

## Intro. and background: two modern crises

### 266: Financial Markets and Institutions

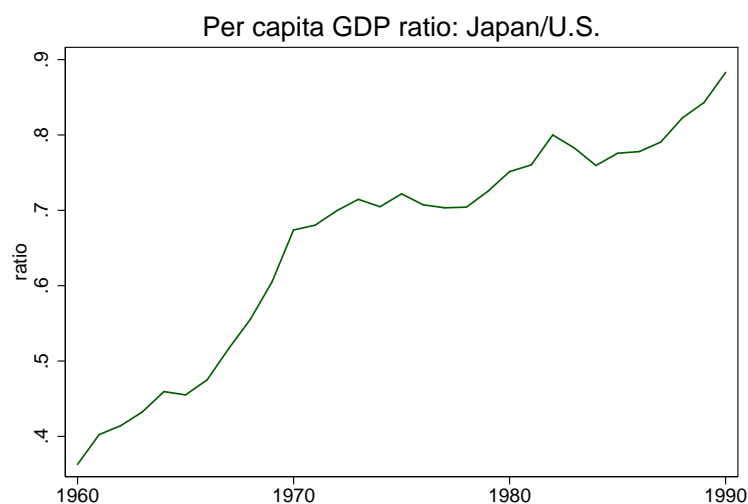
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<http://e105.org/e266>

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#### ► Fast forward to 1950

- Let's jump forward from the late 1800s
- By 1950, the rapid growth in living standards that started in the mid-1800s had continued for about a century.  
that century saw two world wars and the Great Depression: global disasters that probably would not have been possible without the industrial and finance revolutions.
- In the aftermath of WWII, Japan's economy was a wreck, but soon began growing rapidly



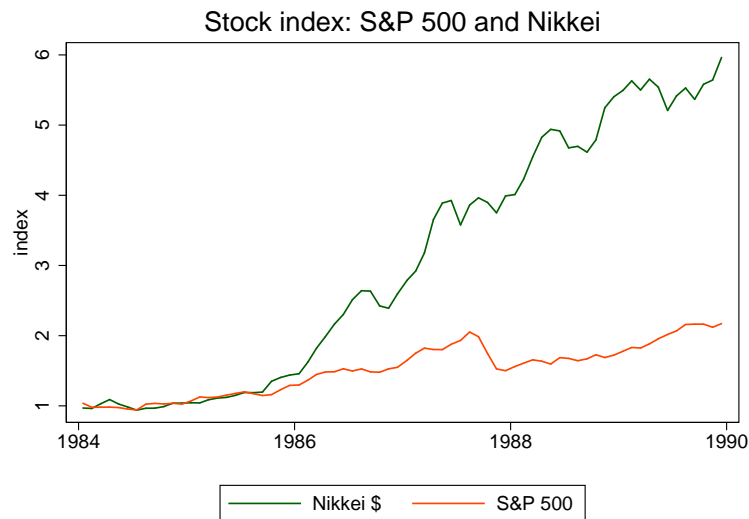
#### ► Japan vs. U.S.

- Japanese per capita GDP was at about 40 percent of the U.S. level in 1960
- Quickly grew to near 90 percent by 1990

- Folks predicted that Japanese income would rocket past the U.S.

### ► Japanese stock market

- The Japanese stock market performance was even more impressive
- If you don't know what a stock index is, we'll cover that later
- For now, think of the stock market data below as an index of the total value of major businesses in Japan and the U.S.



- Japan's stock market grew in value by six-fold while the U.S. market value only doubled.
- Scholars began studying this relative performance and many attributed to differences in how the financial markets and institutions had evolved in the two countries.
- Excitable folks in both countries went nuts
  - In the U.S.: OHMYGOD, this can't happen  
you mean we might not have the most wonderful system ever?
  - In Japan: We're number 1, we're number 1  
Or surely will be in a couple of years
- I'm not exaggerating here  
my language is understated relative to the xenophobia that erupted on both sides.

### ► Financial markets and institutions

- One very important theme at the time in the debates over why Japanese performance was so strong relative to the U.S. centered on financial markets and institutions.
- It echoed the debate between Adam Smith and J.S. Mill.

- The U.S. system gave much less prominence to banks and much greater prominence to stock market finance.
- The stock market created an incentive for short-term gain as opposed to truly valuable progress.  
Note: In Japan's system, banks, businesses, and the government got together in large closely-connected groups and decided what companies should do
- Many folks concluded that market-based financial incentives cannot compete with a bunch of smart guys (and in Japan and, to a lesser extent, the U.S. at this time, it was mainly guys) deciding what businesses should get capital.

► **A few quotes indicative of some thinking at the time**

► **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)

► **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**

- –  
The 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.)

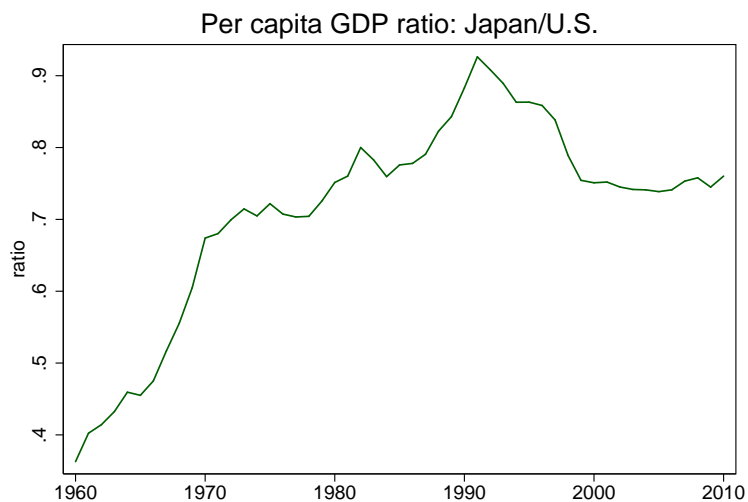
► **Hmmm.**

- Note that these arguments are about how means of financing shapes the incentives of managers.
- The U.S. system made people work hard, but on the wrong things.

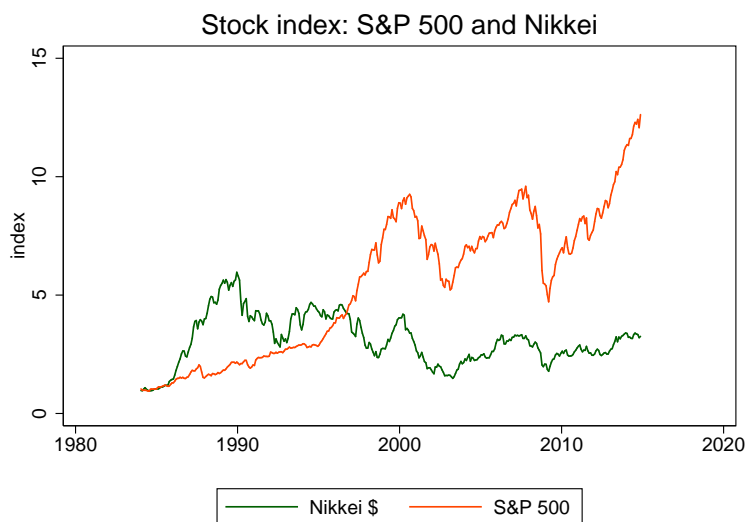
The pressure from the shareholders and others kept firms from making good decisions.

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

► ...



► ...



► 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 has still has not 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

► **Note:**

- There are debates in some circles over just how bad Japan’s economic performance has been over the 25 or so years since 1990.
- It is clear, however, that the miraculous performance relative to the U.S. is gone

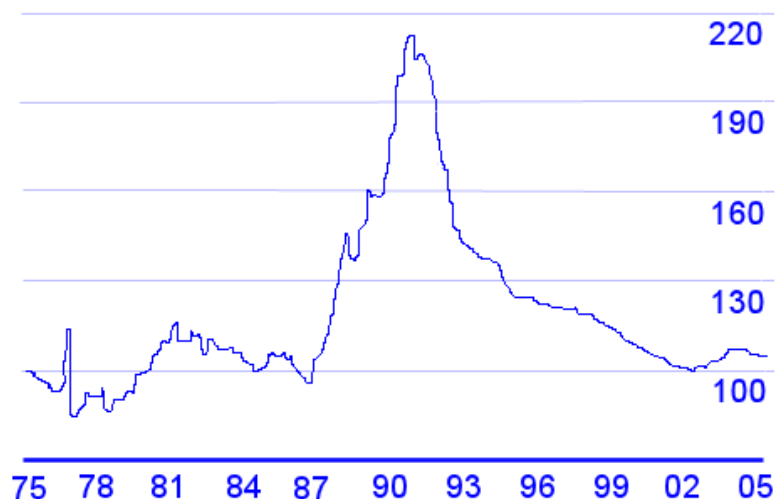
► **What happened?**

- 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’

- A widely repeated anecdote says the land under the imperial palace in Tokyo at its peak value was equal to the value of all land in California.
- 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 always 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
- 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

► **As of today**

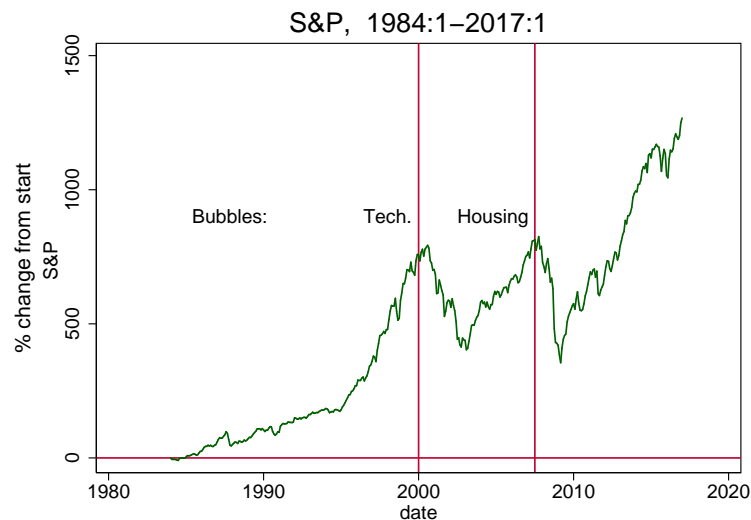
- As you may know, Japan still struggles 25 years or so after the bubble popped
- Just in early 2016, Japanese authorities pushed their policy interest rate negative in a renewed attempt to kickstart the economy.

We’ll talk about policy interest rates and the extreme and peculiar phenomenon of negative nominal interest rates later.

► **One more bit of history: the 2008 financial crisis.**

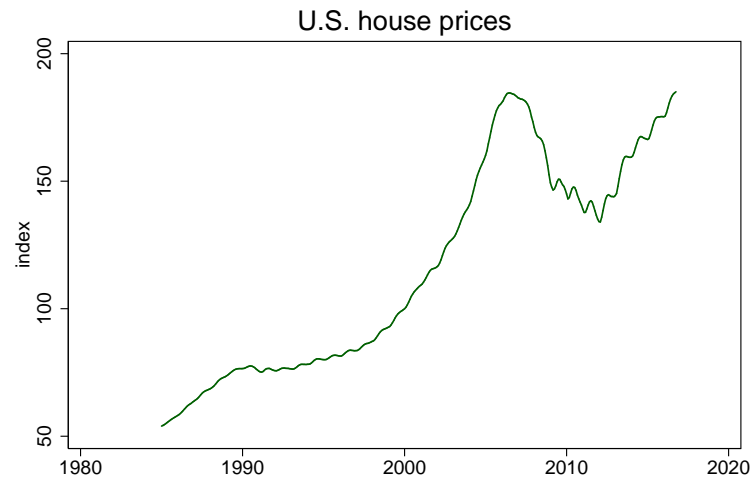
► **The 2008 financial crisis**

- From the late 1990s through 2008, the U.S. had two bubble-like events in stock prices



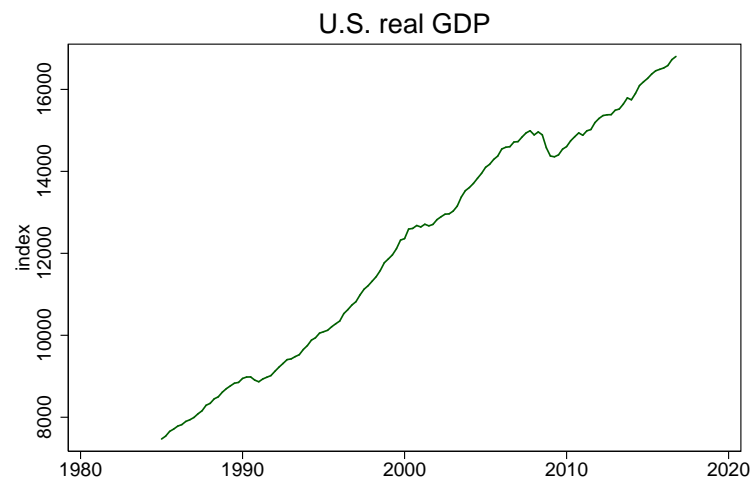
- Around 2000, we had what is known as the ‘tech’ bubble (bubble starting in technology stocks)
- Then around 2007-2008 we had what is known as the housing bubble.

this is because the second bubble-like event was associated with bubble-like behavior of house prices



source: via S&P via Fred

- The second bubble was associated with collapse of many financial firms, a bailout of others, and lots of other grimness.
- In the aftermath of the collapse of the second bubble, GDP seems to have taken a very persistent hit.
- The level dropped and the subsequent growth arguably slowed.



source: BEA via Fred

## ► Echoes of Japan?

- In many ways the recent period in the U.S. may echo the Japanese experience (and 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 it had not been horrendous

► **Why?**

- So why did the Japan case happen?
- And why did the more recent U.S. case happen?
- And which system is better?
- We'll talk about this, but there is no one definitive account so far.
- Even more than that, there is no agreement on how the system should evolve so as to avoid such problems in the future.

► **Financial market evolution**

- After the crisis, the entire regulatory structure in the U.S. was re-written in the Dodd-Frank law

(and in other laws and regulations).

- Dodd-Frank, like all law in this area, is imperfect and a patchwork.

And Dodd-Frank was written and passed in haste, so there are some really crazy bits.

- But lots of folks think there are also some good bits while others think differently.
- Just this week: Pres. Trump

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

- Stay tuned...

► **Summary to this point**

- History has been a struggle to design a set of financial institutions so that financial markets can bring us closer to the perfect markets ideal.
- For much of history, financing large-scale projects was nearly impossible and, partly for this reason, there was very little economic progress.
- Major and rapid changes in financial institutions and practices began in the 1800s and have continued apace ever since.
- Since 1850, we've seen the constant evolution of a patchwork of private and public sector institutions and practices intended to mitigate the age-old and well-known problems with financial markets.



- The patchwork: Contracting law, fraud laws, accounting laws, standards, and practices, limited liability and bankruptcy laws, bank supervision and regulation, deposit insurance, central banks, etc.
- We've made a lot of progress, but the patchwork is still very imperfect and is still evolving.
- Indeed, at present in the U.S. it may be evolving in major ways between any two meetings of this class.