In Defense of Wall Street

The Social Productivity of the Financial System

Finance is powerful

- Mobilizes
- Researches and allocates
- Monitors and exerts corporate control
- Provides risk diversification and management tools
- Conducts transactions

But, is it good or bad?

- "... banks have done more harm to the morality, tranquillity, and even wealth of this nation than they have done or ever will do good." John Adams
- " … banks are the happiest engines that ever were invented for creating economic growth." Alexander Hamilton

Neither; it has no soul

- It can be a source of prosperity:
  - Identify, fund, monitor the best projects and entrepreneurs
  - Efficient resource allocation, expand opportunities.
  - Incentives regarding human capital
- Or misery:
  - Limiting credit—and hence opportunity—to a few.
  - Protecting the wealthy and connected
  - Distorting the flow of capital—and hence human capital

This paper

- Although the degree to which finance fosters prosperity or misery reflects laws, regulations, and supervisory agencies
    - E.g., the politics of public banks
    - E.g., Fed, SEC, FDIC policies
  - This paper does not address this.
- Here, I just try to assess whether finance matters much—beyond crises.

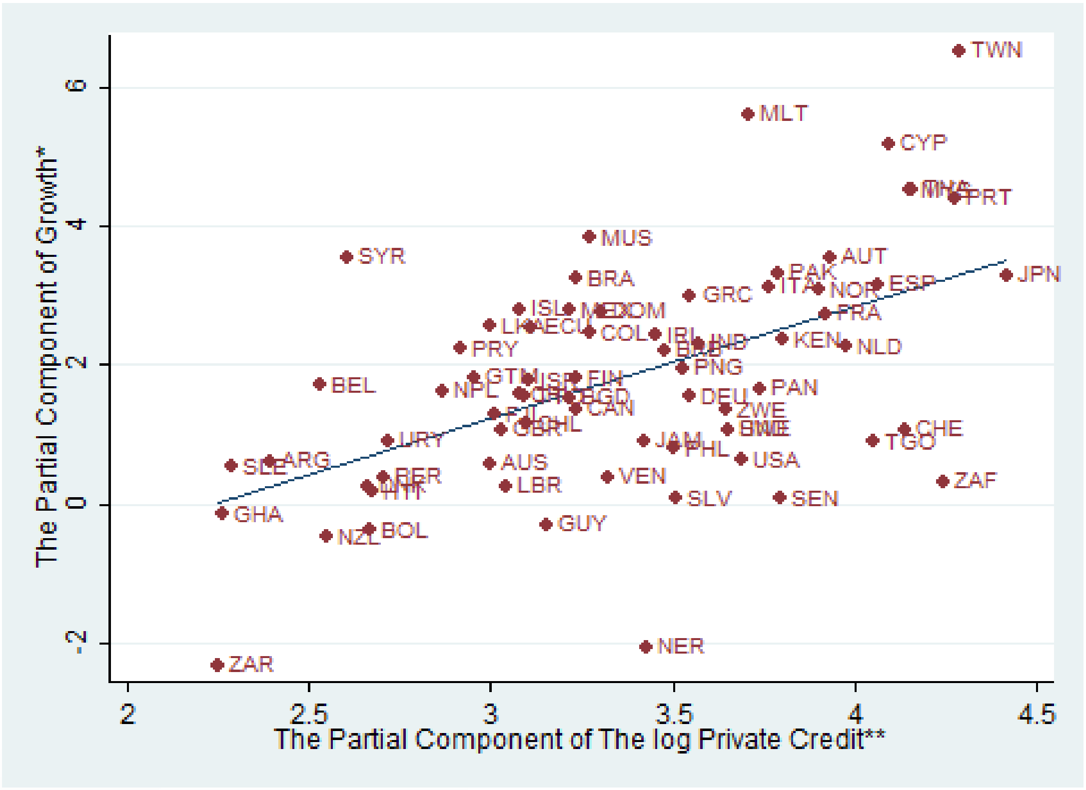
I will primarily use 3 types of evidence

- Cross-country
- Cross-state
- Historical anecdotes

I will examine …

- Aggregate growth
- Income distribution and the incomes of the poor
- And, financial innovation

Finance and growth: X-C

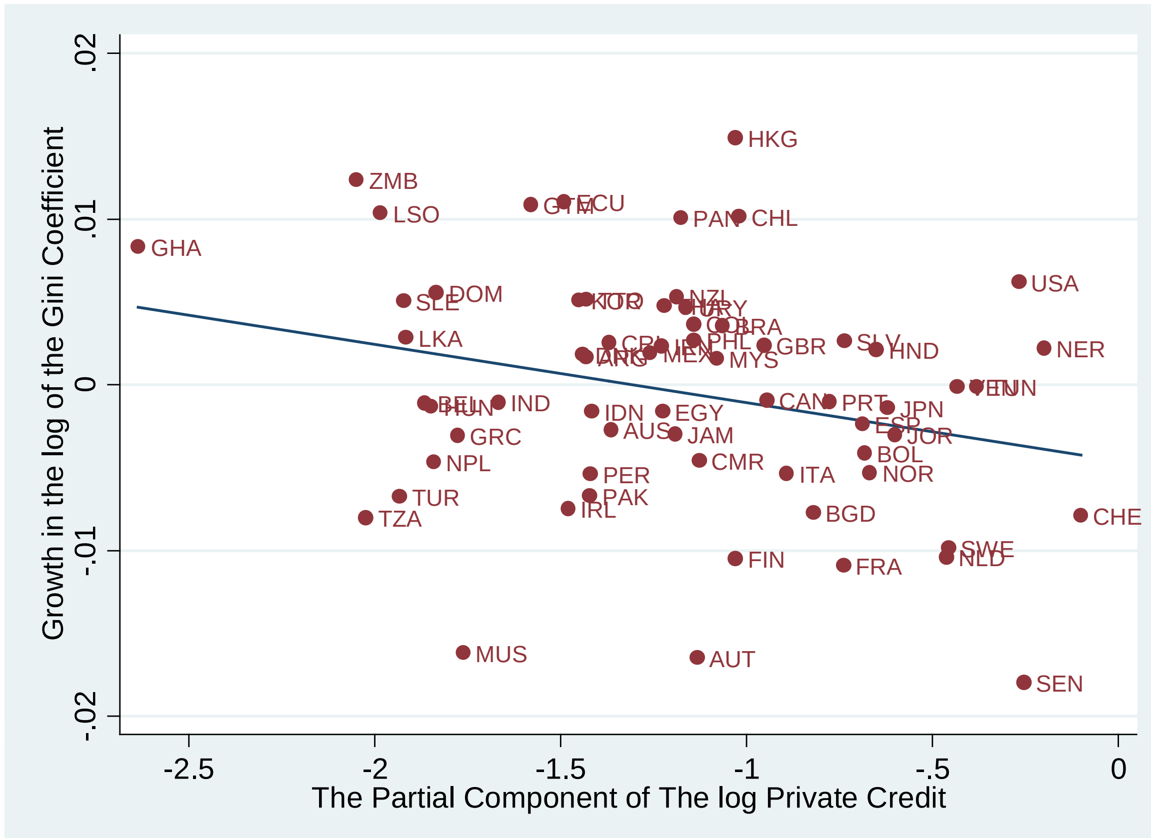


Notes: This is a partial scatter plot of the regression:

$$Growth = \beta_0 + \beta_1 Log(Private\ Credit) + \beta_2 X + \varepsilon,$$

where *Growth* is average real GDP per capita growth over the 1960 to 1995 period

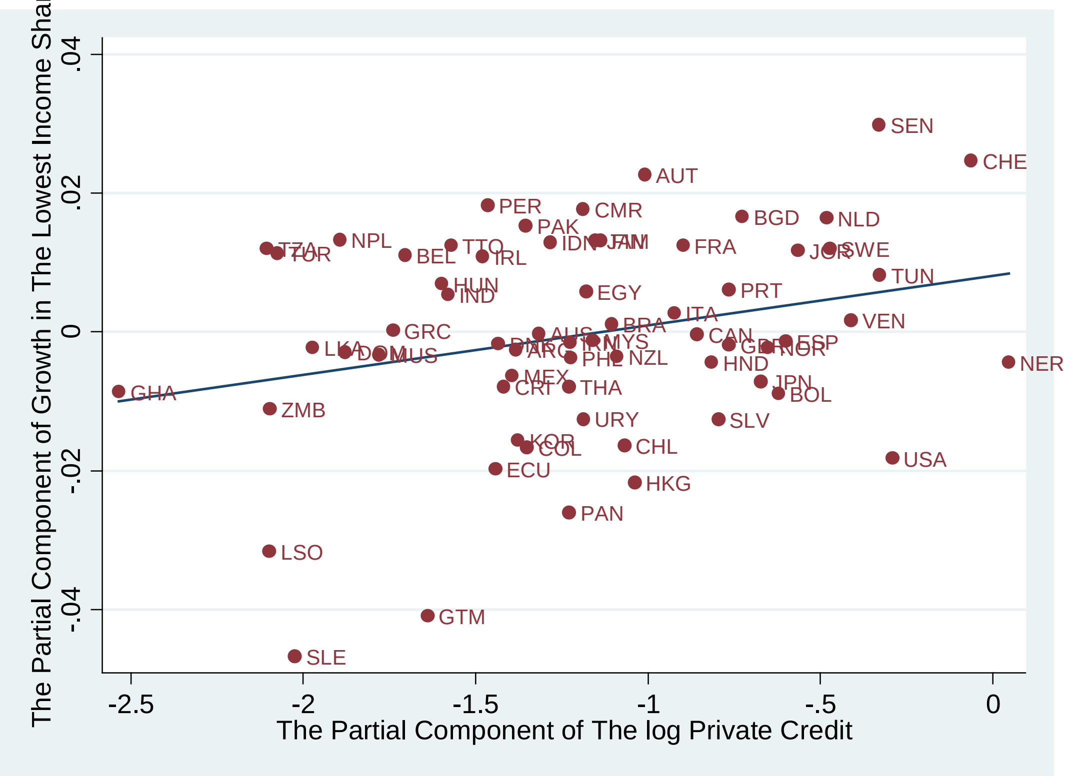
Finance and inequality: X-C



Notes: This is a partial scatter plot of the regression for the 1960-2005 period:

$$Growth\ in\ the\ Gini\ Coefficient = \beta_0 + \beta_1 Log(Private\ Credit) + \beta_2 X + \varepsilon.$$

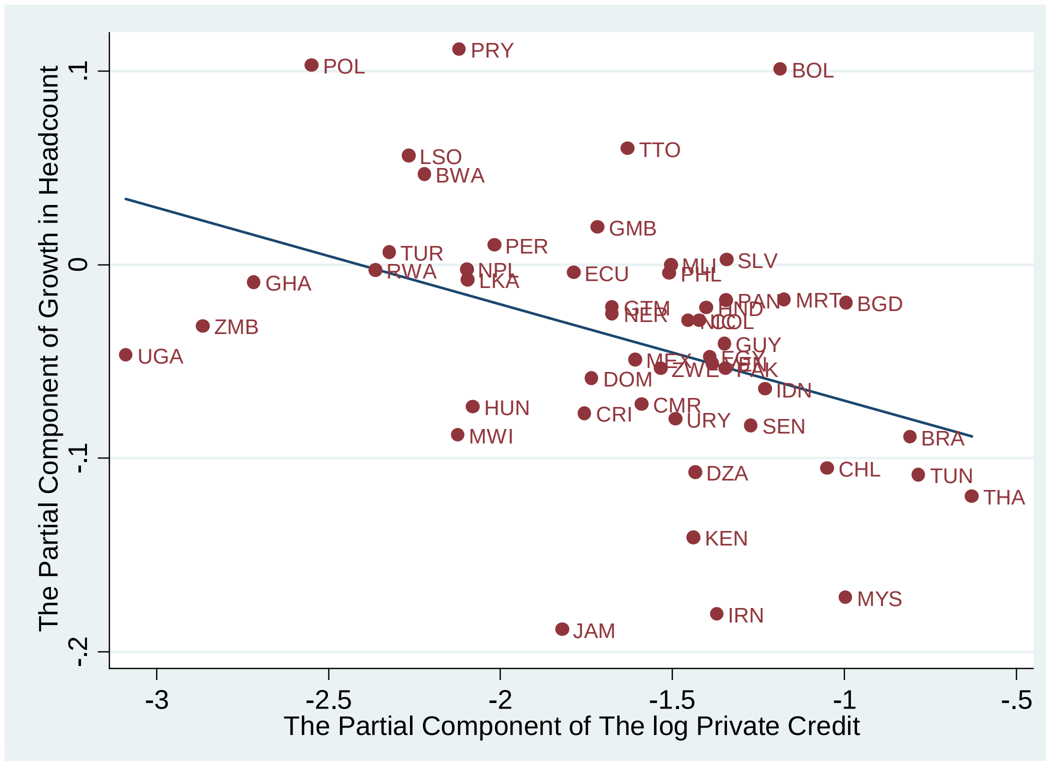
Finance and the incomes of the poor: X-C



Notes: This is a partial scatter plot of the regression over the 1960-2005 period:

$$Growth\ in\ the\ Lowest\ Income\ = \beta_0 + \beta_1 Log(Private\ Credit) + \beta_2 X + \varepsilon.$$

Finance and poverty: X-C

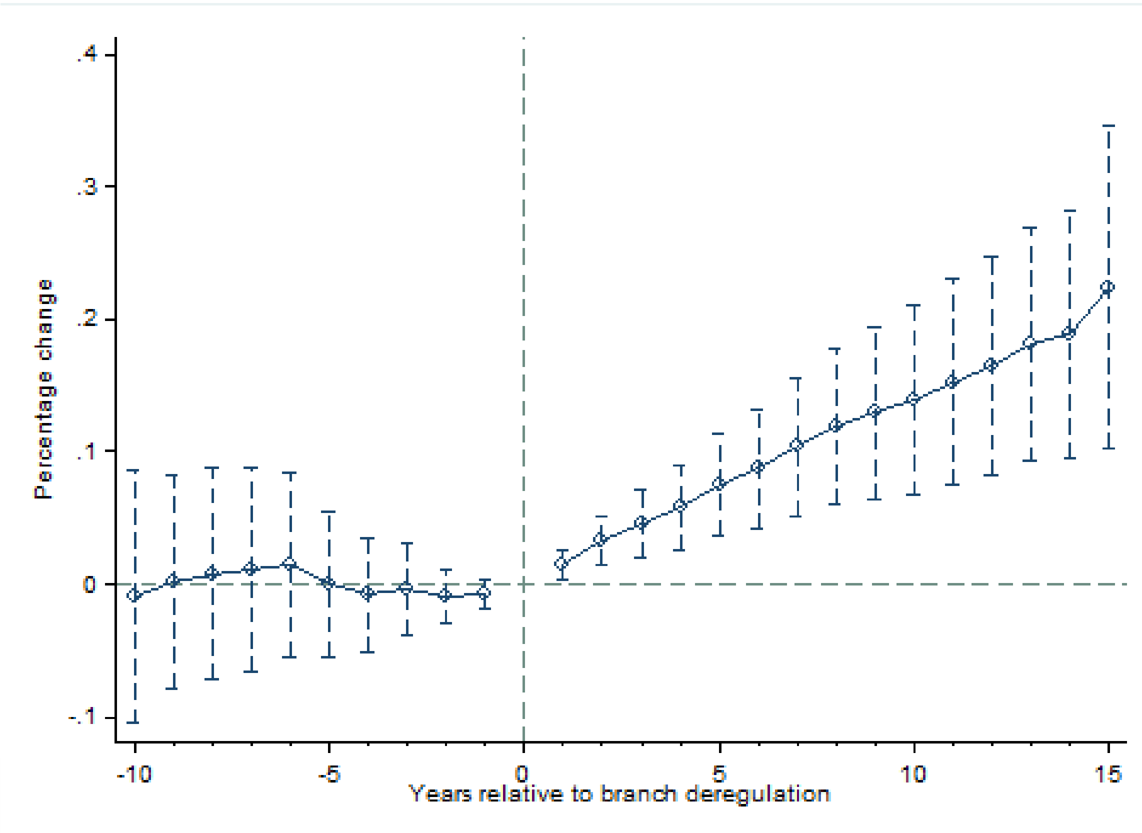


Notes: This is a partial scatter plot of the regression over the period 1980-2000:

$$Growth\ in\ Headcount = \beta_0 + \beta_1 Log(Private\ Credit) + \beta_2 X + \varepsilon,$$

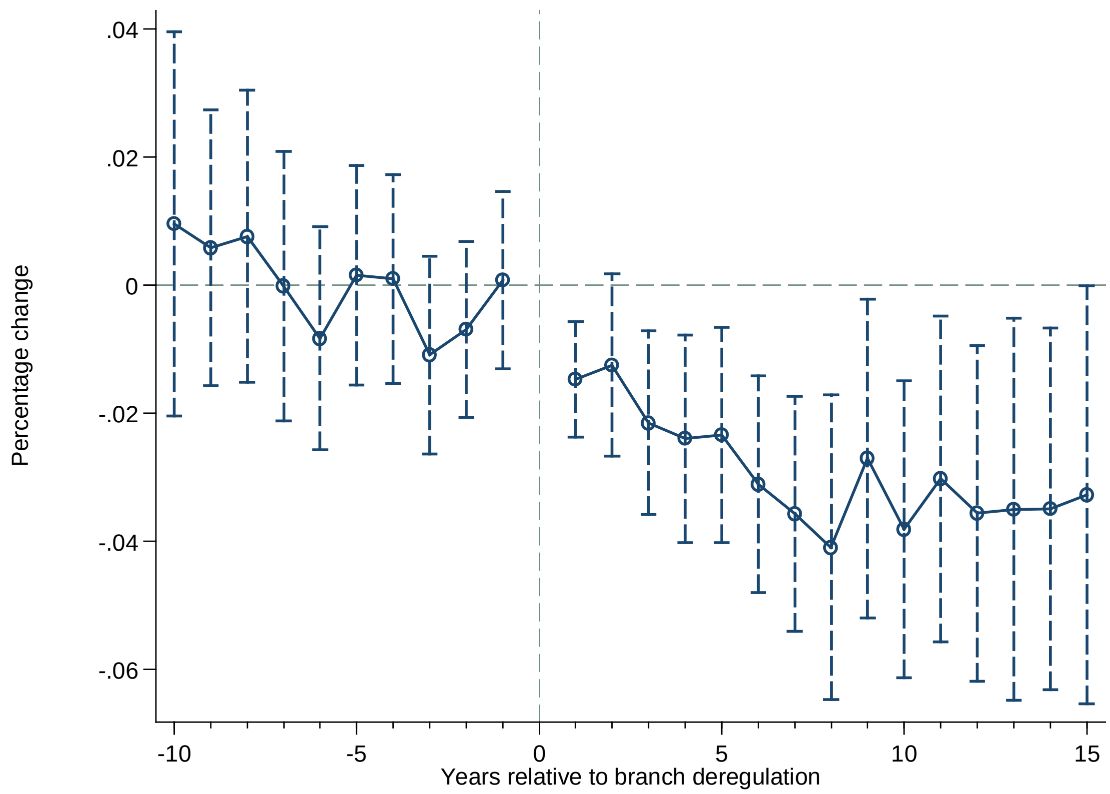
where *Growth in Headcount* is the growth rate of the percentage of the population living below $2 dollar per day.

Finance and growth: U.S. States



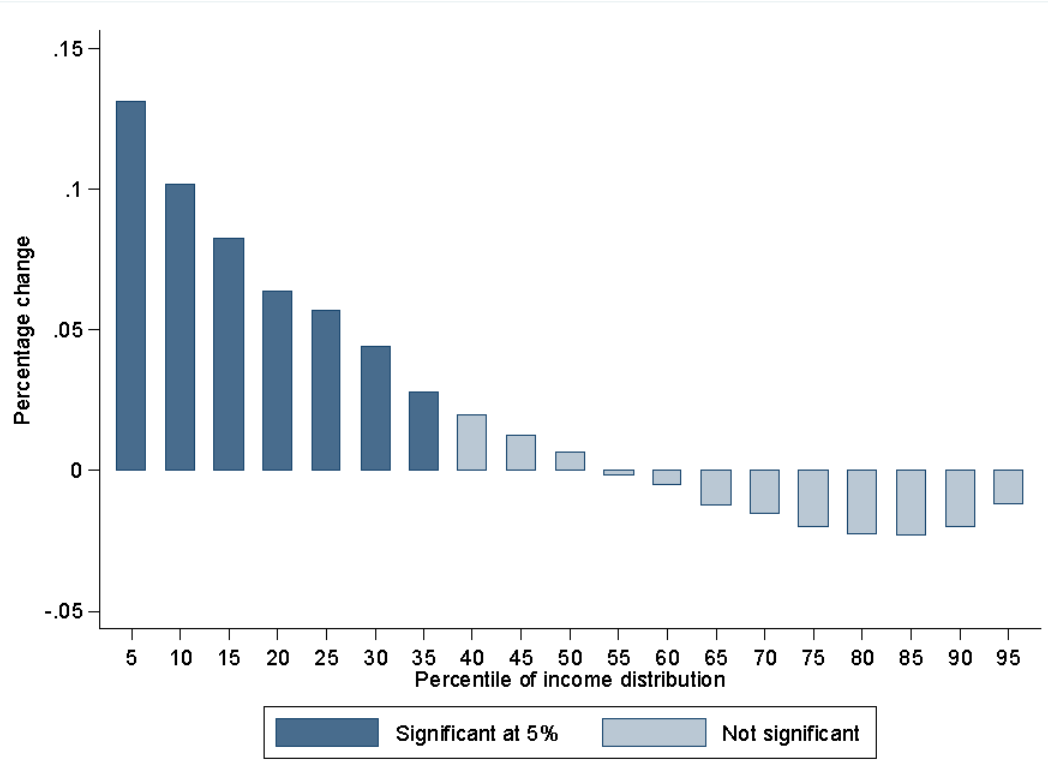
$$\log(GSP)_{st} = \alpha + \beta_1 D^{-10}_{st} + \beta_2 D^{-9}_{st} + \ldots + \beta_{25} D^{+15}_{st} + \mathbf{A}_s + \mathbf{B}_t + \varepsilon_{st}$$

Finance & income inequality: U.S. States



$$\log(\text{Gini})_{st} = \alpha + \beta_1 D^{-10}_{st} + \beta_2 D^{-9}_{st} + \ldots + \beta_{25} D^{+15}_{st} + \mathbf{A}_s + \mathbf{B}_t + \varepsilon_{st}.$$

Finance & income distribution: U.S. States

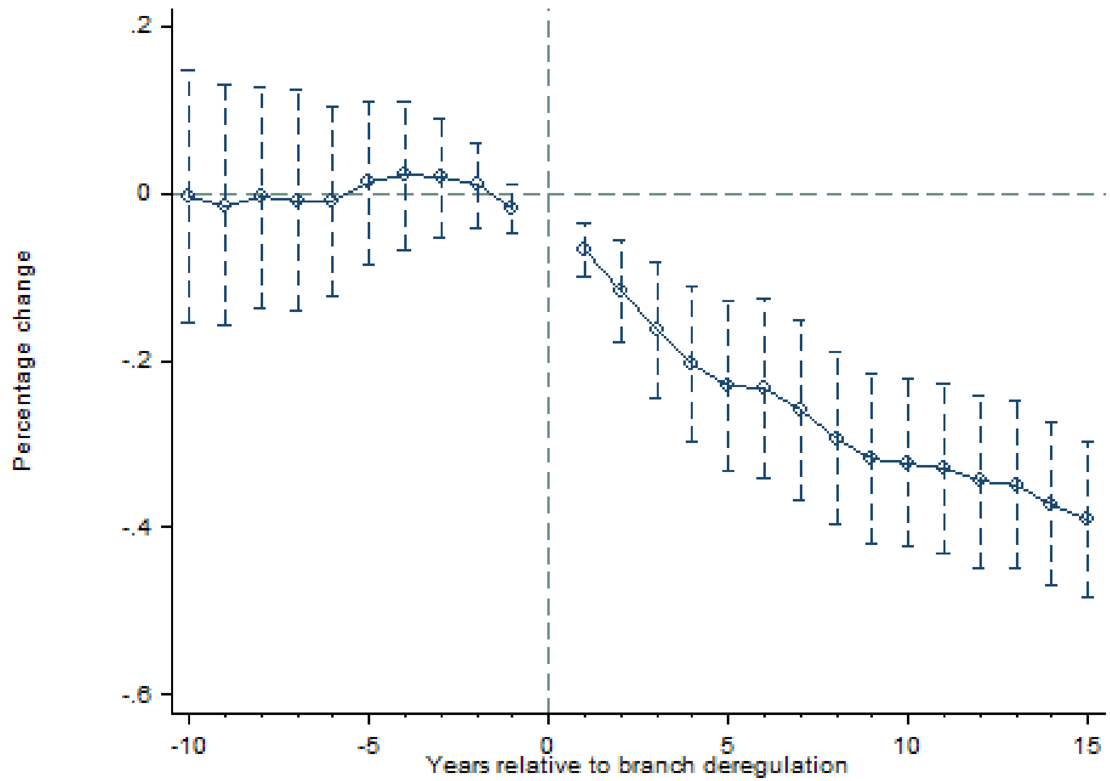


This reports the estimates of γ from 19 separate regressions of the following form:

$$Y(i)_{st} = \alpha + \gamma D_{st} + A_s + B_t + \varepsilon_{st}$$

where $\mathrm{Y(i)}_{st}$ is the logarithm of ith percentile of income distribution in state s and year t.

Finance & unemployment: U.S. States



$$\log(\text{Unemployment})_{st} = \alpha + \beta_1 D^{-10}_{st} + \beta_2 D^{-9}_{st} + \ldots + \beta_{25} D^{+15}_{st} + \mathbf{A}_s + \mathbf{B}_t + \varepsilon_{st.}$$

What about financial innovation?

- Does finance facilitate creative destruction?
- Or, destructive creation?

Both …

- Financial innovation can both foster creative destruction and represent destructive creations.
- But, in this paper, I emphasize a different point …

Financial innovation is *necessary* for prosperity

- The parallels with medical research are apt.
- Not all innovations are economically beneficial to social welfare, but people will not enjoy sustained improvements to welfare without innovation.

There are many examples …

- Oceanic explorations and modifications of business
  - from from partnerships to the *commenda*, and
  - from limited partnerships, to the joint stock company

There are more examples

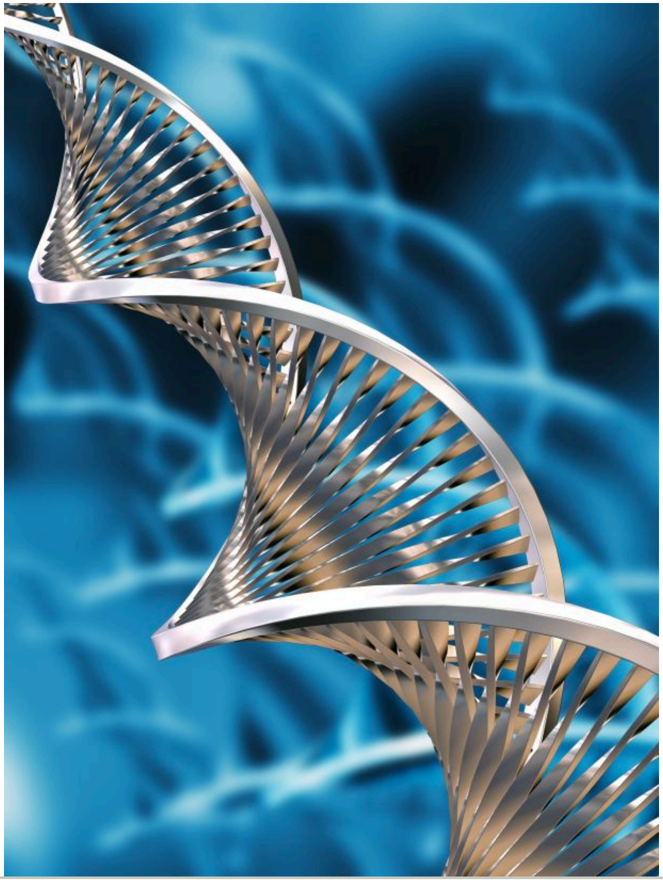
- Initially, railways funded through local private equity since prominent local investors could monitor
- Reliance on local finance restricted growth.
- Problem → profit opportunity …

Financial innovation was necessary for railroad expansion and improvements

- Specialized investment banks emerge to screen /monitor
- Expand nationally and then internationally
- New financial and accounting reports help screening
  - Price, cost, repair, volume information available monthly
  - Then daily and even hourly by the close of the 19th century
  - Etc.

More recently…

- From IT and venture capitalism to …



- … to bio-technologies & ?

Conclusion and policy message

- Finance exerts a first-order impact on economic prosperity primarily by *choosing* where to allocate capital.
- The incentives guiding the decisions of financial policy institutions are the decisive ingredient in shaping these choices and hence in determining the social productivity of the financial sector.