

# Does financial instability really undermine economic performance?

By [Jérôme Creel](#), [Paul Hubert](#) and Fabien Labondance

What relationship can be established between the degree to which an economy is financialized (understood as the ratio of credit to the private sector over GDP), financial instability and economic performance (usually GDP per capita) in the European Union (EU)? [A recent working paper \[1\]](#) attempts to provide a few answers to this question.

Two major competing approaches can be found in the economic literature. On the one hand, an approach inherited from Schumpeter emphasizes the need for entrepreneurs to access sources of credit to finance their innovations. The financial sector is thus seen as a prerequisite to innovative activity and a facilitator of economic performance. On the other hand, financial development can be viewed instead as the result or consequence of economic development. Development implies increased demand for financial services on the part of households and businesses. There is therefore a source of endogeneity in the relationship between financial development and economic growth, as one is likely to lead to the other, and vice versa.

Until recently, analytical studies that attempted to disentangle and quantify these causalities showed a positive significant link between an economy's financial depth and its economic performance ([Ang, 2008](#)). However, the onset of the international financial crisis led to nuancing these conclusions. In particular, [Arcand et al. \(2012\)](#) showed that beyond a certain level the impact of increased financialization becomes negative [\[2\]](#). The relationship

between financialization and economic performance can be represented by a bell curve: positive at the beginning and then, from a level of 80%-100% for the private credit to GDP ratio, fading to zero or turning negative.

Unlike other works that include both developed and emerging or developing countries, our study focuses on the EU Member States from 1998 to 2011. The advantage of this sample is that we include only economies whose financial systems are developed or at least in advanced stages of development [3]. Moreover, it is a relatively homogeneous political space that permits the establishment of common financial regulations. We adopt the methodology of [Beck & Levine \(2004\)](#) who, using a panel and instrumental variables, are able to resolve the endogeneity issues discussed above. Economic performance is explained by the usual variables in endogenous growth theory, namely initial GDP per capita, the accumulation of human capital over the average years of education, government expenditure, trade openness and inflation. In addition, we include the aforementioned financialization variables. We show that, contrary to the usual results in the literature, an economy's financial depth does not have a positive impact on economic performance as measured by GDP per capita, household consumption, business investment or disposable income. In most cases, the effect of financialization is not different from zero, and when it is, the coefficient is negative. It is therefore difficult to argue that financial and economic development go hand in hand in these economies!

In addition, we included in these estimates different variables quantifying financial instability so as to check whether the results set out above might be due simply to the effects of the crisis. These financial instability variables (Z-score [4], CISS[5], bad debt rate, the volatility of stock market indices and an index reflecting the microeconomic characteristics of Europe's banks) usually seem to have a significant *negative* impact on economic performance. At the

same time, the variables measuring the *degree* of an economy's financialization show no obvious effects on performance.

These various findings suggest that it is certainly unrealistic to expect a positive impact of any further increase in the degree of financialization of Europe's economies. It is likely that the European banking and financial systems have reached a critical size beyond which no improvement in economic performance can be expected. Instead, there are likely to be negative effects due to the financial instability arising out of a financial sector that has grown overly large and whose innovations are insufficiently or poorly regulated.

The findings of this study suggest several policy recommendations. The argument of the banking lobbies that regulating bank size would have a negative impact on growth finds absolutely no support in our results—quite the contrary. Furthermore, we show that financial instability is costly. It is important to prevent it. This undoubtedly requires developing a better definition of micro- and macro-prudential standards, together with effective supervision of Europe's banks. Will the forthcoming banking union help in this regard? There are many sceptics, including the economists of [Bruegel](#), the [Financial Times](#) and the [OFCE](#).

---

[1] Creel, Jérôme, Paul Hubert and Fabien Labondance, “Financial stability and economic performance”, *Document de travail de l'OFCE*, 2013-24. This study was supported by funding from the European Union Seventh Framework Program (FP7/2007-2013) under grant agreement no. 266800 (FESSUD).

[2] We consider this work in an earlier [post](#).

[\[3\]](#) In addition to the ratio of private sector credit to GDP, the depth of financialization is also indicated by the turnover ratio, which measures the degree of liquidity of financial markets, measured as the ratio of the total value of shares traded to total capitalization.

[\[4\]](#) Index measuring the stability of banks based on their profitability, their capital ratio and the volatility of their net income.

[\[5\]](#) Index of systemic risk calculated by the ECB and including five components of the financial system: the banking sector, non-bank financial institutions, money markets, securities markets (stocks and bonds) and foreign exchange markets.