

Back to the Future?

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Financial Times

The 1930's/2010's "reset" (or: *What would Kit Kittredge see?*)



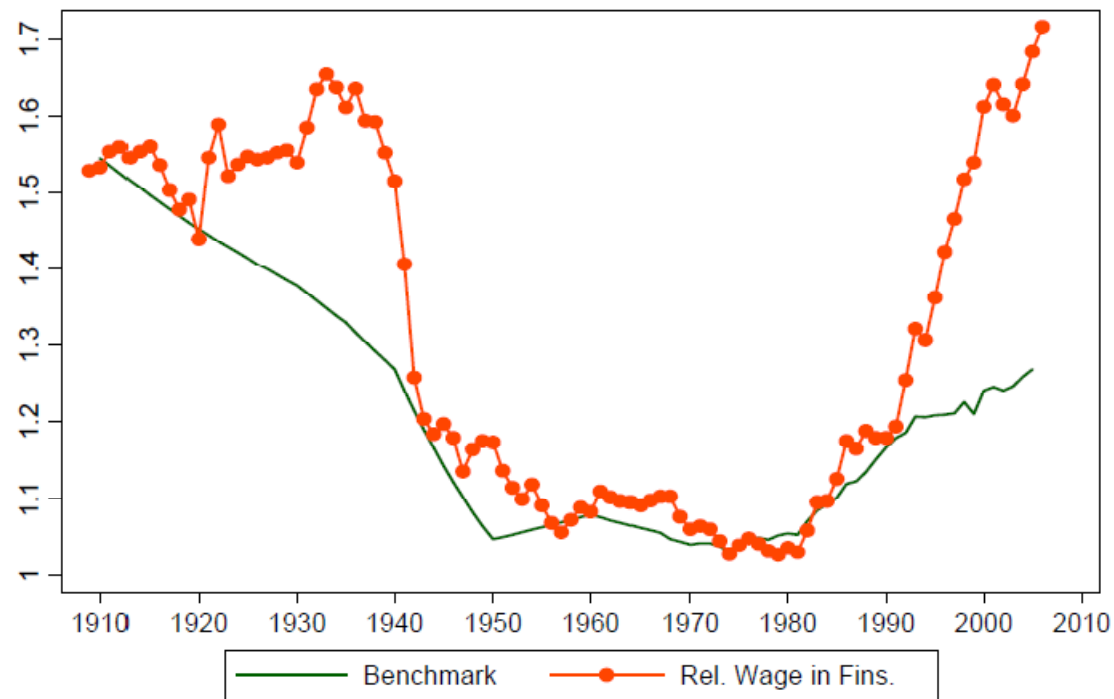
- “*This economic crisis doesn’t represent a cycle...it’s an emotional, raw social and economic reset.*” Jeffrey Immelt, CEO
General Electric

The 1930's reset

- Economic pain
- Hierarchies challenged; paradigm shift
- Shift away from liberal capital markets, open borders
- More state intervention in economy and finance
- Birth of the “American dream” of home ownership

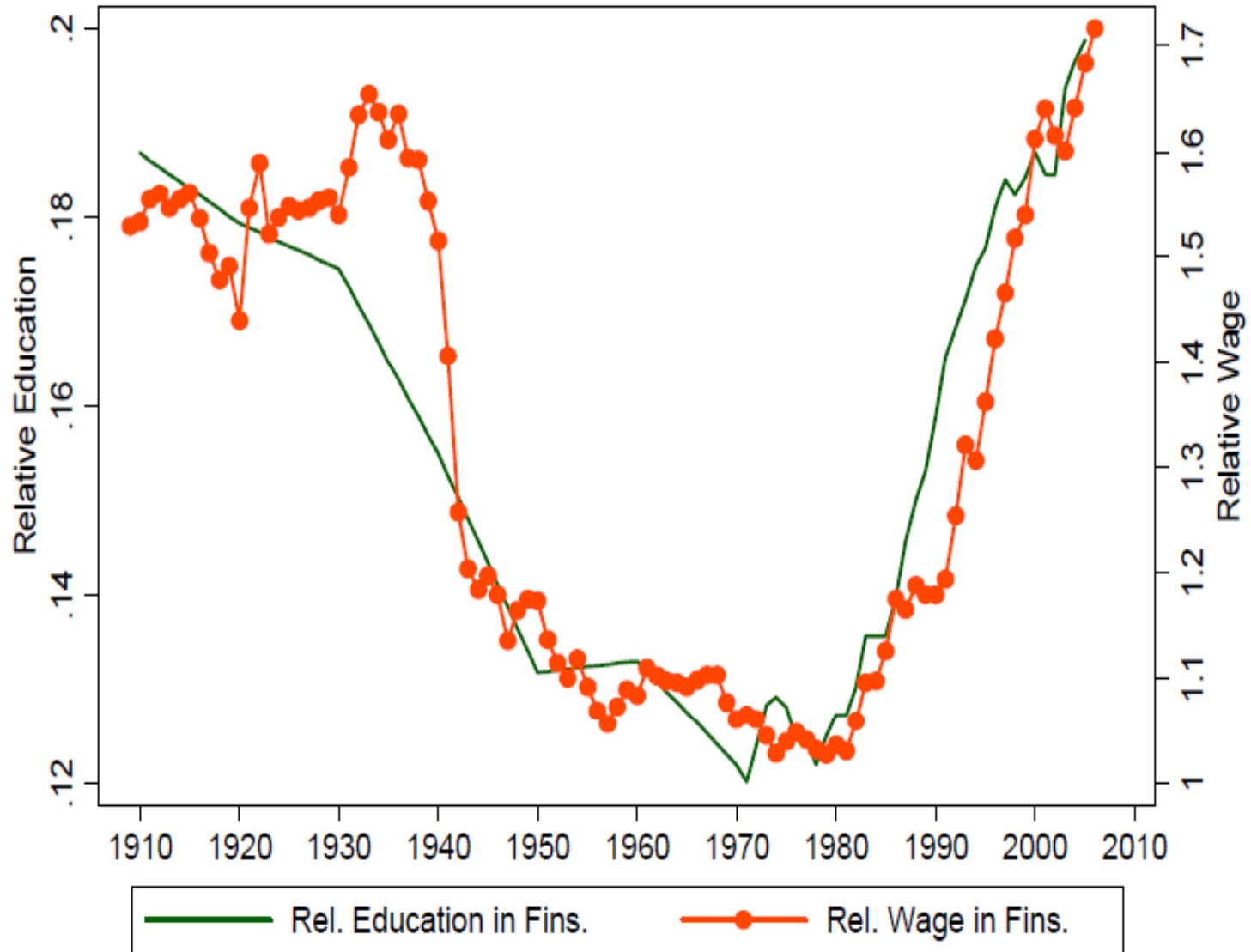
The ups and downs..and ups of banking pay

Figure 10: Actual and Benchmark Relative Wages in the Financial Industry



Notes: Relative wage in Finance (Fins.) is the same as in Figure 1. See text for the calculation of the Benchmark wage.

Figure 1: Relative Wage and Education in the Financial Industry

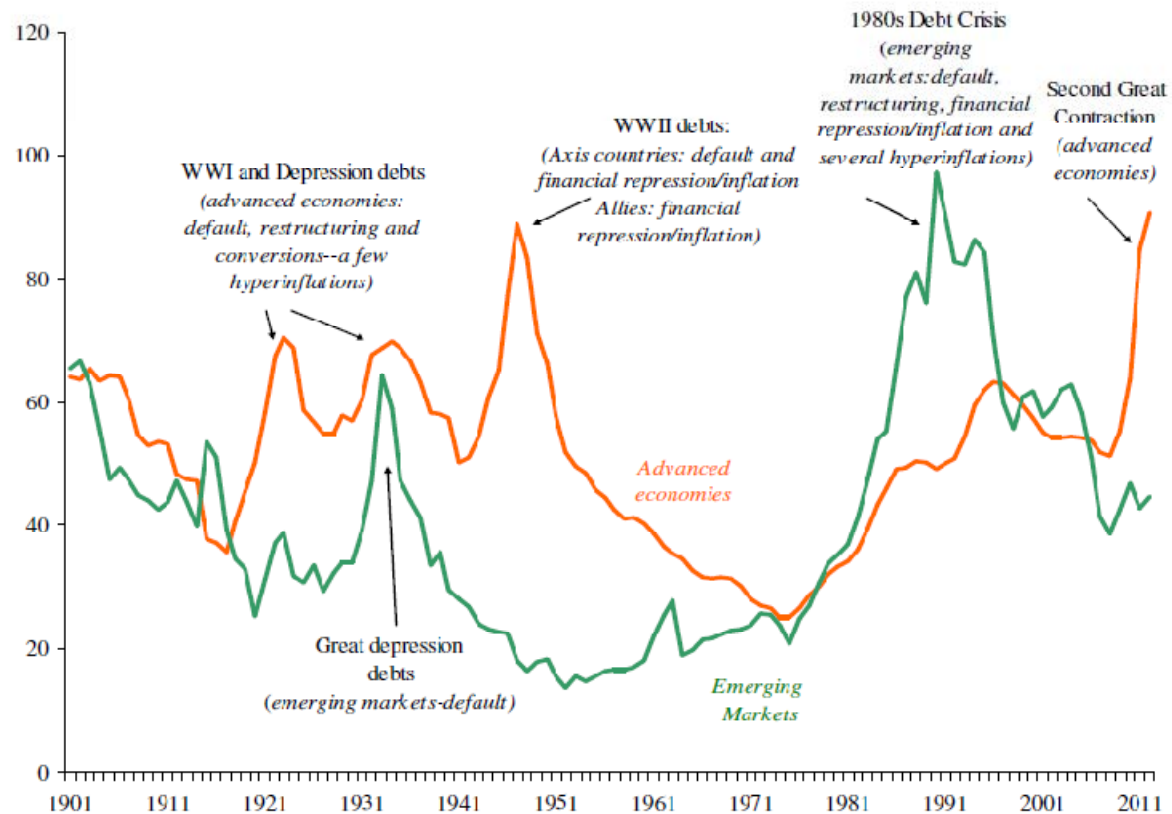


What happened?

- From 1940's to 1970's, finance became more like utility; far more stable
- This was partly due to tighter regulation;
- There was less leverage; credit constraint
- However, another key factor was financial “repression” (cf Reinhart/Sbrancia); state intervention.

Financial “repression”...cf Reinhart and Brancia

Figure 1. Surges in Central Government Public Debts and their Resolution: Advanced Economies and Emerging Markets, 1900-2011



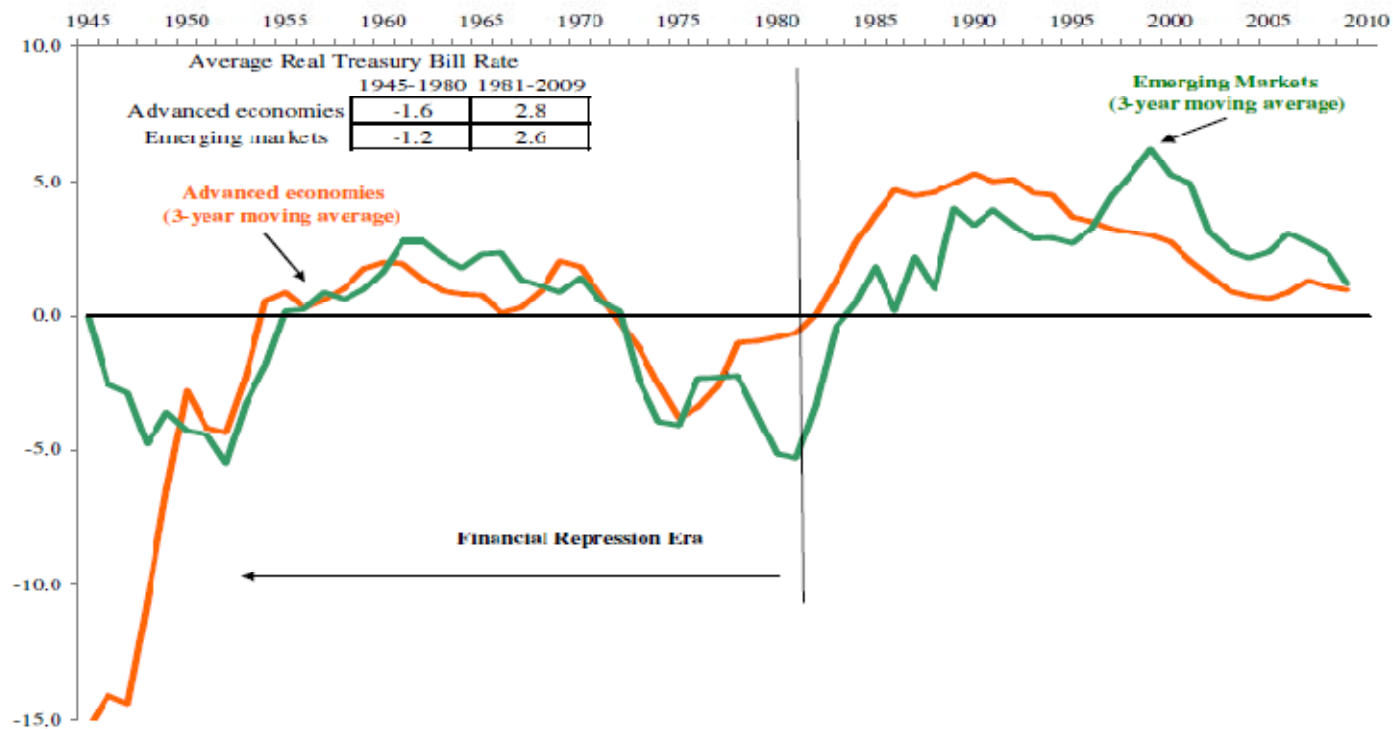
Reducing debts..

Table 7. Debt Liquidation through Financial Repression: Selected Countries, 1945-1955

Country	Public debt/GDP			Annual average: 1946-1955	
	1945	1955 (actual)	1955 without repression savings (est.) ⁴	“financial repression revenue”/GDP	inflation
Australia	143.8	66.3	199.8	6.2	3.8
Belgium ¹	112.6	63.3	132.2	4.6	8.7
Italy ²	66.9	38.1	81.9	3.7	10.8
Sweden	52.0	29.6	59.1	1.8	5.0
United Kingdom ³	215.6	138.2	246.9	4.5	5.9
United States	116.0	66.2	141.4	6.3	4.2

Repression and low rates

Figure 2: Average Ex-post Real Rate on Treasury Bills: Advanced Economies and Emerging Markets, 1945-2009 (3-year moving averages, in percent)

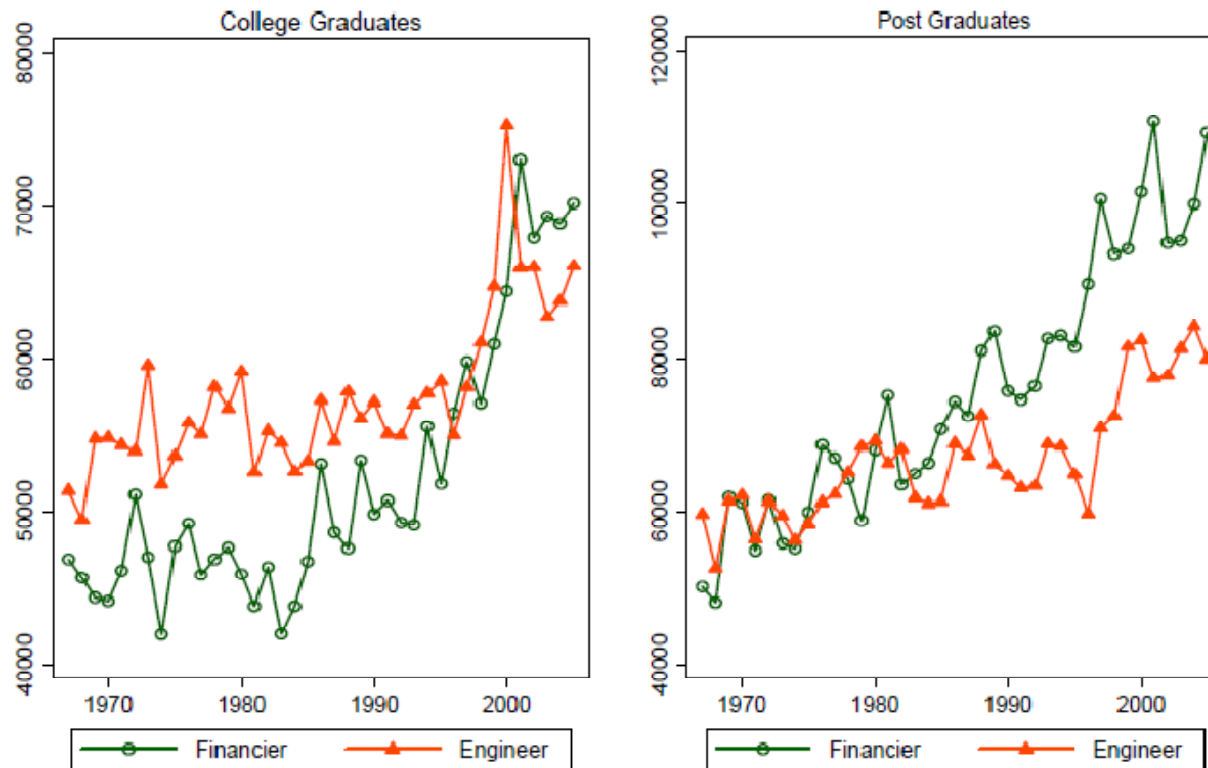


What happened – part 2

- From 1970's on, this changed: deregulation, innovation, complexity, opacity; velocity of money increased; rising leverage;
- Pay rise = technological progress? Brilliance?
- Or rent-seeking? Unhealthy arbitrage? Exploitation of opacity? (Philippon and Reshef: 30-50 per cent rent seeking; mckinsey “middleman” paradox)

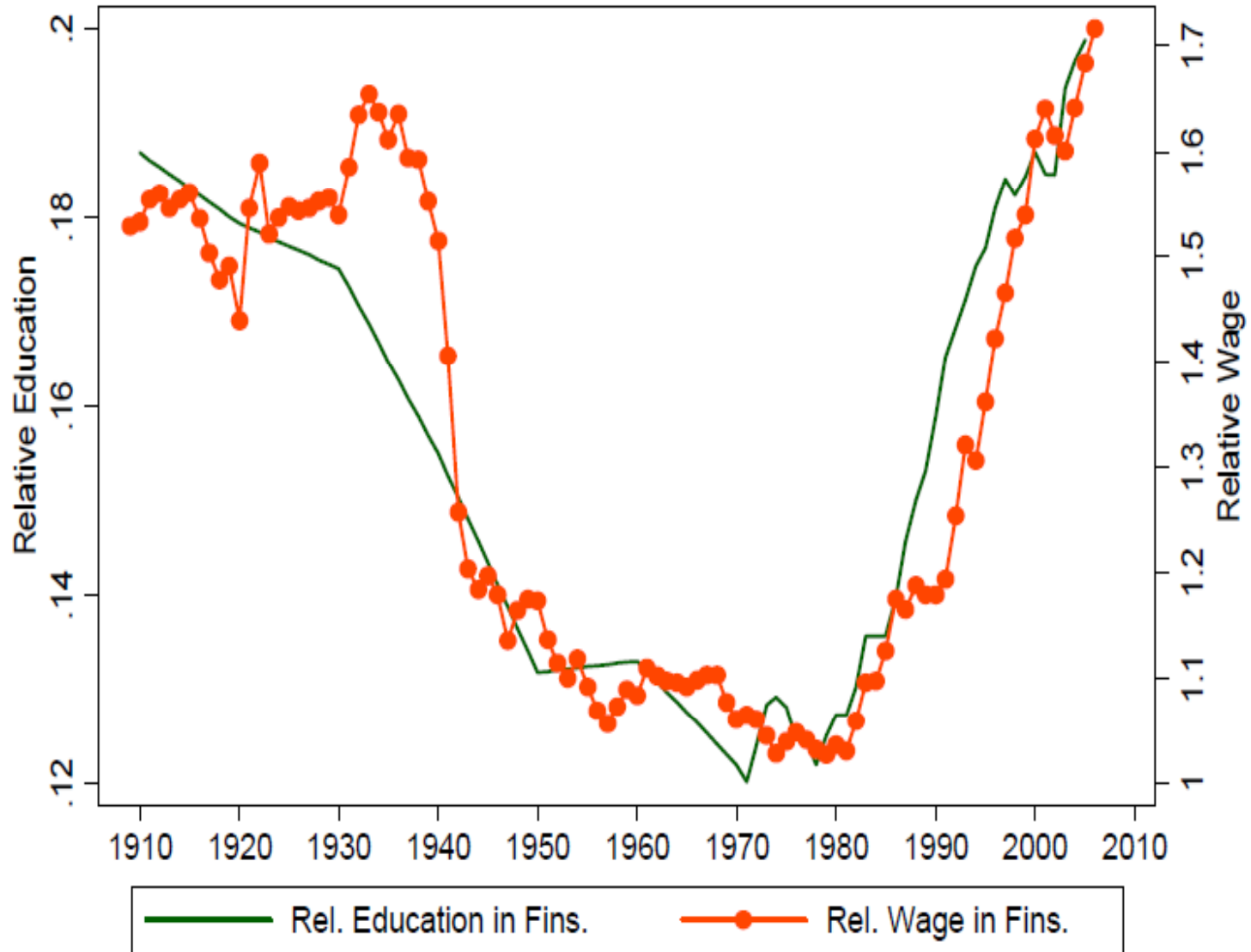
Engineers...and financial engineers

Figure 7: Annual Income of Engineers and Financiers



Notes: All wages are in 2000 U.S. dollars and are weighted using sampling weights. Data: March CPS.

Figure 1: Relative Wage and Education in the Financial Industry



What will happen next?

- No evidence of a decline in Western financial pay/"rents" yet (!); No evidence that finance has not yet turned into a utility...
- But is this just a time lag effect?
- What is the "new normal" of Western finance?
New roe? 40 per cent (aka "Goldman envy"); 15 per cent? 11 per cent (cf Barcap/McKinsey research); 5 per cent?

Will history repeat itself? Reasons why it may not...

- “Global economy is totally different”; integrated world; emerging markets are boosting demand
- “No war”; less legitimacy for state intervention or true “reset” of society/paradigm shift
- “Finance is far more innovative and creative”; shadow banking is flourishing
- Financiers brilliant at exploiting regulatory complexity
- Has technology changed it all??

History repeat itself? Reasons why it might...

- Lots more regulations are coming in West; a subtle paradigm shift is underway; this will reduce returns; political hostility
- Technology tends to commoditize some finance
- low rates will make it harder to make good returns

Repression – again?

- The risks of financial repression are rising; political economy in US and Europe looks increasingly dis-functional
- In eurozone just look at Ireland, UK, Portugal and Ireland (nb and German history); in US just look at budget deadlock; TBAC lobbying on bond purchases
- Repression may be least bad policy option for governments; stealthy “tax”; stability

How does that fit into global picture?

- These are *Western* problems, not global problems; is that a reason for hope or concern?
- Remember: financial crisis was a symptom of bigger imbalances which have not been addressed; these are likely to grow
- Outlook: more fault-lines in global economy; more fault-lines inside Western world too

Kit: again

- We are in a “reset”;
outlook still very unclear
- Potential for backlash
remains there: In 1930’s
bankers shared the pain;
enabled a “reset” and
paradigm shift that was
eventually beneficial for
Western world; tis time
they havent
- Finance no longer treated
as sacred; this is both
good and bad

