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Jeff Powell- The Globalisation of Finance: How big is too big? Podcast Transcript

Welcome to the University of Greenwich podcast series.

We hope you will enjoy our selection of podcasts,

which are linked to various interesting topics,

and A-Level syllabuses; and will hopefully

trigger thoughts and discussions around the various points

raised.

My name is Jeff Powell. I'm a senior lecturer

in economics in the department of international business and

economics at the University of Greenwich. Today, I'm asking, do we have

too much finance in relative terms, how big is the

financial sector? One measure would be to compare the value

of all the financial assets in the world. So we'd

have gold, money, deposits, securities, by which we mean stocks

and bonds on one hand, and GDP on the other.

That is value added in the production and provision of

goods and services, the real things that you and I use

in the economy on a day to day basis. Would

you guess that the value of the financial assets on

the one side is equal to the value of the

goods and services? Is it double their value? Could it

be quadruple their value? If you guessed the latter, you'd be right.

But in isolation, this fact doesn't mean much.

How is this relationship changed over time?

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This is a question for economists. In 1980, finance was about equal in size to global GDP.

By 1990, it was twice as big. And by the time at the start of the great recession in 2007/2008, it had risen to four times as big.

And so in the space of one generation, finances grown from the

same size as the value of goods and services to four times its size.

Now National Data lets us look further back in history to compare with this modern relationship.

Data from the US Central Bank, the Federal Reserve shows that the size of assets of the financial sector,

slightly different measure of the size of Finance.

Compared to US GDP grew slowly from approximate parity in the post-war years, to just under twice as big by 1980.

But at this point, something interesting happens. The graph turns up like a hockey stick.

By 2007, eight financial sector assets were nearly 500% of US GDP.

If we turn now to the UK, the picture is even more dramatic.

Data from the Bank of England show us that from 1880 until 1980, for a century,

Banking sector assets Just banks, not so called non-bank financial institutions such as pension funds,

mutual funds or insurance, banking sector assets were considerably less than the value of GDP for a century.

But by 2007, eight, they had risen from this 1980 level to a ratio that reached nearly 600%.

Six times the value of banking sector assets compared to British GDP.

What's going on? Why does our economy require so much more finance today than it did a generation ago?

Undoubtedly, part of the explanation rests on the new demands

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made at the financial sector to deal with a variety of risks that have

arisen with the internationalization of the global economy. But is that all that's going on here?

Adair Turner was asked this question into 2009.

In the midst of the financial crisis, remember that, at the time, he was head of the Financial Services Authority,

the most powerful regulatory body of the government presiding over the world's most important financial centre.

'Why is there so much finance?' he was asked.

His answer 'I think some of it is socially useless activity.

The Financial Services Authority was abolished in 2013.

The inflection point, that curve, in those hockey stick shaped graphs

I was talking about earlier is important. It marks the point in a shift

in the dominant understanding of finance adopted in both academia

and policy circles after the Second World War,

and prior to the 1970s, the dominant View of finance was that it

should be very carefully managed by the state in order to support

overall social objectives.

This view reflected the analysis of British economist John Maynard Keynes

at the international level, this approach was what led to

the 'Bretton Woods agreement', named after the city in New Hampshire

in the United States where it was agreed,

which established a system of fixed exchange rates,

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anchored by the US dollar and allowed for the presence of capital controls,

which prevented funds from moving quickly between countries.

At the national level, an active role for the central bank

in ensuring that cheap credit was provided to priority sectors was not only accepted,

but encouraged in the post war reconstruction effort.

The combination of economic stagnation and inflation

what economists have called stagflation in the 1970s

led to a crisis of support for Keynesianism ready in the wings

with a very different school of thought and economics,

which purported to have an answer to stagflation.

It's figurehead was the Austrian Economist, Friedrich Hayek,

who had spent the 1930s and 1940s teaching at the London School of Economics.

Hayek argued that the Keynesian acceptance of a central role for the

state in managing the economy was what had led the economy to become sclerotic.

The answer, he said, was to liberalize, to allow

market mechanisms to use all the information that was at their disposal

in order to make better decisions about profitable investment.

In line with this new thinking, Canadian economists Ronald MacKinnon

and his colleague, American economist Edward Shaw, criticized what they termed

'Financial repression' the use by governments of a range of policy tools

to attempt to channel credit to priority sectors.

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They argued in the 1970s for the benefits of financial liberalisation.

Now, note the importance of language here. How could anyone

argue against the end of repression and the support for liberty?

Very different words than Keynes use of the word management of Finance.

Making a long story short, economics has spent the last half century

arguing the benefits of what is described as financial deepening,

that is the creation and expansion of deep and liquid

markets for loans and securities around the world.

The growth of private finance. Central to their arguments are the

concepts of maturity Transformation, intertemporal smoothing and

the reduction of transaction costs. Now economists love jargon. But

these concepts are not in themselves particularly difficult to understand.

The first, maturity transformation refers to the ability of the financial system

to take a great number of deposits, to which savers

want to have regular short term access and turn it into

the provision of long term that is long maturity lending,

to firms for productive investment. Now, this is reinforcing a

misunderstanding of the relationship between loans and deposits.

Namely that banks lend out deposits, when in fact, loans themselves

create the matching deposit, but we'll have to save those arguments

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for another time. The second rule for finance intertemporal

smoothing is to provide different services which support households

at different stages of life, providing loans for house in early years,

savings and investment services during the prime earning years.

And then pension services which can be drawn upon in retirement.

Again, I might argue that while these are valuable services,

undoubtedly, there's no automatic reason why they should be

provided in the manner in which they have been provided.

But again, let's leave that aside for now.

The final benefit of financial deepening is argued to be

the ability to reduce transaction costs. An example might be the time

and effort that is required for investors to investigate prospective investment opportunities.

Think of Dragons Den, not only would I as an investor,

need to evaluate business plans of those who want my money,

but I would need to judge the character of those prospective borrowers.

Are they going to pay me back?

Are they going to do what they've told me they're going to do?

Then I would need to monitor my investments to ensure

that the borrower was doing what she said she was

going to do better perhaps to delegate this responsibility to a

financial institution, reducing the time and effort, the transaction

costs needed for me to make a profitable investment.

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Now, if we accept these arguments, and indeed, if we limit ourselves

to these arguments, then by definition, more finance must be a good thing.

Through maturity transformation, intertemporal smoothing and the

reduction of transaction costs of all varieties, it has been argued that

deeper financial markets mean more savings, more investment, and

ultimately more economic growth. More jobs for you and I and a

better quality of life. Indeed a number of influential cross country

econometric studies set out to prove that those countries which

have deeper financial systems also have better results in terms of

economic growth. The international financial institutions, the IMF,

and the World Bank, use these studies to justify the requirement

that middle and low income countries work to liberalize their

financial sectors to assist in their desire to achieve higher growth

rates and or to receive emergency support in times of crisis.

Whether they liked it or not. But turning back to the UK, whenever a

question mark is raised, about whether or not the financial sector

may have grown too big, the stock response is jobs, taxes and

growth. Any loss in the size of the British financial sector we are told

would spell Massive job loss, a huge hit to the Exchequer and

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thereby to public service provision and a reduction in the growth

prospects of the British economy. But, well, I can't do proper justice

to these arguments in such a short format. It's worth looking at some

new research from economists who are questioning precisely these assertions.

First, jobs. While there is no question that the financial sector is a

significant employer in the UK, it's not as big as most people think it is.

According to the Office for National Statistics, the sector has directly

provided 1 million jobs for a long time. For as far back as these kinds

of records are available in the early 90s, the financial sector has provided 1 million jobs.

Now that's three to 4% of the UK labour force significant

But nothing compared to business services, education, health, or

even the much lamented British manufacturing sector.

But perhaps more important, in relation to the argument over jobs is

what the financial sector has done to attract the best and the

brightest away from other sectors. This phenomenon is known as brain drain.

Work by economists Filipina and Rushev of examining the United

States shows that the relative wage of workers in the financial sector

compared to those in the non-financial sector has risen from

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approximate parity in the period of 1940 to 1980. To nearly double by 2010.

Now, young people going into economics and finance today may find

it hard to believe that wages in the financial sector were no different

from the non-financial sector not that long ago. Now, this reflects a

similar trend in the relative level of the education of workers in the

financial sector, compared to those outside finance, in short, people

working in finance are extremely well educated and very well paid

for their abilities. The question that Philippine and Rushev have

asked and don't yet have a clear answer to is what is the cost to

other sectors of the economy when the best, not only economists

and finance professionals, but increasingly, mathematicians,

statisticians, physicists, engineers, biologists, and even psychologists

are drafted into the finance sector, rather than say, working on

sustainable energy solutions. The second argument made in support

of the financial sectors contribution to the British economy is that it

represents the goose that laid the golden tax egg. But here again, we should take pause.

Surely when evaluating the tax contribution of the financial sector,

we need to take the rough with the smooth. A study by academics at

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the University of Manchester estimated the tax contribution to the

British financial sector in the five year period leading up to the Great Recession.

So we're talking about the period from 2002 to 2007 was 203 billion pounds.

Now, that's a significant contribution. But what about the cost to the

public of the bailout of the financial sector? Now admittedly, this is

difficult to estimate, as it depends on the ongoing efforts to for

example, so the public stake in banks that were part nationalized during the crisis.

However, as a guide, a 2009 IMF study estimated that the direct

costs as well as the indirect costs in terms of loss potential output for

the British economy were between 289 and 1000 billion pounds. 1

trillion pounds. Is the British taxpayer, a net winner, or a net loser

from the finance sector? The picture is a complicated one, I would

argue. Finally, let's look at the growth arguments. A recent study by

an economist at the IMF once again, has argued that the relationship

between financial development and growth is not linear.

Now economists use this term linear to mean that one variable

grows step for step with the other. Indeed, they argue that that

relationship IP is that of an upside down Punchbowl. They grow

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together for a while. But then they go in an inverse direction from

one another for a period. That financial development up until a

certain point, benefits economic growth. But that past that point,

continued growth of finance is leading to growth outcomes that are

lower than they would be if the financial sector was smaller.

Needless to say that the UK financial sector is way over in the

territory of too big to maximize growth.

Now, let's repeat that. The IMF, hardly an organization prone to

outlandish overstatement has made an argument that the size of the

UK financial sector is prohibitive to maximizing its economic growth.

An important recent study led by Andrew Baker at Sheffield University.

An important recent study led by Professor Andrew Baker

at the University of Sheffield has tried to quantify the impact of 'too

big finance' in the UK, what they have called the finance curse.

They've calculated that apart from crisis costs, the two big financial

sector has led to what they call misallocation costs of 2.7 trillion

pounds between 1995 and 2015. They argue that these misallocation

costs include the brain drain of skilled labour to the financial sector.

Detrimentally impacting non-financial sector productivity, while

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disproportionately benefiting low productivity projects such as real estate and construction.

The impact of an overvalued currency resulting from capital inflows to the financial sector.

For example, manufacturing exports, the perpetuation of uneven

regional development, inequality, social segregation, political

privilege, and concentration of power. Now, well, I would view these

figures with a grain of salt. But it certainly suggests is that more

research is needed to better unpack these misallocation costs. Now

some of you listening may be thinking that there is too much fixation

on growth in an era of climate breakdown. And you'd be right. But

we can also ask, what kind of growth does a large financial sector encourage?

Clearly, the British economy has suffered from low productivity, even

comparing with countries where services enjoy a similar share of

economic output. UK investment levels are approximately 17% of

GDP. That's Below the OECD average. Bank lending to the non-

financial sector is only 20% of their portfolios, lower than any other

OECD country. Inequality is high in the UK. Income inequality, though

stagnating in recent periods is at a high level. But this doesn't reflect

the differences within the top 10%. And even greater differences. If

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we look at the top 1%, wealth inequality is also dramatic.

And most of you listening will be very aware of the gross inequality spatially.

That is between the wealthy areas of London and the southeast, and

the Midlands and the North. Certainly, it could also be argued that

the British economy has been prone to crisis. And finally, that we

built an economy that is carbon intensive. Now, while we may avoid

some of the more obvious impacts of manufacturing on the

environment think the Chinese experience, we are indirectly funding

most of the biggest industries contributing to climate change

worldwide. So to sum up, the data tells us that there has been a

seismic shift since the 1980s in the size of finance in the global economy.

This marks a shift in the understanding of the approach to finance, both in academia.

The shift from Keynes managed finance to high x liberalized finance

and in policy marked by the rise of Reagan in the US and Thatcher in the UK.

A large body of economic work has been devoted to theorizing the

benefits of this financial deepening. In public debates, the British

financial sector has drawn upon this approach in defending its place

at the heights of the British economy. Job, taxes and growth are the repeated refrain.

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But new evidence is chipping away at those arguments. And more

and more people are starting to ask whether finance has just

become too big. And this isn't obscurantist academic debate. In

discussions over whether and how to change our relationship with

the European Union, what to do about the financial sector looms large.

And yet, we are entering such negotiations with a very incomplete

picture of which parts of the British financial system are critical to

our achievement of broader social objectives, and which parts may

just be socially useless.

Thank you for listening to this podcast.

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