capitalist forces?” His answer to that last one: “As a liberal, not a neo-liberal, I regard both sides of that argument as catastrophic.”

### What are markets for?

In Avgouleas’s opinion, the fundamental role of a financial system should be:

- Mobilisation and pooling of savings
- Information pooling to reduce the costs of forecasts which guide possible investments
- Competitive pricing
- Competitive monitoring of the impact and quality of investments
- Diversification and management of risk.

The list itself doesn’t tell us *to what end* the financial system is mobilising resources. However, Avgouleas suggests that evidence from the past 10-15 years shows that availability of finance through a developed financial sector can help society to become wealthier, and to develop socially and culturally. “This is strong empirical research and not just a wish of the capitalist.” he says.

If we look deeper, he suggests, there is probably a virtuous connection between financial development and liberal democracy. “When the financial system works well, and distributes wealth on merit, the result - at least in Britain - has been political development as well.” he says.

### Learning from History

Avgouleas turns briefly to 19th century British history in support of this hypothesis. The Electoral Reform Acts of 1832, 1867 and 1884 extended voting rights to previously disenfranchised citizens, People who didn’t have land, but had income, could now vote.

It was access to finance, says Avgouleas, mostly through joint-stock companies (JSC) and the Stock Exchange, which distributed the resources to those who could further technology, and drive the Industrial Revolution.

This accelerated the impact of that technology on social and economic welfare, and those who benefitted asked for the right to vote, to influence the fate of the country they lived in.

Interestingly, this happened despite the fact that the British banking system in the 19th century experienced major crashes and bank failures. Yet the stock exchange worked well, democratising access to finance (that’s what the stock exchange is) and underwriting the British economic prosperity that led to political enfranchisement.

## Two faced finance

So, yes the financial system can certainly do good. However, like the two-faced Roman god Janus, It can also bring grief. The two main reasons for this, says Avgouleas, are excessive leverage and speculation.

Repeated cycles of over-confidence followed by pessimism in the markets make the financial system prone to instability. When excessive leverage is built in, financial crisis is inevitable, and the worst result of a financial crash is that it can push the real economy into deep recession.

This happens because the financial system, unlike other parts of the economy, has the peculiarity of handling other peoples' money.

Financial crises are not new, but the results can be dire, and what interests Avgouleas is how we respond. In the aftermath of the catastrophic 1929 financial crash there was a rise of populism, of extremism and of intolerance; a story which is perhaps repeating itself in our times, suggests Avgouleas.

## The heart of the problem

How, then, do we interpret the financial system today? This is where Avgouleas points the finger of blame. "Speculative finance is at the heart of much evil in today's society and the economy."

Markets need *some* speculation, he says; it's what makes them liquid and delivers market efficiency. "You have lots of willing buying and selling, and that's a good thing." Too much speculation, however, is not.

At stake is what Avgouleas calls the social contract; "an agreement with the public and market forces which is guarded by the servants of the state, by public bodies, which says that finance is a good thing for as long as it enhances growth."

Markets, he says, should be a mechanism to allocate resources competitively and to manage risk. "They are *not* a mechanism to re-distribute resources - that's the job of government; nor are they a means for intermediaries to extract rents at the expense of the market or society."

If markets *do* export harm - by breaking the social contract - then the role of public institutions is to step in with sanctions, hence the need for regulation.

Avgouleas maintains that what we are seeing today is a broken social contract, due to short-termism and too much speculation.

Financial activity is centred on short-term gain, and a massive number of transactions concluded at break-neck speed. Some of this activity is helpful to correct market anomalies; the so-called arbitrage activity. "Most of it is pure gambling, and has no social value whatsoever." he says.

Rapid transactions uncouple financial activity from economic activity, so this form of finance becomes self-serving and socially wasteful. "The consequences are dire." warns Avgouleas, and rising inequality is one of them.

## **Gambling is bad for society**

A major source of harm is allocative inefficiency. "Instead of resources being used to benefit society, they are held up in high frequency trading, or rather speculative trading strategies."

Avgouleas believes that growing inequality is closely linked to the development of speculative finance. In the US, total income share of the Top 1% has been on an upward trend since the 1970s, and particularly sharply since around 1990, coinciding with the financialisation of real assets (sub-prime mortgages).

Both leverage and short-termism exacerbate inequality. "Within measure, leverage can be a good thing, but uncontrollable leverage can destroy society and this is a fact that we are hiding from." He says.

Wealth accrues to those who have enough assets to leverage their positions in order to maximise their wealth. "The more I have the more I can leverage myself, and take bigger and more diverse debts," says Avgouleas. "And what do I do with the money? I put it in the bank or fund or investment house who will lend it to you to speculate and be ruined."

"This is the alchemy of sub-prime loans. Leverage multiplies the gains of those who have, and places at risk the assets - the wealth - of those who do not have much or have nothing."

The wealthy are able to risk fewer of their assets, while higher debt ratios undermine the assets of poorer households, making them more vulnerable to the losses accrued in a downturn or financial crisis.

## **Beware volatility**

Short-termism also harms allocative efficiency. Apart from the inherent dangers of not making long term commitment, high frequency trading creates volatility.

Why is this a problem? After all, the dominant finance models agree that we cannot predict long-term investment returns, and so a degree of volatility is expected.

However, this is exacerbated by short-termism, fuelled by technology, making it impossible to come up with a reliable prediction about future returns on investment. This leads to loss of confidence in the future ability of the economy to provide returns, because all key indicators are upset by continuous transactions.

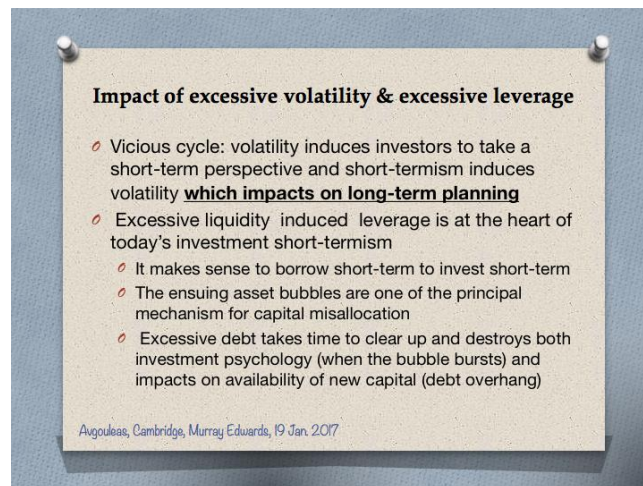
The uncertainty includes the price of global food. For Avgouleas, the problem is not that grain prices have been transactionalised per se; but rather that they have become incorporated into indices, created by investment banks, where traders speculate on the future price of grain.

This means that grain is not being traded between suppliers and consumers; but between those with no underlying interest in the price of grain, who are gambling on future price levels.

The result is a distortion of the allocative efficiency mechanisms and the mechanisms for generating and sharing information. "When you and I trade in order to buy and consume food, and X and Y trade in order to speculate on food, what is the equilibrium between the two competing interests?" he asks.

## **It's time for a new model**

So, where does this leave us? "Everything that we have learnt in the economics of finance has to be revised." says Avgouleas.



“The impact of excessive volatility and leverage is a society laden with bad debts which they cannot restructure, so they cannot borrow new money in order to invest in productive new opportunities. If it’s a serious bubble, as with the housing bubble in 2008, you end up with serious recession and millions of job losses and an awful lot of homeless people.”

This “social evil”, says Avgouleas, is the result of too much short term finance, rather than the financial markets being evil in themselves.

“If you incentivise the markets to do good, they will do good, if you leave them to their own devices, lots of smart people will devise rent-seeking technologies and when you wake up as a public planner, you will be dealing with an intractable mighty mess.” He says.

### **Why have so many things gone wrong recently?**

Ideology is partly to blame. Contracts are repackaged and re-traded in the derivatives market, where borrowed money (debt) is used to speculate on the new products. This has led to highly complex interconnected markets.

“You have lots of artificial markets that serve no real economic or social purpose, but they exist in order to manufacture financial debts, and the more money I have to bet the easier it is to make money, because I can diversify my bets.” Avgouleas says.

Another factor is the Agency Problem. The money belongs to us, the savers, but it is our pension fund managers who invest that money, which can lead to perverse incentives. Besides, says Avgouleas, market complexity makes it very hard - even for academic specialists - to know if an investment is good or bad or socially useful.

“You have a chain of very complex transactions. Nobody knows what’s going on, there isn’t much transparency, and it’s all done for the short term. Why? - because it is controlled by the almighty intermediary with a vested interest in transaction after transaction after transaction. That’s how it makes money; by intermediating and generating commissions.”

The common investor, who entrusts his or her pension, is not irrational. But if they cannot spend money on information services, they have little option but to follow the herd, accepting the advice of their agent.

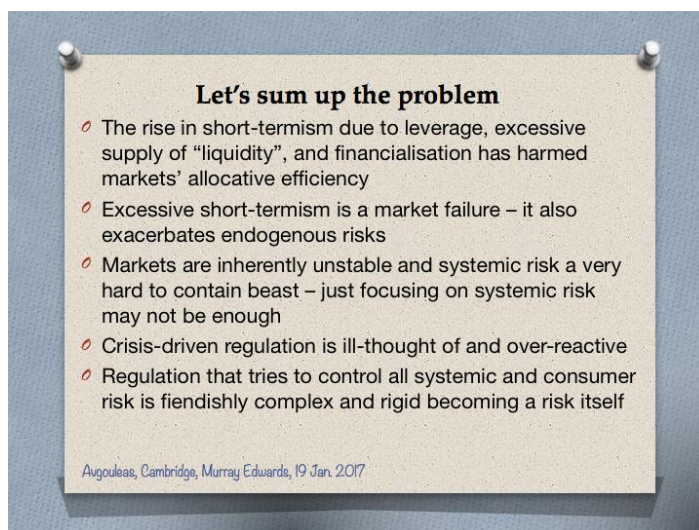
## More money in the shadows

With trillions of dollars traded every day, where does the money come from to finance these complex webs of short term debts? One important source is a parallel system called shadow banking which provides credit intermediation.

Shadow banking can do good things, says Avgouleas, but it operates without regulation, formal oversight or regulatory safeguards. Much short-term funding is channeled to the global financial system, through people taking short-term debts in the shadow banking system.

It's another system of enormous complexity, says Avgouleas's; "Impossible to supervise, impossible to understand."

How can these fiendishly complex and interconnected parallel markets possibly allocate resources efficiently for society's benefit? A system that we thought was about allocating resources now has an impact on political development, and serious economic, political and social consequences.



But haven't we spent a huge amount of resources to resolve all these problems since 2008? Maybe. But, says Avgouleas, crisis-driven regulation - designed to counter the causes of the previous crisis - is not well designed; above all it is not flexible.

"The current regulatory system is rigid, prescriptive and very complex; a systemic risk in itself," he says. Worse, it misleads consumers and society, because they think regulation means safety, and that is false. Markets manage risk, they do not make it disappear."

## A sustainable solution

What is to be done? Avgouleas proposes a way for financial markets to re-build the social contract. His solution is a system focused on long-term (sustainable) committed investment.

The need for long-term investment is urgent in order to counter the massive shortfall in public and private investment in infrastructure and social development in Europe, the US and most major economies.

In Europe there is a combined Euro130 billion shortfall of private and public investment in R&D. With most European member states described by Avgouleas as “technically bankrupt” (i.e. with public debt of over 100% of GDP), there is little hope for renewed public investment.

In the US, core infrastructure investment was a mere 0.9% of GDP (in 2011), and health and education investment 0.5%. Avgouleas suspects there is a causal relationship between the levels of indebtedness of the US and the levels of public investment.

Such a massive investment shortfall for the long term development of the economy and society is not what we might expect. After all, with extremely low interest rates the cost of money is effectively zero and there is lots of liquidity from central banking money. Surely these are ideal conditions for companies to invest in 40 year projects? Besides, share indices such as the Dow Jones and the FTSE are buoyant. So what is happening to all the money?

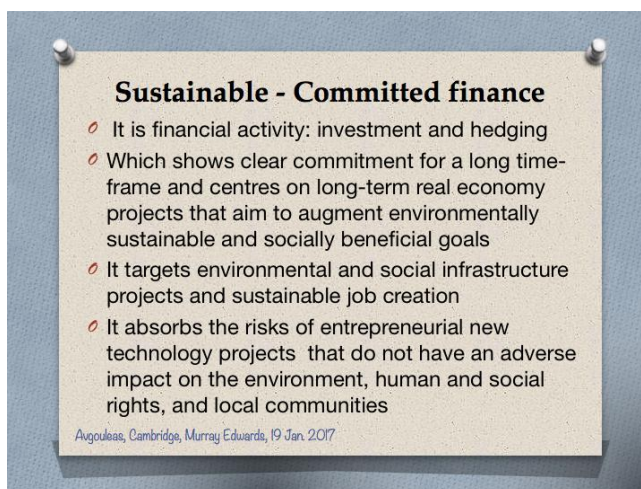
What we are seeing, says Avgouleas, is a fall in capital investment in favour of share buybacks, where companies borrow money in order to buy their own shares and push prices up.

Nobel Laureate Michael Spence is perhaps the most respected economist to voice concerns that big companies are increasingly using the bond market - fuelled by quantitative easing money from central banks - for the benefit of shareholders.

This is a serious problem, says Avgouleas, and it reinforces his belief in the need for sustainable committed investment.

## Not a new idea

Sustainable finance is not a new notion. The World Bank, the OECD and big Investors already have their own definitions. But Avgouleas wants to see an agreed international standard, which goes further. He sums up his proposal in this slide:



The last point raises the issue of financial innovation, often blamed in today's high tech world for distorting the markets? Can we do away with it? Of course not, says Avgouleas. The Sumerians were using financial innovation to insure future harvests, and the Ancient Greeks traded with the world via a system of marine insurance not so different from today's joint stock companies.

"That's finance; we split the gains and we split the risk." says Avgouleas. "We cannot exclude, nor demonise financial innovation." But, he adds, "nor can we leave it in the hands of the bad guys".

### **The need to open up the markets**

How, then, should the financial system operate? Avgouleas calls for a New Liberal Contract; one that is open to credible new long-term players and new long-term assets, by broadening the current regulatory barriers to incentivise sustainable commitment.

His proposed new class of assets would be cheaper, easier to understand and have a social value. Yes, there must be strict quality controls for these products, but they should not be barred from entering the market just because they are as yet untested, with no credit rating.

A revised tax system - regularly reviewed - would be key in this new contract, with the aim of increasing incentives for long term commitment, disincentives for excessive speculation and heavy penalties for toxic products.

The new contract would simplify things, breaking down agency barriers, so that savers can understand where their agents are investing their money.

Within the new system, good financial innovation - products and processes which meet long term finance criteria - would be protected by patents. Their creators would control derivative products and benefit from high rents attached to exclusivity.

Another feature of the contract would be monitoring, away from the interests of the industry itself. This is important because the nature of a financial product can change over its lifetime. Nowhere was this more blatant than with sub-prime mortgages. Before they developed into such a toxic product, sub-prime mortgages were a ticket to the American dream, offering provisional credit to people with no assets so they could join the classes of American citizen who did.

### **The benefits of a new liberal contract**

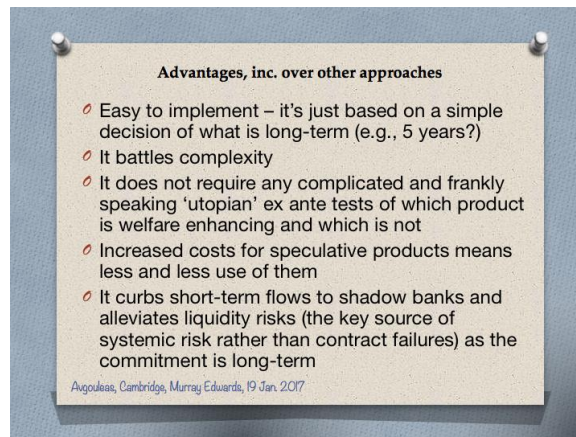
One benefit of the proposed contract, says Avgouleas, is that new investments - with uncorrelated goals and risks - will act as natural stabilisers in the market. Thus, long term committed finance is not only socially beneficial, it also offers opportunities to diversify risk.

And while the markets are not a redistributive mechanism, more emphasis on long-termism can provide investment for infrastructure and R&D, leading to job creation and mitigating inequality.

Another advantage: by including simple incentives, you alleviate the agency problem. The new classes of sustainable financial products would be more conspicuous through advantageous regulatory and tax regimes, making it easier to see where agents are investing - or not - in socially useful products.

## Better than the alternatives

Avgouleas believes his proposed new contract is more practical than alternative proposals, such as attaching fiduciary duties in the investment chain, or giving company's long-term shareholders more votes than short term shareholders.



And he sees a number of ways in which the new contract would impact on short-term speculation:

- making long-term finance cheaper will divert resources from short-term trading;
- moral signaling puts pressure on institutional investors to shift to more sustainable investment;
- stricter regulatory restrictions on short-term investment create an un-even playing field.

## Finance cannot solve all problems

One pressing issue that long term investment *cannot* remedy, says Avgouleas, is the inequality that will arise as labour is replaced by robots. But, he insists, this is a challenge for public planners, not finance. Private markets serve the system, but that system should be guided by public order.

He acknowledges there are some disadvantages in his model for long-term committed finance.

- It doesn't conform to consumerist ideal because it doesn't eliminate risk to the consumer (as model regulations implicitly purport to do)
- Libertarians do not like public interference in private markets, which is what Avgouleas's model is all about (although regulatory intervention is less intrusive)
- It calls for new international trade agreements, not currently in vogue

## Green bonds: a bubble or good news?

However, Avgouleas is confident that his solution is realistic. The best example to date of long-term sustainable finance products, he says, is green bonds: fixed income instruments which channel proceeds to activities that promote climate change mitigation or other environmental projects.

First issued in 2007 by the European Investment Bank in 2007, they have grown rapidly in popularity, with \$36.6 billion of green bonds issued in 2014, and forecasts of up to \$100 billion for 2015.

Some say that it is a bubble, but Avgouleas suggests instead that it is good news.



“Green bonds are social and ethical, and there are investors out there who want to do the right thing.” He says.

True, as the market grows, questions about the definition of “green” will surely intensify, but Avgouleas sees green bonds leading to:

- more committed investment to generate jobs, battle volatility and protect the environment
- more opportunities for innovative entrepreneurs
- more emphasis on high risk, high tech, sustainable projects.

Above all, he sees the recent rise of the green bond as evidence that his proposed new system for long-term committed finance *can* work. As he says:

“Perhaps it is liberal democracy’s last chance.”

## QUESTIONS

Q. Why are savers triggering short-termism in the market if they are ultimately hurt by it? Of course we want to see returns on our investments go up, even when we also want to do good, so institutional investors are under pressure to deliver. How do we use regulation to change behaviours?

*A: Regulation is the problem not the solution. If investors created a new bond that brought together, say, five long-term diverse projects in S E Asia that gave a return of 2.5%, would that solve your savings concerns? All you need is for that bond to enter the market, but currently, no regulated institution is allowed to buy that bond.*

*I think the job of the regulator here is to unclog the system, to create secure signaling of what they regard as a good investment or product and let them enter the market.*

Q. You suggest a regulatory body to signal preferred long term investors for socially useful projects, but won't that lead to some kind of super-international regulator? Why is such a regulator better than the markets to tell me what is socially beneficial?

*A. I do not propose super regulation, but rather a standards board - for everything; a strong system of accreditation and civil liability. For new long-term investments, you make the issuer responsible (i.e. it is a private sector solution) to control the quality of their product (and its derivatives). Crucially, because you can sue the issuer, the bad issuers will disappear from the market.*

Q. Currently all you need for a green bond is to call it a green bond. Is there a risk that markets will respond to signaling that we want more responsible investments by simply applying labels, such as angel investment/social impact bonds/green bonds. Are we being duped?

*A. Today there is no system of accreditation for green bonds and you can sue nobody for the bad apples; but that is exactly what we need in the new system.*