Ballooning finance

Bruno Biais, Jean-Charles Rochet, Paul Woolley 21 August 2014

The Global Crisis has intensified debates over the merits of financial innovation and the optimal size of the financial sector. This column presents a model in which the growth of finance is driven by the development of a financial innovation. The model can help explain the securitised mortgage debacle that triggered the latest crisis, the tech bubble in the late 1990s, and junk bonds in the 1980s. A striking implication of the model is that regulation should be toughest when finance seems most robust and when innovations are waxing strongly.

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One of the curiosities of the modern economy is why the finance sector is so large. Economists have only recently sought to document and ponder this phenomenon. Empirically, Greenwood and Scharfstein (2013) find that, in the US, financial services, which accounted for 2.8% of GDP in 1950, made up 8.3% of GDP in 2006.

In Biais et al. (2014), we offer a formal analysis suggesting why finance has become so large, asking whether it is in society's interest and, if not, what might be done about it. In our model, the growth of the financial sector is driven by the development of a financial innovation. The analysis is applicable to a wide range of innovations – from specific instruments such as collateralised debt obligations (CDOs) or credit default swaps (CDSs), to asset classes such as junk bonds or exchange-traded funds (ETFs) – and management styles.

Our model considers two types of market participants: investors who own the assets, and managers who operate the innovation. The analysis is conducted first under the assumption that investors can

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