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HIGH & LOW FINANCE

Wall Street Paychecks May Wither

By FLOYD NORRIS

It is one thing when the best-paid people seem to be the smartest and the most accomplished. Those who make much less may not like it, but the differential seems understandable. It is another thing when those people are shown to have committed huge blunders that would have driven their companies out of business, and them into the unemployment line, but for government bailouts.

So it is now with Wall Street. In both Europe and the United States, antipathy toward the bailout is rising amid complaints that the money has not helped the economy by encouraging loans, but has kept the bankers in Champagne and caviar.

Are financial workers overpaid? And if so, will it continue?

The answers, according to a new study by two economists, are yes, they are overpaid, and no, it will not last.

“Wages in finance were excessively high around 1930 and from the mid 1990s until 2006,” wrote Thomas Philippon of New York University and Ariell Reshef of the University of Virginia, in a National Bureau of Economic Research working paper released this week, “Wages and Human Capital in the U.S. Financial Industry, 1909-2006.”

They forecast that up to half the wage differential observed in recent years “can be expected to disappear.”

They won’t disappear overnight, of course. The sad story of how Merrill Lynch bosses handed out bonuses just before the Bank of America takeover was completed — and just before about $15 billion in losses materialized from Merrill’s portfolio — reinforces the suspicion that Wall Streeters see themselves as entitled to outsize paychecks even if their companies are failing.

But even in the Depression the adjustment took time. The professors calculate that relative financial wages, taking into account education and other demographic factors, declined sharply in the 1930s and then at a slower pace until about 1980, when there was virtually no difference. Then, in a new era of financial innovation, “The financial sector became once again a high-skill, high-wage industry,” Mr. Philippon wrote on the N.Y.U web site this week.

It may be no accident that New York City, the country’s financial capital, went broke in the 1970s as financial industry wages approached their low point. Nor is it surprising that Manhattan real estate prices soared in the 1990s and early in this decade, as multimillion-dollar Wall Street bonuses pushed up demand for high-end apartments. If relative wages are set to decline, the pain in New York could be greater than in other regions.

The authors offer several reasons why financial salaries soared in the 1920s and again since 1980. It isn't computers, they argue, because there were no computers the first time, and it is not just a strong stock market. Instead, they attribute it in part to strong demand for financial analysis at a time when technical revolutions were leading to an explosion of new stock offerings and loans to young and risky companies. Before 1930, that was the electrical revolution. More recently, it was information technology.

There is also the lure of increasing financial innovation, which they say is least likely to occur when there is more regulation. "Highly skilled labor left the financial sector in the wake of Depression-era regulations, and started flowing back precisely when these regulations were removed."

The authors note that risky debt was popular in the 1920s, then all but disappeared until the 1970s brought junk bonds. Such debt, they note, is used to finance companies with high growth potential, but skilled analysis is required.

"This explains the dynamics of rating agencies, which were important players in the interwar period, small and largely irrelevant in the 1950s and 1960s, and growing fast from the 1970s until today," they write.

By the peak of the credit boom, rating agencies were essential to financial innovation; they had developed models that somehow proved that there was little risk for investors who put up most of the money for very risky loans. The models turned out to be very wrong.

As a result of the current crisis, much of that innovation now seems foolish or even criminal. Without the innovation, banks could never have issued subprime mortgages with teaser interest rates that would later soar. Nor could such mortgages have been bundled into securitizations financed largely by AAA-rated investments.

Nor could regulators have been persuaded that the banks' own risk models should be used to evaluate the safety of the banks. "In retrospect," the authors write, "it is clear that regulators did not have the human capital to keep up with the financial industry, and to understand it well enough to be able to exert effective regulation. Given the wage premia that we document, it was impossible for regulators to attract and retain highly skilled financial workers."

"Of course," they add, "regulators will be able to hire cheap skilled labor in 2009, just as they were able to in the 1930s."

Just how much the demand for financial innovation will fade is unclear, of course. "These things come in waves," Mr. Philippon said in an interview. "If for the next 10 years, we go back to a '60s-style economy, where big firms make investments without taking too much risk, finance will shrink." But, he added, if the green revolution, alternative energy and biotech "turn out to be like electricity, then we will need them."

He is convinced that less financial innovation could be good for a time, and that this crisis has shown to all that much more regulation is needed. "Some of the financial innovations we have seen are obviously inefficient," he said. "A good chunk of innovation has to do with tax and regulation arbitrage. That is really a waste for the society."

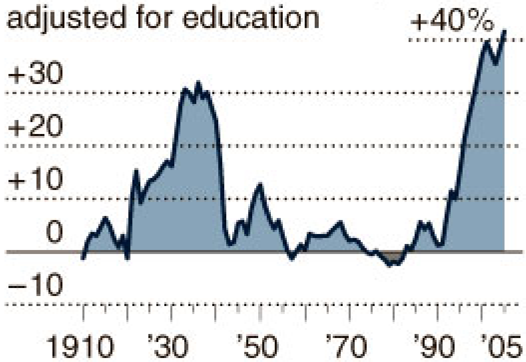
And, he added, the society could benefit from a flow to other industries. "As a society, do we want to put a third of our best brains in the financial sector?" he asked, pointing to a study indicating Harvard graduates from the early 1990s were far more likely to go into finance than were those who had graduated a decade earlier.

That generation has grown accustomed to the idea that investment banks, not to mention hedge funds and private equity funds, pay far better than companies in other industries. There is no guarantee that at least some of the advantage will not continue, but as I read the study, I recalled a passage from the recently published history of Goldman Sachs, "The Partnership," by Charles D. Ellis.

"Goldman Sachs was fighting for its life all through the Depression and World War II and was profitable in only half of the 16 years from the 1929 crash to the end of the war," Mr. Ellis wrote. "Most of the partners owed the firm money because their partnership income was less than the moderate 'draws' that their families needed to get along."

Floyd Norris's blog on finance and economics is at nytimes.com/norris.

Financial sector wages relative to other industries, adjusted for education



Source: Thomas Philippon

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