

Investment Analysis¹

Lecture 2: The Role of Finance

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¹These lecture slides are based loosely on the set of lectures by Professor Raymond da Silva Rosa.

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Introduction

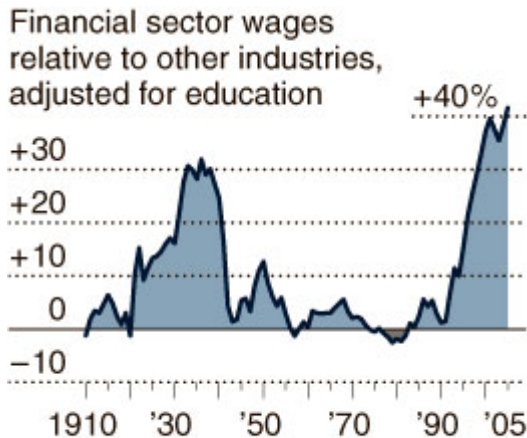
- What does finance contribute to the economy, i.e., why is it so important?
- Why do people in finance get paid so much?
 - Why do some important jobs not get paid so much?

Figure: Larry Fink, CEO of BlackRock



Figure: David Solomon, CEO of Goldman Sachs





Source:
Thomas Philippon

THE NEW YORK TIMES

<https://www.nytimes.com/2015/05/19/upshot/wall-street-is-back-almost-as-big-as-ever.html>

Role of finance

- Well functioning capital markets facilitate:
 - Intertemporal matching of consumption and productivity
 - Allocation of risk to those best able to bear it
 - Separation of ownership and management
 - Capitalism
- Challenges include:
 - Finding people with money to invest and matching them with people who need money to enable profitable projects
 - Overcoming information asymmetry
 - Establishing circumstances where savers and borrowers trust each other

Intertemporal need for finance

- Life-cycle needs
 - Education, old-age support
- Emergencies
- Opportunities
 - Investment in a business
 - Finance a war

“The commercialisation of war [in Europe before 1600 AD] led to longer and more extensive conflicts and to better and more expensive military technology. To mobilise the enormous sums they needed to wage war, princes had little choice but borrow and to hope that victory would provide them with the means to repay.”

– Meir Kohn, *Finance before the Industrial Revolution: An Introduction*.









Overview of finance landscape

- To understand why financiers get paid well, need to step back and take a broad, very brief overview of the financial services landscape.

- Two main features of financial landscape:
 - Financial instruments (e.g., securities)
 - Intermediaries (e.g., banks and advisors)
- Financial instruments are claims on real assets (e.g., shares and bonds)
 - People who want money sell securities
 - People who want to make money work for them to buy securities.
- Intermediaries help sellers find buyers
 - The more sellers and buyers there are, the greater the chance of finding a match of a buyer and seller for a security (i.e., liquid markets).
 - The harder it is to match buyers and sellers, the higher the commission the intermediaries can demand.

Introduction

Overview of finance landscape

Conclusion

- "I Had a friend who was a bond trader at Merrill Lynch in the 70s. He had a job as a train conductor at night, because he had three kids and couldn't support them on what a bond trader made. By 1986 he was making millions of dollars, and through it was because he was smart."*

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Overview of finance landscape

- Deregulation of financial markets beginning in the 1980s spurred innovations in financial intermediation that required talent to devise and to put into operation.
- Would increased regulation lead to a decrease in financial innovations and hence decrease in returns to pay in the financial sector?

Some good additional resources

- Below are some key articles I want you to read and consider:
 - "Are Bankers Overpaid?" by Thomas Philippon
 - Philippon and Reshef (2012, QJE)
 - "Defending the 1%" by Greg Mankiw

Conclusion

- Thinking about the role of finance and asking whether or not financiers deserve their pay is a very difficult topic.
- It's also highly relevant in politics and economics today, especially given the 2008 GFC, Occupy Wall Street movement, and the rise of populism across the US and Europe (e.g., Trump's 2016 victory, Sanders' popularity, and the hunger for Brexit).

Conclusion

- It's hard to dispute the fact that we need finance. But we perhaps need to think about how big the finance sector should be, or how much regulation they should go under.
- Not having a well functioning finance sector can lead to disastrous economic consequences.
 - See, for example “The Poor and their Money: An Essay about Financial Services for Poor People” by Stuart Rutherford and “Poor Economics: A Radical Rethinking about the way to Fight Global Poverty” by Banerjee and Duflo (2011).
 - But we also see other instances of badly functioning financial markets: the 2008 GFC, European sovereign debt crisis, and the 1997 Asian Financial Crisis.