



Democratization of Finance: How We Got Here and What It Means

Professor Mitchell Petersen

Finance Department – Kellogg School

Director – Heizer Center for Private Equity & Venture Capital

Northwestern University



Financial Crisis: Finding Someone to Blame

- Greedy Bankers
- Incompetent Regulators
- Corrupt Politicians & Lobbyist
- Greedy or Cleverly Naïve Investors
- Finance Professors
- Consumers without a Budget Constraint



Value of Financial History: Looking Forward by Looking Back

“So what should business schools do to improve their performance?”



Value of Financial History: Looking Forward by Looking Back

“So what should business schools do to improve their performance?”

More history classes would help. Would-be business titans need to learn that economic history is punctuated with crises and disasters, that booms inevitably give way to busts, and that the business cycle, having survived many predictions of extinction, continues to prey on the modern economy.”

The Economist, September, 24, 2009



Value of Financial History: Looking Forward by Looking Back

“History doesn’t repeat, but it does rhyme”

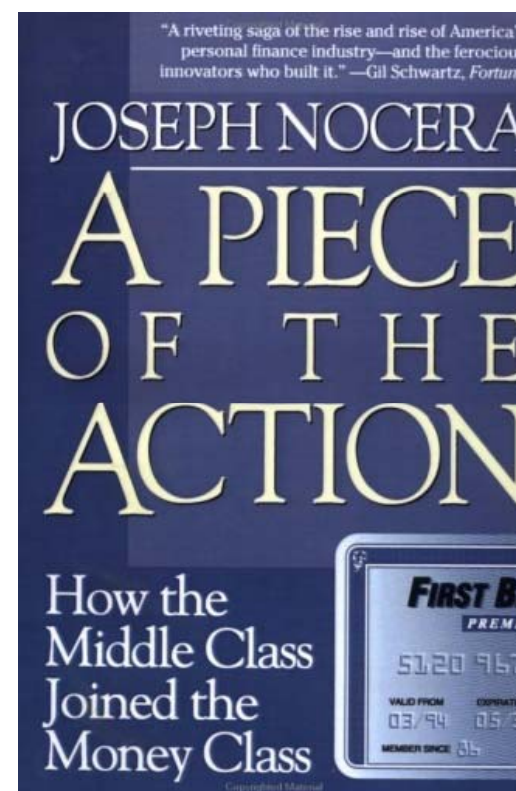
Mark Twain

“The curious task of economics is to demonstrate to men how little they know about what they imagine they can design.”

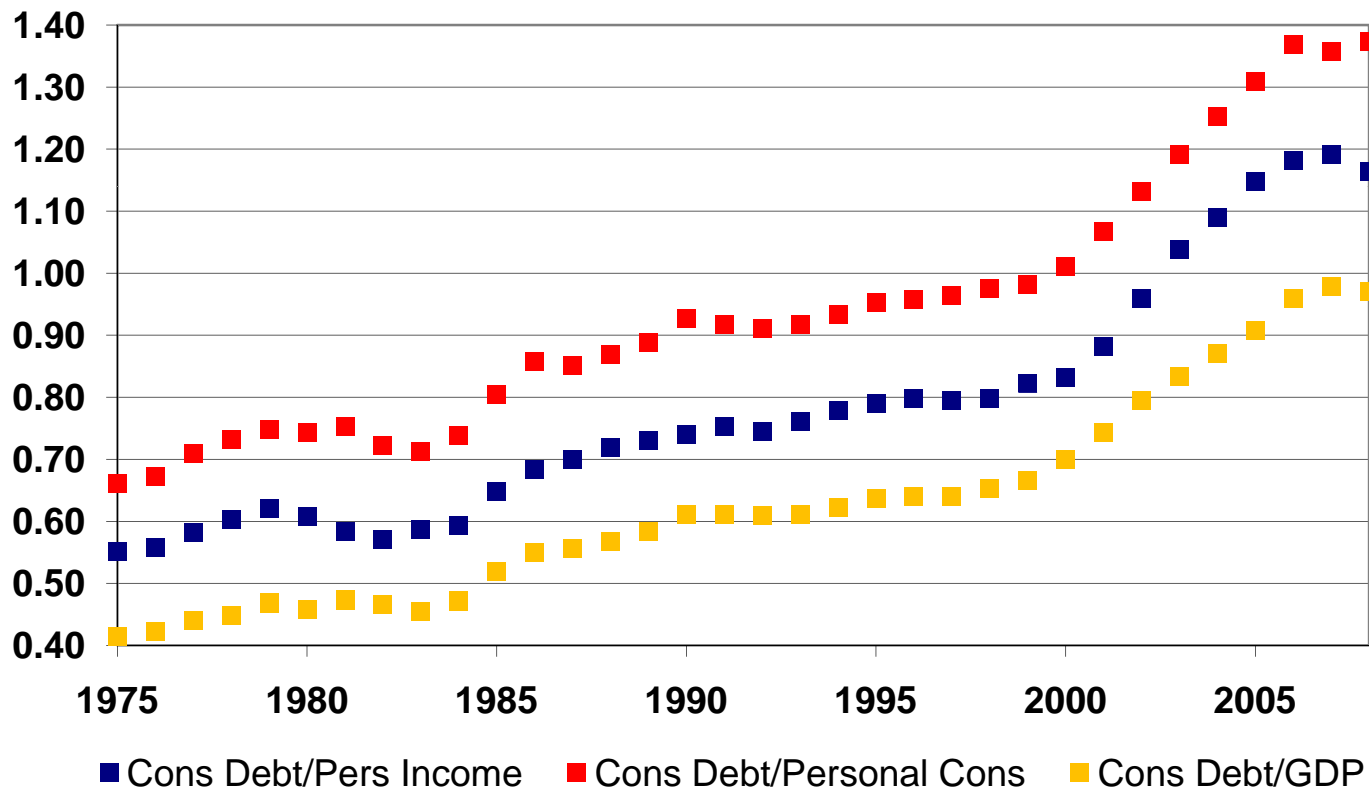
FA Hayek, 1988, “The Fatal Conceit”

History & Evolution of Consumer Finance

- The Wealthy Are Different
 - How they invest
 - How they borrow
- Middle Class
 - Bank savings, not stocks
 - No signature loans
 - Limited ability to borrow



Growth of Consumer Credit



Consumer Credit: Too Much of A Good Thing?



“the prospect of even a mild recession is daunting because many individuals and companies would be unable to meet their obligations.”

“...people ...can't afford lobster,..(but) they buy them anyway (this shows) just how over leveraged the typical American credit-card-toting consumer is.”

“American’s spending spree is being financed by heavy borrowing byhouseholds and firms, whose debts are growing at their fasted rate for a decade. Consumer debt is at record levels relative to income”

“The ...reason... for fearing a recession is that the consumer is stretched quite thin. Consumer debt per household is near record highs. But these trends threaten only a small percentage of consumers, hardly enough to drag down the overall economy.”

Consumer Credit: Too Much of A Good Thing?



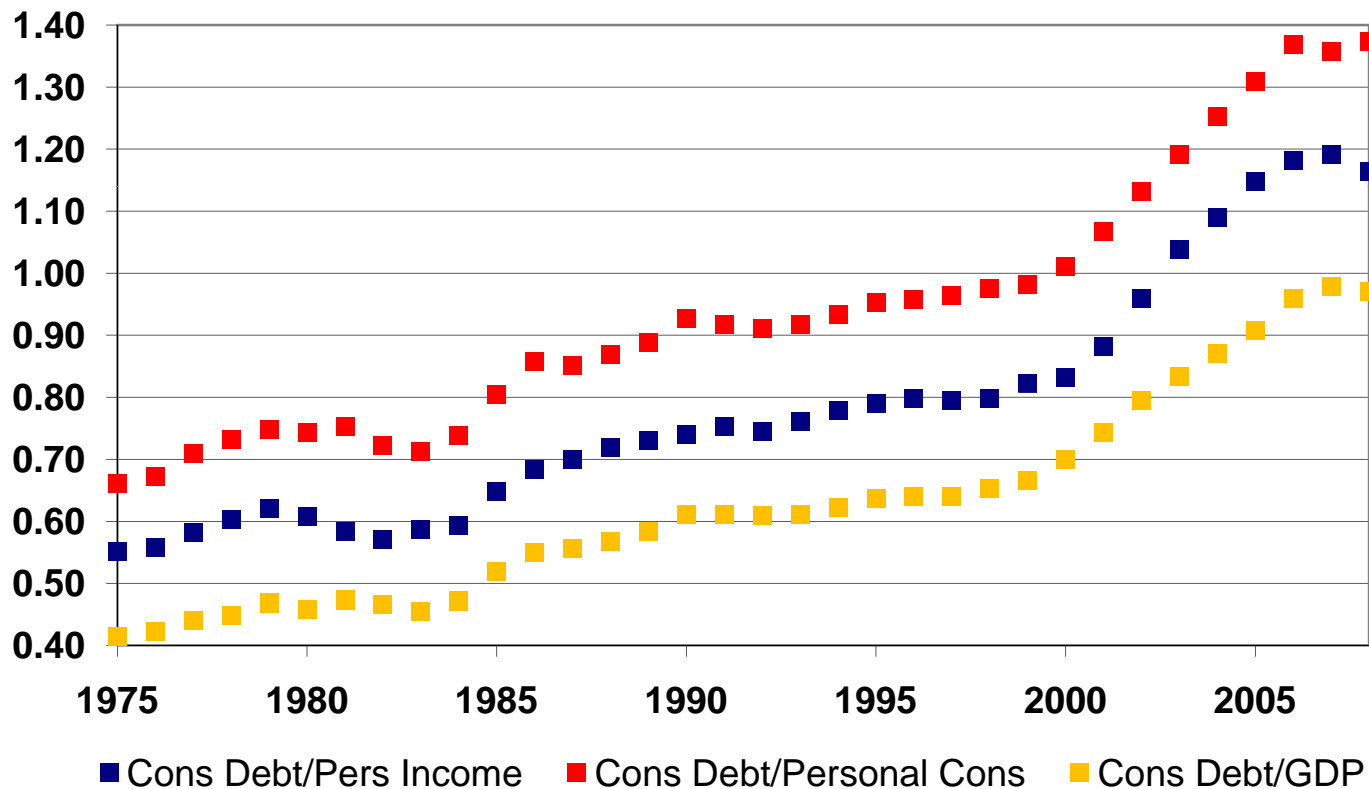
"the prospect of even a mild recession is daunting because many individuals and companies would be unable to meet their obligations." *Fortune*, March, 1987

"...people ...can't afford lobster,..(but) they buy them anyway (this shows) just how over leveraged the typical American credit-card-toting consumer is." *Fortune*, June, 1990

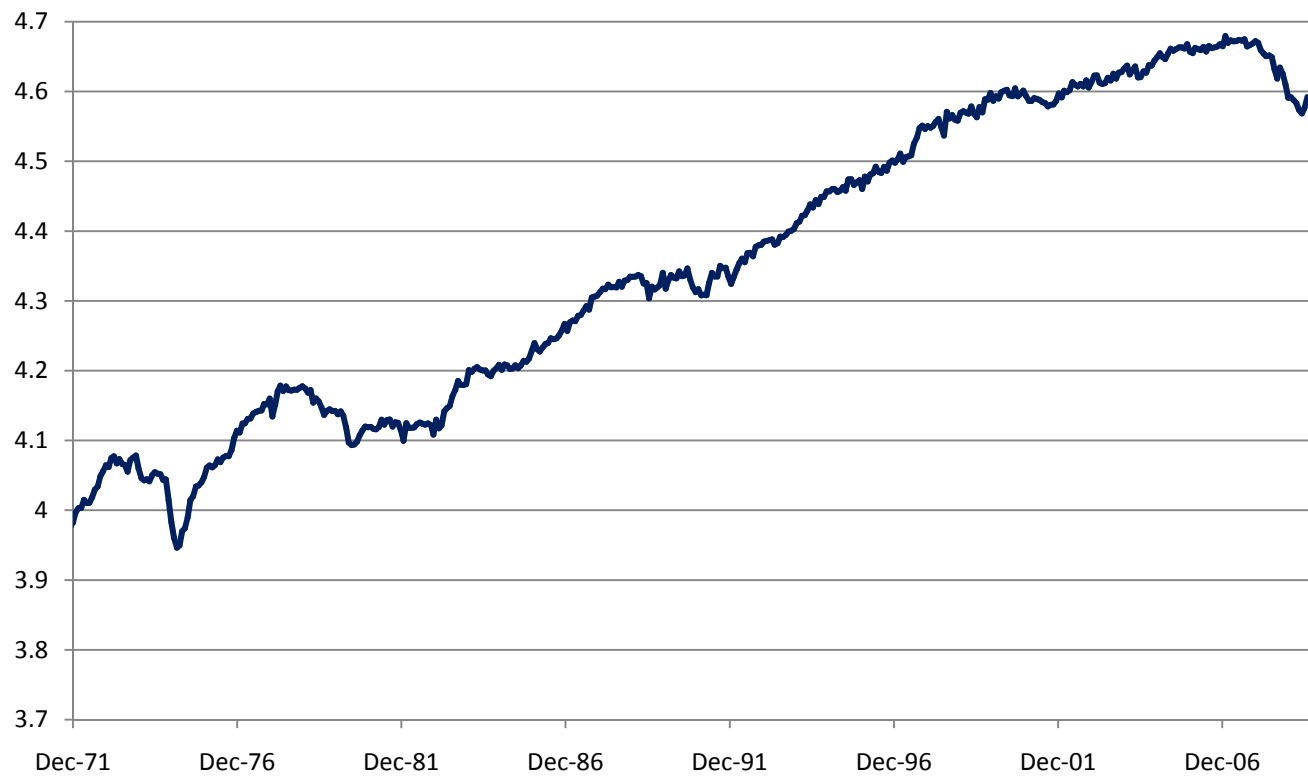
"American's spending spree is being financed by heavy borrowing byhouseholds and firms, whose debts are growing at their fasted rate for a decade. Consumer debt is at record levels relative to income" *The Economist*, June, 1999

"The ...reason... for fearing a recession is that the consumer is stretched quite thin. Consumer debt per household is near record highs. But these trends threaten only a small percentage of consumers, hardly enough to drag down the overall economy." *Money*, February, 2006

Growth of Consumer Credit

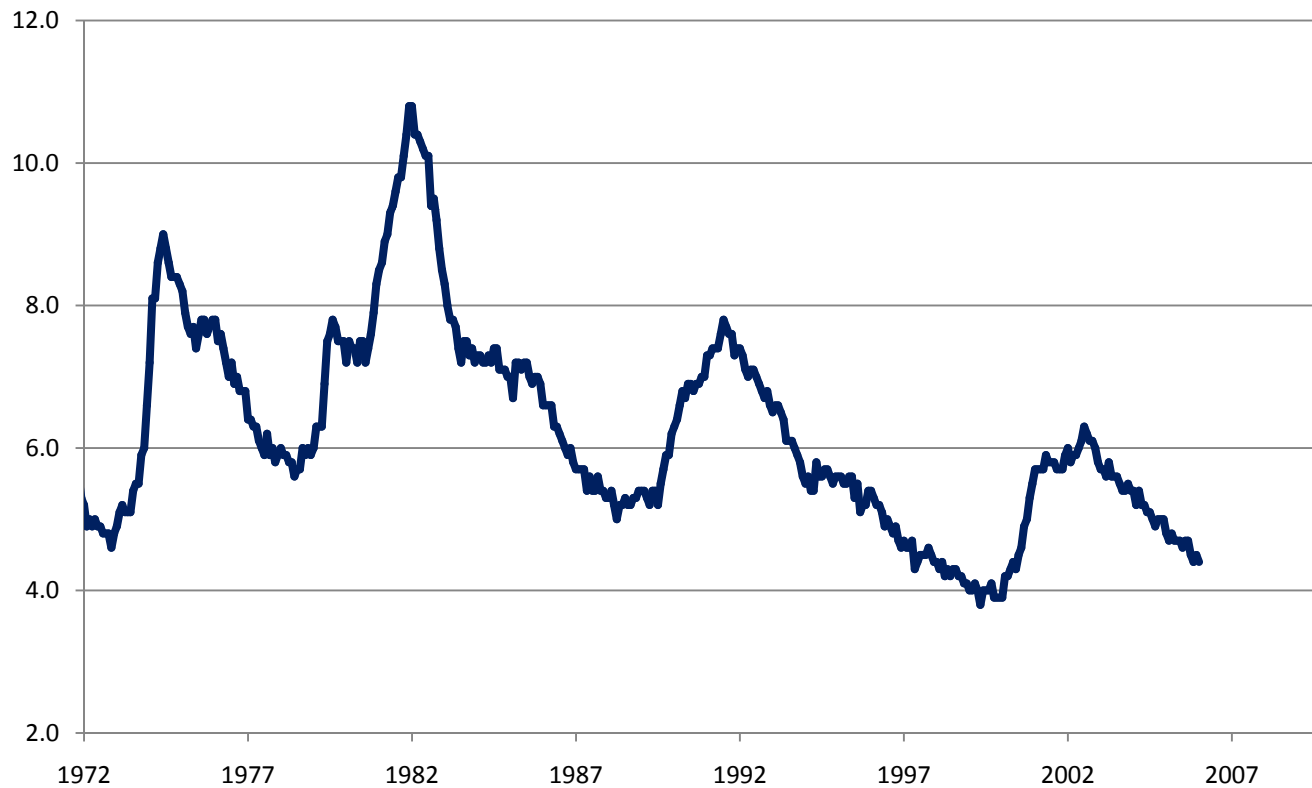


The Great Moderation



Industrial Production: Consumer Products

The Great Moderation



Unemployment rate



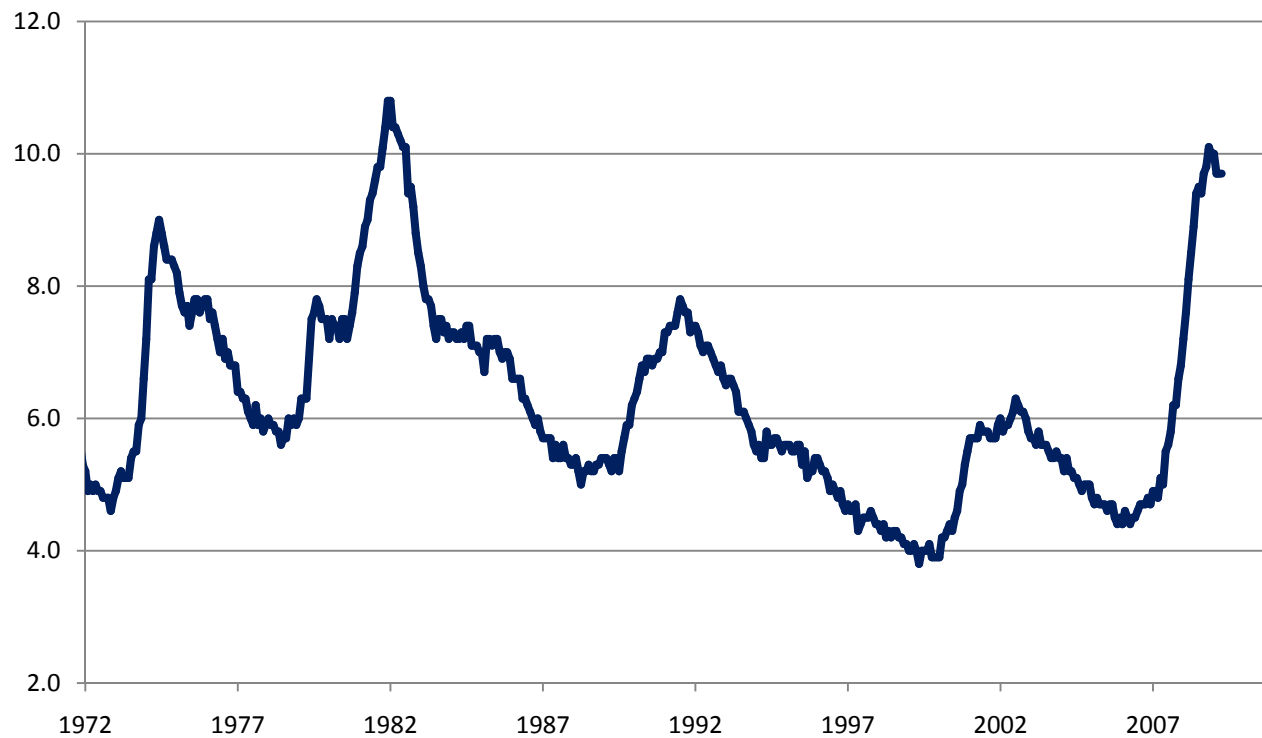
The Great Moderation

“...if the Great Moderation was largely the result of good luck rather than a more stable economy or better (monetary) policies, then we have no particular reason to expect the relatively benign economic environment of the past twenty years to continue.”

“My view is that improvements in monetary policy, though certainly not the only factor, have probably been an important source of the Great Moderation. In particular, I am not convinced that the decline in macroeconomic volatility of the past two decades was *primarily* the result of good luck...”

Governor Ben S. Bernanke, February, 2004

The Great Moderation ?!?



Unemployment rate



Consumer Finance Revolution: A Good Idea Taken Too Far

- Consuming Future Wealth Is Addictive
 - When times are bad, borrow
 - When times are good, ~~save~~ borrow
- Housing Policy
 - Expanding home ownership is good
 - What do we do when we run out of households who can afford a house?
- Expectations: Economic Risk is Small



How to Building a Fragile Economy

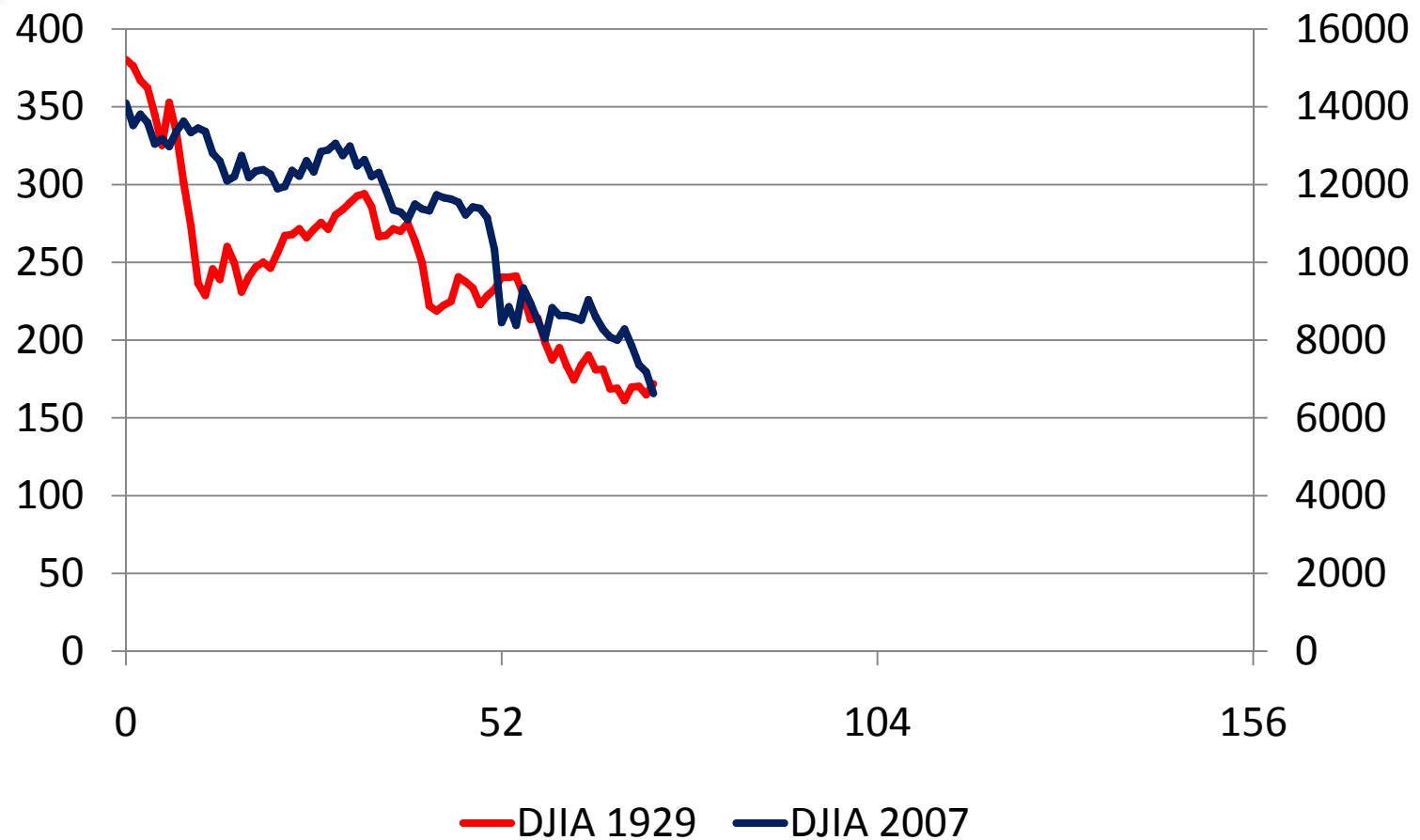
- Expectations: Economic Risk is Small
- Allocate more to the risky asset
 - More stock in our portfolios
 - More stock in our pension plans
 - Buy more house
- Borrow more/Save less
 - Larger credit card balances
 - Larger mortgages/Less home equity



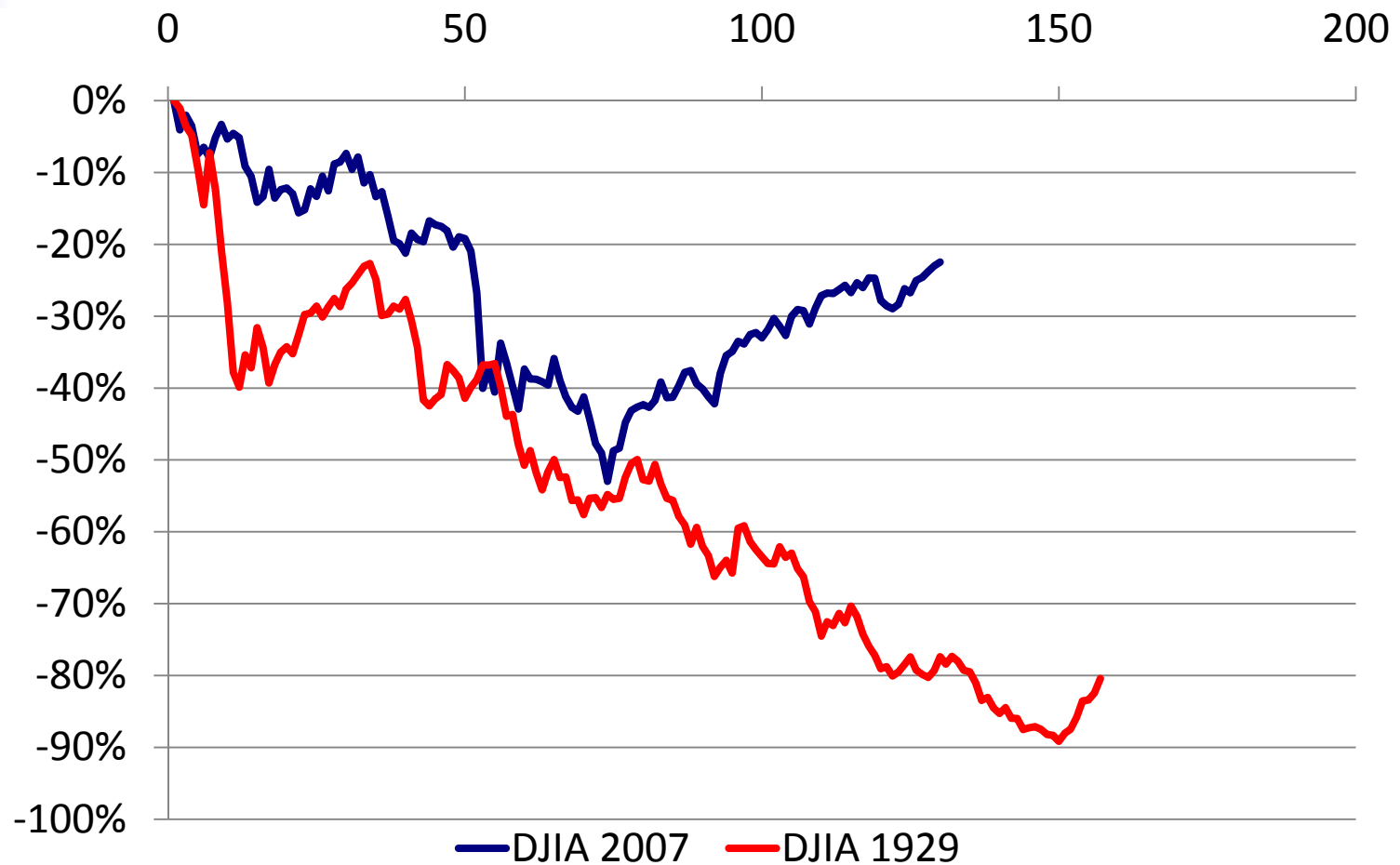
The Way Forward: Consumers

- Asset Values are Lower
 - Stock market is still down
 - Real estate values are still down

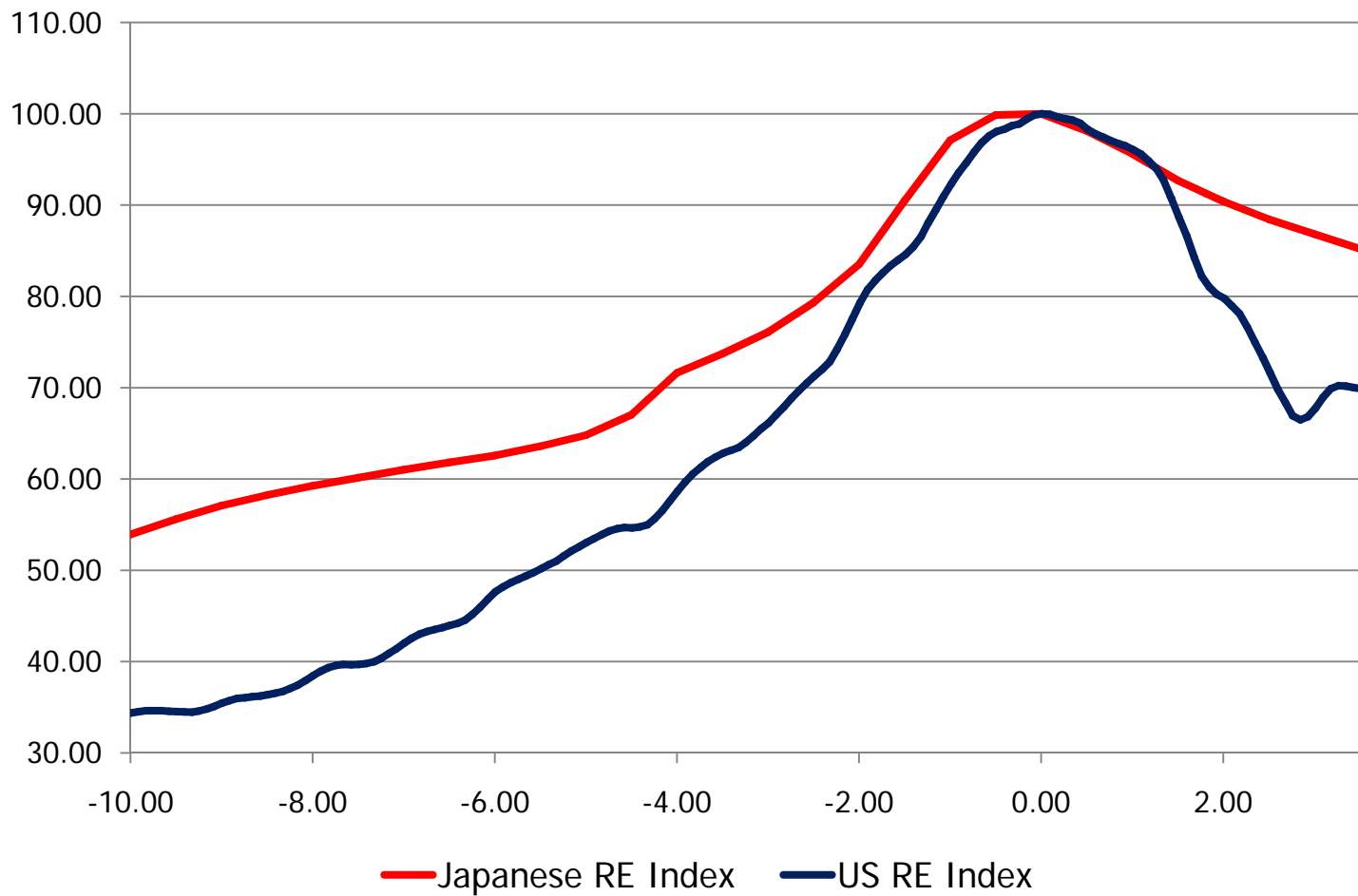
Equity Market Returns: DJIA Then & Now



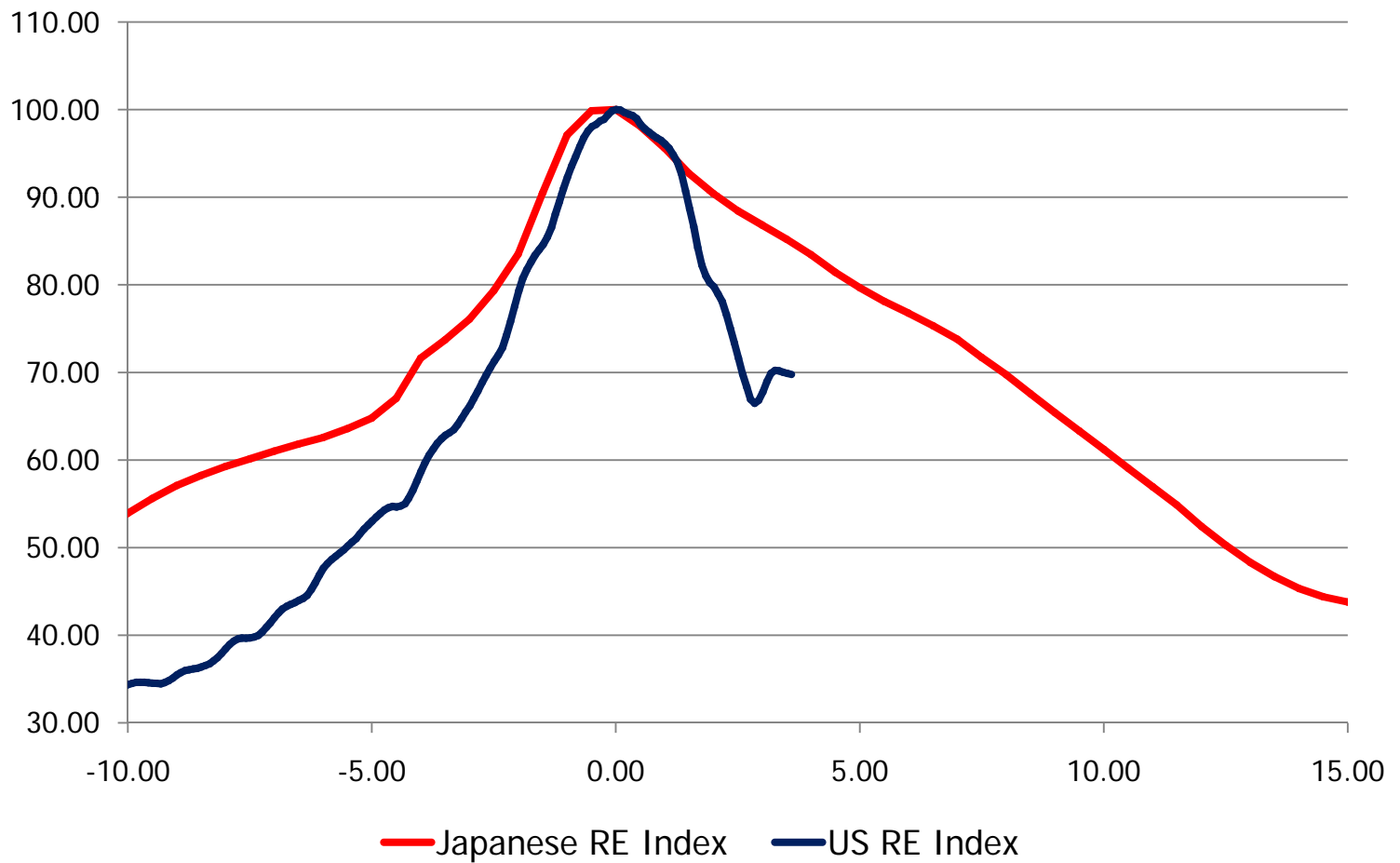
Equity Market Returns: DJIA Then & Now



House Prices Rise & Fall



House Prices Rise & Fall

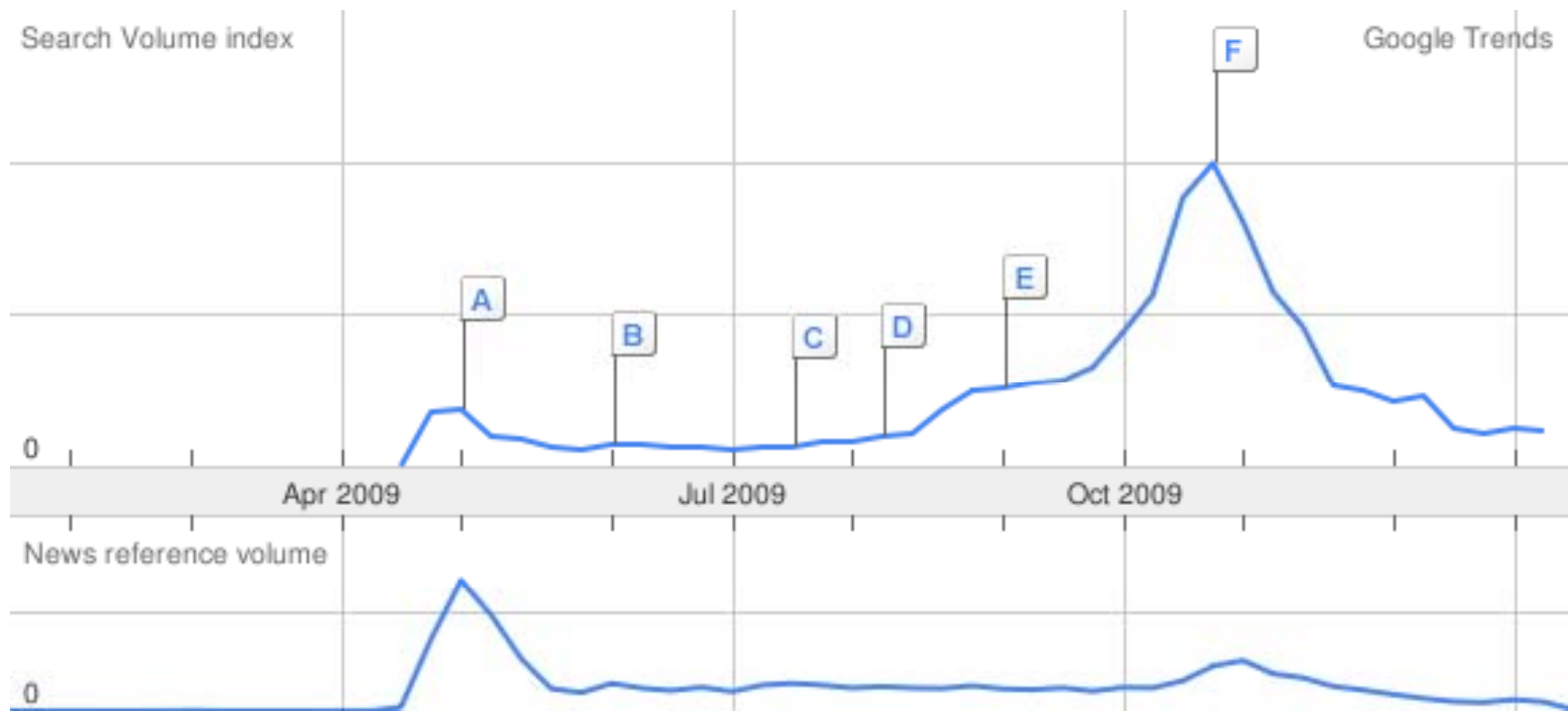




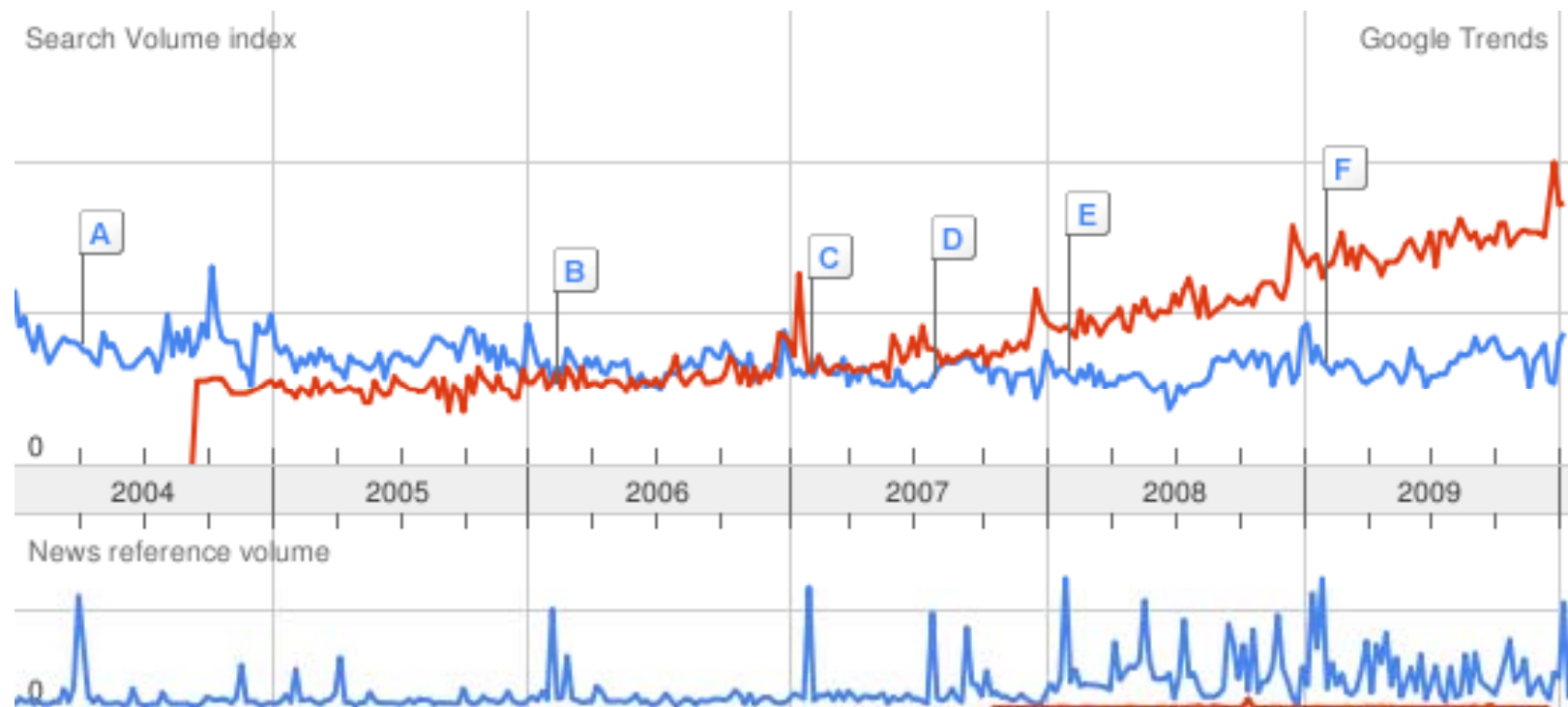
The Way Forward: Consumers

- Asset Values are Lower
- Unemployment is higher
- Wage growth is lower
- Risk aversion is higher ?
 - Job, House, Portfolio
- Frugality is in fashion ?

Google Trends: H1N1



Google Trends: How Do I Save?





The Way Forward: Consumers

- Asset Values are Lower
- Unemployment is higher
- Wage growth is lower
- Risk aversion is higher ?
 - Job, House, Portfolio
- Frugality is in fashion ?
- Ability to borrowing is lower



The Way Forward: Governments

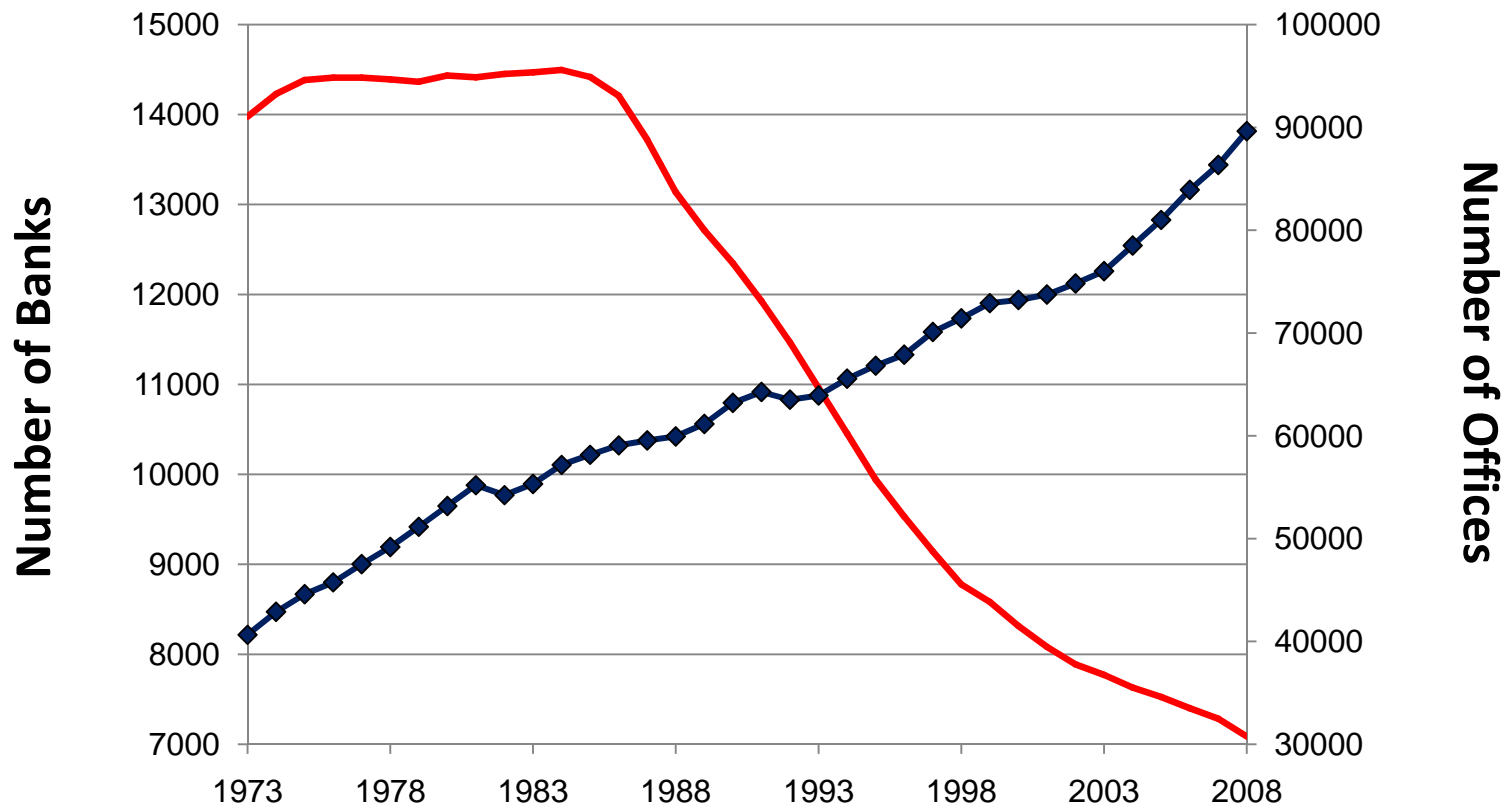
- Federal Government Debt
 - \$7.8T now, was \$4.6T in 2005
- State Government Debt
 - Projected 2010 Deficit: 192B (28%)
 - Under funded pensions (equities)
- Fiscal Policy Solutions
 - Cash for clunkers
 - First time (any) home buyer tax credit



The Way Forward: Restricted Capital Access

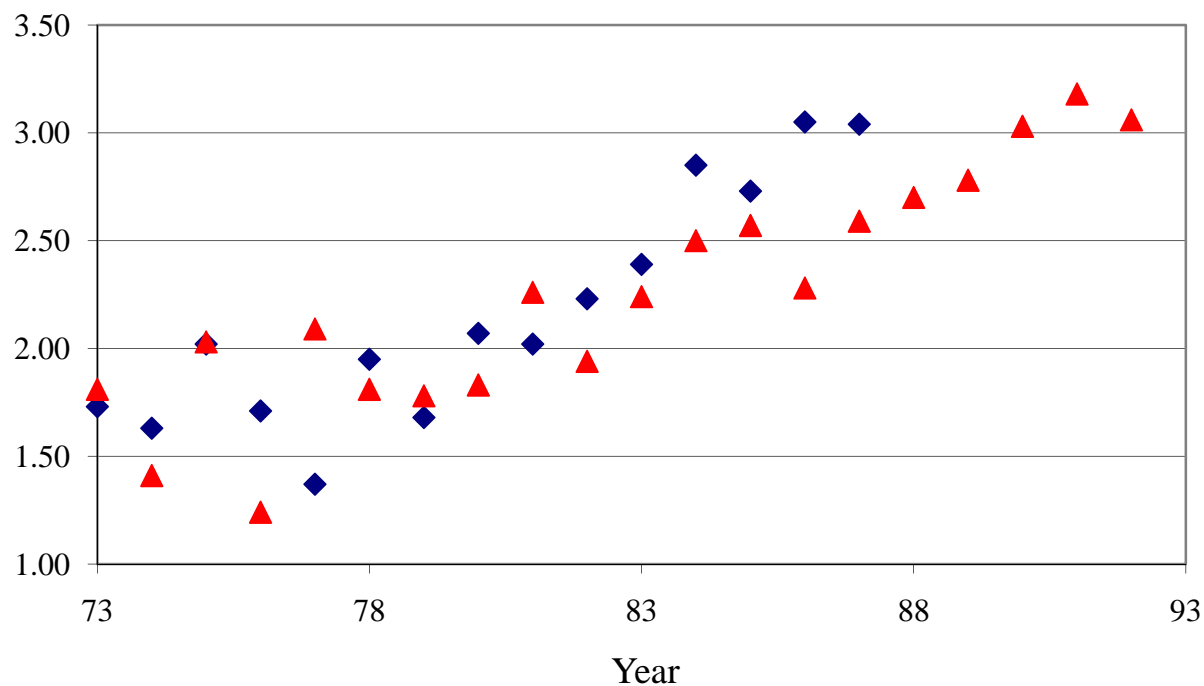
- Tighter Bank Credit
 - Drop in credit quality (recession)
 - Limited bank capital
 - Loan officer have learned
 - Loan officer risk aversion
 - Regulator risk aversion
- Evolution of Business Bank Lending

The Way Forward: Restricted Capital Access



The Way Forward: Restricted Capital Access

- Lending at Greater Distances





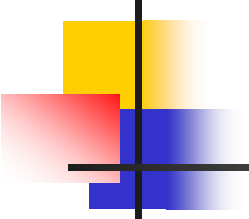
The Way Forward: Restricted Capital Access

- Tighter Bank Credit
- Evolution of Business Bank Lending
 - Greater distance and more impersonal
 - Justifying opaque credit risks:
“This firm is a good credit risk, trust me”



The Way Forward: Reduced Consumption

- Parable of the Forest
- Lower Wealth → Lower Consumption
 - Housing, equity, and income
- Solution: Borrowing Against the Future?
 - Less feasible, less desirable, & temporary
- Positive Feedbacks: Up & Down
 - Lower consumption → Lower wealth



The Importance of Experience

Financial Trivia Quiz

- Fall 1998: LTCM and A Near Miss
 - Federal Reserve Calls Meeting of 15 Banks
Bankers Trust, Barclays, Bear Stearns, Chase, Credit Suisse
First Boston, Deutsche Bank, Goldman Sachs, J.P.Morgan,
Lehman Brothers, Merrill Lynch, Morgan Stanley, Paribas,
Salomon Smith Barney, Societe Generale, UBS
- Fall 2007: Only 2 CEOs Remain
 - Trivia Question: Which Two?

Your Turn:

Questions & Thoughts

