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Avoiding Financial Crises

Andrew Smithers, Author, The Economics of the Stock Market

Monday, 10 October 2022

A Word From Today's Chairman

Professor Michael Mainelli

Chairman

Z/Yen Group

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Today's Agenda

- 11:00 – 11:05 Chairman's Introduction
- 11:05 – 11:25 Keynote Presentation – Andrew Smithers
- 11:25 – 11:45 Question & Answer

Poll

The Financial Times writes “Liz Truss should head economic orthodoxy, not ignore it.” (Leading article 2nd October 2022) Do you agree?

- Yes
- No

Poll

Do you think crises in the financial system are inevitable?

- Yes
- No

Today's Speaker

Andrew Smithers

Author

The Economics of the Stock Market

Avoiding Financial Crises

Andrew Smithers

www.smithers.co.uk

Members of The Financial Services Club

10th October 2022

Slide 2.

- **Policy is based on the consensus model (“CM”) of the economy.**
- **Which leads to recurring financial crises.**
- **The stock market model (“SMM”) allows policy to avoid such errors.**

Slide 3.

- **SMM is based on data for financial market returns.**
- **CM ignores them.**
- **When used, they show that CM is invalid.**

Slide 4.

- **Different assumptions lead to different conclusions.**
- **CM is a single equilibrium model.**
- **If demand and supply are in balance, all is well.**

Slide 5.

- **SMM explains how the economy can collapse, even if demand balances supply.**
- **As least two equilibria are needed to ensure stability.**
- **Monetary policy aiming at balanced demand can cause financial crises.**

Slide 6.

- **CM assumes this is impossible.**
- **Because equities cannot become overvalued unless there is too much demand.**
- **It assumes that equity returns vary with real short-term interest rates.**

Slide 7.

- **The ratio between stock market value and net worth is *q*.**
- **It is a mean reverting ratio.**
- **Through changes in share prices, not through net worth via investment.**

Slide 8.

- **Easy monetary policy pushes up *q*, but only in the short-term.**
- **The difference between the short and longer term impact of easy money is the cause of financial crises.**
- **Monetary policy designed to balance demand readily imbalances *q*.**

Slide 9.

- **There is therefore more than one imbalance that can destabilize the economy.**
- ***Ex ante*** **savings must equal** ***ex ante*** **investment (Keynes's equilibrium).**
- **And** ***q*** **must not be too far from 1 (Tobin's equilibrium).**

Slide 10.

- **Different assumptions lead to different conclusions.**
- **Returns from cash, bonds and equities do not move together.**
- **Investment does not vary with the cost of capital.**

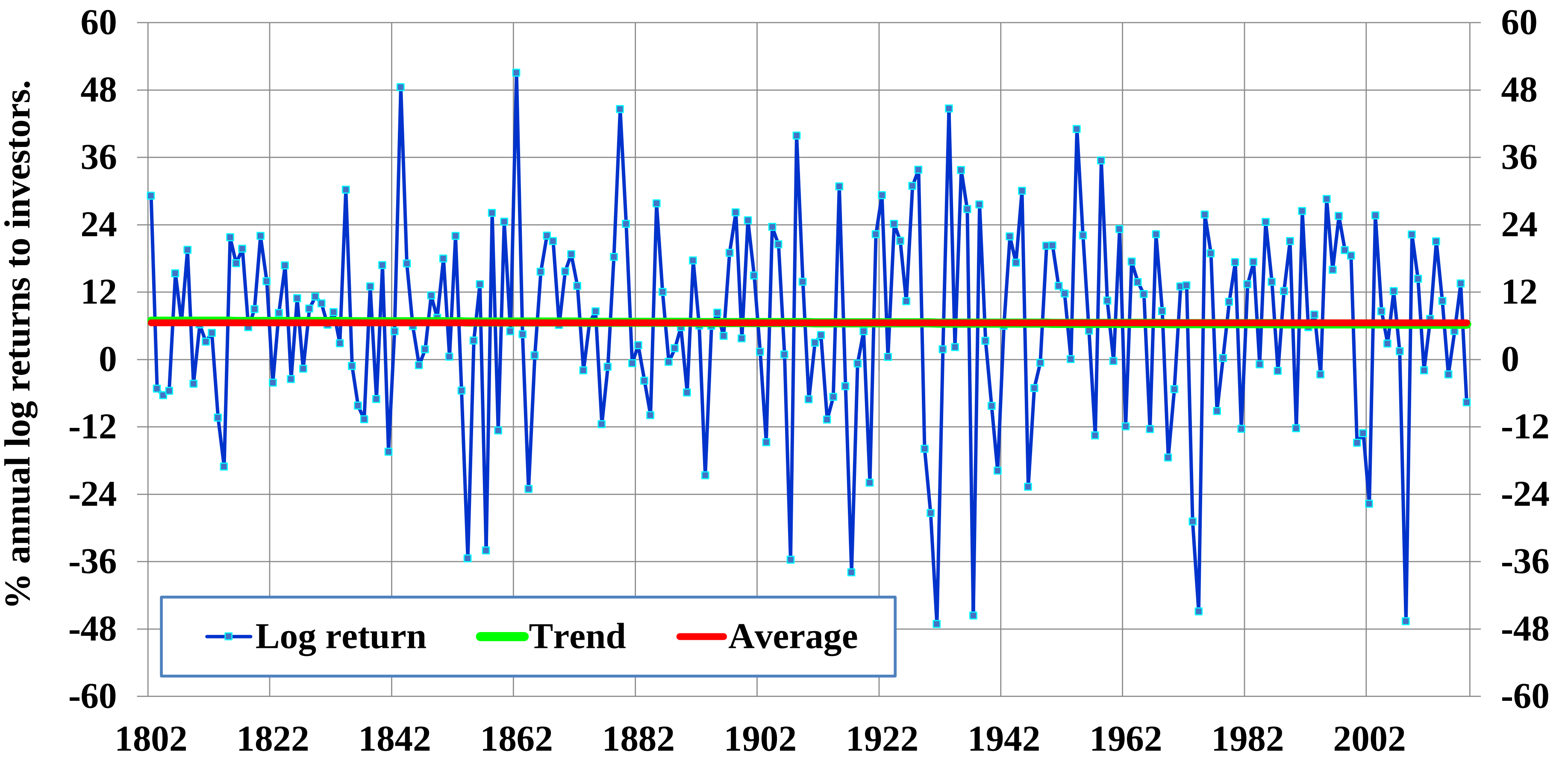
Slide 11.

- **These wrong assumptions arise from misunderstanding human behaviour.**
- **Company managers wish to keep their jobs.**
- **They therefore worry about their company’s share price.**

Slide 12.

- **SMM is consistent with the data.**
- **It depends on managers worrying about share prices, not net worth.**
- **Key evidence for SMM is the stability of the long-term real return on equity.**

Slide 13. US Equities: Annual Real Returns.



Data sources: Jeremy Siegel, Elroy Dimson, Paul Marsh & Mike Staunton.
S&P 500 and BLS.

Slide 14.

- **“It takes a model to beat a model.”**
- **Policy must be based on one.**
- **SMM is better than CM.**

Comments, Questions & Answers

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Forthcoming Events

- Wed, 12 Oct (10:00-10:45) Personal Data: The New Charitable Economic Asset
- Thu, 13 Oct (16:00-16:45) The Four Ages of American Foreign Policy: Weak Power, Great Power, Superpower, Hyperpower
- Mon, 17 Oct (15:00-15:45) Satellite-Based Sustainability Data: A New Frontier
- Tue, 18 Oct (16:00-16:45) Dealing With Difficult People At Work

Visit https://fsclub.zyen.com/events/forthcoming-events/

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