Andreas Dombret: From dream to reality – how finance serves the economy, and how not

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the South African Institute for International Affairs, University of Pretoria, Pretoria, 30 August 2016.

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1. Introduction

Ladies and gentlemen

Dreams can be built – at least, if you believe the movie Inception. In that motion picture's scenario, a technology has been developed that allows one to enter another person's dream. In that dream, then, thoughts can be planted – or incepted. For this, the intruder needs to construct a dream scenario inside the target person's dream.

By incepting an idea in a person's mind, his actions in the real world can be manipulated.

Unfortunately, politics sometimes shows surprising parallels to the world of cinema – in politics, colourfully painted dreams are often used to sway voters.

But all too often, political dreams are built on a limited understanding of reality. That's why they are bound to crumble. That's why swayed voters wake up to a nightmare version of reality.

Such a dream world is the political strategy of finance-led growth, a dominant political ideology since the 1980s. The dream goes as follows: growth of financial markets fuels investment; and in this way, it leads to an increase in wealth and well-being for all people.

Many people, among them the majority of experts, believed this to be true – explicitly or implicitly. However sophisticated the construct of the dream, it did not pass the test of reality. It crashed hard when the financial crisis erupted in 2007.

Nine years later, one might think that we would have sorted out what went wrong. And so we have, to an extent: we have learned that markets cannot regulate themselves; they do not work without rules. That's why we devised far-reaching reforms.

But unfortunately, we are still struggling with perhaps the most important lesson. In our quest for well-being, the dream of finance-led growth has still not been replaced with more realistic policies. As memories of the crisis fade, decision makers are once again pushing for finance to produce illusionary wealth.

Today, I want to talk to you about the dreams and the reality of finance-led growth – about what finance can deliver, and what not.

2. Old temptations … and relapse into old patterns?

Immediately after the financial crisis struck, stringent financial market regulation was considered to be the silver bullet to end the excesses of the financial industry. The idea was that strict rules would end banks' risky behaviour to ensure they never again take down entire economies with them.

As memories of the crisis fade, this attitude is becoming less visible. The general public and the policy makers are faced with other, more pressing worries – in the economic sector these are, notably, concerns about growth. In this context we refer, in particular, to emerging market economies such as South Africa and China, as well as to the euro area. We bemoan low growth levels because growth is seen to be the main source of jobs and prosperity.

Unfortunately, this policy logic causes us, time and again, to seek a quick fix – fast, easy-to-understand and convincing solutions. This makes the finance-led growth dream the ideal mantra.

3. The dream of finance-led growth

Greater growth through increased credit and enhanced financial market activity has long been an attractive policy idea. It is held to be a magic formula for economic development, the rationale being that higher levels of debt and liquidity at financial institutions lead to increased lending. This, in turn, promotes investment and therefore growth and so, finally, economic development.

All too often, policy decisions are driven by this seductive notion – or by fear of missing out on the growth that's been promised. The problem with this idea, however, is that it's flawed. Which makes finance-led growth a truly dangerous dream.

Believing the dream that greater growth is created by the financial markets, there are many who would like to see financial institutions given kid-glove treatment – meaning that credit institutions should be subjected to less stringent regulation and supervision.

We saw something along those lines before the last financial crisis. Calls for bigger and more liquid financial markets that encourage investment and lending to the private sector, thereby leading – so the idea goes – to more growth, put deregulation and lenient supervision on the policy agenda.

Economic theory and empirical evidence backed up this policy. Various studies pointed to a positive correlation between the volume of loans granted to the private sector and economic development[1] These results would appear to confirm the finance-led growth dream. I will come back to this.

But is the situation the same for advanced economies on the one hand and emerging ones, like South Africa, on the other? Well, not entirely. For these economies, experts and policy makers had – in addition to finance-led growth – a further dream ready: that of growth through openness to international capital flows. The dream suggested that developing and emerging economies should allow international finance to enter the country without restrictions. Such a capital account liberalisation, as it is called, would lead to higher growth rates. The dream was constructed on the basis of state-of-the-art economic theory at that time. And most developing and emerging economies went along with it.

4 …and the reality

Both dreams crumbled once they were hit by a financial crisis.

The growth through capital liberalisation dream fell apart with the onset of the Asian financial crisis in 1997. Since then, studies have clearly shown that capital liberalisation has no direct positive effect on growth, and only rarely has an indirect one as a result of improving markets. Rather, it seems that those countries grow faster that rely less, not more, on foreign capital.[2]

Most importantly, the studies suggest one crucial insight: whether capital liberalisation is a good thing for an economy depends heavily on its specific situation. For example, if a country

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

2 D Rodrik & A. Subramanian (2009). Why Did Financial Globalization Disappoint? In: IMF Staff Papers, 56(1): 112–138; ES Prasad & RG Rajan (2008) A Pragmatic Approach to Capital Account Liberalization. In: The Journal of Economic Perspectives, 22(3) 149–172.

has insufficient savings, foreign capital might be the solution. If, however, there are not enough incentives or opportunities to invest in a country, additional capital won't help.

Which brings me to the other dream, that of finance-led growth. This was not challenged until the financial crisis of 2007 hit. But this has changed thanks to more recent academic studies. They show that increased credit and a higher volume of financial transactions can have negative effects, too. There are two reasons why more finance can be negative.

First, higher credit volumes lead to more frequent and more serious financial crises.[3] In other words, as more credit is granted and more financial transactions are carried out, a financial system becomes more crisis-prone.

Second: the larger the mountain of debt that has built up until a crisis erupts, the more severe the crisis typically is and the longer it typically lasts.[4] Debt was at a very high level before the most recent crisis, too – which is why many economies are still suffering from the fallout.

The more growth through finance dream became the more crises through finance nightmare.

Excessive credit growth leads to greater vulnerability to crises and their consequences, but it also unleashes yet another negative effect. Most recent studies provide evidence that it really is possible to have "too much of a good thing" – which is to say too much credit and too much financial market.

Various analyses show that economies expand more slowly when they arrive at an unsustainable, excessively high credit volume.[5] These studies do not state a universally valid limit. But they do suggest that additional credit growth adversely affects growth when the ratio of total private sector loans to gross domestic product oversteps 90 to 100 per cent. Many developed economies exceeded that level before the crisis – and, unfortunately, they still exceed it today.

In a nutshell, this means that more lending and the expansion of financial market activities is not unreservedly positive. The effect is better described by an arc. Growth can pick up in times of weak economic development; at later stages of development, a further increase can have negative implications. For developed countries, this means that more financial market alone will do little to advance prosperity. But emerging and developing countries, too, should be careful not to raise finance to unsustainable levels.

5. The task: finance for the future

I would recommend all financial market participants and policy makers with an interest in promoting public welfare to heed these findings.

But as John Maynard Keynes once wrote about the influence of academic advice: pragmatic decision-makers who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist. The false and outdated assumptions of deceased economists serve, he argued, as the basis for their decisions. At this point I make

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

4 C M Reinhart & K S Rogoff (2008), This Time is Different. Eight Centuries of Financial Folly, Princeton University Press.

5 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; 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.

a conscious decision not to quote the man, as his wording was not especially diplomatic.[6] Unfortunately, however, the point Keynes made was spot on.

The main problem at the heart of Keynes' remark is the attraction that simple theories with clear, universal recommendations have for policy makers. By contrast, insights which would be useful, but which are more complex and inconvenient, are sadly often neglected in the heat of policy arguments.

For this reason, when we contemplate the role financial markets should play in our economy, we must discard the simplistic notion that more financial market automatically spells more development.

Instead, what we need is a better quality of financial markets. What does that mean? By and large, financial markets serve the economy through five quality assurance mechanisms. First: payment services facilitate the day-to-day exchange of goods and services. Second: the pooling of savings plays a part in funding large-scale projects. Third: the systematic review of investments and loans reduces the workload for the individual, thus leading to an increase in investment and lending activity. Fourth: after loans have been granted, this review is continued in the form of controls. Fifth: because a bank offers a wide and varied range of products, it is able to spread risks and therefore manage them better.

None of these functions contributes directly to economic growth. Rather, they are supporting functions. The main purpose of these mechanisms is to facilitate development by contributing to the efficient distribution of resources. Financial markets are not in themselves engines of growth; but every engine of growth needs a powerful catalyst. And our financial system needs to focus more on precisely that function. This is where market players, policy makers, supervisors, researchers and, of course, qualified university graduates come into the picture. Only if we all look at and steer the financial sector in terms of our long-term economic and social responsibilities will the financial system perform its supporting function successfully.

We don't need financial market transactions in a financial system that is only focussed on itself. We need banks and other institutions that take their job seriously and promote the appropriate, forward-looking investments by distributing funds efficiently. And we need banks that are prudent in their lending.

What should be done? Policies need to be chosen wisely, away from the extreme, ideologically tainted positions. We should certainly not think that our modern economies can thrive without the catalytic functions of banks and financial markets. On the other hand, we should not fall prey to claims that regulatory reform and limitations of market freedoms will hurt development.

Policies should aim to enable financial markets to work at the service of the economy – as a supporting function. At the same time, these policies should aim to limit those transactions that only serve profit-maximisation while externalising costs to taxpayers. This might imply somewhat lower volumes of financial market transactions and somewhat lower credit volumes.

What does this mean? From the perspective of banking and financial market supervisors, it means that we need to regulate risky trading strategies and risky business models more rigorously. Therefore, to give you just one example, we now expect institutions with such approaches to refinance themselves to a greater extent using equity, rather than debt.

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6 Practical men who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back […]" (JM Keynes (1936), The General Theory of Employment, Interest and Money. Macmillan, p 383).

From a political perspective, this means that we cannot rely on financial markets to fix structural political problems. For example, if it is felt that the income of low income households is growing too slowly, it is not enough to simply rely on credit institutions to finance investments in the hope that this will create jobs. This is because the financial markets would provide more loans to such households – and if this is not sustainable, it could lead to yet another financial crisis. Thus, politics must enable banks and markets to support the economy, not to fix it.

Finally, let's turn to capital liberalisation in emerging markets. Full capital account liberalisation may not be the best strategy for many developing and emerging economies. A careful analysis of national circumstances is needed here – followed by a careful choice of economic policies.[7]

Here, too, simply hoping for more finance to lead to more development is a tempting strategy, but not a promising one. As is the case in advanced economies, one cannot rely on financial markets to fix structural political problems in emerging markets either.

That being said, in countries with low savings rates, the additional funds may help to foster investment. In countries without savings restrictions, foreign capital can indirectly support the economy by improving market structures and establishing best practices. In both types of countries, it is crucial to have strong supervisory institutions as well as market regulation to provide the necessary environment for markets to function. The less countries are able to regulate and supervise markets, the more careful they should be with regard to liberalising capital movements.[8]

6. Conclusion

Ladies and gentlemen,

Dreams are an essential element of brain activity. Likewise, economic dreams and theories are essential for developing policy strategies.

However, both types of dreams become problematic if taken at face value, and without careful analysis. The dreams of finance-led growth and growth through capital liberalisation have turned into nightmares – and clinging to them will do us no good. We need to find a new path to guide our economies into better territory.

Credit, banks, and financial markets – no doubt – will play a key role in that strategy. But growth will not be finance-led – it will be finance-supported.

Thank you for your attention.

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7 R Hausmann, D Rodrik & A Velasco (2005) In: N Serra & J Stiglitz (Eds) The Washington Consensus Reconsidered: Towards a New Global Governance, Chapter 15: 324–355; D Rodrik (2005) Growth strategies. In: P Aghion & SN Durlauf (Eds) Handbook of economic growth, Volume 1, Part A, Chapter 14: 967–1014.

8 ES Prasad & RG Rajan (2008) A Pragmatic Approach to Capital Account Liberalization. In: The Journal of Economic Perspectives, 22(3) 149–172.