Andreas Dombret: Could less be more? The role of finance for the economy

Dinner speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the SAFE Conference on Regulating Financial Markets, Frankfurt am Main, 30 May 2016.

*   *   *

1. Introduction

Dear Mr. Kick,

Ladies and Gentlemen

Given that my speech is standing between you and the next course of our dinner, I will endeavour to be brief.

One colloquial definition of insanity is doing the same thing, over and over again, but expecting different results.[1] By that standard, how sound is current financial regulation?

Looking at the many new topics of financial regulation on the agenda of this conference, it would appear that the response to the crisis has been quite sound. Your contributions and this conference in general are, in my view, very valuable in helping to understand why financial regulation needs to be strong and how it can work for the economy and our society.

And since you will be debating the details of these issues all day long, I will not go into the specifics of financial regulation.

Instead, I will discuss a remaining fundamental problem of financial policy making – one where our current policies might fit the definition of insanity I quoted earlier. It relates to the question of how much finance we need for solving our current economic problems.

For over three decades before the crisis, the simple answer was "more is better." This mind-set led us into the crisis, the consequences of which we are still witnessing today. To keep relying on more finance seems questionable.

The core problem, I believe, is one of mind-set. I am talking about the idea that more credit and financial activity lead directly to economic growth. According to this plain idea, leverage and liquidity in banks lead to more lending, which in turn fuels investment, which then leads to more growth and economic development. In that spirit, some are, again, arguing that what the economy needs is less regulation and more lending.

I refer to this ideology as a "finance-led growth strategy". I am convinced that we must overcome these intuitively appealing ideas and their ideological siblings. In that spirit, tonight I will talk about our current economic challenges and the role that finance, on the one hand, and financial regulation, on the other, can play in underpinning sustainable economic development.

2. Less and more in the current economy

After the financial crisis, financial regulation has been hailed as a saviour of the economy. Yet the current state of the world economy and that of most advanced national economies are eroding this standing. In the face of populist pressures, simple political solutions that hold out

[1] Even though this definition is often attributed to Albert Einstein, he most likely never actually said it. One verified usage of this axiom is in the novel Sudden Death by US author Rita Mae Brown.

the promise of jobs and participation in growth are being sought. Finance offers an imaginary panacea for this situation.

This situation is familiar from the pre-2008 period. It seems to be back on the rise, as global economic growth continues its sluggish trajectory of recent years. Fittingly, the IMF reported in April "*Too Slow for Too Long*".[2] Moreover, the Fund expects growth to remain stubbornly stagnant. These growth problems seem to be based on fundamental economic challenges, all of immense magnitude: secular stagnation, be it driven by weak demand or weak supply; debt overhang; and demographic change.

Policies that do not look beyond the end of the election cycle are not the right way to address these types of challenges. Which is probably why the success of policy responses seeking to put output levels and growth back on track was only short-lived. Growth has been slowing in most advanced countries. So what now?

In the past, a popular response to sluggish growth was finance-led growth policy. But there are a couple of problems with that strategy which make it an unhealthy policy choice. The recent financial crisis offered yet another impressive example. However, too much finance leads not only to financial turmoil but also to economic growth being stifled by mountains of debt.

The overblown financial system and the extreme leveraging have left the world economy with a severe debt overhang, a mountain of debt. It was this excessive credit creation which paved the way for the financial crisis. During the crisis itself, it was plain to see that leverage needed to be lowered, especially in the financial sector. But precious little headway has been made in this regard, leaving us with an unstable financial system.[3]

What's worse, the tectonic movements of these debt mountains have serious repercussions on the stability of the financial system. Doubts about the sustainability of the mountains of credit increase uncertainty about the economy in general and the financial sector in particular. Non-performing loans and unsustainable business models – which in many cases continue to build on the assumption that the pre-crisis environment will return – are still a drag on the resilience of the financial system.

Thus, while finance-led growth might be intuitively appealing, pursuing it once again would seem to fit our definition of insanity above.

3. How much is enough? More finance is not a panacea

Nevertheless, policymakers are looking for solutions. Unfortunately, some still think that more finance is a sound way to ignite investment and development. Such a finance-led growth policy emerged as the dominant political strategy in the 1980s. That meant that financial deregulation was high on the agenda to foster financial development. And theory appeared to support this intuition, with studies showing that financial development corresponded strongly with economic growth.[4]

But, while finance seemed to be conducive to economic growth in the early stages, it also had serious negative repercussions for the economy. We learned the hard way that more finance is not a panacea! For two reasons: first, more credit and finance tend to lead to more frequent and more severe financial crises.[5] Excessive credit creation increases the fragility of the

---

2 IMF World Economic Outlook, Update April 2016.

3 See also McKinsey (2015), Debt and (not much) deleveraging.

4 R Levine (2005), Finance and Growth: Theory and Evidence, in: Handbook of Economic Growth.

5 A Turner (2015), Between Debt and the Devil: Money, Credit, and Fixing Global Finance, Princeton University Press.

financial system and the likelihood of financial crises. And the bigger the mountain of debt, the more severe post-crisis recessions tend to be.[6]

Moreover, financial turmoil is not the sole possible outcome of excessive debt. The second reason why more finance is not a panacea is that leverage seems to hamper economic growth once it exceeds GDP levels of around 90 to 100 per cent. Recent evidence reveals that there is indeed such a thing as too much finance.[7] Financial depth starts having a negative effect on output growth once credit to the private sector reaches 100 per cent of GDP. Most advanced countries exceeded this level prior to the financial crisis – and continue to do so.

Recent studies found even lower thresholds at which financial deepening unleashes negative effects. In a Bank for International Settlements working paper, Cecchetti and Kharoubi found that the effects of credit on GDP growth turn negative once corporate debt exceeds 90 per cent – or household debt 85 per cent – of GDP.[8] The OECD's report on finance and inclusive growth last year found that the effects of private leverage on GDP growth turn negative once total private credit – household and corporate credit combined – exceeds 90 per cent.

For sure, there is no exact science to determine the appropriate level of leverage, but two crucial insights can be derived: first; there is such a thing as too much debt; second, current levels in most advanced and emerging economies exceed these levels. Together, these insights provide much better guidance for prudent policy and regulatory strategy than the finance-led growth agenda.

Thus, the diagnosis for advanced economies like the EU und the US is that increasing credit and financial activity is beneficial, but only up to a point. This point has been exceeded in most developed economies.

4. Better finance? More quality, please

What's the takeaway from all this? It's that more finance is not the solution to our current problems. Sticking to the simple "more finance, more growth" trajectory is not sustainable. That would run the risk of focusing on what is currently our most pressing problem – lifting growth expectations – at the expense of our long-term – and fundamental – goal of achieving a stable financial system that serves the real economy.[9] And by doing that, we would also sacrifice sustainable growth.

But, at the same time, excessive limits on financial intermediation would certainly undermine economic development.

Thus – as you all know – there is no simple, linear positive or negative relationship between finance and growth. And that is because there is a problem with the simple indicator that is typically used to assess the effects of financial deepening on economic development – that is private credit to GDP. It's a crude measure which is incapable of measuring the quality and

---

[6] C M Reinhart and K S Rogoff (2008), This Time is Different. Eight Centuries of Financial Folly, Princeton University Press

[7] J L Arcand, E Berkes and U Panizza (2015), Too much finance? Journal of Economic Growth, 20(2): 105-148; European Systemic Risk Board (2014), Is Europe Overbanked? Report of the Advisory Scientific Committee No 4/June 2014.

[8] SG Cecchetti, E Kharroubi (2012), Reassessing the impact of finance on growth. BIS Working Paper No 381; SG Cecchetti, E Kharroubi (2015), Why does financial sector growth crowd out real economic growth? BIS Working Paper No 490.

[9] AR Dombret (2016) More More painkillers, please? Why more finance is the wrong medicine or our growth problem. Keynote remarks delivered in Armonk, New York on 8 April 2016 at the Harvard Law School Symposium on Building the Financial System of the 21st Century: An Agenda for Europe and the US.

efficiency of a financial system – but that's what further development of an already advanced economy is about.

The problem with the current simple measure mirrors the problem with the political reality: a simple measure enables researchers to build great data sets and publish papers. Likewise, a finance-led growth strategy enables policymakers to create a simple political narrative and win support for a campaign or a specific policy action. The scientific and the political problem are of the same nature: complexity and detail simply aren't sexy.

Until the crisis, it was very, indeed very sexy to claim that more finance meant more development. That truth was simple; it was clear; it was sexy. But it turned into an ugly sham. To find the new truth appealing, we need to embrace the complexity of the quality of finance and the subtle, indirect roles it plays for the economy. In other words, we need to accept the fact that the role of the financial sector in real economic development seems to lie in the quality of financial intermediation. And the importance of quality increases as an economy becomes more advanced.

The quality of finance can be found in the five mechanisms through which it serves the economy. Payment services reduce transaction costs; the pooling of savings helps to overcome investment indivisibilities; the large-scale organisation of screening and monitoring investments and loans reduces costs and increases overall investment; the reduction of liquidity risk enables long-term investment; portfolio diversification helps to spread out cross-sectional and inter-temporal risk.

None of these functions contributes directly to growth. Instead, all of these functions are support functions for economic development. Payment services, for example, are an important backbone of a monetary economy. The same goes for collecting and pooling savings, and, of course, the screening of investments. Yet, none of these functions in and of itself generates economic development – they merely facilitate it. This means, that finance can enhance growth sustainably only by supporting real economic development.

So what do we take away from this? First, the economic value of intra-financial market transactions should be viewed with some scepticism. Second, the intermediation function – in particular to enterprises and to investment projects – is a crucial component of high-quality finance. Third, private credit is a double-edged sword: too much of it poses a hazard to financial stability and sustainable economic development.

In sum, in pursuing economic development, we should focus less on the cheap credit channel, and more on finding answers to two important questions: what kinds of investment are important for fostering economic and social progress? And how can the financial sector enhance the quality of its intermediation? The first question is for politicians and the public to discuss. The second requires the sector, researchers and also supervisors to come up with answers.

5. Conclusion

Ladies and Gentlemen,

For over three decades, the finance-led growth agenda hid the dangers of an uncontrolled financial system. This had serious negative repercussions for the economy. More finance is not a panacea: beyond sustainable levels, more credit and financial activity may lead to more frequent and more severe financial crises. And, moreover, without the event of a financial crisis, they seem to hamper economic growth once they exceed around 100 per cent of GDP.

We must not lapse back into bad old habits when finalising, implementing and enforcing the reforms aimed at restoring financial stability.

Moreover, some deeper challenges remain to be addressed: we need to understand how secular stagnation and debt overhang trends affect the economy, and which structural reforms are necessary. And, we need to understand how the financial sector can contribute effectively

to the economy: the actual mechanisms through which financial intermediation can serve the real economy of advanced nations.

The bottom line is: what advanced economies need is not more finance, but better finance.

In that sense let me quote Antoine de Saint Exupéry, author of “The Little Prince”, who said that “*perfection is attained not when there is nothing more to add, but when there is nothing more to remove.*” That wisdom could serve financial policy makers well, but it should not keep you any longer from continuing to enjoy a delightful dinner!