EUROPE'S FINANCE INDUSTRY OVER THE PAST HALF-CENTURY: Rapid growth but at a high cost to the real economy

The finance sector played an increasingly important role in European economies between 1951 and 2007, but its growth came at a high cost in terms of productivity. That is the central finding of research by **Guillaume Bazot**, to be presented at the annual congress of the European Economic Association in Mannheim in August 2015.

His study uses a new accounting method, which shows that the finance sector rose from making up 2.3% of GDP in 1951 to 8.2% in 2007. When deregulation kicked off in the 1970s, it was meant to make the industry more productive. But looking at the unit cost of production – the cost of creating and maintaining each euro's worth of financial services – it turns out that finance actually became more expensive.

While this increase in cost can at first be explained as following the rest of the economy, since 1990 the development of modern finance (in particular the capital market activities of banks) has been responsible for this increase in cost.

The research compares a range of financial services in terms of their unit costs. Usually this has been done by looking at the 'value added' of each service, but this study also looks at income from capital. Although unit costs surged while interest rates were high in the late 1970s and early 1980s, they have remained high even as rates fell as the sector became more reliant on underwriting, marketmaking and trading on their own accounts. The author concludes:

> 'The ability to transfer the costs of risk to other areas has allowed the finance industry to grow at the expense of the real economy.'

More…

Using a new accounting method, this paper shows that finance played an increasingly important role in European economies over the past few decades, growing from 2.3% of GDP in 1951 to 8.2% in 2007.

But since the subprime mortgage crisis, the role and size of the financial sector in our societies has been hotly debated. A key question in the debate is whether recent financial developments justify the accrued importance of finance in our economies and whether, as some propose, regulation should be aimed at reducing its importance.

This study proposes a measure of the unit cost of the production of financial services over the long term in Europe, as a way of assessing the efficiency gains in financial services production. The results show that finance has become more 'expensive' since the 1970s, just when deregulation was intended to make it more productive.

According to the research, the growth in intermediation costs between 1970 and 1990 can be explained by macroeconomic and monetary conditions. By contrast, the increase in unit cost after 1990 coincides with the development of modern finance that gives a greater role to market activity.

Because of the heterogeneity of financial services, this paper relies on macroeconomic data to measure the size and cost of the finance sector. It aims to measure the unit cost of financial intermediation, defined as the real cost of the creation and maintenance of one euro’s worth of financial services over one year. In this respect, the unit cost corresponds to the ratio of the domestic income of the financial sector to the quantity of domestic financial services produced.

The paper takes a different approach to measuring financial industry income. Economists usually measure the contribution of the financial services industry to GDP in terms of value added (VA), a measure that focuses on fees and spreads. But banks also get income from securities in the form of capital gains, interest and dividends. This was increasingly true in the years before the crisis as banks became ever more heavily involved in underwriting, marketmaking and trading on their own accounts.

This capital income is not included in the calculation of VA. But so long as capital income generates wages and profits to financial intermediaries, it is akin to an implicit consumption of financial services. By comparing financial VA with all financial income in Europe, Figure 1 shows how important capital income is in the financial industry.

Then the paper calculates a unit cost of finance by comparing the sector’s income with the stock of financial assets. The calculation shows that, outside France (where it has been stable), the unit cost has increased over the past 40 years in Germany, the UK, and Europe as a whole (Figure 2).

There was a surge in unit costs in the late 1970s and early 1980s when interest rates were high. But in more recent times, unit costs have not fallen as might have been expected, given the low level of interest rates since 2000. Instead the capital market activities of the banks seem to have pushed costs higher.

In fact, the competences required for securitisation and the management of complex asset portfolios and risks have increased both financial intermediaries’ demands for human capital and finance sector compensation. Moreover, insofar as financial incomes derive from risk, the capacity to transfer the costs of risk to non-financial agents has allowed the finance industry to increase its revenues at the expense of the real economy.

ENDS

Financial Consumption and the Cost of Finance: Measuring Financial Efficiency in Europe (1950-2007)
Guillaume Bazot

Figure 1:
The size of the financial industry in Europe

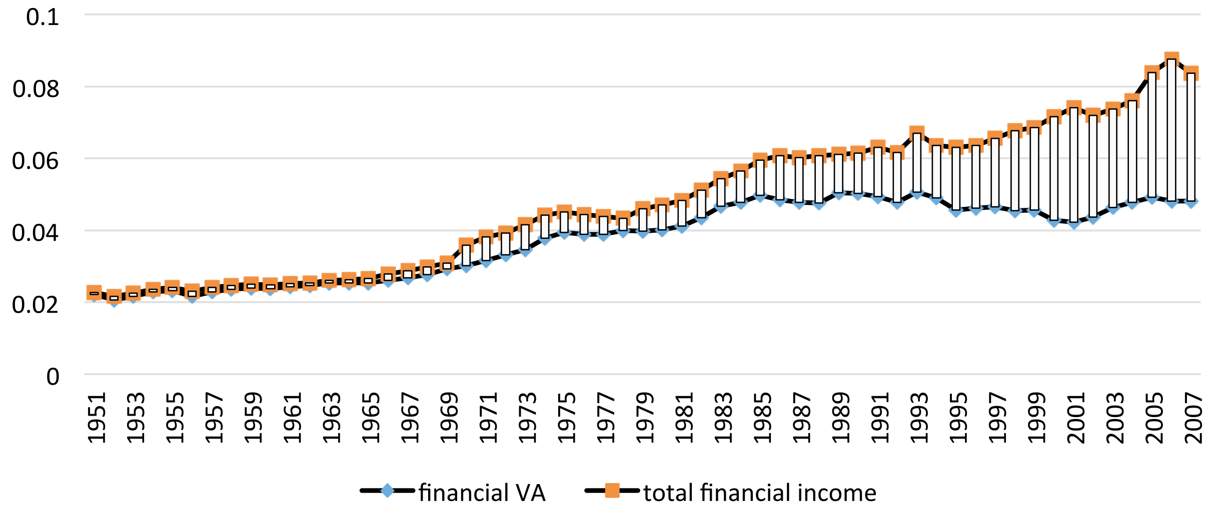

Figure 2: unit cost of financial intermediation