Intro. and background: two modern crises
266: Financial Markets and Institutions

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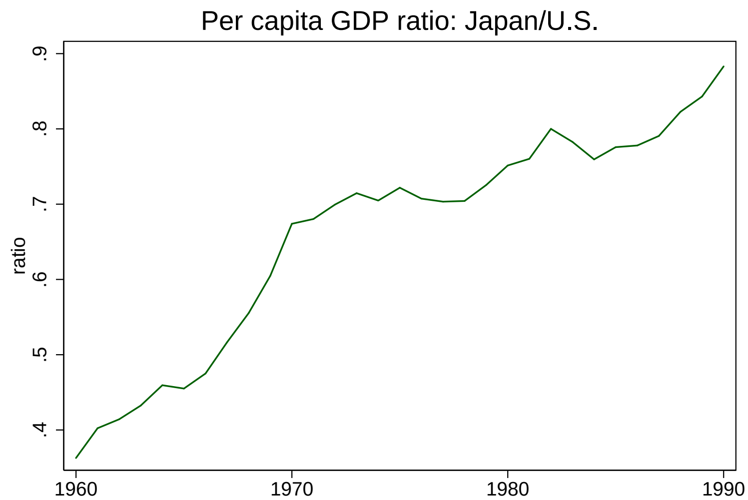
- ...
  - The previous section brought us up through the end of the 1800s
  - Quick review of the 1850 to 1950

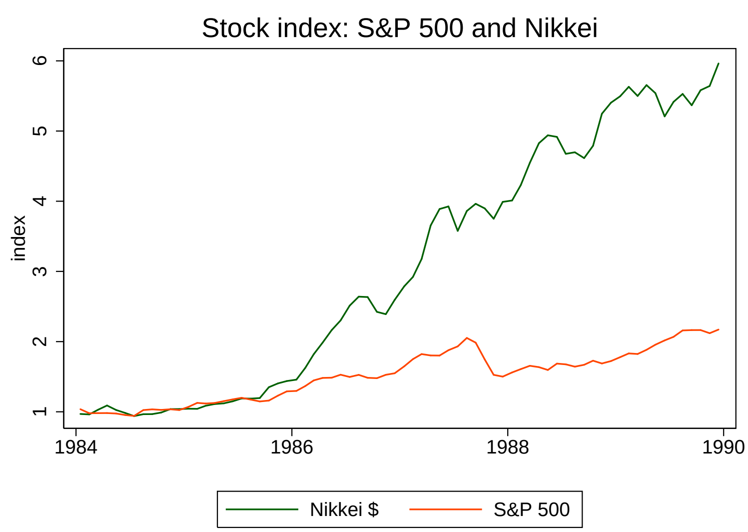
    Living standards in industrialized economies grew rapidly
  - But the 100 years were pretty bumpy

    two world wars, the Great Depression, etc.
  - Make no mistake, neither world wars nor the depression could have happened without the finance and industrial revolutions.
  - But by 1950, the turmoil in advanced countries and economies had settled out a bit.
  - Let's pick up the story looking at Japan and the U.S. after 1950.

- **Japan and the U.S. in the post-WWII economy**
  - In the aftermath of WWII, Japan's economy was a wreck, but it soon began growing much more rapidly than the U.S.



- ▶ **Japan vs. U.S.**
  - Japanese per capita GDP was at about 40 percent of the U.S. level in 1960
  - Grew to near 90 percent by 1990
  - Around 1990, many folks were predicting that Japanese income would rocket past that of the U.S.
- ▶ **Japanese stock market**
  - The Japanese stock market performance was even more impressive



  - Japan's stock market grew in value by six-fold while the U.S. market value only doubled.

- **Aside:: Stock index**
  - If you don't know what a stock index is, we'll cover that later
  - For now, think of the stock market values in the figure as an index of the total value of major businesses in the two economies.

- **As Japan outpaced the U.S. by several metrics. . .**
  - Excitable folks in both countries went nuts
  - In the U.S.: OHMYGOD, you mean we might not have the most wonderful system ever?
  - In Japan: We're number 1, we're number 1

    (well, soon anyway)

- **Why was Japan outperforming the United States?**
  - Scholars began studying this relative performance and many attributed the differences to differences in the financial markets and institutions in the two countries.
  - The debate echoed arguments given by Adam Smith and J.S. Mill.
  - The U.S. system gave much less prominence to banks and much greater prominence to stock market finance.

    That is, less debt, more equity in the U.S.

  - And debt finance in Japan was highly structured as opposed to market driven

    In Japan's system, banks, businesses, and the government worked together in large closely-connected groups, which decided what companies should do

  - Many folks concluded that market-based financial incentives of the U.S. system pushed U.S. companies to make bad decisions.
  - Consider a few quotes indicative of some thinking at the time

- **Clyde Prestowitz**
  - Secretary of Commerce in the Reagan Administration
  - Book title: How We Are Giving Our Future to Japan and How to Reclaim It

    The single greatest weakness of U.S. industry in competing with Japan is lack not of management effort but rather of financial staying power. Our capital is both too expensive and too impatient. (Trading Places: How We Are Giving Our Future to Japan and How to Reclaim It, p519)

- **Robert Kearns**
  - –

[In the Japanese system] corporations own each other and are operated not to maximize returns to shareholders, but to minimize risk and thus to maximize long-term earnings. (Robert L. Kearns, Zaibatsu America: How Japanese Firms Are Colonizing Vital U.S. Industries, 1992, p. xi.)

- **Chalmers Johnson**
  - well known Political Science Prof.
  - –

    Japan is dynamic because its managers devote themselves to competing with other companies at home and abroad, without having to serve the parasitic interests of shareholders or the passive interests of workers who have no stake in the viability of the company. (Chalmers Johnson, Japan: Who Governs?, p63)

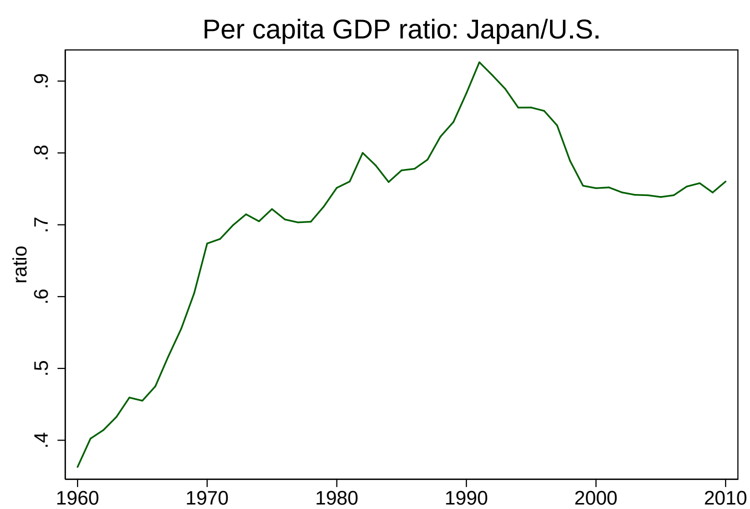
- **Hmmmm, parasitic interests of shareholders and passive interests of workers. . .**
- **Do financial arrangements matter?**
  - These arguments are about how means of financing might shape the incentives of managers.

    And thereby lead to dramatic differences in economic performance

  - The U.S. system made people work hard, these folks were arguing, but they were incentivized to work on the wrong things.

    The pressure from the shareholders and others kept firms from making good decisions.

- **Before going much further into this debate, we should extend those figures on Japanese economic performance**
- **. . .**



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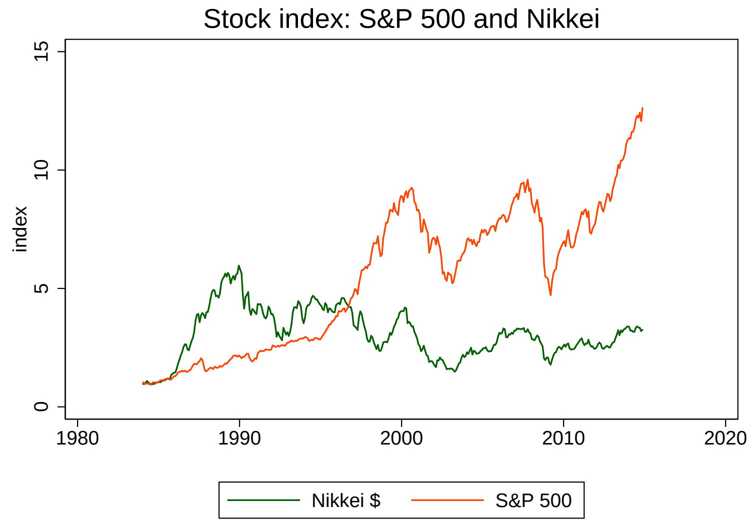


- **Ouch**
  - Japanese income fell back to about 70 percent of that in the U.S.
  - And Japan's stock market crashed and over the subsequent 25 years didn't rise much at all.

    only recently may it have regained clear upward momentum

- **One more detail**
  - A main source of per capita income growth is growthy in productivity.
  - Japan's Labor Productivity growth 1981–1990: 3.1 %; 1991-2000: 2.0%; 2001–2010: 0.79%; 2011–2014: 0.71

    Source:Productivity Statistics of Japan Productivity Center, productivity at establishments with 30 or more employees

- **O.K. maybe all those dramatic conclusions about the Japanese system being better were not so solid.**

- **Aside:: Misery or merely solid performance?**
  - There are debates over just how bad Japan's economic performance has been over the 25 or so years since 1990.
  - By many metrics, after a very bad period in the early 1990s, things have been solid
  - It is clear, however, that the miraculous performance relative to the U.S. vanished

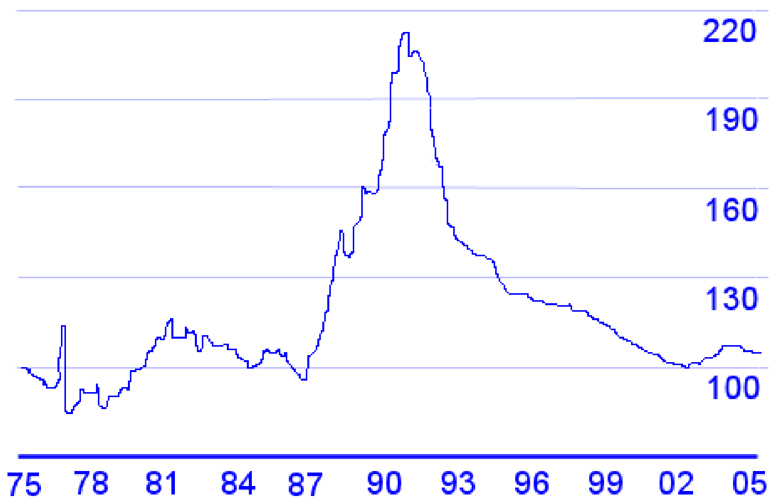
- **What happened?**

- In the 1980, real estate values in Japan skyrocketed far beyond what economic fundamentals seemed to warrant.

  when this happens we say there is a 'bubble'

- Real estate prices then collapsed, dragging the stock market down as a result

▶ **Japan House prices**



▶ **Aside:: Real estate bubbles**

- Crazy bubbles in real estate markets are a familiar thing worldwide.

  These are arguably another example of the general notion we have trouble designing institutions under which financial markets work well.

- The bubbles generally end with a crash in prices, and the crashes may or may not cripple the economy for a time

▶ **Aftermath of Japan's bubble**

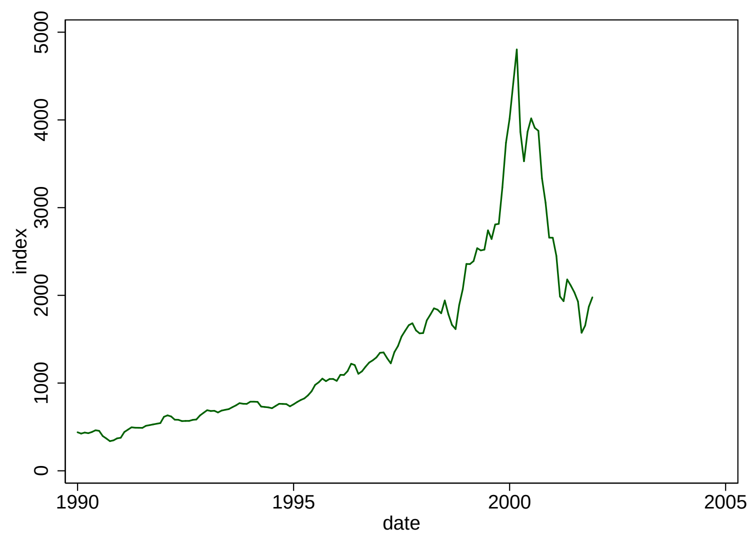
- There is no definitive account of why things evolved as they did in Japan after the bubble collapsed
- Many experts, however, attribute at least part of the blame to the fact that the collapse of the bubble left many banks in a weak financial condition.
- And the weakened banks could not play their essential role in financing economic activity

▶ **But surely this sort of thing wouldn't happen in the U.S.**

▶ **The Tech Bubble**

- Around 2000, the U.S. experienced a bubble in share price values centered mainly in technology stocks
- The bubble is clear in the NASDAQ index, which covers lots of tech stocks.

▶ **NASDAQ Index**



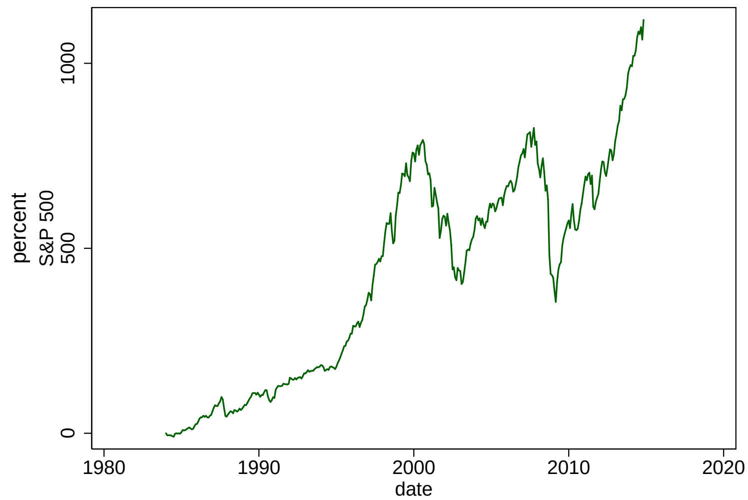
▶ **Tech. bubble aftermath**

- The collapse of the tech bubble was associated with a very mild recession in the U.S.
- And by the early 2000s, the economy was roaring again.
- Many analysts argued that the dynamism and flexibility of market-based finance in the U.S. made the economy resilient and unlikely to falter after a financial disruption.
- Fed Chair Alan Greenspan was one of the most vocal cheerleaders for this view.

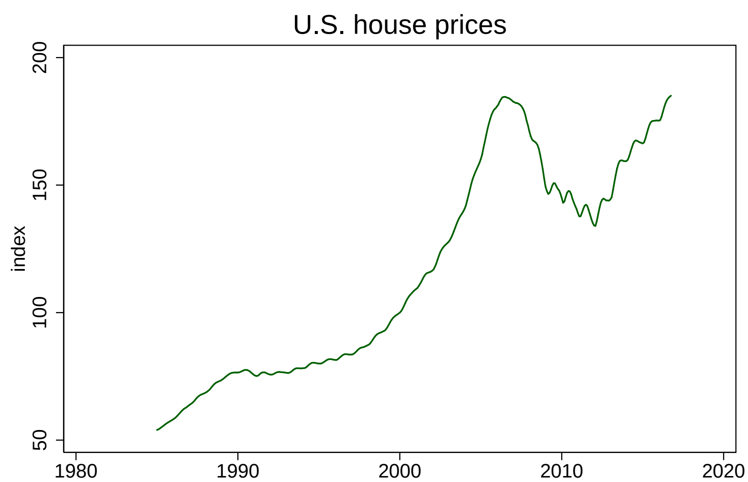
> Over the past couple of decades, the American economy has become increasingly resilient to shocks. Deregulated financial markets, far more flexible labor markets, and, more recently, the major advances in information technology have enhanced our ability to absorb disruptions and recover. go
>
> https://www.federalreserve.gov/boarddocs/testimony/2001/20010920/default.htm

▶ **And then**

- Both house prices and the general stock market boomed once the modest recession ended and up through the years up to 2007

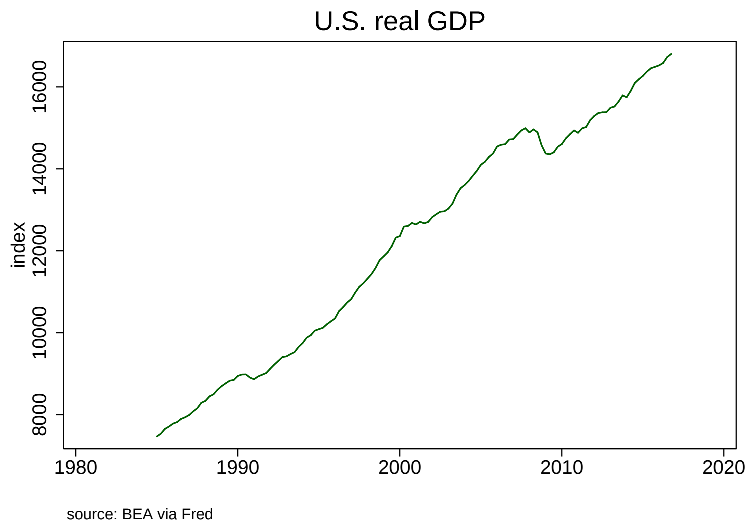


Note: year label marks start of year



source: via S&P via Fred

- And when the apparent bubble in house prices collapsed there was lots of turmoil
- The unemployment rate went to 10%
- And U.S. GDP seems to have taken a very persistent hit



- **Financial firms in the crisis**

  - Many large financial firms failed.
  - Many others probably narrowly avoided collapse due to a major rescue plan from the Federal government.

    (the bailout also saved GM)

  - The *ex post* critiques of the problems leading to collapse of major financial firms contains nothing that would surprise Adam Smith, or J.S. Mill.

    Indeed, the modern analysis in many cases basically looks like paraphrasing the earlier thinkers.

- **OECD review**

  - The OECD analyzed corporate governance and the crisis and had several conclusions

    go

    http://oecdobserver.org/news/archivestory.php/aid/2931/Corporate%5Fgovernance:%5FLessons%5Ffrom%5Fthe%5Ffinancial%5Fcrisis.html

  - –

    Recent surveys have shown that four out of five market participants believe that compensation practices played a role in promoting the accumulation of risk that led to the crisis.

  - –

    Surveys of audit committee members have shown that they are not too satisfied with the current state of reporting. Only four out of ten said that the risk reporting they received was very good.

  - –

If boards have failed in many cases, then where were the shareholders? Some did raise their voices, or sold their investments, but others were just as interested in shortterm gain as traders and management were.

- **The point**
  - There is modern rocket science underlying how financial firms operate, but core ideas understood by Adam Smith and Shakespeare are still dominant.
  - And society continues to try to refine that web of public and private sector institutions to, as Bagehot put it, allow the system to operate safely.
  - And, as the OECD noted, we still don't understand very well the best approach:

    The age-old debate about whether higher standards of corporate governance can be enforced by laws and rules or encouraged via guidelines and market behaviour has heated up considerably since the crisis.
  - In the U.S., the debate heated up and is still raging

    Right now in Congress, there is a battle over whether the post-crisis reforms to regulation went too far, and various regulations are now being gutted
  - As our none-to-subtle President put it,

    Dodd Frank is a disaster. . . We're going to do a big number on Dodd Frank. go

    http://thehill.com/policy/finance/316879-trump-we-will-do-a-big-number-to-dodd-frank
  - Note: The Dodd-Frank law contained the main post-crisis regulatory reform
- **Back to Japan vs. the U.S.**
  - In many ways the recent period in the U.S. may echo the Japanese experience

    (and the experience after other house price bubbles elsewhere in the world)
  - But note that unlike the Japanese case, both house prices and the stock market have recovered
  - While GDP performance has been disappointing is had not been horrendous
- **Why?**
  - So why did the Japan case happen?
  - And why did the more recent U.S. case happen?
  - What did the structure of finance have to do with the crisis arising and with the better (but not good) response of the U.S. in the aftermath?
  - We'll talk about many issues that will go into answering these questions.

- There is no expert consensus answer to these questions at present.

  History is very much still being made on this topic.

▶ **Summary**

- Financial markets are prone to all sorts of problems that have been pretty well understood for centuries.
- Modern economists can detail the deviations from the perfect markets assumptions that explain why real-world financial markets often produce results far from the perfect markets outcome
- Societies have grappled with how to design public and private sector institutions and practices to mitigate these problems
- The patchwork includes or has included: Debtors prison, contracting law, fraud laws, accounting laws and standards, limited liability and bankruptcy laws, bank supervision and regulation, deposit insurance, central banks, etc.
- History makes two things very clear:
  - This stuff matters. When an economy's financial markets work badly, the economy performs badly.
  - We don't yet have the right mix.

▶ **For folks looking for what to do with their lives**

- This unsettled area is a treasure trove—or snake pit—of opportunities
- Unsettled issues always provide amazing opportunities for financial gains
- Unsettled areas provide amazing opportunities for study, if you are inclined toward research.

  You too could have a glamorous job studying and teaching this stuff.

- And there are great opportunities in governmental, private sector, and quasi-governmental organizations that oversee various aspects of the system.

▶ **Finally,**

- No matter what you want to do with your lives, finance is likely to be important.

  Fixed or floating mortgage to buy a house, saving wisely for retirement, should I max my credit card(s)...

- This course is intended to give you a basic understanding of the key issues in all these areas.