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# THE ROLE OF PROFESSIONAL ECONOMISTS IN THE FINANCIAL MARKETS

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# THE ROLE OF PROFESSIONAL ECONOMISTS IN THE FINANCIAL MARKETS

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Economists have always been interested in the workings of the financial markets, but most of them neither seek nor get the opportunity to work in a financial institution as a professional economist. Here we detail how (a minority of) economists became involved in the financial markets, and what that professional involvement has entailed, in order to come up with implications for economists who are considering working in the financial markets as well as for the universities that provide training for future economists.

## **Historical background**

In the formative stages of the economics profession, to be sure, things were very different. For example, the great classical economist David Ricardo developed a comprehensive knowledge of the London money, bond and equity markets as they functioned in the early 19th century.<sup>2</sup> He acquired this knowledge as an industry insider, however, thanks to a career as a stockbroker (under the tutelage of his father) and then as a bond trader – before he took an interest in what we now call “economics.” By the time Ricardo read a copy of Adam Smith’s *The Wealth of Nations* when he was 27 years old – the book that sparked his lasting passion for economics – he had already

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<sup>2</sup> See Timothy Davis, “David Ricardo, financier and empirical economist,” *European Journal of the History of Economic Thought* (Spring 2002), pp. 1-16.

been working in the London financial markets for over a dozen years and had amassed a fortune that allowed him to turn his attention to more intellectual pursuits. Nowadays, in sharp contrast, virtually everyone learns economics in the classroom rather than on the job, and then applies their mastery of economic concepts and analysis to various situations, such as those that arise in the financial markets.

Large commercial banks and industrial corporations in the United States began to employ economists in the 1930s, in the wake of the Great Depression. “Each great bank maintains an economist nowadays” noted a business monthly in 1936, as part of an interview with the then economist for the Chase National Bank, a forerunner of J.P. Morgan Chase.<sup>3</sup> A young David Rockefeller spent the summer of 1937, in fact, as an intern with Chase’s economics department, after he had completed a first year of graduate study in economics at the University of Chicago.<sup>4</sup> And yet, there is no evidence that during the 1930s economists played much of a role in, or were even hired by, investment banks, brokerage houses or asset-management firms – namely, by the financial intermediaries that constitute the core of Wall Street.<sup>5</sup> Indeed, the demand for economists in the private sector was quite limited. By 1940, fewer than 70 new professional economists, representing a mere 8% of the total number who obtained a

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<sup>3</sup> See Herbert Corey’s interview with Benjamin M. Anderson Jr., *Nation’s Business* (August 1936), p. 27.

<sup>4</sup> Rockefeller would return to the Chase in 1946, several years after obtaining his Ph.D. degree in economics, to start a career that would eventually lead him to the chairmanship of the bank. See John D. Wilson, *The Chase: The Chase Manhattan Bank, N.A., 1945-1985* (Boston, MA: Harvard Business School Press, 1986), p. 26.

<sup>5</sup> For example, there is no mention of economists in Vincent P. Carosso, *Investment Banking the America: A History* (Cambridge, MA: Harvard University Press, 1970).

Ph.D. in economics during the 1930s in the United States, had managed to find jobs in the business community.<sup>6</sup>

Job opportunities for economists in business, though not yet in finance, began to open up during the 1940s and 1950s, both in the United States and in Europe. By the early 1950s, there were about 600 persons serving as professional economists throughout the US business community. A survey of the economics departments of major US companies yielded replies from 49 firms including 27 industrial concerns, 13 banks and insurance companies, four public utilities, and five other companies. One quarter of the companies had a single economist; one third of the firms employed two or three economists; and another third of those surveyed employed four or more economists.<sup>7</sup> Their main responsibilities were to follow domestic and international business conditions, demand and prices for their firms' products, governmental policies, and developments in the money and capital markets. By the early 1960s, the US business community was the destination of about 11% all economists who had earned a Ph.D. degree during in the 1950s.<sup>8</sup>

It was in the 1960s, and especially during the turbulent 1970s and early 1980s, that economists were hired in larger numbers, and rose to prominence, on Wall Street. Increasingly sharp swings in the pace of economic activity, ever more activist fiscal and monetary policies, an escalation of inflation and interest rates in the wake of two oil

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<sup>6</sup> See Howard Bowen, "Report on graduate education in economics," *American Economic Review* (September 1953, Part Two), p. 11.

<sup>7</sup> *Ibid*, pp. 18-19.

<sup>8</sup> See Francis M. Boddy, "The demand for economists," *American Economic Review* (May 1962), p. 505.

price shocks, and the collapse of the Bretton Woods regime of fixed exchange rates – these were the underlying factors that increased the demand for macroeconomic analysis, and particularly for accurate economic and financial forecasts. One of the early beneficiaries was Henry Kaufman, whose academic background combined an undergraduate degree in economics with a business school Ph.D. in finance, plus several years of work experience at the credit department of a bank and at the Federal Reserve. He was recruited by Salomon Brothers in 1962, when he was 35 years old, to start up a fixed-income research effort. In order to determine future trends in the value of bonds, Kaufman began to monitor the operations of the Federal Reserve and the U.S. Treasury – thus becoming one of the founding fathers of the art and science of “Fed watching” – for the purpose of forecasting future credit conditions.<sup>9</sup> His mostly accurate warnings about looming inflationary pressures, the dangers of rapid debt accumulation, the specter of rising interest rates, and the risks inherent in financial deregulation, securitization, and globalization, earned him the sobriquet “Doctor Doom.” As Salomon’s outspoken chief economist, eventual head of a large research department, and ultimately Vice Chairman of his firm, no financial economist before or since has ever matched the influence that Kaufman exercised in his heyday (the 1970s and early 1980s).

The influx of professional economists to Wall Street in the wake of the economic and financial upheavals of the 1970s and 1980s was such that, by 1985, nearly 600 members of the American Economic Association reported that they were working in

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<sup>9</sup> See Henry Kaufman, *On Money and Markets: A Wall Street Memoir* (New York: McGraw-Hill, 2000), p. 139.

banking or finance.<sup>10</sup> Another 900 or so, for their part, identified themselves as working in business or industry. Despite the impressive increase in the absolute number of economists working in the US financial markets, they remained in the minority in relation to the overall community of AEA members. Economists working in banking or finance represented a mere 4.4% of the total, and those engaged in business or industry accounted for 6.8% of total AEA employment. As had been the case in prior decades, as of the mid-1980s the vast majority of economists based in the United States were working in academia (60% of total) or, to a much lesser extent, in government (13%).<sup>11</sup>

In Europe and beyond, meantime, there were economists working in the major financial institutions and in large industrial concerns, but with the exception of some of the economists in London, they were mostly relegated to staff functions and were not directly involved in the financial markets. In the stormy 1970s or 80s, there never arose a European, Asian or Latin American equivalent of a Henry Kaufman – namely, someone who could move their financial markets by persuading issuers and investors to buy or sell securities or currencies on the basis of their economic forecast. For a variety of reasons, many of the best economists in Europe had – and still have – a strong incentive to be recognized and gain influence by getting involved in politics, for the purpose of being appointed to central bank, finance ministry, or other executive

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<sup>10</sup> According to other sources of information, in the early 1980s there were nearly 300 economists working in commercial banks, about 30 in investment banks, and still more in insurance companies and credit-rating agencies. See George G. Kaufman, “The academic preparation of economists employed by commercial and investment banks,” *Journal of Money, Credit and Banking* (August 1984), p. 352.

<sup>11</sup> See Edward A. Schroeder IV, “Careers in economics. a sample study of AEA members,” *Journal of Economic Education* (Autumn 1988), p. 391. AEA members that were retired or resided outside the US were excluded from the sample of more than 13,000 respondents. The overall membership of the AEA grew from about 3,000 in 1940 to 11,000 in 1960, 19,000 in 1970, and a peak of 22,000 in 1993.

positions.<sup>12</sup> The same would apply to professional economists in Asia, Latin America and elsewhere in the developing world during the 1990s – and is still the case nowadays: there is no greater prestige than to be appointed to a high government post. More often than not, the first economists based in financial centers such as Frankfurt, São Paulo, Tokyo or Singapore to advise issuers and investors (in stocks, bonds or currencies) were employed by US financial institutions, such as J.P. Morgan, Goldman Sachs or Citibank. They set the standard in terms of how to put economists to good use (in the financial markets), a standard that would later be emulated by domestic and European financial institutions.

Indeed, the 1980s and 1990s would see an expansion of the role of financial economists to encompass coverage of international developments in general, and of investment risks and opportunities in the emerging markets, in particular. The globalization of investment horizons and the interconnection of financial markets throughout the world meant that economists with a different background were needed in New York, London and other financial capitals – those with a specialization in international and development issues, firsthand knowledge of regions such as Latin America, Asia and the Middle East, a willingness to travel and possibly to relocate, and fluency in languages other than English. The downfall of communism and the expansion of financial markets throughout Eastern Europe, as well as the emergence of China as a major investment destination, also added to the demand for economists with an international or development orientation. These economists would work alongside

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<sup>12</sup> See Bruno S. Frey and Reiner Eichenberger, “American and European economics and economists,” *Journal of Economic Perspectives* (Autumn 1993), pp.185-193.

their peers – namely, the more traditional Fed (Federal Reserve), ECB (European Central Bank) and BoJ (Bank of Japan) watchers, the USD/EUR and USD/JPY currency forecasters, and the OECD data analysts – and they would learn from them, adopting and adapting their best technical practices.

In recent years, the reputation of financial markets research, at least as practiced on Wall Street by investment banks, has been besmirched by scandals that came to light after the bursting of the Internet bubble in 2000. The scandals involved some high-profile equity analysts covering the technology and telecommunications industries, who exaggerated the likely performance of the companies they were following and failed to point out to investors some of the risks entailed – probably because their compensation was tied directly or indirectly to the underwriting fees that their employers were earning from those same companies. Although no economists were involved in these scandals, many new rules governing all research distributed to US investors have since been put in place for the purpose of ensuring that analysts are as objective as possible, including a provision forbidding compensation to research analysts out of investment banking profits. One consequence, however, is that the production of research on Wall Street, whether by American or foreign banking firms operating in the US, has now become a heavily regulated, formalized, and thus more costly activity.<sup>13</sup> Economists working in the financial industry are not immune to the new regulatory climate, and thus compensation and hiring trends have not been favorable for them, as well as for other researchers, as of late. Since US standards often end up being adopted elsewhere

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<sup>13</sup> See Yoon-Young Lee and Stephanie Nicolas, “Research analyst independence: efforts to eliminate conflicts lead to conflicting requirements,” *Journal of Investment Compliance* (Fall 2003), pp. 15-24; and Kyle L. Brandon, “Research management issues: how are the rules working?,” *SIA Research Reports* (March 14, 2006), pp. 3-7.

around the world, because consumers – in this case, investors and regulators – demand them, chances are that many financial economists will have to abide by the new rules, regardless of where they are located, and that they too will have to bear some of the cost.

### **Economists in financial markets**

The economists who work in financial institutions tend to be remunerated very well relative to their peers in industry, academia or government – but their work schedule is very long and demanding, and they have little or no job security.

The National Association of Business Economics (NABE), which represents mostly professional economists working in the United States outside of academia, carries out a survey of compensation among its members every two years. The latest such survey, produced in 2004, reveals that economists working on Wall Street earned on average almost 250,000 dollars per annum, which was 75% more than did economists in industry, nearly twice as much as their peers in commercial banking or insurance, and more than two-and-a-half times as much as their colleagues in government or academia. These compensation figures are averages, as noted; this author is personally acquainted with quite a few Wall Street economists who have earned more than 500,000 dollars per year, and also with a small minority of very successful ones that have earned more than one million dollars per annum.<sup>14</sup>

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<sup>14</sup> From personal experience, we know that some of the highly (and highest) paid economists on Wall Street are so busy that they do not have time to fill out surveys such as the one carried out by the NABE.

**Figure 1: Compensation of economists by type of employment (USD/annum)**

	<u>Base salary</u>		<u>Other compensation</u>		<u>Total earnings*</u>
	<u>Median</u>	<u>Number</u>	<u>Median</u>	<u>Number</u>	<u>Median</u>
Securities & investments	148,500	32	100,000	31	245,375
Manufacturing	118,100	34	30,000	25	140,159
Consulting	116,000	97	30,000	68	137,031
Banks & insurance	105,000	99	27,700	84	128,503
Nonprofit research	119,000	22	14,000	11	126,000
Trade associations	111,500	33	12,000	23	119,864
Other	99,000	50	14,500	32	108,280
Public utilities	90,000	56	15,000	43	101,518
Government & central bank	93,420	114	5,000	59	96,008
Academic	83,200	76	18,000	31	90,542

*\*Calculated assuming that survey respondents who did not declare a compensation above and beyond their base salary had zero other compensation.*

*Source: NABE, author's calculations.*

As is usually the case, however, “there is no free lunch.” The workload of financial economists is very heavy and stressful. Especially in this day and age of the ubiquitous cell phone, Blackberry and laptop computer, it can be said that they are either at work or on call 24 hours a day, seven days a week. The position usually entails considerable domestic and foreign travel, be it to gather information or to visit clients, and this tends to affect their family and social life. Vacations tend to be short and are often interrupted by telephone calls or e-mail messages from the office or from clients.

The typical workday starts at around seven in the morning and does not end before seven o'clock in the evening. Economists are expected to read the leading newspapers and financial magazines, preferably before they arrive at their desks; monitor during the course of the day the latest information released by news organizations such as Bloomberg, CNN, Dow Jones and Reuters; and keep up with useful empirical research published by other economists, whether in academia, government agencies, or think tanks – at home and abroad. It is understood that they will maintain a database of statistical information and that they will use or develop an econometric model to come

up with forecasts of key macro variables like inflation, GDP growth and the foreign trade balance. To the extent that social, political or institutional factors affect the pace and nature of economic activity – and they always do – every macroeconomist must take them into consideration in shaping a view of the present and the likely future. Most importantly, these economists are expected to predict the behavior of financial variables such as interest rates, bond spreads and exchange rates – the ones that are of greatest relevance to issuers, traders and investors. The objective is not just to be right more often than wrong, but to be right more often than their counterparts in competitor firms.

Financial economists are also expected to convey their analysis of current events, and their views on the future, to actual and potential clients of their firm. They do this primarily by writing up and distributing “instant analyses” during the course of the day (via Bloomberg or e-mail), and also by producing more polished, original essays or studies every week or every other week (which are e-mailed and also printed and then mailed) – and frequently also on a monthly or quarterly publication schedule.

Economists must communicate their views to clients by placing telephone calls and sending e-mail messages to them, visiting them on a regular (usually quarterly) basis, and otherwise getting their attention via interviews with newspapers and radio and television stations. The goal here is for economists – just like others carrying out fixed income, currency or equity research – to encourage existing and potential clients to act on the ideas and forecasts they have received by using the services of their employer.<sup>15</sup>

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<sup>15</sup> See, for example, Richard A. Yamarone, “The business economist at work: Argus Research Corporation,” *Business Economics* (July 1999), pp.65-70. For an even more frenetic lifestyle, see Nancy J. Kimelman, “The business economist at work: Thomson Financial Services,” *Business Economics* (October 1998), pp. 53-55. For

For example, an economist working at an asset management company (e.g., a pension or mutual fund) tries to encourage investor clients to entrust more money to be managed by his/her firm, whereas an economist working for a broker-dealer attempts to spur issuer or investor clients to use the underwriting, trading or distribution capabilities of his/her firm. It is this attraction of new business that makes it possible for financial companies to cover the cost of economic and other types of financial research that is provided to clients free of charge.

Working as an economist in the financial markets is obviously not for everyone. It takes a special combination of interest, ability, dedication, stamina, risk-taking and ambition. It is definitely not suitable for those who are introverted, prefer working alone, dislike being regimented, are not “morning persons,” abhor uncertainty, or value uninterrupted weekends and long holidays. In terms of what are some of the key ingredients for a successful professional experience in the financial markets – or for that matter in the private sector in general – the advice given more than half a century ago by an economist who was then head of marketing research at the Ford Motor Company still seems appropriate:

*“[The economist] must get things done. He is working for a money-making organization, and he can justify his position only if he strengthens the company’s earning power by developing information that actually can be used to advantage by his management. ... He must recognize what is important, and get that part of*

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some historical background on the origins of financial forecasting, see also Kaufman, *op. cit.*, chapter 8, pp. 137-155.

*the job done first. He must sense what deserves priority, and operate with a built-in set of urgency ratings that cover the span of his firm's operations. He must observe deadlines. Nothing in business is quite so useless as a beautiful chart and graph presentation proving that last month's decision was right. ... It behooves the economist to consider the attention factor – to keep his conclusions simple, and to talk plain language. Finally, he must make strong recommendations. To borrow a slang expression, in business, it's a case of 'Put up or shut up.'*<sup>16</sup>

In light of the recent scandals on Wall Street that were mentioned earlier, and which did involve some researchers who as was pointed out were not economists, it seems appropriate to discuss the inherent conflicts of interest that an economist will usually find when working in the financial markets. According to one outside observer,

*"Perhaps the most important [conflict] is the self-imposed intellectual isolation. Among economists in the academic world, as well as for those in government, consultation with one's colleagues is standard operating procedure and considered essential to doing good work. ... The contrast on Wall Street is striking. It seems hard to believe, but some Street economists claim not even to know the names of their competitors. There appears to be little or no contact among most of them, professional or social."*<sup>17</sup>

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<sup>16</sup> See R. J. Eggert, "Needed training and opportunities for the industrial economist," *Journal of Farm Economics* (December 1954), pp. 924-925.

<sup>17</sup> See George B. Henry, "Wall Street economists: are they worth their salt?," *Business Economics* (October 1989), p. 45.

In our opinion, while it is true that economic analysts in the private sector generally do not exchange ideas or engage in collaboration with other economists outside their own firm – precisely because they are being paid to come up with original work, and because of the competitive climate that is all around them – it is also true that their work is inspired and enriched by ongoing dialogue with traders, issuers and investors. Said dialogue may not be “intellectual” in nature, but it definitely discourages any potential intellectual isolation on the part of the economists working in the financial markets. After all, they cannot afford to be viewed as being outdated or irrelevant – never mind wrong.

Another conflict inherent in the job is the pressure to have an economic forecast, or at least an opinion, that is different from the consensus – because it will tend to get noticed by clients and the press.<sup>18</sup> Here again, while it is true that researchers have a strong incentive to stand out from the crowd and to gain notoriety for themselves and their firm, it is also true that lasting recognition is awarded only to those who are proven right, and not to those who are merely different. An economist who is always going against the consensus and is usually wrong will surely not be taken seriously by issuers and investors – and probably will be fired by his employer sooner rather than later.<sup>19</sup>

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<sup>18</sup> *Ibid*, p. 45.

<sup>19</sup> There is evidence that inexperienced analysts are more likely to be terminated for inaccurate forecasts than are their more experienced colleagues, and that controlling for forecast accuracy, they are also more likely to be terminated for bold forecasts that deviate from the consensus. See Harrison Hong, Jeffrey D. Kubik and Amit Solomon, “Security analysts’ career concerns and herding of earnings forecasts,” *RAND Journal of Economics* (Spring 2000), pp. 121-144.

Realistically, the most important conflict of interest, as was made evident by the scandals on Wall Street, is that a research analyst will be tempted to be – or will be pressured into being – insufficiently critical about the present and likely future performance of a company or government entity. The conflict is most likely to arise when the analyst’s employer does business with the company or government that is the potential target of criticism, and especially when the analyst’s compensation is directly or indirectly tied to the profitability of that business relationship. The reason is that many company presidents and ministers of finance do not take kindly to criticism, and they have been known to demand the firing of the analyst in question and to pull business away from financial firms that publish unfavorable research reports – even when analyst criticism proves to be justified.

As mentioned earlier, new rules have been put in place in the US to minimize this kind of conflict of interest, and chances are that similar rules will be adopted in other leading financial capitals. However, even if a research analyst’s compensation is no longer tied to the profitability of his employer’s relationship with a particular company or government entity, it would be foolhardy for him to ignore the existence of that relationship and to come up with overly critical or pessimistic assessments – even if they are eventually proven correct. Therefore, chances are that industry and economic research published by financial firms will tend to remain biased in favor of the companies and governments being discussed.<sup>20</sup>

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<sup>20</sup> Several papers have documented the prevalence of so-called forecast optimism, at least among Wall Street equity analysts. See, for example, Terence Lim, “Rationality and analysts’ forecast bias,” *Journal of Finance* (February 2001), pp. 369-385; and John C. Easterwood and Stacey R. Nutt, “Inefficiency in analysts’ earnings forecasts: systematic misreaction or systematic optimism?,” *Journal of Finance* (October 1999), pp. 1777-1797.

## **Implications for universities in Latin America**

The employment of economists in the financial markets has by now a well-established history, at least in the more advanced countries which have had unfettered financial markets for centuries. In the so-called emerging markets, where the trading of stocks, bonds, commodities and currencies free of government intervention has a much shorter history, job opportunities for economists and other financial analysts have appeared only in the past one or two decades – and usually thanks to US and European financial firms. If universities in Latin America and beyond are to prepare their graduates well for possible employment in the financial industry, there are two suggestions that come to mind.

First, the university curriculum must reflect the fact that English is the universal language of business and finance. At a minimum, students who are contemplating a career in business or financial economics should be told early on that proficiency in written and spoken English is a necessary component of their education. Whether proficiency in English should or should not be a requirement for graduation is debatable, but students ought to know that their horizon of job opportunities after graduation will be widened considerably if they are fluent in English.

Second, the traditional economics curriculum, which is so heavily weighted with courses of a purely theoretical nature, should include at least one offering of a practical nature, namely, a course that teaches students how to monitor, analyze and compare economies. This course ought to show students where to obtain and how to interpret

essential macroeconomic and financial data (e.g., industrial production, monetary aggregates and corporate earnings). Last but not least, the course should teach students to become proficient in the use of Excel and PowerPoint, software that is relied upon extensively in the financial markets for all sorts of calculations and presentations.

Nearly 20 years ago, a survey was conducted in the United States among graduate students in economics. A major objective of the survey was to gain a better understanding of the perceptions that students had about what were the factors that would be responsible for their professional success. One of the choices they were given was “Having a thorough knowledge of the economy,” and amazingly 68% of the students believed that acquiring such knowledge was *not* important, and fewer than 5% of the total said that having such knowledge was very important. “Being good at problem-solving” and “Excellence in mathematics” were the only things that students thought were very important for professional success.<sup>21</sup>

Given this kind of misperception on the part of students, it is no wonder that US financial firms would find it increasingly difficult to hire economists fresh out of the university during the 1990s and this decade, forcing them to hire mostly economists who had first “come down to earth” by working several years at the Federal Reserve or the IMF. To the extent that students outside the United States may also share this misperception, we need to educate them differently if we want to make it easier for financial and other firms to hire our graduating economists.

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<sup>21</sup> See David Colander and Arjo Klamer, “The making of an economist,” *Journal of Economic Perspectives* (Autumn 1987), pp. 99-100.