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:

\[ \text{Growth} = \beta_0 + \beta_1 \log(\text{Private Credit}) + \beta_2 X + \varepsilon, \]

where \( \text{Growth} \) 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:

\[ \text{Growth in the Gini Coefficient} = \beta_0 + \beta_1 \log(\text{Private Credit}) + \beta_2 X + \varepsilon. \]
Finance and the incomes of the poor: X-C

The Partial Component of Growth in The Lowest Income Share

The Partial Component of The log Private Credit

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

\[ \text{Growth in the Lowest Income} = \beta_0 + \beta_1 \text{Log(Private Credit)} + \beta_2 X + \varepsilon. \]
Finance and poverty: X-C

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

\[ \text{Growth in Headcount} = \beta_0 + \beta_1 \log(\text{Private Credit}) + \beta_2 X + \varepsilon, \]

where \text{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

\[
\log(\text{GSP})_{st} = \alpha + \beta_1 D_{10}^{st} + \beta_2 D_{9}^{st} + \ldots + \beta_{25} D_{15}^{st} + A_s + B_t + \varepsilon_{st}
\]
Finance & income inequality: U.S. States

\[
\log(Gini)_{st} = \alpha + \beta_1 D_{st}^{-10} + \beta_2 D_{st}^{-9} + \ldots + \beta_{25} D_{st}^{+15} + A_s + B_t + \varepsilon_{st}.
\]
Finance & income distribution: U.S. States

This reports the estimates of $\gamma$ from 19 separate regressions of the following form:

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

where $Y(i)_{st}$ is the logarithm of $i$th percentile of income distribution in state $s$ and year $t$. 
Finance & unemployment: U.S. States

\[
\log(\text{Unemployment})_{st} = \alpha + \beta_1 D^{-10}_{st} + \beta_2 D^{-9}_{st} + \ldots + \beta_{25} D^{+15}_{st} + A_s + B_t + \epsilon_{st}.
\]
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 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.