Word for PowerPoint Presentation for FS Club Webinar

Slide 1.

Avoiding Financial Crises
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Comment with Slide 1.

Many thanks Michael for that kind introduction and to all of you for sparing your time to listen to me. I plan to talk for 20 minutes and then hope that you will have lots of questions so that I will be able to expand on the issues on which you wish to concentrate.

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.**

Comment with Slide 2.

Slide 2 sets out the two key conclusions of *The Economics of The Stock Market* which are that the consensus model is invalid, and that the alternative stock market model is robust when tested against data.

The book also explains how current consensus theory leads to financial crisis - another of which, I fear, we are about to experience. They are unnecessary and the SMM explains how to avoid them.

Samuel Butler suggested that a sign should be put up in churches which read – "Important if true". I claim the same for my views.

Their importance, if true, is twofold. If accepted, they will improve our understanding, which is the aim of all science and will in addition allow us to avoid in future a regular repetition of damaging financial crises.

Slide 3.
- **SMM is based on data for financial market returns.**
- **CM ignores them.**
- **When used they show that CM is invalid.**

Comment with Slide 3.

Slide 3 is about the difference between science and non-science - as famously set out by Karl Popper. Valid theories can be falsified by testing against data. The CM was developed before these data became available and could not be tested. It then fell therefore the wrong side of Popper's demarcation. Now we have data with which we can test the CM and know that it is falsified by them. The CM has changed its scientific

status: it used to be invalid because it was untestable, it is now invalid because it is falsified.

Slide 4.
- **Different assumptions lead to different conclusions.**
- **CM is a single equilibrium model.**
- **If demand and supply are in balance all is well.**

Comment with Slide 4.

The aim of policy is stability - growth with low and stable levels of inflation and unemployment. As Slide 4 shows, the assumptions of the CM lead to the conclusion that stability is assured if demand matches supply at full employment – or, to put it in neo-Keynesian terms, when net *ex ante* savings equal zero.

Sadly, it is very, very wrong.

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.**

Comment with Slide 5.

The SMM shows that at least two equilibria are needed for stability and that shows the CM is wrong to conclude otherwise. It also shows that this error leads to 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.**

Comment with Slide 6.

The CM conclusions follow from its assumptions. One is that shares can't be overvalued unless interest rates are too low and then of course demand is excessive. Basically, it assumes the validity of the Efficient Market Hypothesis.

James Mitchell has shown that, while equity returns vary with short-term interest rates, the relationship is only a short-term one.

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.**

Comment on Slide 7.

Because q is mean reverting and net worth is relatively stable, the economy is unstable when q ratios are high - and the higher they are the more unstable it becomes.

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.**

Comment with Slide 8.

As James Mitchell has shown, declines in short-term interest rates have the temporary effect of pushing up share prices. They rise much more than net worth – so the q ratio rises.

But the effect is only temporary; if q is high it will tend to fall through declines in share prices not net worth. If interest rates rise the speed of decline is amplified.

The aim of monetary policy is to stabilize inflation and unemployment.

But low interest rates designed to stabilise demand push up q and can thus also be destabilizing.

The impact is amplified by boosting long-dated bond prices through QE.

Slide 9.
- **There is therefore more than one imbalance that can destabilize the economy.**
- **Not only - *Ex ante* savings must equal *ex ante* investment (Keynes's equilibrium)…..**
- **But also - q must not be too far from 1 (Tobin's equilibrium).**

Comment with Slide 9.

Classical, i.e. pre-Keynesian theory, held that economic equilibrium could be maintained by central banks varying short-term interest rates. Keynes showed that fiscal policy might also be needed to achieve an *ex ante* savings/investment balance and called this a liquidity trap.

But, even without a liquidity trap when fiscal plus monetary policy has balanced demand, the economy is unstable if q is too high.

Slide 9 emphasizes a major failure of consensus theory, which is failing to recognize that economic stability also requires that q does not veer too far from 1.

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.**

Comment with Slide 10.

Valid models are testable and not falsified when tested. The CM assumptions lead to conclusions which are demonstrably wrong - the CM's assumptions are wrong and it is thus an invalid model.

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 prices.**

Comment with Slide 11.

The CM assumes that managers seek to maximise the present value of their company's net worth, this is called "profit maximization." The SMM follows other critics of the CM in making the fundamentally different assumption that both shareholders and corporate managements are primarily concerned with stock market value.
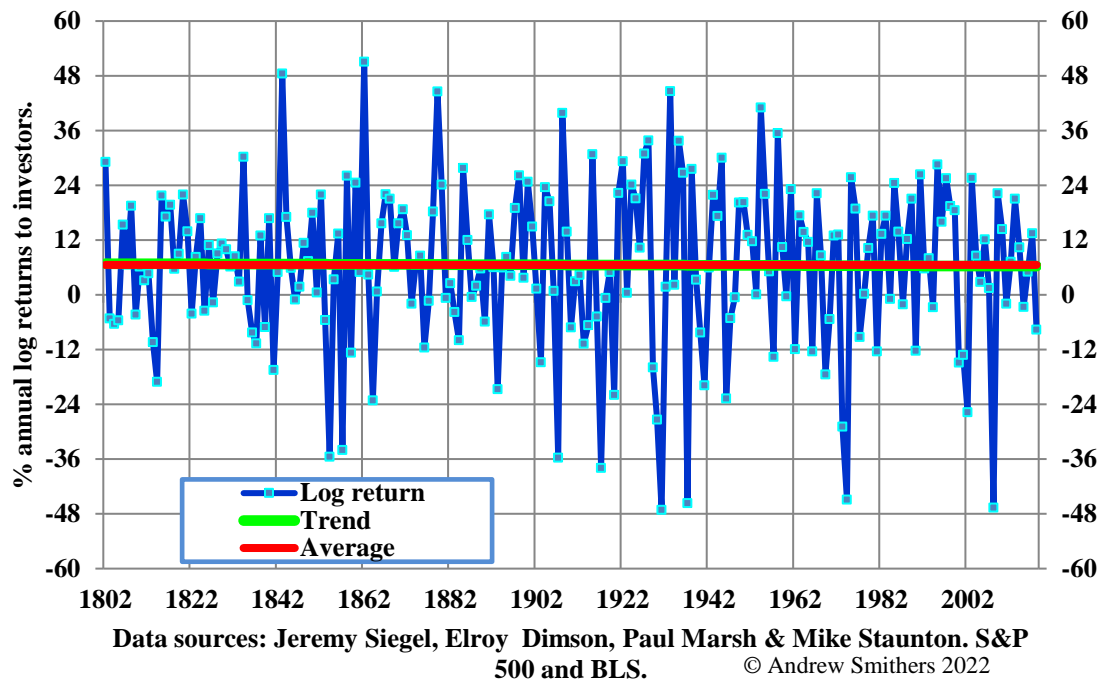
Slide 12.

- **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.**

Comment with Slide 12.

I started *The Economics of The Stock Market* by seeking to explain this stability which I illustrate in the next slide.

I was pleasantly surprised about the result of my efforts, which resulted in the SMM.

Slide 13. US Equities: Annual Real Returns.

Data sources: Jeremy Siegel, Elroy Dimson, Paul Marsh & Mike Staunton. S&P 500 and BLS. © Andrew Smithers 2022

Slide 14.

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

Comment with Slide 14.

 The SMM will no doubt be improved and perhaps fundamentally replaced by a better model.

 In particular I suspect that there is another potential disequilibrium which is the ratio of money supply/GDP. In addition to zero net *ex ante* saving stability I can show that q must not be greatly elevated and, while I cannot prove that the same applies to money supply/GDP, I think it likely.

 Until the SMM is replaced by a better model it should be the preferred theoretical model and the guide for policy.

Final Comment.

 It is dangerous to take ideas, particularly one's own, too seriously.

 Stephen Hawking starts his *Brief History of Time* with a tale of a famous scientist who, after giving a public lecture on the universe, was contradicted by an old lady who said that his views were rubbish as the world was a flat plate supported on the back of a giant tortoise. With a superior smile the scientist asked, "What does the tortoise stand on?" "You are a very clever young man – but its tortoises the whole way down."

I offer this as a warning to both myself and you. My views are revolutionary and I take them seriously.