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Finance Following Growth

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Recent research suggests that eyond a certain point, the benefits of financial development diminish, with further development possibly even hurting growth. Credit: IPS

SYDNEY and KUALA LUMPUR, Nov 14 2017 (IPS) - Economists of all persuasions recognize the critical role of finance in economic growth. The financial sector's stability and depth are widely considered important in this

connection.

Thus, many believe that the lack of a well-developed financial sector constrains growth in developing countries. Neoliberals generally attribute this to excessive regulation, especially the role of state-owned financial institutions, interest rate limits and restrictions on short-term cross-border capital flows.

It is often assumed that banks and financial markets allocate capital to the most productive endeavours, and that the financial infrastructure for credit reduces ‘information inefficiencies’, such as ‘moral hazard’ and ‘adverse selection’. Another presumption is that greater financial development will ensure sufficient finance for otherwise excluded sectors, thus raising growth potential.

Financial deregulation
Following the sovereign debt crises of the early 1980s precipitated by the sudden hikes in US Federal Reserve interest rates, neoliberal economists have advocated financial sector deregulation. It was a standard part of the Washington Consensus also including privatization and economic liberalization more broadly.

This agenda was typically imposed as part of structural adjustment programmes required by the Bretton Woods institutions (BWIs), led by the World Bank. However, many developing country and transition economy governments adopted such policies even if not required to do so, following the neo-liberal counter-revolution against Keynesian and development economics.

Financial deregulation, privatization and liberalization also gained momentum in the developed world, especially in the UK and the USA following the elections of Margaret Thatcher and Ronald Reagan in 1979 and 1980 respectively. In the US, such reforms culminated in the repeal of the Glass-Steagall Act in 1999 when President Clinton declared “the Glass-Steagall law is no longer appropriate”.

Initial results of financial liberalization generally seemed encouraging. Deregulating countries experienced rapid financial expansion and innovation. Finally, it seemed that the long elusive elixir of growth had been found. Finance had a free hand, expanding much faster than the real economy.

But soon, with inadequate prudential regulation and supervision, booms became bubbles as excesses threatened financial and economic stability, besides undermining the real economy. Economies became increasingly prone to currency, financial and banking crises such as the 1994 Mexican peso crisis, 1997-1998 Asian financial crisis, 1998 Russian financial crisis and the 2007-2009 global financial crisis.

Tipping point?
Recent research suggests that beyond a certain point, the benefits of financial development diminish, with further development possibly even hurting growth. In other words, the finance-growth relationship is not linear; it may be positive to a point, before turning negative.

Additional finance beyond this tipping point thus becomes increasingly counterproductive. By exacerbating macro-financial fragility, credit growth thus leads to bigger booms, bubbles and busts, ultimately leaving countries worse off. Interestingly, research done at the BWIs also finds that rapid credit growth is commonly associated with banking crises.

The IMF found that three quarters of credit booms in emerging markets end in banking crises. The OECD found that deregulating finance over the past three decades has stunted, not boosted, economic growth. It concluded that further credit expansion beyond exceeding three-fifths of GDP not only dents long-term growth, but also worsens economic inequality.

A commonly used measure of financial development – average private credit to GDP – increased steadily from about 1960. It has grown more rapidly since around 1990 – exceeding 100% in developed economies and 70% in emerging market developing economies (EMDEs).

The OECD report also found that over the past half century, credit from banks and other institutions to households and businesses has grown three times faster than economic activity. But

GDP growth per capita changed little before and after 1990, with a strong negative relationship between finance and growth emerging after 1990, especially in the Eurozone.

EMDEs with lower credit-to-GDP ratios benefited from more credit growth, experiencing a positive finance-growth relationship until about 1990. But with higher credit-to-GDP ratios, the finance-growth relationship turned negative in developed economies well before 1990. Hence, thresholds for credit-to-GDP ratios are likely to be higher for EMDEs than for developed economies.

Finance following growth?

The new research also points to the possibility of reverse causality – of financial development necessitated by growth. This seems to support Joan Robinson's suggestion that "where enterprise leads, finance follows". More money and credit become available as demand for both increases with economic growth.

After all, money and credit are supposed to lubricate the real economy. EMDEs start from relatively low incomes and therefore have greater growth potential. As they realize that potential, demand for finance leads to greater financial development.

In the case of developed economies, especially the Eurozone, finance continued to grow even as growth slowed. Apparently, savings adjusted slowly to sluggish income growth, resulting in a rising wealth-to-GDP ratio.

This, in turn, creates demand for finance as households seek to 'park' their savings, borrow for consumption and buy new consumer durables. Thus, the financial system grows even as economic growth continues to decline. This may result in rising household indebtedness, or increasing debt-to-income ratios, ending in debt defaults.

Policy lessons

Besides being cognizant of "too much finance" beyond a tipping point, policymakers need to be aware that causality may run in both directions. Therefore, financial development must accompany productivity enhancement.

Financial liberalization, or other financial development policies alone cannot spur productivity growth. Without entrepreneurship, finance is likely to prove to be an illusory source of growth.

This is important as short-term capital inflows cannot enhance productive long-term investments. Short-term capital flows are easily reversible, and can suddenly leave, plunging countries into financial crisis.

If the financial sector continues to grow after growth potential falls, it greatly increases the relative size and role of finance, thus accelerating the likelihood of financial instability. Countries need strong macro-prudential regulations to contain such vulnerabilities.