SOUTH CENTRE

FINANCE, STABILITY AND GROWTH

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ISSUES AT STAKE

- True that a strong and well-functioning financial system could play an essential role in promoting growth and macroeconomic stability.
- But there is no agreement on what "strong" and "well functioning" system means. Significant differences exist in the way financial institutions and markets are seen to operate, their effects on stability and growth and how they should be regulated and organized (market-based/bank-based and private/state-owned).
- Developing and emerging economies (DEEs) need to have a good understanding of appropriate ***size, structure*** and ***organization*** of finance from the point of view of their growth and development needs and to establish a system that serves these objectives.

POST-WAR "FINANCIAL REPRESSION"

- Key elements:
  1. Extensive state ownership and management of banks
  2. Ceilings over deposit and credit rates and rates on government debt
  3. Directed credit allocation, differentiated lending rates.
  4. High and often non-remunerated reserve/liquidity requirements
  5. Capital account restrictions and exchange controls

- Cheap finance to governments. US Regulation Q (no interest on demand deposits and cap on savings deposits); negative rates on government debt; liquidation of war debt by 3-4% of GDP pa in US and UK during 1945-1980.

- In many DEEs and some AEs another objective was to promote rapid industrialization. In Japan moral suasion was used.

LIBERALIZATION: THE NEO-CLASSICAL RATIONALE

- Market economy cannot function effectively if some markets are missing. Finance is an essential part of complete markets.

- Financial markets are efficient (EMH), correctly pricing risk and return.

- Deep, broad and liquid financial markets and innovations make market economy more efficient, allowing savers and investors to manage risk better and achieve and reconcile their desired risk-return-liquidity positions. These in turn increase both savings and investment and result in a more efficient allocation of capital.

- Restrictions other than those designed to address well-identified market failures and to improve transparency thus reduce welfare (but no failures in financial markets by EMH!)

THE RECORD

- In many DEEs with FR, record on growth and stability was generally poor; but notable exceptions in East Asia (e.g. Korea). Fast-growing DEEs, China, India and Brazil, still retain some key elements of FR (SOB, directed credit etc.).
- US, Europe and Japan enjoyed significant and stable growth under FR.
- Liberalization led to rapid increase in financial sector: not only bank assets, stocks and bonds (now 4 times global GDP), but also derivatives (11 times).
- No clear historical link between financial intensity and growth, but increased instability and recurrent crises in AEs and DEEs; and greater inequality partly because innovations often redistribute rather than generate wealth and income.
- Limits of financialization: "I wish someone would give me one shred of neutral evidence that financial innovation has led to economic growth" (Volcker).

IS "FINANCIAL REPRESSION" COMING BACK?

- FR is seen coming back in several ways in AEs facing growing public debt:
  - Large purchases of government debt by CBs (including foreign CBs), restricting the role of private markets.
  - Negative interest rates, transaction taxes, higher liquidity requirements (in UK in gilts), forcing pensions to hold government debt (France, Ireland) ...
- Capital controls in DEEs facing a surge in short-term capital inflows
- Reduced hostility towards state intervention and SOB; shift in deposits to SOB in some (India); increased recognition of importance of countercyclical lending by SOB and of having bank assets held in more secure government paper.

FINANCE AND GROWTH: SAVINGS

- Financial liberalization, including that of interest rates, does not necessarily lead to increased savings, but concentration of savings in financial assets :
  - Theory is ambiguous on the link between interest rates and savings
  - US had much higher savings under Regulation Q than subsequently.
  - Declines in US private savings due to consumption of capital gains during dot-com and home equity withdrawals during subprime bubble.
  - In several DEEs too savings fell when liberalization led to rapid growth of debt-financed consumption, including externally funded debt.
  - Today some DEEs still with FR have higher savings rates (China and India) than those with more liberal finance.
- Impact of concentration of savings in financial assets depends on how efficiently they are allocated and used through banking and capital markets.

CREDIT MECHANISM

- Credits generate income and savings by expanding demand and increasing utilization of existing capacity and adding to productive capacity.
- But credits not always linked to income generation and investment. US corporate debt up from 50% of GDP in 1960s to 200% now, but investment still around 10%. Credit is increasingly used for financial leverage (M&A, buyouts, derivatives…).
- Several instances of unsustainable debt accumulations both domestically and internationally, supporting unviable investments and leading to crises – Japan 1990s, Asia 1997, US sub-prime, and property bubbles in EU (UK, Spain).
- Banking efficiency: competition is needed, but to be accompanied by effective regulations. Foreign banks may bring competition and greater efficiency but can also lead to regulatory arbitrage and increased external vulnerability (CEE)

CAPITAL MARKETS

- "There is no such thing as liquidity of investment for the community as a whole … Capital markets provide liquidity to make investments which are 'fixed' for the community more 'liquid' for the individual" (Keynes)
- But, these liquid markets are also highly speculative and subject to volatile expectations and herd behaviour, creating bubbles unrelated to fundamentals and boom-bust cycles (US dot-com) and DEEs (stock market cycles in the 2000s).
- Search for yield and liquidity is pushing individual and institutional savers to capital markets almost everywhere. To meet competition, commercial banks are also tempted to go into securities, liquefying their non-traded claims via securitization (US subprime) or investing in securities (Germany). Increased exposure of banking to capital market volatility – also in some DEEs.

SYSTEMS OF FINANCE

- *The world has turned a page on the Anglo-Saxon model* – (Sarkozy- 2009)

1. German-Japan bank-based finance: long-term lending by banks to enterprises based on substantial own capital to safeguard solvency
2. Anglo-American market-based finance: short-term lending and adequate liquidity, with corporate investment depending on share issues.

- BB allows better monitoring of enterprises by banks and of banks by state and more evenly spread wealth. Stock markets can provide wider options in allocation of risks and monitoring by shareholders, but foster short-termism.
- Historically bank-based system is more stable. But now shift to market-based banking almost everywhere. US move to universal banking (1999 repeal of Glass Steagall); German banks investing and losing a lot in sub-prime.

THE GLOBAL DIMENSION: CAPITAL FLOWS AND FINANCIAL STABILITY

- (Bernanke) : "*Looking back on the crisis, the United States, like some emerging-market nations during the 1990s, has learned that the interaction of strong capital inflows and weaknesses in the domestic financial system can produce unintended and devastating results. The appropriate response is … to improve private sector financial practices and strengthen financial regulation, including macroprudential oversight. The ultimate objective should be to be able to manage even very large flows of domestic and international financial capital in ways that are both productive and conducive to financial stability.*"

CAPITAL FLOWS TO DEEs

- No conclusive evidence on link between capital account openness and growth
- Impact of surges in capital flows:
  - Currency appreciations and CA deficits
  - Unsustainable booms in credit and asset markets
  - Currency and maturity mismatches in private balance sheets
- How to respond?
  - Currency interventions and liberalization of resident outflows are problematic
  - Appropriately extended prudential measures can limit mismatches in banks' balance sheets and credit-related forex risks.
  - But these may not be enough – 70 % of inflows not intermediated by banks.

INCLUSIVE FINANCE

- Access of poor farmers, self-employed and small enterprises. Two options:

  1. SOB. Record mixed but successful examples in agriculture. Performance now improving (India). Key issue is how to prevent political abuse.

  2. Directing credit in private banks. US community banking (former restrictions on geographical diversification and Community Reinvestment Act – banks lending in low-income neighbourhoods where they take deposits).

- Crises hit small banks and firms hard. SOB can help their recovery; but governments often focus on bailing out systemically important institutions, not using their leverage to direct credits to where most needed.

CONCLUSIONS

- For most DEEs establishing a modern banking, appropriately extended to all segments of society, rather than trying to set up stock markets, should be priority. For MICs, a judicious combination of banks, corporate bond and equity markets; and their effective functioning and stability.
- The kind of financialization and financial engineering (including market-based banking) that have devastated several AEs should not be allowed in DEEs.
- CBs should pay as much attention to asset price inflation as inflation in labour and product markets. Both monetary and regulatory policy should address bubbles in credit, asset and currency markets.
- Significant and increased role for SOB in DEEs – for access of the poor to financial services, countercyclical lending during crises and for development finance. No longer clear that SOB waste more resources than private banks.