Does Finance Accelerate or Retard Growth? Theory and Evidence

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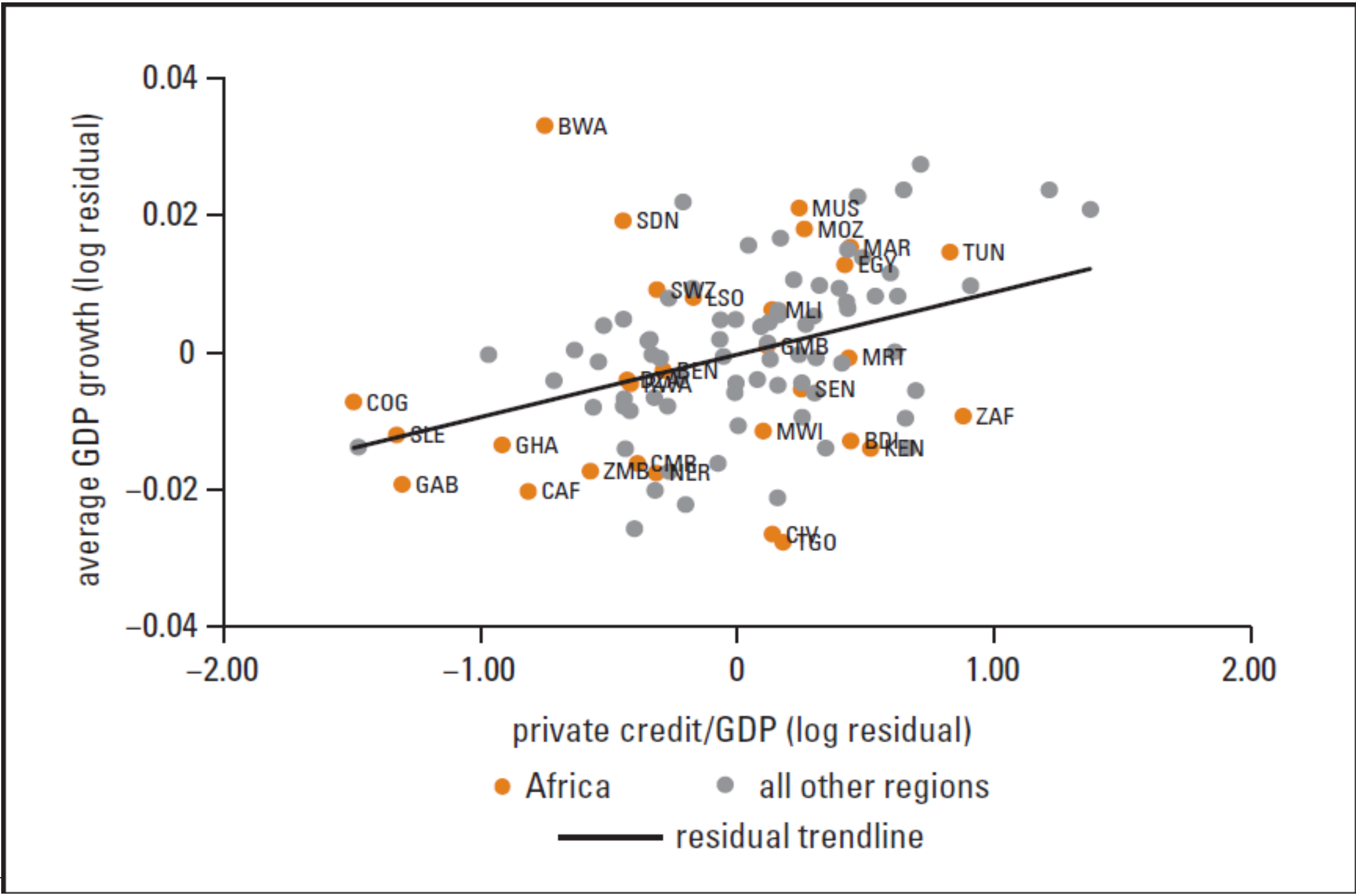
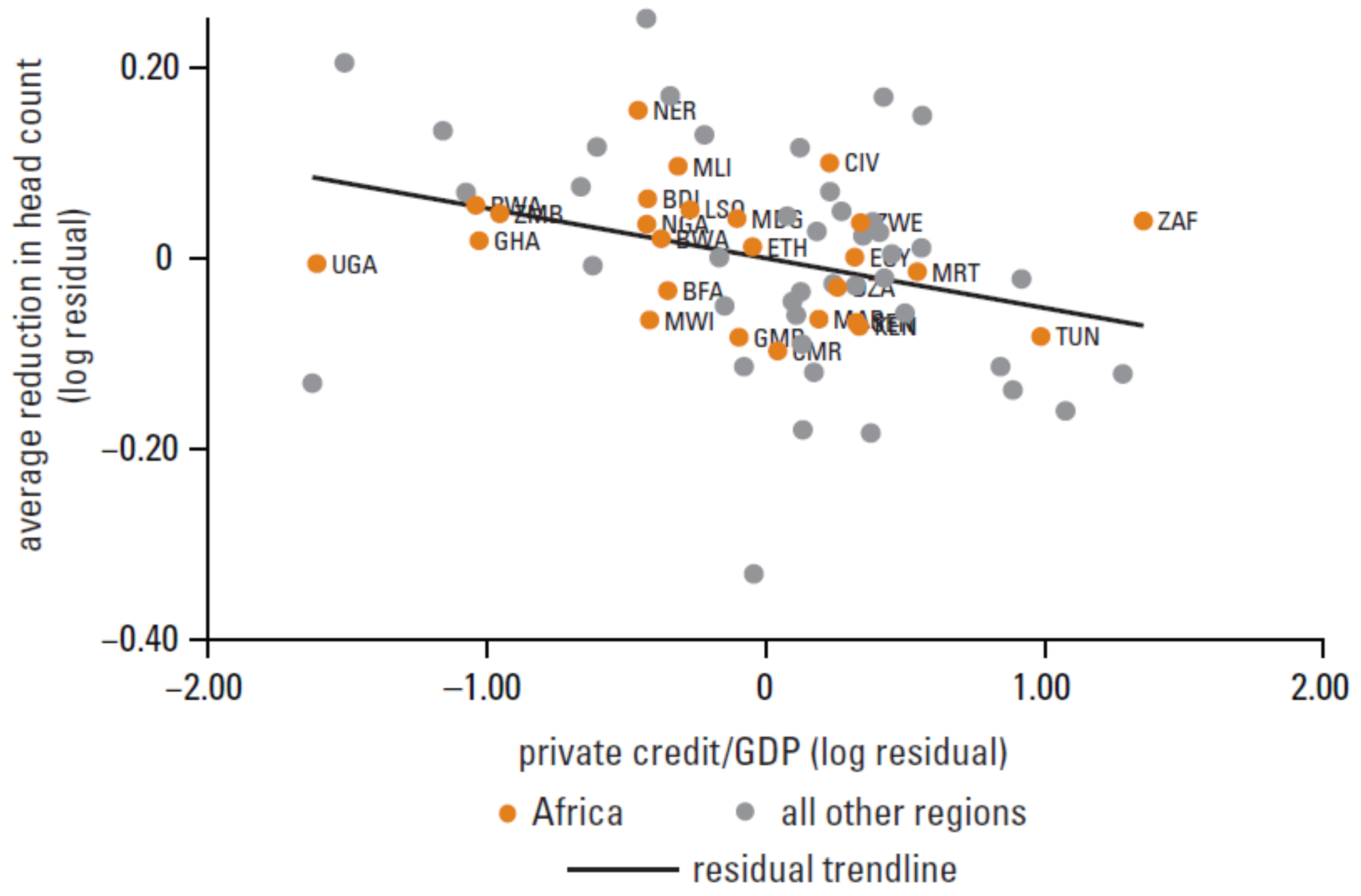
My main points

- Non-linearity of finance-growth relationship – different reasons
- Financial frontier concept to understand bright and dark sides of finance
- Finance for the poor – different channels

Finance is pro-growth

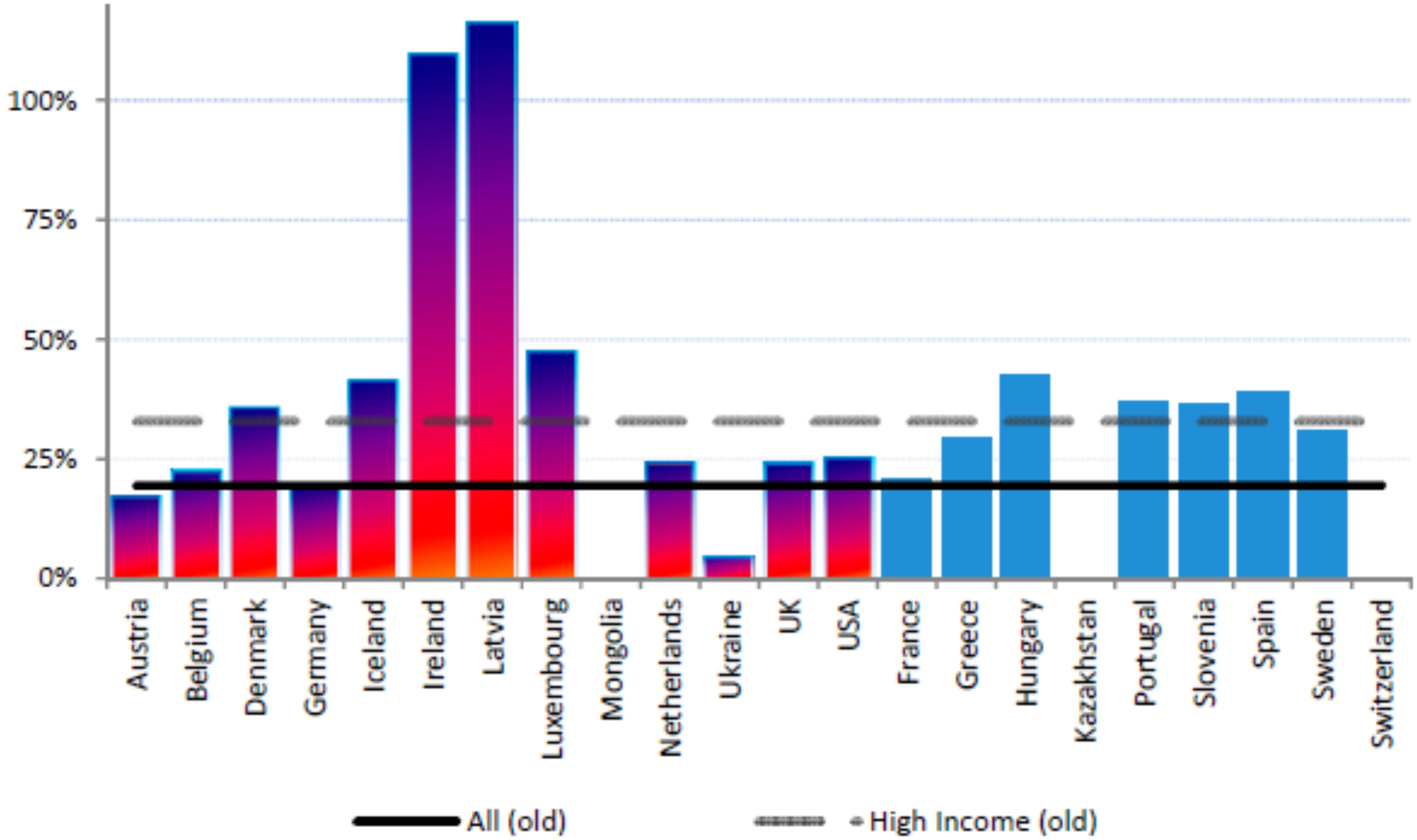


...and pro-poor



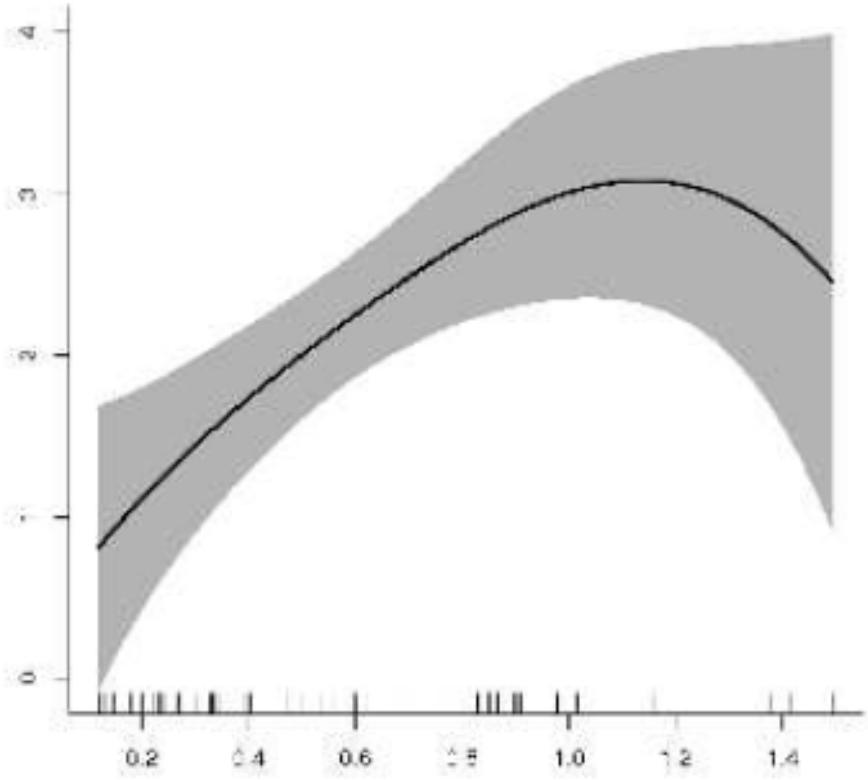
average reduction in head count (log residual)
0.20
0
–0.20
–0.40
–2.00
–1.00
0
1.00
2.00
private credit/GDP (log residual)
NER
MLI
CIV
RWA
ZMB
GHA
UGA
BDI
LSO
NGA
BWA
MDG
ETH
ZWE
ZAF
EGY
MRT
BFA
TZA
MWI
GMB
CMR
MAR
KEN
TUN
Africa
all other regions
residual trendline

…but also fragile

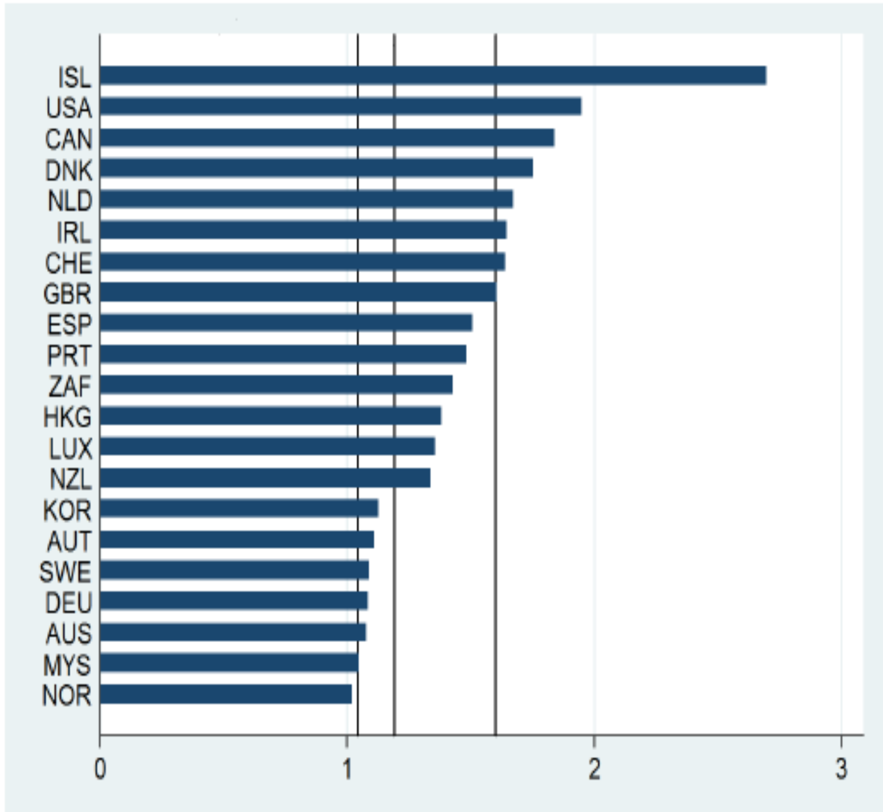


Output losses relative to potential output;
Source: Laeven and Valencia (2010)

Too much finance?



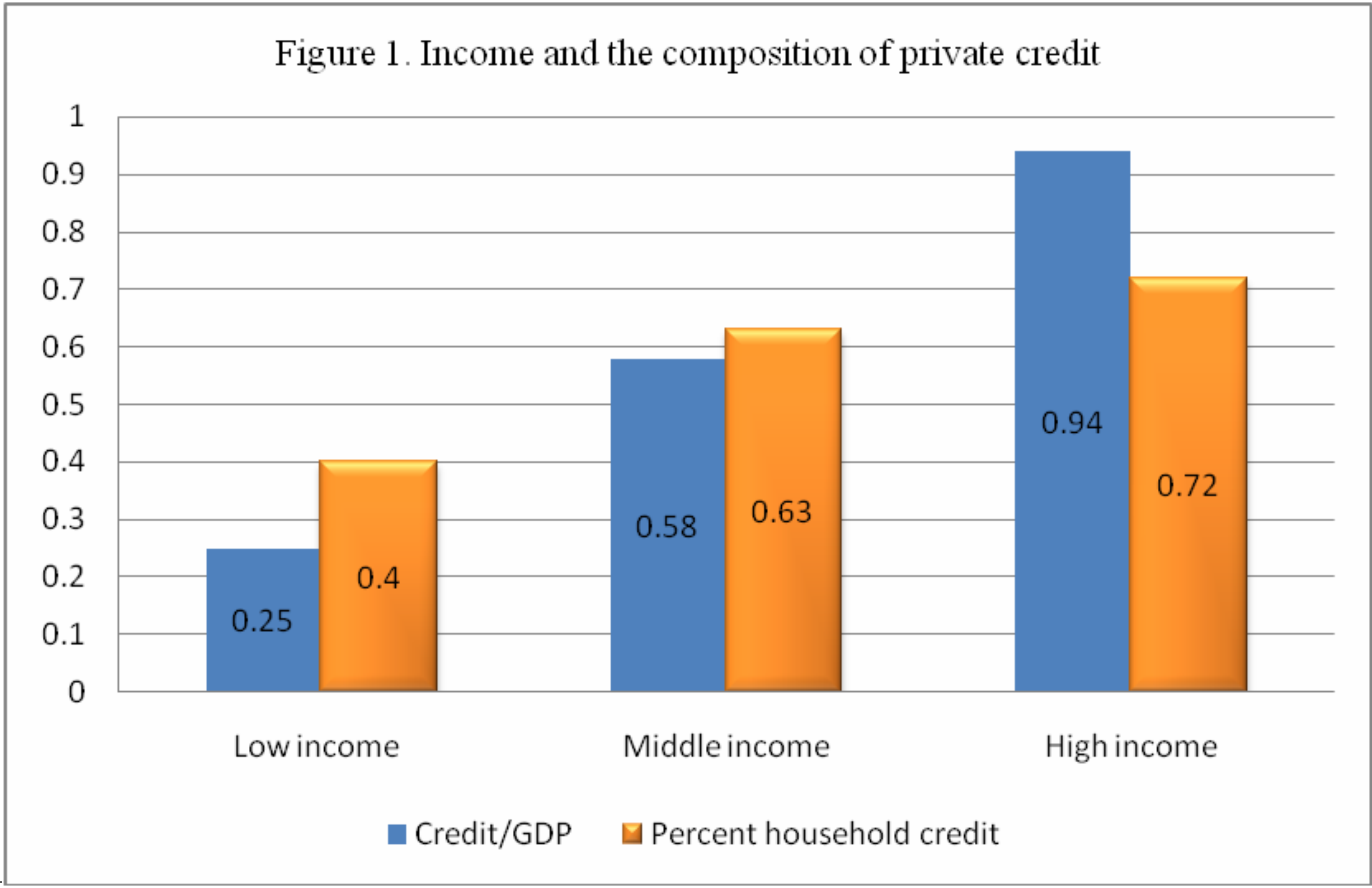
Arcand, Berkes and Panizza, 2012



Non-linearities in finance and growth

- Relationship between finance and growth varies across countries, and systematically so with GDP per capita
- Explanations:
  - Measurement error - banks are going into non-intermediation business lines
  - Finance only helps to reach frontier, but not once country gets there
  - Who gets credit?
  - What kind of concept of financial system?
  - Financial safety net subsidy causes overexpansion of financial system

Who gets credit?



Who gets credit? And does it matter?

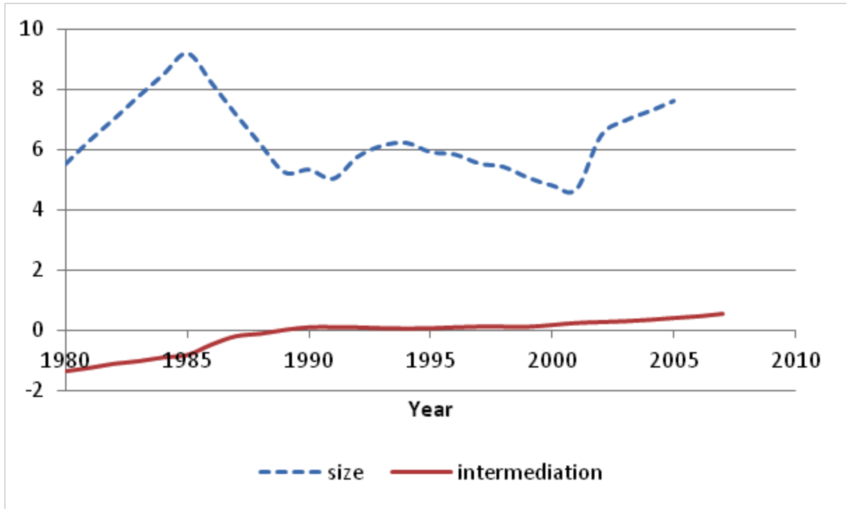
- Only enterprise component of bank lending robustly linked to economic growth
- Lending to households has no significant effect on growth (consistent with ambiguous effect predicted by theory)
- Increasing importance of household credit in total credit in high-income countries explains partly why the impact of overall bank lending in these countries is insignificant.
- Credit to enterprises, but not to households explains pro-poor effect of finance
- Beck et al. (2012)

What kind of financial sector – financial intermediation vs. financial center view

- Financial intermediation or facilitator view
  - Finance as "meta-sector" supporting rest of economy
- Financial center view
  - One of many sectors
  - Nationally centered financial center stronghold based on relative comparative advantages such as skill base, **favorable regulatory policies, subsidies**, etc.
- Compare the two views (Beck, Degryse and Kneer, 2013), using pre-crisis data

What kind of financial sector – financial intermediation vs. financial center view

- Private Credit to GDP vs. Value added of financial sector in GDP



- Long-term: intermediation matters, not sector size
  - Higher growth and lower volatility
- Short-term: size is associated with higher volatility in high income countries, intermediation with higher growth in low-income countries
- Kneer (2013 a,b): evidence for brain drain from skill-intensive industries to financial sector

Implications for post-crisis regulatory reform

- Back to basics!
- Focus on intermediation
- It's about services, not specific institutions
- Over-reaching of financial sector due to financial safety net subsidy
  - Financial safety net reform
  - Start with resolution

Financial possibility frontier – understanding the bright and dark sides of finance

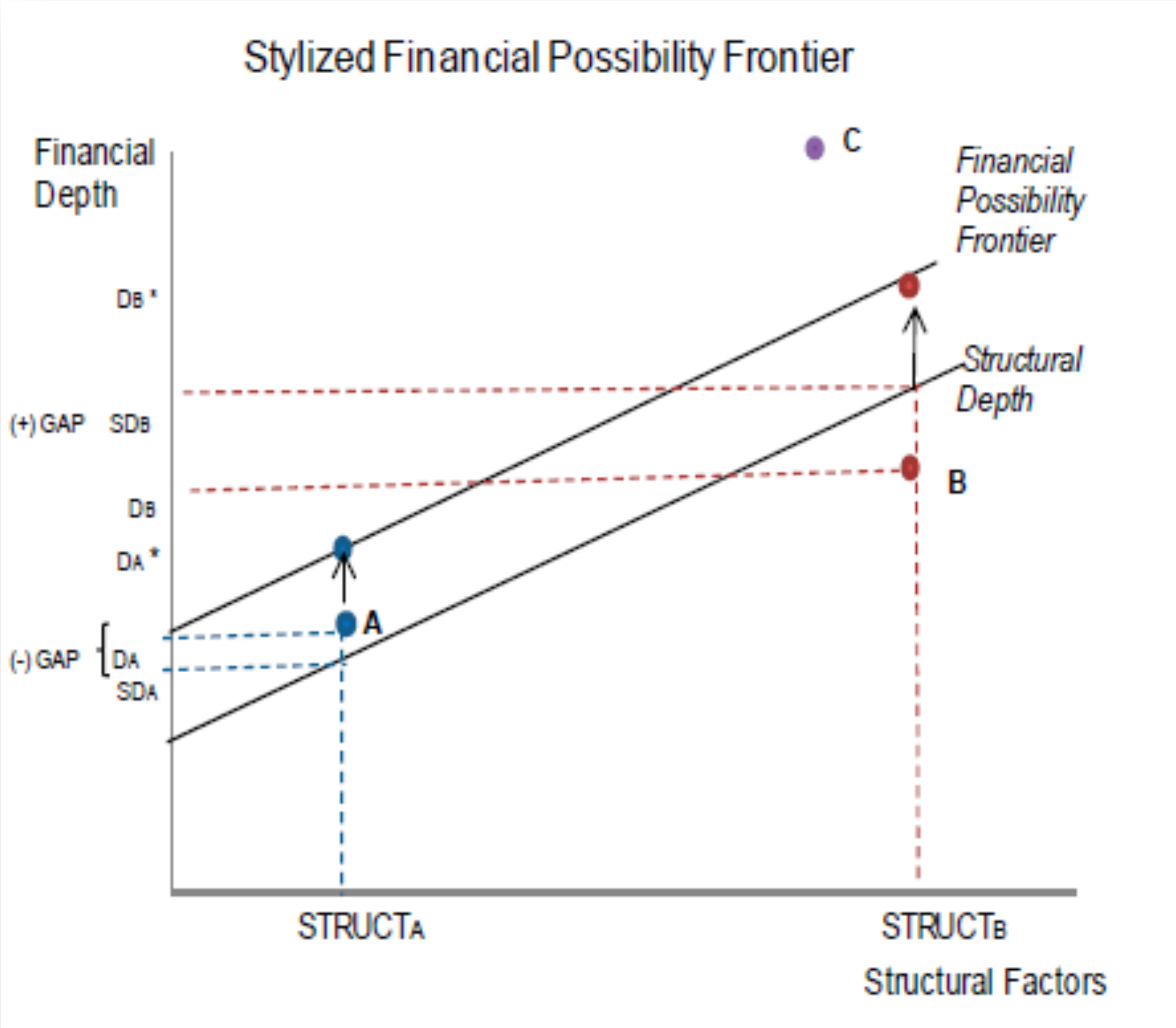
Constrained optimum of financial depth, outreach or breadth given state variables (invariant in the short-run), might not be market-clearing

State variables:

- Socio-economic factors (income, market size, population density, age dependency ratio, conflict)
- Macroeconomic management and credibility
- Contractual and information frameworks
- Available technology and infrastructure

Financial system can be below or above the frontier

Graphical illustration



Taxonomy of challenges

- Frontier too low
  - Structural variables
  - Institutional variables
  - Market-developing policies
- Financial system below frontier
  - Lack of competition
  - Regulatory constraints
  - Demand-side constraints
  - Market-enabling policies
- Financial system beyond frontier
  - Incentive compatible regulatory framework
  - Also on demand-side
  - Market-harnessing policies

Channels of pro-growth and pro-poor finance

- Allocation effects of financial deepening more important than capital accumulation
- Pro-poor effects: Access to credit? Not necessarily – differential effects across different groups (recent work by Banerjee et al.)
- Pro-poor effects: important indirect effects
  - Allocation effects
  - Labor market and migration effects
  - Evidence from Thailand, U.S. and India
- Pro-poor effects of finance can be structural!

In summary:

1. Non-linearity of finance-growth relationship– different reasons
2. Financial frontier concept to understand bright and dark sides of finance
3. Finance for the poor – different channels

Thank you

Comments and suggestions?

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