BOOKSHELF | By Burton G. Malkiel

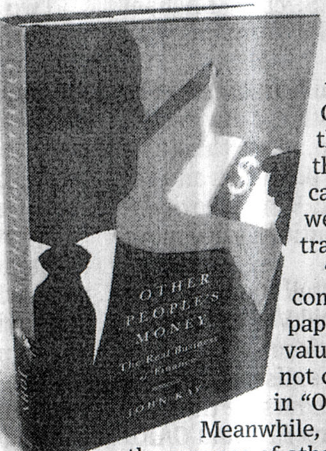
Trading Places

Other People's Money

By John Kay
(PublicAffairs, 336 pages, $27.99)

From 1980 to 2006, the finance sector of the American economy grew to 8.6% of GDP from 4.9%. According to John Kay, a visiting professor at the London School of Economics and a regular contributor to the Financial Times, the finance sector is too large and too powerful. Its growth represents not the creation of wealth but an expropriation of other people's money by those who derive income from the sector itself, much of which "contributes little, if anything, to the betterment of lives and the efficiency of business." What is needed, he argues, is not more regulation but a reform of the industry so that it gives priority to "financial services that meet the needs of the real economy."

Mr. Kay calls the process by which the finance industry has been altered "financialization" and sees the explosive growth of trading as an especially troublesome example of it. Lloyd Blankfein, the chief executive of Goldman Sachs, once said that his firm was doing "God's work" by helping companies raise the capital they needed to grow. In fact, Goldman was deriving less than 10% of its revenues through underwriting new capital issues. Their profits were mainly derived through trading.



"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," Mr. Kay writes in "Other People's Money." Meanwhile, "profits can only be made at the expense of other members of the same circle." He deplores the increase of outstanding graduates seduced into high-paying finance jobs and tasked with devising "algorithms for computerised trading in securities that exploit the weaknesses of other algorithms for computerised trading in securities."

Another example of financialization is the change in the process of "intermediation." In the old structure of housing finance, mortgage loans were originated by people who were experts in local property values and who carefully monitored the borrower's ability to service his mortgage debt. The new system depends not on experts in housing but rather on financial innovators who bundle mortgages into complex and risky derivative securities that are not understood by either the buyers or the regulators. People with expertise in capital allocation are thus replaced by people who do complicated math, trade with one another, "reward themselves generously" and yet have little to offer "the real economy."

Mr. Kay is a brilliant writer with an ability to explain the role in the 2007-08 financial crisis of such concepts as credit default swaps, collateralized debt obligations and moral hazard, "the tendency of people to take more risk when they are protected against it." Moral hazard takes on particular importance in the context of "too big to fail" banks, institutions that enjoy the implicit guarantee of the federal government because their failure, it is believed, could bring down the whole financial system. Critics of government bailouts, Mr. Kay notes, argue that they encourage such institutions to take more risk—to use more leverage and engage in more risky trading activity than they otherwise would. The concept of "too big to fail," he says, moves the responsibility of managing risk away from market participants and places it "in the hands of regulators," creating a duty that, in 2007-08, "they were not capable of discharging."

Banks now put talented recruits to work devising computer trading algorithms designed to exploit the weaknesses of other algorithms.

There is certainly considerable truth to the criticisms that Mr. Kay levels against the growth of the finance sector. Not all the growth over the past 3½ decades has been beneficial to society, and there have been many bad actors. But it is also clear that financial innovation has historically been associated with greater economic growth. We should not jump to the opposite extreme and conclude that all the recent financial innovations are bad.

Some new forms of intermediation have improved the flow of funds to the real economy. Derivative products can indeed make both buyers and sellers better off. The farmer who sells futures on his wheat crop can more confidently buy his supplies and ensure a decent profit. So can the bread maker who buys the futures contract and thereby reduces the risk involved in making a fixed-price, long-term bread-making contract. It should be noted that, during the financial crisis, simple futures contracts that were traded on an exchange and marked to the market survived without default.

Even "excessive" trading activity is not without some social benefit. It ensures that the low-cost, indexed, exchange-traded funds bought by many individual investors will not deviate from their underlying net asset values, and it helps make American stock markets the most liquid in the world.

Mr. Kay is at his best in reminding us that the financial system is still fragile and in explaining that more regulation is not the answer. Regulation is expensive—it involves enormous compliance costs, and the finance industry is quite adept at capturing its regulators. We can applaud his call for a cultural change that will enhance ethical standards and put the customer first. Financial managers should indeed watch over other people's money with the same vigilance with which they would watch over their own.

It would be wrong to assume, however, that decreasing the complexity and interconnectedness of the financial system—something Mr. Kay also recommends—is either feasible or desirable. The collapse of the Internet bubble in 2000 led to limited economic distress not because there was less interconnectedness but because the stock bubble was not financed by margin debt. The collapse of the housing bubble in 2007 caused devastating world-wide malaise not because the world was more complex and interconnected but because its advanced economies were inflated by huge increases in personal and corporate debt. The central role of too much debt cannot be overemphasized. Many of the excesses described by Mr. Kay could be ameliorated by more capital and less borrowing.

Mr. Malkiel is the author of "A Random Walk Down Wall Street" and the chief investment officer of Wealthfront.