

SS 129: Introduction to Capital Markets

Three part session

- A. Introduction to capital markets
- B. History of the financial system
- C. The recent financial Crisis in historical perspective

Introduction to capital markets

Why capital markets?

What kinds of claims?

What kinds of intermediaries

What role for the state

1) What if we did not have K-Markets

Back to the Solow growth model (class 1)

Growth comes from shifts to the production function (technology) and from increases in capital. If investment fully divisible? We will still get to efficient trade-off between consumption and investment

So does technical change require capital markets?

A. new technologies are not just ideas but R&D and you need some sort of venture capital to realize them. Then need resources for production

What happens in the absence of capital markets?

Then investment in the new technology directly depends on the wealth and savings of the inventor (because she can't borrow). But still with divisibility you reach the efficient allocation. (maybe slowly).

Capital markets matter when time matters

If there are indivisibilities then some projects are never undertaken. {think railroads or new airplanes).

Best example: human capital

Other example: firm entry

2) What do Financial markets do

They break the iron law that capital = wealth or savings = investment for a given individual, firm, region or country.

Markets move resources from units where returns are relatively low (or who for any other reason want to save) to units where returns are relatively high.

In that sense capital is just like any other commodity.

The difference is that finance is all about the future. What is moving are promises.

So two interrelated issues (1) do capital markets move resources to people who want them now most, (2). Do people keep their promises?

What kinds of claims?

(1) Can we solve the above with a simple contract (debt) you give me L and I promise $(1+r)L$.

(2) So why are there other kinds of contracts?

a. Two solutions, contracts and firms

i. Contracts

1. Specify income rights (when people get interest, capital, dividends....)
2. Specify control rights (who has control of the underlying asset)
3. But these rights are contingent and may not be enforceable.
4. Some simple (bond) some complicated (convertible bond with a call option...)

ii. Firms

1. Manage information (e.g credit rating agency, lien registrar)
 2. Transform claims (eg. a bank that takes deposits and makes loans)
 3. Sells those claims (e.g. a broker)
- b. Not that if TC are too large the market may fail. (there is no price at which the market clears)
- 3) The role of the state
- a. It sets the rules of the game
 - i. Legal framework (what kinds of contracts can be written and enforced)
 - ii. Entry framework (who can be a financial intermediary)
 - iii. Regulatory framework (limits on their behavior)
 - b. Plays an important role because it's a major player as a borrower.
 - i. Public debt is one of the two largest classes of debts in any economy
 - ii. The structure of financial markets matters for revenue (dividend, interest, capital gains and so forth)
 - iii. It may attack capital markets if it really needs a lot of money
 - c. It can act to smooth shocks or exacerbate them

B. The history of capital markets in the US

- d. Before 1789
 - i. No private banks
 - ii. Whole sale merchants
 - iii. States create debt instruments
- e. Antebellum (1790-1860)
 - i. The legacy of the constitution
 - ii. The legacy of Andrew Jackson
- f. Post bellum (1860-1929)
 - i. The rise of national banks

- ii. The rise of New-York as a financial center
- iii. The invention of the Federal Reserve
- g. Post Great Depression
 - i. The federal government as a partial regulator
 - ii. The rise of unregulated fringes (Hedge funds, and non bank financial intermediaries)

C. The recent financial Crisis in historical perspective

1) Liberalization

- i) Clinton administration (Greenspan-Bentsen/Rubin/Summers)
 - (1) Financial innovation and changes in Fannie Mae portfolios
- ii) Bush administration (Greenspan/Bernanke-O'Neal/Snow/Paulson)
 - (1) Low interest rate, not tightening of lending standards,
- iii) The rising problems with a low interest

2) Political costs of intervention were high

Homeowners, Construction industry, Real Estate Industry Financial Industry Would be home owners
Speculators in real estate

3) Before the Crash, History does not matter

- i) Financial Innovation and bank concentration
- ii) Past crises not relevant

4) Since the Crash

- i) Once in a century crisis!
- ii) Bernanke, Romer derive legitimacy from their expertise in the Great Depression

5) But is that the right history to understand the causes of the crisis?

- i) No. 1929 goes from equity to banks to mortgages and real estate (almost the reverse chain from 2007)







