Finance, Regulation, and Inclusive Growth

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Financial matters for economic growth:
- Mobilizes savings
- Chooses where to allocate those savings
- Monitors the use of capital after it is allocated
- Helps in pooling & diversifying risks

But, what about “inclusive” growth?
Definition of “inclusivity”:

- The degree to which economic opportunities are shaped by individual skill, ideas, and initiative rather than by familial wealth, political influence, and social connections.
I address two questions:

① Does the functioning of the financial sector affect inclusive growth?
   - Are financial markets just casinos?
   - Does finance really affect economic liberty?

② If finance is key, what financial regulatory strategies foster inclusive growth?
Finance exerts a first-order impact on inclusive growth, opportunity, & liberty

Concepts
- Entrepreneurship
- Human capital
- Labour market opportunities
- Discrimination
Evidence … Consider the deregulation of branch banking in the U.S.

- History: Politics and economics
- Impact: On bank structure and bank quality
- Why did it change?
- Impact: On quality of banking
- Impact on the economy …
Finance exerts a first-order impact on inclusive growth, opportunity, & liberty

Evidence
- Entrepreneurship and financial competition
- Labour income inequality and financial competition
- Discrimination and competition
Finance affects entrepreneurship
Finance affects labour income inequality
Finance affects racial discrimination

![Graph showing the relationship between finance and racial discrimination. The graph plots the percentage change in the relative wage rates of blacks against the years before/after deregulation for intrastate and interstate deregulation.]
Finance disproportionately helps the poor around the world
But, which regulations promote inclusive growth?
There are sound reasons for direct government policies to promote inclusivity

- Information advantages
- Poor contract enforcement for private firms
- Externalities
- Etc.

But,

- There are government failures too
30 years of research warns about

- The grabbing hand of government: Officials use power to stay in power (Shleifer & Vishny)
- Directed credit programs & guiding regulations: Funnel credit to the biggest and best connected

Powerful frequently want exclusive—NOT inclusive—growth: Use power accordingly
Evidence: A few examples …

- Kwaja & Mian (2005, QJE) GOB protect and promote large firms with the strongest political ties in Pakistan, but private banks don’t.
- Cole (2009) GOB banks in India lend to regions where there are close elections.
- Sapienza (2004, JFE) GOB in Italy favor large politically connected firms, but not private banks
More evidence

- GOBs increase corruption in lending, but do not reduce poverty (Beck et al, 2006)
- GOB around the world increase their lending in election years to maintain incumbent officials in power; private banks don’t. (Dinc, 2005)
So, what regulatory strategies work?

- Foster—and do not impede—competition
- Compel transparency
- Incentives
  - Do not create pernicious incentives
  - Do not encourage banks to engage privately profitable, but socially destructive ways.
  - Facilitate and compel equity and debt holders to oversee the management of financial institutions
Does recent U.S. crisis undermine these recommendations?

No! U.S. reinforces them …

- Policies created incentives, and opacity, for financial institutions to take excessive risks.
- GSEs hurt competition, transparency, and incentives. Perniciously manipulated credit

The U.S. did not follow the basic lessons.
Conclusions:

① Finance matters for inclusive growth
② The political economy is complex
   ① While inclusive growth is an admirable goal
   ② It has fierce and powerful opponents
   ③ This undermines well-intentioned policies
③ Regulatory strategies should
   ① Boost competition, transparency, & incentives
   ② Minimize government direction of credit.