FINANCIAL TIMES

August 26, 2009 8:06 pm

Overmighty finance levies a tithe on growth

By Benjamin Friedman

The protracted debate over how to clean up after the financial crisis – and how to reform our accident-prone financial system to prevent another such episode – is stuck on the problem of how to regulate markets without undermining the benefits they bring.

What is sorely missing is any real discussion of what function our financial system is supposed to perform and how well it is doing that job – and, just as important, at what cost.

The crucial role of the financial system in a mostly free-enterprise economy is to allocate capital investment towards the most productive applications. The energetic growth and technological advance of the western economies suggest that our financial system has done this job pretty well over long periods. The role of start-up companies in this process – Apple, Microsoft, Google and many others – testifies to the success not just of our entrepreneurs, but our financial markets, too. The financially triggered Great Recession of 2008 blemishes this record but does not wipe it away.

Aside from the recession, it is important to ask what this once-admired mechanism costs to run. If a new fertiliser offers a farmer the prospect of a higher crop yield but its price and the cost of transporting and spreading it exceeds what the additional produce will bring at market, it is a bad deal for the farmer. A financial system, which allocates scarce investment capital, is no different.

The discussion of the costs associated with our financial system has mostly focused on the paper value of its recent mistakes and what taxpayers have had to put up to supply first aid. The estimated $4,000bn of losses in US mortgage-related securities are just the surface of the story. Beneath those losses are real economic costs due to wasted resources: mortgage mis-pricing led the US to build far too many houses. Similar pricing errors in the telecoms bubble a decade ago led to millions of miles of unused fibre-optic cable being laid.

The misused resources and the output foregone due to the recession are still part of the calculation of how (in)efficient our financial system is. What has somehow escaped attention is the cost of running the system.

One part of that cost is especially apparent just now as students return to universities. For years, much of the best young talent in the western world has gone to private financial firms. At Harvard more than a quarter of our recent graduates who have taken jobs have headed into finance. The same is true elsewhere. The extent to which employees in the US financial sector are more likely to have college educations than other workers has more than tripled over the last three decades.

At the individual level, no one can blame these graduates. But at the level of the aggregate economy, we are wasting one of our most precious resources. While some part of what they do helps to allocate our investment capital more effectively, much of their activity adds no economic value.

Perversely, the largest individual returns seem to flow to those whose job is to ensure that microscopically small deviations from observable regularities in asset price relationships persist for only one millisecond instead of three. These talented and energetic young citizens could surely be doing something more useful.

The fact that they are not is itself a waste of resources. But the reason they are not – what provides the incentive that attracts so many of our best students into finance – also bears on how well our financial system is serving our economy.

In the US, both the share of all wages and salaries paid by the financial firms and those firms' share of all profits earned have risen sharply in recent decades. In the early 1950s, the "finance" sector (not counting insurance and real estate) accounted for 3 per cent of all US wages and salaries; in the current decade that share is 7 per cent. From the 1950s to the 1980s, the finance sector accounted for 10 per cent of all profits earned by US corporations; in the first half of this decade it reached 34 per cent.

These wages and profits – and the office rents, utility bills, advertising and travel expenses – are all parts of the cost of running the mechanism that allocates our economy's capital. To recall, what makes a new fertiliser a good deal for the farmer is not just that it delivers greater production per acre but that the added production is sufficient to buy the fertiliser and increase the farmer's own return.

What makes a more efficient financial system worthwhile is not just that it allows us to achieve greater production and economic growth, but that the rest of the economy benefits. The more the financial system costs to run, the higher the hurdle. Does the increased efficiency our investment allocation system delivers meet that hurdle? We simply do not know.

Economic decisions are supposed to turn on weighing costs and benefits. It is time for some serious discussion of what our financial system is actually delivering to our economy and what it costs to do that.

The writer is an economics professor at Harvard University and author of The Moral Consequences of Economic Growth

Italy plunges back into political turmoil

Can I discipline my bickering employees?

Fed easing stokes risk of bond reckoning

Dublin makes it easier to repossess homes

US watchdog warns on auditor failings

US requires innovative funding rethink

Russian 'civilisation' stirs resentment

Lebanon fighting as bodies return from Syria

Offshore pension sharks circle wealthy

Shareholders look to Glencore NEDs

La Traviata, Teatro di San Carlo, Naples; Simon Boccanegra, Teatro dell'Opera di Roma

CWC chairman defends executive pay plan

Removing EU cross-border tax obstacles

Civil service rejects ministerial role

Civilisation never grows from fear

Is my will worth the paper it's written on?

Printed from: http://www.ft.com/cms/s/0/2de2b29a-9271-11de-b63b-00144feabdc0.html