The New York Times

April 10, 2009

OP-ED COLUMNIST

Making Banking Boring

By PAUL KRUGMAN

Thirty-plus years ago, when I was a graduate student in economics, only the least ambitious of my classmates sought careers in the financial world. Even then, investment banks paid more than teaching or public service — but not that much more, and anyway, everyone knew that banking was, well, boring.

In the years that followed, of course, banking became anything but boring. Wheeling and dealing flourished, and pay scales in finance shot up, drawing in many of the nation’s best and brightest young people (O.K., I’m not so sure about the “best” part). And we were assured that our supersized financial sector was the key to prosperity.

Instead, however, finance turned into the monster that ate the world economy.

Recently, the economists Thomas Philippon and Ariell Reshef circulated a paper that could have been titled “The Rise and Fall of Boring Banking” (it’s actually titled “Wages and Human Capital in the U.S. Financial Industry, 1909-2006”). They show that banking in America has gone through three eras over the past century.

Before 1930, banking was an exciting industry featuring a number of larger-than-life figures, who built giant financial empires (some of which later turned out to have been based on fraud). This highflying finance sector presided over a rapid increase in debt: Household debt as a percentage of G.D.P. almost doubled between World War I and 1929.

During this first era of high finance, bankers were, on average, paid much more than their counterparts in other industries. But finance lost its glamour when the banking system collapsed during the Great Depression.

The banking industry that emerged from that collapse was tightly regulated, far less colorful than it had been before the Depression, and far less lucrative for those who ran it. Banking became boring, partly because bankers were so conservative about lending: Household debt, which had fallen sharply as a percentage of G.D.P. during the Depression and World War II, stayed far below pre-1930s levels.

Strange to say, this era of boring banking was also an era of spectacular economic progress for most Americans.

After 1980, however, as the political winds shifted, many of the regulations on banks were lifted — and banking became exciting again. Debt began rising rapidly, eventually reaching just about the same level relative to G.D.P. as in 1929. And the financial industry exploded in size. By the middle of this decade, it accounted for a third of corporate profits.

As these changes took place, finance again became a high-paying career — spectacularly high-paying for those who built new financial empires. Indeed, soaring incomes in finance played a large role in creating America’s second Gilded Age.

Needless to say, the new superstars believed that they had earned their wealth. “I think that the results our company had, which is where the great majority of my wealth came from, justified what I got,” said Sanford Weill in 2007, a year after he had retired from Citigroup. And many economists agreed.

Only a few people warned that this supercharged financial system might come to a bad end. Perhaps the most notable Cassandra was Raghuram Rajan of the University of Chicago, a former chief economist at the International Monetary Fund, who argued at a 2005 conference that the rapid growth of finance had increased the risk of a “catastrophic meltdown.” But other participants in the conference, including Lawrence Summers, now the head of the National Economic Council, ridiculed Mr. Rajan’s concerns.

And the meltdown came.

Much of the seeming success of the financial industry has now been revealed as an illusion. (Citigroup stock has lost more than 90 percent of its value since Mr. Weill congratulated himself.) Worse yet, the collapse of the financial house of cards has wreaked havoc with the rest of the economy, with world trade and industrial output actually falling faster than they did in the Great Depression. And the catastrophe has led to calls for much more regulation of the financial industry.

But my sense is that policy makers are still thinking mainly about rearranging the boxes on the bank supervisory organization chart. They’re not at all ready to do what needs to be done — which is to make banking boring again.

Part of the problem is that boring banking would mean poorer bankers, and the financial industry still has a lot of friends in high places. But it’s also a matter of ideology: Despite everything that has happened, most people in positions of power still associate fancy finance with economic progress.

Can they be persuaded otherwise? Will we find the will to pursue serious financial reform? If not, the current crisis won’t be a one-time event; it will be the shape of things to come.

David Brooks is off today.