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The Reasons the World Loves to Hate Bankers

By Howard Davies

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Even after the passage of new financial regulations in the United States — the Dodd-Frank Act — and the publication of the Basel Committee's new capital requirements, the financial sector's prospects over the next few years remain highly uncertain. There has been some recovery in prices for bank shares from the lows of 2008, of course, but that rally has faltered recently. Quite apart from their concerns about the robustness of the rebound in the economy, investors are uncertain about many financial firms' business models — and about the future size, shape and profitability of the financial sector in general.

After all, banks remain deeply unpopular in all developed countries. Bankers are still social pariahs, as lowly valued by the public as drug dealers or journalists. They are reviled if they lose money and assailed if they make it. For banks and their shareholders, it looks like a case of heads they win, tails we lose. Thus, as banks return to profitability, politicians in North America and Europe have begun to talk again about new taxes that would skim those profits off to the benefit of taxpayers, whose support kept banks in business at the height of the crisis.

This is a huge contrast to the financial sector's position in the previous three decades. From the late 1970s until 2007, the financial sector grew far more rapidly than the real economy. In 1980, financial assets — stocks, bonds and bank deposits — totaled about 100 percent of gross domestic product in the advanced economies. By 2007, the figure was more than 400 percent in the United States, Britain and Japan.

During this period, credit expanded rapidly as a share of GDP, reaching more than 300 percent at the peak. In Britain, the profits of financial intermediaries, which had averaged about 1.5 percent of the whole economy's profits in the 1970s, reached 15 percent in 2008. In the United States, bank profits were an even larger share of the total.

This was the golden age of finance. Bankers' pay soared alongside profits — indeed, it grew even faster. To paraphrase 19th-century English poet William Wordsworth, bliss was it in that dawn to be alive, but to be a derivatives trader was very heaven. But the expansion came to a shuddering halt in 2008, the first year in decades in which aggregate financial assets fell, and there is still little sign of a sustained recovery.

Is this a short-term phenomenon? Will the financial sector return to pre-crisis growth rates when the economic situation has been fully stabilized? Will financial "deepening" continue? Will bank stocks once again outperform the market?

A recent study led by Andy Haldane, executive director of financial stability at the Bank of England, casts doubt on the prospect of a return to the status quo ante. Haldane and co-authors of the study note that the golden age was in fact an unusual period if you look at the last two centuries of economic history.

Haldane bases his analysis on the trend in the gross value added, or GVA, of the financial sector. Over the past 160 years, the GVA of finance has grown by 2 percentage points a year faster than that of the economy as a whole. But this excess growth has not been evenly spread. During the two decades leading up to World War I, the financial sector grew almost four times faster than the economy — the first wave of financial deepening and globalization — but from 1918 until the 1970s finance expanded less rapidly than average economic growth.

Only when markets were deregulated and liberalized from the early 1970s onward did finance once again leap ahead. In the United States, financial sector GVA was only 2 percent of the total in the 1950s, but stands at 8 percent today.

Haldane believes that this growth spurt is well and truly over. He argues that much of the apparent growth in value added has in fact been illusory, based on increased leverage, excess trading and banks writing deep out-of-the-money options — for example, credit-default swaps, a $60 trillion market in 2007.

"What all these strategies had in common," writes Haldane, "was that they involved banks assuming risk in the hunt for yield — risk that was often disguised because it was parked in the tail of the return distribution."

From a regulator's perspective, this is a powerful argument for requiring higher capital to constrain the risk that banks can take on. Indeed, the Basel Committee plans to require more capital in the future, though the new requirements will be delayed, owing to concerns about the cost and availability of credit to sustain the recovery.

Against that backdrop, it is hard to believe that we will quickly return to the heady growth in financial assets, credit and risk we saw from the 1970s to 2007. Financial sector returns are likely to be lower. Returns of 20 percent on equity targets are a thing of the past. And lower profitability will reduce pay more effectively than any direct regulatory controls.

For most of us, unless we remain seriously overweight in financial stocks, this may not be a bad prospect. We do not want to inflate another asset-price bubble on the scale of the one that burst in 2007-08. But there is a risk for regulators and central banks. If they overconstrain the financial sector, risk may migrate outside the regulatory frontier, where it will be harder to measure and monitor.

That is why it is important to maintain some flexibility, to allow currently unregulated institutions like hedge funds and private-equity funds to be swept into the regulatory net if they become large and systemically important. The tighter their controls on risk in banks, the more frontier police the regulators will need.

Howard Davies, former chairman of Britain's Financial Services Authority and former deputy governor of the Bank of England, is currently director of the London School of Economics. His latest book is "Banking on the Future: The Fall and Rise of Central Banking."

The views expressed in opinion pieces do not necessarily reflect the position of The Moscow Times.