New Approaches to Economic Challenges [B12a]
Increasing the resilience of economies to external shocks (Micro resilience)

THEME OF THE PROJECT

The substantial expansion of the financial sector

The financial sector has expanded considerably in the OECD countries since the 1970s and especially in the United States. Credit provided by bank and other financial intermediaries has reached almost 200% of GDP in the United States and 110% in the OECD on average. Econometric investigations indicate that, while financial expansion is an engine of growth when starting from low or moderate levels, further expansion from the high levels observed in OECD countries generally harms growth.

has imposed significant costs on the real economy

Excess credit, mispricing of risky financial instruments, and lax regulation led to the deep financial crisis of 2008 and the subsequent recession. The impact on the real economy has been severe. Unemployment rose throughout the OECD and economic growth fell while flows of new lending and borrowing dried up. Weak investment in the medium to long term can lead to secular stagnation.

... and necessitates a reconsideration of the future role of finance

Widespread bank difficulties since 2008 required large bailouts with taxpayers' money while the need to fight the recession following the financial bust also proved very costly for public finances. These costs for governments as well as the economic hardship associated with the recession have raised questions about the future role of finance and its institutions (bank, non-banking savings and credit institutions, sovereign wealth funds, private investment funds and others).

RESULTS OF THE WORK STREAM

A healthy financial system will avoid excesses ...

An appropriately run financial system will have strong capital buffers to reduce the need for costly government intervention in a time of low liquidity. The Basel III framework was developed with this in mind; but further work remains necessary in particular to reduce governments' implicit support for too-big-to-fail institutions.

The financial regulatory environment requires reform. Financial supervision needs to take a more comprehensive approach. Systemic risks need to be monitored better, as well as distributional effects from credit expansion.

The high wage premium in the financial sector contributes to income and gender-pay inequality. Compensation reforms will be important to counter this.

... and favour a balanced composition of financial instruments

OECD countries have currently tax systems that encourage corporate funding through loans rather than equity. This creates a debt-bias in firm financing. Excess in debt funding creates instability and can be bad for growth. An expansion in equity financing has a positive association with growth in the long run. These results apply on average across the OECD and to most countries individually.

A well-functioning financial system relies on trust in the economy due to the illiquid nature of banking assets and the presence of leverage. Trust in turn requires accountability and transparency. An important element to creating trust in finance is to end policies that create moral hazard, such as implicit guarantees for large institutions deemed too-big-to-fail. This limits financial excess and eventually restores efficient credit provision and investment.

NEW APPROACHES

Considering the distributional effects of finance is a novel approach

The work re-assesses the contribution of finance to growth and stability, but it makes important contributions to our understanding of the effects of finance on growth and income distribution, as well as highlighting reforms of financial regulation and other policy areas for a better-performing financial sector.

POLICY IMPLICATIONS

Short term trade-offs need to be considered to ensure long-term stability ...

Ultimately, there is no trade-off between a sound financial sector and robust growth in the long-term. In the short-term, however, some measures to curb financial growth and potential financial excesses can have negative implications for growth. Their judgement needs to be balanced against the long-term benefits for growth, stability and income distribution.

Econometrically, financial expansion has been positively associated with increases in economic inequality. The high level of pay in the financial sector is an important factor behind this link. Similarly, significant gender imbalances at the top of financial institutions contribute to widening gender pay differences. This means that the gender imbalance in the sector needs to be addressed, compensatory policies need to be put in place and the size of the financial sector needs to be regulated.

Evidence from this work suggests that even relative to disposable income, low-income households have less credit than higher-income households. In this way the uneven distribution of credit in financial systems unable or unwilling to lend to low-income customers contributes to income inequality.

PROJECT PAPERS

- **Cournède, B., Denk, O., Hoeller, P. (2014),** ''Finance and inclusive growth'' ECO/CPE/WP1(2014)16

OECD