15-1. Finance and its stewardship

The economy is human activity examined from the standpoint of price

Price is a measurement in terms of a quantity of money

A commodity is a material object having a price

As first mentioned by Aristotle, the Greek philosopher (IVth century B.C.), all commodities have a proper usage and a usage in exchange. E.g. the proper usage of shoes is to be worn at one's feet; their use in exchange is to be exchanged for money, for guitar lessons, etc. Money is the one commodity whose proper usage is the same as its usage in exchange: the proper usage of money is to be exchanged.

Keynes distinguishes "money proper" and "bank money". Bank money is promissory notes, i.e. acknowledgements of debt. Bank money is discounted when exchanged as its face value (the amount which was initially borrowed) will only materialize at a future date.

Finance is the economic activity where the commodity traded is money.

Financial activities

There are five socially useful functions of finance: 1) acting as a safe, 2) intermediation, 3) insurance and 4) the operation of a *primary market* for debt instruments and 5) the maintenance for their trade of a *secondary market*; there is one socially useless, or one may say harmful, function of finance: speculation.

1. Acting as a safe

Financial institutions can act as a safe for the public or businesses : money is entrusted to them by customers and it will circulate (most often for free) according to their instructions under the form of checks, wire transfers or credit cards.

2. Intermediation

Intermediation, ensuring the meeting of one party needing funds with another party having access to funds which it is prepared to lend for a period of time as long as interest gets paid for the service rendered, is usually referred to as the "price discovery process". The phrase is unexpected, a price will indeed get discovered in the process, although it will rather be a rate used for pricing than a price proper, but this seems somewhat incidental in view of what are the more salient events taking place: the discovery process of a would-be lender for a borrower seeking advances, followed by the exchange of an amount of money against a transferable promissory note or a non-transferable IOU.

Van Horne, author of *Financial Market Rates and Flows*, writes about the "price discovery process": "The mechanism by which savings-surplus units come into equilibrium with savings-deficit units is known as the *price discovery mechanism process*" (van Horne 1994: 5), which is straightforward even if expressed in an unnecessarily convoluted way.

Intermediation is thus the process by which financial actors, individuals, firms, municipalities, States such as the U.S.' "states" or nations, in search of capital to borrow are being put in touch with those entities likely to provide them with funds. There are several means to such purpose that financial institutions can resort to: savings' booklets, certificates of deposit, notes, bills, bonds, or simply through depositors' checking accounts, a portion of these deposits being lent to borrowers on the basis of statistical assessments of how long such sums remain on an account before being withdrawn by the owner. Banks compensate themselves for the service provided through a profit margin coming on top of their costs.

3. Insurance

As far as insurance is concerned, it is the insurance companies' size which allows them to perform a function of this type. The loss for instance for a renter of having set his apartment on fire exceeds in most cases by far his financial means. Due to their size, *Property & Casualty* insurers are able to deal with such risk on a statistical basis: historical data are collected over the years about the occurrence of such events as fires and associated damages whenever they occur. An actuarial assessment by an insurance company in terms of average and maximum loss tolerable before insolvency allows the

calculation of an insurance premium level which will not only cover for losses but will allow the company a profit. However costly individual fires may be, they become by this method collectively manageable as their individual occurrence remains at a degree of rarity which has been accurately assessed.

Life insurance operates from similar principles. Life expectancy rests however on simpler probabilistic assumptions than other types of damage. As for the investment part of life insurance, it is but a variety of intermediation between the insured and the issuers of the debt products in the insurer's portfolio.

4. *Primary* and *secondary* markets for debt instruments

The fourth and fifth main types of financial activities which are unquestionably socially useful are in the operation of a *primary market* for debt instruments and the upkeep of a *secondary market* for them. A debt instrument or security is a title establishing acknowledgement of a debt, such as a promissory note or an IOU; are mentioned on the title, the agreed upon interest rate and the time-schedule for reimbursement and interest payments. A primary market is a market where a producer sells its products – issuance of debt or of shares is in that respect a variety of *production*. A secondary market is a market where such products can then be resold and rebought in principle forever until their life ends through consumption or wear and tear. In the case of a secondary market for debt instruments, the end of life of a product occurs when it reaches maturity: the pre-set time when it will be redeemed for money.

Bankers, and goldsmiths before them, have been prepared since the Middle Ages to trade promissory notes. In exchange for a discount on the face value of the debt instrument, the financier purchases the promissory note from its owner, the burden of obtaining payment at maturity becoming henceforth his own. The seller benefits from having gained immediate access to cash but suffers the inconvenience of a reduction in the amount he would have received had he waited instead for the promissory note to reach maturity.

The preparedness of financial firms to maintain such a secondary market for debt instruments has led to consider these as near-equivalents of money. Such equivalence is however more theoretical than real as it is conditional on the loan amount being

reimbursed *in fine*, and the interest payments – if any – being thorough and timely. The equivalence between debt instruments and genuine money is for that reason particularly susceptible to economic circumstances.

The capacity of a debt instrument to be regarded as an equivalent for money and therefore to be readily translatable into cash through its purchase is called its liquidity. The "illiquidity" of debt instruments can result from potential buyers having temporarily lost as far as they are concerned, access to cash, most often however it is due to severe disagreement between sellers and buyers on what is a fair price for the product, potential buyers claiming in that case a higher discount reflecting in their mind the rising probability that reimbursement will fail to take place or, should it happen, only for a lower amount than face value (a process then called the "restructuring" of a debt). The illiquidity of debt instruments is a major cause of financial crises. The onset of the *subprime* crisis is generally regarded as having occurred in the early days of August 2007 when a fund-manager for BNP-Paribas bank stated that prices had ceased to be quoted for American *Asset-backed Securities* backed by *subprime* mortgages.

5. Speculation

Any financial activity whereof the only aim is to confiscate as large a part as possible of new wealth created will not qualify as "socially useful" and in particular activities which are nothing but bets on prices' fluctuations, as is the essence of what we call "speculation".

Speculation will be dealt with in a separate lecture.

Stewardship

The concept of stewardship, that of the service to the community, has a religious origin: it was central to the creed of the Quakers, or "Religious society of friends" as they prefer to call themselves, an English radical seventeenth century protestant splinter group whose members have taken to some extreme the notion of a direct relationship to God allowing them to dispense altogether with a priesthood.

Quakers regard stewardship as being the true relationship which should exist in

the same exact manner between the single individual and the overall community of Friends, and between the latter and society at large.

Finance providing the economy with its bloodstream, it would be rational to regard it as the steward of the economy, rather than an activity aiming at commanding as high as possible profits for their own sake.