Claudia Buch: Finance and growth – guidelines for financial sector reform

Speech by Prof Claudia Buch, Deputy President of the Deutsche Bundesbank, at the Frankfurt Finance Summit 2015: “The Last Word”, Frankfurt am Main, 17 March 2015.

* * *

Ladies and gentlemen

It is my pleasure to share a few thoughts with you at the end of this year’s Frankfurt Finance Summit. Given the challenges that lie ahead, the Summit’s key question: “How to foster growth in a new regulatory framework?” could not be more timely.

At the moment, economies worldwide are still struggling with the adverse effects of the financial crisis. The average loss of potential output resulting from the financial crisis has been estimated at 8.4%. And these output effects can be very persistent. Crises reduce an economy’s capital stock – and the catch-up process via investment takes time. Constrained credit supply in times of financial crisis can lead to inefficient capital allocation. Investment in innovations is postponed.This shrinks potential output and productivity, thereby slowing down long-run growth.

In order to weaken the negative effects of financial crises on growth, many new regulations have been designed. In Europe, the Banking Union and, more recently, the Capital Markets Union feature prominently. At an international level, the regulation of globally significant financial institutions has been at the core. Overall, these reforms are headed in the right direction. Yet concerns are being raised that the regulatory system is becoming too complex and thus less transparent. This makes it necessary to focus on the key principles of regulatory reform.

In the next 15 minutes, I would like to step back and ask

- What is the relationship between finance and economic growth?
- And is there a “double dividend” in the sense that financial systems which are conducive to growth are also more stable?

To answer these questions, we can draw on a large body of empirical (and theoretical) evidence that can give us guidance for financial sector reform.

Let me start with the evidence we have on the link between financial development and growth.

1. Financial development and growth

In the 1990s, there was a widespread consensus that financial development fosters economic growth. Developed financial sectors stimulate entrepreneurship, innovation, investment, and productivity. Many of these beneficial features of financial markets arise through equity finance. Through venture capital finance, for instance, new start-ups obtain not only financial resources but also management expertise. Yet, in much of the academic and policy debates, “financial development” has been associated with the share of credit intermediated through the banking system. And empirical research in fact supported the view that countries with larger banking systems also grow faster.

However, the financial crisis raised a critical question. Is there a turning point after which additional financial sector growth no longer spurs, but perhaps even hinders economic growth? Or put differently: is more bank credit a bit like water in that there can be too much of a good thing? Water is certainly needed for life, but when there is too much water, there can also be a fatal water overdose which can lead to water intoxication. And if the financial sector can grow beyond the limit that is good for economic health, what are the implications for the reform agenda?

Recent empirical evidence indeed shows that the link between finance and growth is non-linear. In middle-income countries, financial sector development has positive effects on economic growth. In high-income countries, additional growth in the financial sector may even have negative effects on growth.

Hence, there is no “optimal” size of the financial sector. This is important for us as policymakers. It shows that we should aim at providing the right institutional framework and incentives for the financial sector. The goal should be to prevent excessive leverage and risk taking.

But before discussing regulatory implications, let me shed some light on the mechanisms that are at work. In 2009, Paul Krugman coined the term “boring banking” to describe banks focusing on their core business – taking household deposits and being conservative in giving out corporate loans. Banks fulfilled their role of financing entrepreneurship and firm entry, leading to positive firm dynamics and innovation. This raises the question why, at some point, the banking sector fails to support economic growth.

A first explanation is related to the structure of banks’ activities. In banking sectors that grow fast, business tends to shift towards non-interest income generating activities. Banks tend to rely on wholesale instead of deposit funding. Banks no longer fulfil their traditional role of taking deposits and providing credit to the real economy. When market sentiment shifts, banks with a high share of wholesale funding are affected most and have to cut back credit to a greater extent.

A second explanation distinguishes between household and corporate credit. In general, corporate credit is more closely aligned with the financing of investment and innovation. Yet, as countries develop and reach the productivity frontier, it becomes more difficult to stimulate growth further. Often, bank credit then shifts from the corporate to the household sector, with negative implications for growth.

A third explanation is based on the structure of employment in the financial sector. In the US, the financial sector was a relatively high-skill and high-wage industry at the beginning of the 20th century as well as in the past 30 years. In the interim period, thefinancial sector lost its high human capital position and its wage premium relative to the rest of the private sector. This raises the question whether a highly developed financial sector attracts high-skilled labour – and whether such labour might be employed more efficiently in other sectors of the economy.

All these factors – changes in the structure of bank funding, in bank assets, and in the skill composition of bankers – help explain why the financial sector may at some point become detached from the real economy. These explanations would remain incomplete, however, without stressing the role of regulations and the role of the public safety net. Regulations which encourage high leverage and public sector safety nets that subsidise risk taking leave the financial sector vulnerable to shocks. Systemic financial crises, which impose large costs on society, are the result.

In short: financial systems that are built on equity rather than debt are inherently more stable. A related question is: which balance between bank-based and market-based finance is most conducive to growth? This question is not new. In the early 1990s, for instance, the Eastern European countries had to decide whether to opt for a bank-based or a market-based financial system. Both systems indeed have advantages, depending on the stage of economic development and the stage of the business cycle.

As countries develop, the growth-enhancing effects of banking sector development decreases while the beneficial effects of capital markets become more important. As for individual firms, there is a “pecking order of finance”: at early stages of development, internal funds and external working capital loans dominate. As firms (or markets) mature, external funds raised through bond and equity markets become more important. Also, while market-based systems help alleviating recessions after financial crises, bank-based systems are more effective in smoothing the impact of "normal" business cycle fluctuations.

2. Financial structure and financial stability

The structure of finance is important not only when discussing the implications of finance for growth. Rather, the structure of finance also has important implications for the stability of the financial system. The higher the share of debt finance, the larger "financial accelerator" effects can be – seemingly small shocks can have large and systemic implications. Economic fluctuations magnify and threaten the stability of the entire financial system. The channel of transmission can run through consumption or investment.

- High levels of household debt affect output stability through the adjustment of consumption. Evidence for the US shows that households with high levels of real estate debt cut back consumption in response to shocks to asset prices, thus amplifying the cycle.
- Firms with high levels of debt cannot smooth investment when an adverse shock hits.
- High levels of public sector debt can be destabilising. As well Government spending cannot cushion the effects of financial crises when public debt levels are already too high.

These effects are further magnified if households, firms, and governments have borrowed from a banking sector which is insufficiently capitalised. Adverse shocks then set into motion a downward spirals of asset valuations and prices that ultimately threaten the solvency of financial institutions.

The destabilising effects of debt arise from its contractual features. Standard debt contracts are insensitive to the borrower's situation. After risks have materialised an adjustment to shocks can occur only through new lending or through haircuts on existing loans. In contrast, the value of equity adjusts if the situation of the borrower changes so that equity provides a risk sharing mechanism. In other words, equity as a claim on real assets has stabilising features compared to debt as a claim on nominal assets.

The stabilising features of equity contracts have also been visible during the European debt crisis. In Europe, debt finance has been more prone to capital flight than equity finance. Furthermore, diversified cross-border equity holdings help detach consumption from business cycle fluctuations. Cross-border equity allows more effective cross-border risk sharing and consumption smoothing. Increased reliance on equity finance would be particularly beneficial in the European Monetary Union, where exchange rates cannot adjust to cope with regional macroeconomic shocks.

3. What are the policy implications?

Financial systems which rely more on equity rather than debt finance can be conducive to growth, and they tend to be more resilient to shocks. This suggests that there might indeed be a "double dividend" – financial sector reforms that contribute to financial stability also promote growth.

Viewed in this light, there are a couple of takeaways for policymakers and regulators.

The first is that a more developed financial system is the basis for economic growth. However, our reform efforts should not be aimed at the mere size and growth of the financial sector. Instead, we must ensure that the financial sector fulfils its intermediation role and processes information efficiently. Microprudential regulations that improve banks' risk assessment and ensure the application of common rules are crucial in this regard. The

Banking Union is a key step forward, because it specifically aims at establishing common supervisory standards in Europe.

Second, macroprudential policy is a necessary complement to microprudential regulation. There might be risks to the stability of the entire financial system that microprudential supervision cannot detect. For instance, increasing household debt might threaten stability through its impact on consumption – while individual banks may remain sound.

Third, post-crisis private sector deleveraging was much lower in the euro area than in the US. This could partly explain the slower economic recovery in Europe. Reducing debt to levels which do not threaten stability requires efficient mechanisms to deal with distressed financial institutions. Bank recovery and resolution regimes provide important tools to restructure banks' balance sheets. This is where the second pillar of the Banking Union – the Single Resolution Mechanism – plays a key role. Through the bail-in tool it facilitates, most importantly, increased private sector risk sharing.

Fourth, the Banking Union needs to be complemented by reforms that strengthen the development and integration of equity markets.

The Capital Markets Union offers a great opportunity. Many initiatives that are currently being discussed aim at integrating European markets for debt instruments, such as securitisations or covered bonds. The Capital Markets Union can indeed contribute to an improved functioning of debt markets. To facilitate debt restructuring, reforms of insolvency regimes are needed in some countries. The goal should be to allow for quick recovery or liquidation in a predictable and transparent manner.

Yet, the Capital Markets Union ought to put more emphasis on the development and integration of European equity markets. Improving access to venture capital, and the sharing of information on local markets can be important in this regard. The Capital Markets Union should also be taken as an opportunity to remove the preferential tax treatment of debt versus equity. These measures would strengthen banks' and firms' loss-absorbing equity buffers and stabilise growth in Europe.