Session 15
On Speculation and Financial Super-Profits
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Speculation is a concept that has positive connotations, unless it is financial in nature. After all, the scientific method is little else than the organisation of speculation. Once again, finance is different. There cannot be investment without speculation about our future. However, excessive speculation is associated with instability and inequality. History reminds us why financial speculation has such a negative cultural resonance. Our objections to excessive speculation are not just moral in nature. History indicates that excessive financial speculation contains the seeds of its own destruction, which is why it can be so destabilising. A logic of return-to-mean applies to the financial industry as much as for any other industry.

The two great financial crashes of the last century were both preceded by periods characterised by rapid growth of the share of financial profits, financial activity and financial employment within the major western economies. Our most recent crash represented the culmination of a quarter century in which the financial industry grew stronger and richer, above all in America, as a consequence of disinflation, deregulation and globalisation. The antecedents of the crash of 1929-30 were similar. In the collective memory the 1920s is remembered as a decade of wealth and excess, at least in America. Such periods of financial super-profits invariably produce a surge in the remuneration of those who work in the financial industry.

Those who doubt the strength of the link between financial profits and remuneration in the financial industry would do well to consult the NBER research paper written by Philippon & Reshef[1]. They found that compensation in American banking and finance, relative to the private sector as a whole, adjusted for age, skills and sex differences, rose to a premium of 30-50% through the boom years from the mid-90s to 2007. Only one other period in recent history has seen such as differential emerge; in the late 1920s.

A financial crash almost invariably signals a watershed between phases of financial de-regulation and re-regulation. In the 1930s the re-regulatory response was organised rapidly. The Pecora Commission of 1932 led to the Glass-Steagall Act of 1933. It might appear that the re-regulatory reaction since 2008 has been lenient. In particular, it does appear that America wishes to maintain the international dominance of its investment banks. However, the pendulum is swinging inexorably in favour of restriction regulations that will limit the profitability of financial activities. The practice of non-orthodox monetary policy provides a source of support for the financial industry, but one whose effects should diminish with time.

The evidence since 2008 supports the interpretation that the profits of the trans-Atlantic financial industry will not return to the super-profits of the years from the mid-1990s anytime soon, in Europe in particular (see charts below). The supposition is that the differential of compensation enjoyed by finance is on a return-to-mean trajectory. Ultimately it can return to virtually zero. Let us quote the

[1] NBER Working Paper. December 2008: "Wages and Human Capital in the US Financial industry: 1909-2006". Thomas Philippon and Ariell Reshef.

Philippon & Reshef paper: "Our main conclusion […] is that deregulation and corporate finance played dominant roles. We find that corporate finance activities linked to IPOs and credit risk increase the demand for skilled labour. At the present time it can be argued that the boom associated with cheap credit has been replaced by the boom of cheap capital. However, over the longer term […] tighter regulation is likely to lead to an outflow of human capital out of the financial industry."

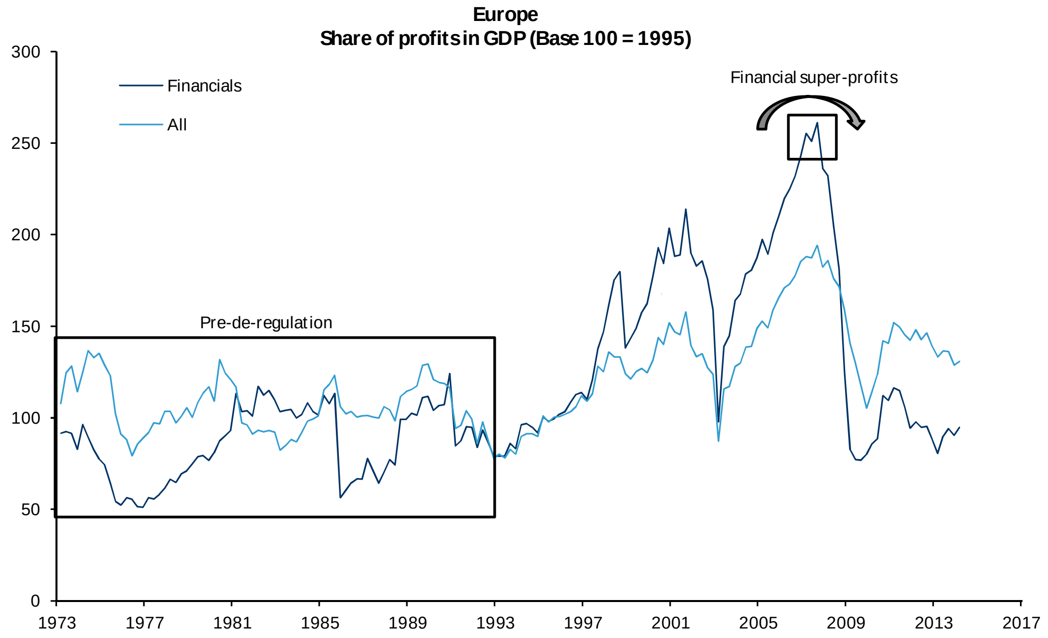
The end of financial super-profits is the single most effective mechanism that will resolve the question of excessive remuneration in the financial industry. Its effects are only just beginning to be apparent. In this respect the most interesting and most important question relates to the repercussions throughout our societies. It concerns the extent to which the financial industry is an authentic leading indicator.

The rise of financial profits and of remuneration in finance over the last twenty years has had a powerful demonstration effect upon compensation differentials in other industries. It is estimated by the Economic Policy Institute that the total compensation of chief executives in large US corporations in recent years is of the order of 250-300 times that of the salary of the average worker. 40 years ago the differential was about 35 times. The decline of super-compensation in the financial industry suggests that the tide may be turning.

The end of financial super-profits in the great crash may be the leading indicator of the climax of the rise in the profit share in the national incomes of the developed economies that is such a characteristic feature of the last quarter century. The current investment cycle may mark the culmination of the fall in the share of labour in the national incomes of the developed world. After all, it is now widely recognised that sustained economic recovery requires an increase not just in labour participation but also in wage rates.

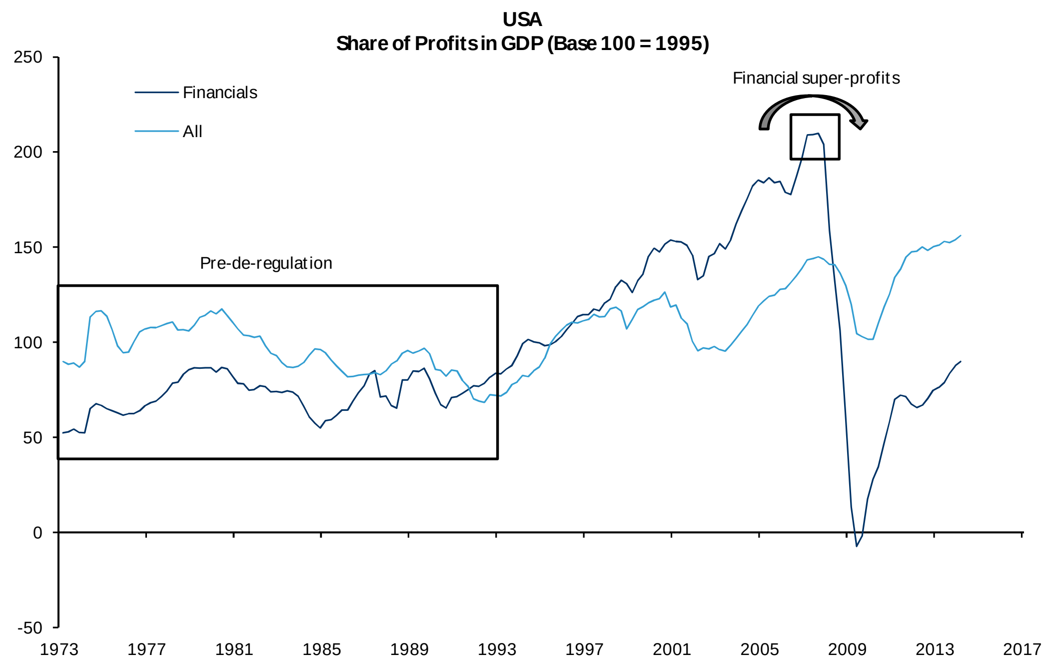
The decline of super-compensation in the financial industry may presage the narrowing of compensation differentials in the private sector in general. With a lag of perhaps a decade in relation to the financial industry it is becoming plausible to think that the degree of inequality of compensation within the private sector of the major developed economies is close to its highest point in recent history. Already we can note that there is greater emphasis upon income protection schemes for the disadvantaged, including extension of minimum wage legislation.

Chart 1 – The End of Financial Super-Profits in Europe



Source: Bloomberg, Datastream

Chart 2 – The End of Financial Super-Profits in the USA



Source: Bloomberg, Datastream