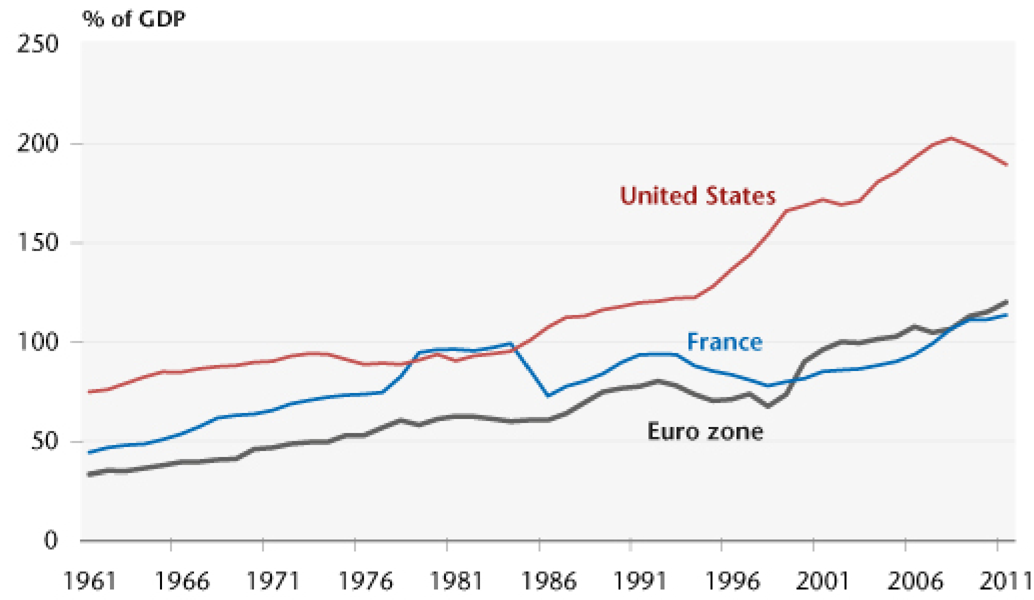
Does too much finance kill growth?

By Jérôme Creel, Paul Hubert and Fabien Labondance

Is there an optimal level of financialization in an economy? An IMF working paper written by Arcand, Berkes and Panizza (2012) focuses on this issue and attempts to assess this level empirically. The paper highlights the negative effects caused by excessive financialization.

Financialization refers to the role played by financial services in an economy, and therefore the level of indebtedness of economic agents. The indicator of the level of financialization is conventionally measured by calculating the ratio of private sector credit to GDP. Until the early 2000s, this indicator took into account only the loans granted by deposit banks, but the development of shadow banking (Bakk-Simon *et al.*, 2012) has been based on the credit granted by all financial institutions. This indicator helps us to understand financial intermediation (Beck *et al.*, 1999) [1]. The graph below shows how financialization has evolved in the euro zone, France and the United States since the 1960s. The level has more than doubled in these three economies. Before the outbreak of the subprime crisis in the summer of 2007, loans to the private sector exceeded 100% of GDP in the euro zone and 200% in the United States.

Figure. Credit granted to the private sector by banks and other financial institutions



Source : World Bank.

Arcand, Berkes and Panizza (2012) examined the extent to which the increasingly predominant role played by finance has an impact on economic growth. To understand the importance of this paper, it is useful to recall the existing differences in the findings of the empirical literature. On the one hand, until recently the most prolific literature highlighted a positive causal relationship between financial development and economic growth (Rajan and Zingales, 1998, and Levine, 2005): the financial sector acts as a lubricant for the economy, ensuring a smoother allocation of resources and the emergence of innovative firms. These lessons were derived from models of growth (especially endogenous) and have been confirmed by international comparisons, in particular with regard to developing countries with small financial sectors.

Some more skeptical authors believe that the link between finance and economic growth is exaggerated (Rodrik and Subramanian, 2009). De Gregorio and Guidotti (1995) argue that the link is tenuous or even non-existent in the developed countries and suggest that once a certain level of economic wealth has been reached, the financial sector makes only a marginal contribution to the efficiency of investment. It abandons its role as a facilitator of economic growth in order to focus on its own growth (Beck, 2012). This generates major banking and financial groups that are "too big to fail", enabling these entities to take excessive risks since they know they are covered by the public authorities. Their fragility is then rapidly transmitted to other corporations and to the economy as a whole. The subprime crisis clearly showed the power and magnitude of the effects of correlation and contagion.

In an attempt to reconcile these two schools of thought, a nonlinear relationship between financialization and economic growth has been posited by a number of studies, including in particular the Arcand, Berkes and Panizza (2012) study. Using a dynamic panel methodology, they explain per capita GDP growth by means of the usual variables of endogenous growth theory (*i.e.* the initial GDP per capita, the accumulation of human capital over the average years of education, government spending, trade openness and inflation) and then add to their model credit to the private sector and the square of this same variable in order to take account of potential non-linearity. They are thus able to show that:

1. The relationship between economic growth and private sector credit is positive;
2. The relationship between economic growth and the square of private sector credit (that is to say, the effect of credit to the private sector when it is at a high level) is negative;
3. Taken together, these two factors indicate a concave relationship – a bell curve – between economic growth and credit to the private sector.

The relationship between finance and growth is thus positive up to a certain level of financialization, and beyond this threshold the effects of financialization gradually start to become negative. According to the different specifications estimated by Arcand, Berkes and Panizza (2012), this threshold (as a percentage of GDP) lies between 80% and 100% of the level of loans to the private sector. [2]

While the level of financialization in the developed economies is above these thresholds, these conclusions point to the marginal gain in efficiency that financialization can have on an economy and the need to control its development. Furthermore, the argument of various banking lobbies, *i.e.* that regulating the size and growth of the financial sector would negatively impact the growth of the economies in question, is not supported by the data in the case of the developed countries.

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[1] While this indicator may seem succinct as it does not take account of disintermediation, its use is justified by its availability at international level, which allows comparisons. Furthermore, more extensive lessons could be drawn with a protean indicator of financialization.

[2] Cecchetti and Kharroubi (2012) clarify that these thresholds should not be viewed as targets, but more like “extrema” that should be reached only in times of crisis. In “normal” times, it would be better that debt levels are lower so as to give the economies some maneuvering room in times of crisis.

The ban on naked CDS takes effect

By Anne-Laure Delatte

The small CDS market serves as an instrument for coordinating speculation against European states. To stop the speculation, the European Union recently adopted a new regulation that came into force on 1 November. Unfortunately, this new law, though pioneering and ambitious, suffers from flaws that render it ineffective. This provides an example of how the interests of a single economic sector can capture policy.

Quick primer on finance: how to speculate against a State

Two methods have won their spurs: short sales in the bond market and naked sales on the CDS market. Let’s take two examples. If you think that Spain will not be able to meet its commitment to reduce its deficit in 2013, you could make money by betting against it the next time it issues bonds. To do this, you need to find an investor on the market who is prepared to buy Spanish bonds when they are next issued. You sell your customer bonds at that point while wagering that the price will be lower than what they think. You do not buy the titles at that time, as you can buy them at the time of delivery. You win if your expectations were correct: if the price of Spanish bonds declined due to the deterioration in the country’s economic situation, then you will buy them for less than the purchase price that you agreed to. You are engaging in short selling.

There is another way of operating that the new European law also tries to counter. You make your bets on the market for credit default swaps (CDS), that is, the market for insurance against a Spanish default. It is smaller, it is concentrated, and it is easier to affect than the bond market. There’s no need for Spain to declare bankruptcy to pocket your winnings! Buy Spanish CDS (on state or Santander bonds) today and sell them when the risk has increased: you resell the protection for more … One detail: do not actually burden yourself with Spanish bonds. They are useless since it is on the resale of the CDS that you make your profit. Your intention was never to insure the bonds… The CDS are tradable goods whose price evolves according to supply and demand. And this is precisely the advantage of a small liquid market: you can move the market with lesser amounts…

The Directive that took effect on 1 November 2012 banned these two strategies: short selling sovereign bonds and naked trading in sovereign CDS. If you now want to bet on the CDS market, you are required to hold in your portfolio the securities that the CDS protects, or at least very similar ones.

At last, a courageous law! A ban on naked CDS, which was considered in the United States and then abandoned in 2009, is a pioneering act by Europe! It's no longer possible to speculate against Europe's states…

Except that:

The ban does not apply to "market makers". Who are they? To be sure that a market works, certain operators are committed to always buy or sell a security to anyone who so wishes (they simply determine the price of the transaction). This ensures market liquidity. For example, Morgan Stanley is a very active market maker on the entire CDS market; the bank provides continuous prices for all market transactions. "So these market makers are useful. Can you imagine if we even included these operators in the ban on naked CDS? There would be no more liquidity!" This is the essence of the argument used by the major banks to negotiate their exemptions and the specific argument used to justify the exemption of these market makers from the ban on naked sovereign CDS sales in Europe. The market makers won: they can continue to trade CDS without holding the underlying bonds.

But wasn't the point made in the previous post that this market is in fact highly concentrated? That 87.2% of transactions were carried out by the 15 largest banks in the world … all of which are market makers? In other words, the new rule will be applied to everyone … except the main players on the market. It seems that the big French banks are currently in discussion with the European financial markets authority (ESMA) over the exact definition of a market maker to ensure that they too are exempt.

Of course. But the hedge funds too? They aren't market makers, they're clients. So the Directive must apply to them!

Except that:

Only the sovereign CDS market is concerned. It is still possible to hold CDS on a bank issue without holding the title. So it will be easy to circumvent the ban on betting against a State by betting against one of its banks (Santander in the example above). One shudders when contemplating the fragility of Spain's banks…

In conclusion, the idea for such a law was commendable. But the devil is still and always in the detail. The financial sector has defended its interests during the drafting of the law. It is urgent to develop the means to counterbalance this during negotiations. The Finance Watch association has been created specifically with this objective: to be present and make the voice of civil society heard during the preparation of financial reforms. The only problem is, it's David against Goliath…