Comments on "Does Finance Accelerate or Retard Growth? Theory and Evidence,"

by Franklin Allen, Elena Carletti, Jun "QJ" Qian, and Patricio Valenzuela

Stijn Claessens

I want to start with much praise for the paper. It is a very comprehensive review of the roles of finance in economic development and citizens' welfare. It covers all relevant aspects—the drivers of financial sector development; the impact of finance on growth; the relationship between finance and crises; the determinants and impact of access to financial services, especially for small firms and low-income households; and the relationship between finance and inequality—and offers many suggestions for policy improvements and paths of financial reforms. It provides extensive theoretical perspectives and is rich on historical and recent evidence, presenting many facts and relationships. It also reviews many countries' experiences, covering advanced countries, emerging markets, and low-income countries. In addition to the many specific suggestions and concrete policy advice, it highlights areas of unknowns. Importantly, it focuses on the issues of key interest to the Global Citizen Foundation (GCF): globalization, inequality, financial inclusion, poverty, and income distribution.

Given the quality of the paper, reflecting the erudition of the authors and their extensive research in this area, it is hard to be critical. It is even harder to add much to the paper, particularly as I had a chance to do so at the interim workshop. As a modest attempt to add value at this stage, I have put together a set of ruminations on possible policy implications, in part inspired by the paper but largely my own thoughts, as well as possible implications for the GCF project.

I begin with some policy issues. I then continue with some broader lessons, as I see them, and a possible agenda for going forward. My broader lessons focus on governance and oversight in the financial sector, both national and international. I argue that a financial sector to service all citizens in better ways requires better governance and engagement with a broader group of stakeholders in

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designing financial reforms. I conclude with a possible agenda on how to conduct better reform processes and build relationships among stakeholders.

Policy Issues

I focus on four themes: financial sector development, risk prevention, crisis management, and making finance work for more.

Financial Sector Development

It has become clearer with the recent financial crisis that the market-driven approach, while still the starting point for designing financial reforms, needs to acknowledge more explicitly two aspects: the many market failures that can arise in the financial sector and the large (implicit) role of the state in the financial sector, which, although necessary in many ways, has not always been productive. The paper devotes much attention to these policies and problems. It highlights the recent call for macroprudential policies that can possibly correct some of the many externalities that arise in financial services provision. And it is very cognizant of the fact that, although a large role of the state is needed (for regulation and supervision, for example), it comes with drawbacks. Distortions can arise, for example, as a result of moral hazard (associated with "too big to fail" institutions, for example) or the deductibility of interest payments, leading to increased systemic risks.

Although these issues have been acknowledged, the often poor provision of financial services provision and the repeated occurrence of financial crises shows that the profession is still not able to design regulatory frameworks or implement them consistently in a way that creates financial systems that are efficient, serve the needs of all, and are reasonably "fail and fool proof." Although many deeper issues are at fault here—notably political economy factors, which I address later—more needs to and can be done, in academics as well in practice, regarding the "optimal" design and sequencing of financial reforms.

Specifically, in my view, too little attention has been given to how to coordinate and phase various types of financial reforms. There is a need—and I am borrowing here from the thoughts of Joseph Stiglitz—to conduct more "dynamic portfolio analyses" of financial reforms. Doing so would attempt to explicitly model the actions of financial agents given the various incentives for profit and growth opportunities and the risks they face at a given point in time. These opportunities and risks would depend in turn, at least in part, on prevailing and expected regulatory and market structures. The analysis would then aim to achieve some "optimal" degree and paths of financial liberalization (or conversely a certain degree of "repression") in market segments or activities, given the effects that the associated degree of competition, rents, and franchise values have on agents' incentives, including regarding the efficient provision of financial services, in terms of quantity and quality, and the degree of (systemic) risk taking.

It would be very challenging to model these dynamic aspects, which would therefore be very imprecise. The idea would be to proxy how financial reforms affect the behavior of financial markets' participants. Doing so could address aspects such as the fact that over time basic services (such as deposit and payments services) become more contestable, and new financial markets develop that allow for more scalable transactions. This increased competition in basic services may lead banks to undertake more market-based transactions (for example, trading of derivatives). Such transactions, which are easier than other services to scale up, could be a way for banks to use their franchise value in traditional banking in the face of competition. Yet this practice could be risky from a system point of view. Limiting this behavior (for some time) could therefore be beneficial, at least until other supporting institutions are in place.

A dynamic portfolio approach could be beneficial not just from a financial stability perspective but also from an access to financial services point of view. For example, providing information-intensive banking services may require some "rents" for banks to be willing to invest in information acquisition. This approach could call for a specific or slower path of financial liberalization. Given a level of development in a country, some financial services may also matter more for "welfare." For example, payment services may be more important than credit for low-income people and low-income countries. These differences may have implications for reform paths—for example, opening up the savings markets first before credit and other financial markets may be best. Or the approach may help determine when it is feasible, useful, and prudent to develop "new" financial services. Many countries have struggled, for example, to develop well-functioning capital markets, notably stock markets. One reason why may be that the incentives of financial agents to actively support such markets are not yet sufficiently present, as the development of a stock market would undermine their existing franchise values.

Approaching financial reforms dynamically from financial stability and access perspectives can have important implications for reform processes. Such an analysis could lead to policy implications similar to those used at some point for industrial policy in East Asia (as reviewed in the paper by Dani Rodrik): give some rents to some segments or forms of financial services that have the highest social value at that point in time and then take those rents away as the economy changes and systems develop. Such an analysis could also help identify thresholds for specific liberalization and reforms (for example, only when the institutional environment—regulation and supervision, market discipline, institutional infrastructure, and so forth—is adequate to allow for some new types of financial services).

Risk Prevention

As the paper shows, financial crises can have very adverse impacts on not only economic growth but also on inequality and poverty. Preventing financial crises should thus be an important objective. At a minimum, the goal should be to prevent countries from having "old"–type financial crises. For example, one would hope that enough has been learned so that "frontier markets" do not have to suffer the types of financial crises emerging markets (in, for example, East Asia or Latin America) experienced more than a decade ago or the advanced countries experienced recently (and many still endure).

Reducing systemic risks is closely related to the need for better implementation of basic regulations, such as higher capital adequacy requirements, good supervision, clear resolution frameworks for weak financial institutions, better cross-border coordination, and more generally, incentive structures that are less prone to incentivize excessive risk taking. Some ex ante measures could limit the risk of financial institutions that become too big to fail and that are subject to the moral hazard of a bailout. Some institutional infrastructures, such as central counterparties, could help reduce the risks of and problems of contagion.

As the paper amply notes, however, lessons have also been learned on what types of reforms, financial system structures, and types of capital flows can be considered more susceptible to crises. For example, a fairly robust finding suggests that rapid financial liberalization, including capital account liberalization, can increase the risks of crises. Some types of capital flows (for example, bank flows) seem to raise countries' vulnerability to a balance of payments crisis, whereas others (for example, foreign direct investment) are less closely associated with crises. Also, it appears that a model in which foreign banks obtain funding locally leads to fewer vulnerabilities than one in which foreign and domestic banks in a country rely heavily on cross-border lending.

Findings thus suggest that in addition to basic reforms, certain type of financial systems or configurations of financial exposures or flows can make countries less prone to crises. A general lesson from recent crises is that there is a greater need for policies aimed specifically at reducing market failures and externalities. As such, there has been a renewed interest in capital account openness in recent years. This interest questions the fully liberalized model and supports the notion that capital account management tools can be used to prevent or deal with the build-up of financial sector vulnerabilities and systemic macroeconomic risks. And while it is still early to draw conclusions, macroprudential policies seem to offer promising new tools to reduce the build-up of systemic risks, notably in real estate booms, reducing the chances of a bust.

Many questions remain about both capital flow management and macroprudential policies. Among others these include evidence on their effectiveness and optimal calibration to reflect country conditions and circumstances; the interactions of these policies with other policies, notably macroprudential policies and monetary policy; the institutional design (who is in charge of these policies); and general political economy considerations (for example, how to ensure that they will be implemented properly when needed). Further thought and research (on, for example, how to design optimal externality “taxes”) would be useful, so that these policies can help reduce the frequency of crises and mitigate their impact if they do occur.

Crisis Management

Unfortunately, as noted in the paper, although more needs to be done to reduce risks ex ante, many policies have had limited success. Crises have recurred partly because knowledge of their causes remains imperfect. The “this time is different” syndrome highlighted by Reinhart and Rogoff in *This Time is Different: Eight Centuries of Financial Folly*—that is, the fact that in the face of the build-up of vulnerabilities, the collective view remains that systemic risks are limited “because conditions and institutional environment have changed”—is often likely to prevail.

With crises likely to continue to occur, the question of how to best manage their aftermath remains very relevant. Unfortunately, the record here, although better than for crisis prevention, is also poor. Interventions are often too late, too timid, and insufficiently coordinated across policy areas let alone countries. The latest crisis—which has been drawn out and included large cross-country spillovers within the Euro zone—is a case in point.

Poor management leads to higher economic costs (in the form of lost output) and increases the final fiscal bill (incurred directly when governments resolve failed financial institutions and indirectly when they support the economy in the aftermath of a crisis). It can also have both direct and indirect adverse impacts on inequality, income distribution, and poverty. Paying for the fiscal costs incurred, for example, may fall disproportionally on lower-income households. And following a financial crisis and its resolution, small and medium-size enterprises (SMEs) may have less access to finance than large firms. Small savers may be worse off, while richer households may escape the high inflation or financial repression that often follows a crisis. There is thus a critical need to manage crises better from an inequality perspective.

Relatively well-known lessons at both the national and international levels could be applied better. The main one is the need to absorb any losses resulting from the crisis—in the financial, corporate, or household sectors or at the level of the sovereign debt restructuring—as quickly as possible. In practice, doing so means recapitalizing banks when needed quickly; having strong, efficient, less creditor-biased financial resolution and restructuring mechanisms to resolve overindebted corporations and households; and restructuring sovereign debt if necessary quickly, including through the use of coordination mechanisms (such as collective action clauses and the like). Disseminating and applying these best practices more widely would be very useful.

Making Finance Work for More

I think this area, as the analysis of the paper shows, is one of the most complex and raises many fundamental questions. Financial systems typically serve a relatively small set of the population and the corporate sector; low-income people and SMEs, especially in developing countries, have little access to financial services at reasonable costs. Although "demand" factors, such as creditworthiness, obviously play a large role in hindering access, "supply" factors matter as well. Such supply incentives can relate to the financial system structure; the return to banks and other financial institutions to cater to these segments is often too low relative to other opportunities. Although technology has reduced costs in many areas, for many services they remain high, in part because service provision often still involves human input. Considering financial sector structures can be important here.

Relative lack of access also arises because finance has become more rules oriented, with a multitude of new rules following the global financial crisis. Obviously rules can have benefits, but they also have compliance and other indirect costs. They can hinder access, as when money laundering rules are applied to very small financial transactions or the opening up of a bank account. Especially when they need to be harmonized internationally, rules can also suffer from the lowest common denominator problem. New rules are not always subject to proper cost-benefit analyses. More generally, many rules and regulatory approaches have limited analytical foundations, as the academic discussion on the level of capital adequacy requirements, noted in the paper, shows.

Some weaknesses in the design of rules can be overcome by better processes, an issue I take up later. More generally, though, it may be good to move away from the very detailed Basel III and other Financial Stability Board "standards" approaches and allow more room for different models of financial services provision, particularly given the scope for countries to leapfrog. Innovations can increase access to financial services and improve equality, especially in emerging markets and developing countries. Some case study evidence cited in the paper, including on the extensive use of mobile payments in Kenya, suggests that there are ways around the current financial market and institutional structures and related constraints. Some of these new approaches can also help overcome vested interests (for example, provision of mobile phone–based financial services may not be subject to the same capture as traditional banking services). More analyses on which of these models are best for enhancing access would be useful.

In addition to less emphasis on standards and more on innovative approaches, more work could be done on legal and institutional reforms. Judicial systems, information systems, and competition policies are often barriers to the efficient provision of financial services in many (low-income) countries. Countries need such systems for their overall development, particularly as they are important for overall private sector development. Because they are less driven by financial sector–specific needs, these reforms may be less subject to capture than other reforms (there are no guarantees, of course: as the paper notes, when legal reforms hurt insiders, they may be blocked as well). Property rights protections—including both vertical property rights (which protect citizens again expropriation by the state) and horizontal property rights (which foster private sector transactions)—are key. Both affect financial sector development, with vertical property rights being more important for general financial development and horizontal property rights more important for capital market development.

Broad Themes

Let me now move from these specific policy issues to broader themes. I think the big question here is the governance of finance, a theme that is common to some of the other papers of the GCF project as well (for example, the paper by Nancy Birdsall). This question has both national and international dimensions, including about processes and stakeholders. I discuss each in turn, ending with some ideas on how governance of finance can become a forward-looking agenda for the project.

National Governance

Capture is a big problem in the financial sector, with adverse effects on access to financial services and financial stability. Capture occurs in many ways. Some are subtle: insiders—both people within the financial services industries and important users of financial services—set the rules, standards, and institutional designs, mostly to benefit themselves. As rents arise, the costs of financial services increase and access declines for some groups. In some cases, capture occurs in very blatant ways, such as corruption, which includes not only "stealing" (as when state-owned banks lend to cronies who subsequently default) but also the misallocation of resources. Capture often occurs ex post—through, for example, bailouts induced by the moral hazard of too big to fail financial institutions or more relaxed monetary policy and fiscal policies to help avoid the risks of a systemic financial crisis. Regulators, supervisors, and many other officials often fail in their public policy roles, with little ex post costs (in terms of loss of jobs or reputations, for example).

How to improve national governance is a complex matter. Despite the costs of capture, the general public is little involved in financial sector matters, ex ante or ex post, both because it is poorly informed about the causes of crises—financial systems and regulations are complex—and because it is not easily mobilized. Other "whistle-blowers" (including auditors, accountants, rating agencies, investors, and financial markets more generally) have a poor track record in disciplining financial agents, markets, and countries, partly because group think is often prevalent. One would want to retain the bias toward private sector–led, open financial systems and not assume that controls can easily correct for these deficiencies. Yet the high cost shows clearly that more balance to counter capture is needed.

For one, more attention to the governance of regulators and supervisors would be useful. In many countries, regulators lack sufficient legal, financial, and operational independence from legislative bodies and political economy pressures more generally. There is also often too little formal public oversight of regulators and supervisors. Through objective assessments and regular checks, weaknesses in their independence, accountability, integrity, and transparency of operations could be brought out and corrected. It would also help if the standards assessors (the IMF, the World Bank, the Financial Stability Board, and the like) moved away from assessing formal compliance of countries with international "standards" to assessing the "governance" of regulators and the transparency of "processes" (and outcomes).

Better governance should also involve more transparency and greater participation of the public in the design of rules. There needs to be more transparency in rules-setting, with more views allowed to be expressed. Better and maybe new institutions are likely needed, in part as the public is hard to mobilize. The establishment of the Consumer Financial Protection Bureau in the United States can be seen as an attempt to create a counterforce to insiders designing and applying the rules. Although few other such bureaus exist so far, and the one in the United States remains very incipient, it could be a sensible model, as it replicates what often exists for other products (for example, consumer product safety bureaus).

There could also be additional formal oversight, both ex ante and ex post. For example, some academics have proposed a "sentinel"—an informed, expertly staffed, and independent institution evaluating financial regulations and regulators' actions from the public's point of view. Although a sentinel seems hard to design, as the problem is often group think, it is worth considering. Perhaps requiring formal, ex ante Food and Drug Administration–style approval of new financial instruments could be useful to ensure that they are not only "safe" for the general public but also socially valuable. Or—and maybe more realistically, as each new financial service would be hard to approve ex ante—a National Transportation Safety Board–like agency for finance could be set up. Such an agency could systemically investigate and report on failures. It would be better than financial crises commissions, which are too ad hoc and often have too little standing.

International Governance

Issues are even more complex internationally than nationally. International regulators and supervisors often fail in their (macroeconomic and financial stability) surveillance roles. More attention has been placed on international governance and legitimacy in recent years, and some progress is being made to broaden the set of stakeholders (as reflected in the greater role of the G-20). Still, international governance has proven hard to change (witness, for example, the ongoing governance and quota debate for the IMF, as noted in the paper). Also, although transparency at the international level has improved, more is still needed, in terms of both specific issues and countries (for example, on country surveillance and program decisions) and data availability (for example, on cross-border exposures).

Overall, one should be skeptical of the scope for rapid progress in international formal governance arrangements, if only because of the multitude of actors involved. Perhaps there is scope for improving some of the processes for decision-making internationally. One step could be opening up further the standards-setting processes, including by soliciting public input more explicitly (although many users will need support given the technical nature of the discussions). At the margin, there may also be some scope for involving existing institutions. Although expertise may be an issue, there could perhaps be a greater role for broader agencies such as the World Trade Organization, in both debates about rules and in various processes, including dispute resolution.

In the end, changing the financial sector paradigm and the way in which the benefits and risks are allocated has to be about changing governance. Doing so will be complex and require changing both the set of stakeholders involved as well as the processes that set the rules of the game, in both static and dynamic ways. Although many stakeholders are involved in financial services, not all are well represented. In most countries, providers of financial services are well represented; users, notably households, but also many institutional investors, are much less well represented. As much of financial sector regulation is determined through standards set by groups such as the Basle Committee on Banking Supervision, the international dimension is crucial as well. Internationally, advanced countries dominate, emerging markets are much less represented than their current economic sizes warrants, and low-income countries are hardly represented at all. With the shifts in income and financial assets toward emerging markets and developing countries, these discrepancies are likely to increase.

Improving governance thus requires greater representation of some groups. Representation is largely an (international) political economy question, on which economists have less to say. How can relevant parties, including the general public, be better mobilized to demand a bigger say in discussions? How can one better harness the power of nongovernmental organizations, 99%–type movements, and other groups? Of course, it is also relevant to understand better existing stakeholders' objectives and views. How uniform or diverse are they? The lack of an effective voice of emerging markets, for example, reflects in part their diversity, with groups like the BRICs not necessarily unified in their views. How can they be made to coalesce better?

Moving Forward

With these "answers," one can try to assess what a better model might be. Here, as in many other areas of international governance, the path is not obvious. Should one, for example, work through existing mechanisms? Should "new" stakeholders try to play a greater role in formulating rules and standards, assessing public bodies and countries, and the like? It may be that using existing mechanisms is not the most efficient means of reforming financial systems, because it risks entering a (losing) game of being coopted. I have no insights on this; perhaps political economy experts and others could help design better ways to influence financial sector reforms around the world. Such an agenda could benefit all global citizens.