

FINANCIAL STABILITY AND GROWTH: SOME THEORETICAL ISSUES

*Mario I. Blejer**

My task was to develop and present a framework for the overall subject of this symposium on From Stabilization to Growth. I have decided to focus not on general macro economic stability but rather on financial stability. There are a number of reasons for this decision. One of the reasons is that, from the analytical point of view, it is relatively well-known that there is a relationship between macro stability and growth that goes through the process of reducing uncertainty, strengthening credibility and improving the overall macroeconomic environment, thus leading to increasing investment rates, and thereby accelerating the process of growth. The literature on this is well established and there is no gain trying to explain this relationship. It is well understood here, and there is theoretical basis for that understanding, that growth will come as a consequence of, and following, stabilization and responsible monetary and fiscal policy.

My preference is, therefore, to discuss the issue of financial stability - stability in the financial sector - and the consequences on growth, because this is a subject that has become extremely important and also extremely topical in the last ten years or so. The Bank of England has a special committee, the Financial Stability Committee, although the Bank no longer supervises banks or the financial sector (that responsibility has been given to the Financial Services

Authority). But it is considered that financial stability is an issue that does not concern only the stability of individual institutions, but also has to be viewed from the macro perspective because it has a lot of interactions and relationships with the conduct of monetary policy.

The subject of preserving financial stability has, therefore, become a very important one all over the world and is receiving special attention in industrialized countries. And it is important for a country like Ghana, which is in the process of starting a much faster financial development and inserting itself into the international financial structure and international financial markets, to keep in mind the relationship and the factors that can affect financial stability and financial instability and particularly how these factors interact with some others to promote further growth. In that way, we will be relating directly to the theme of this symposium.

Let us start from conventional wisdom: we would expect any one who has some general knowledge of the subject to say that financial stability promotes and stimulates growth. However, like some other conventional wisdom, this is not necessarily rooted in fact. Indeed, from the overall analytical point of view, there are a number of problems with the statement that financial stability promotes economic growth. First, there is not much in the literature about this relationship. If you made a search on the Internet about stability and growth, you will get millions of hits. On monetary stability and growth you will get hundreds. But try to find the relationship between financial stability and growth and you find practically nothing; the literature is very poor in that area. In addition to that, there is a very ambiguous definition of what financial stability really is. We know what macro economic stability is; we know what monetary stability means; but what financial stability exactly means is highly debatable. Then, the transmission channels are not clear: we still do not know exactly what the transmission mechanism is between preserving financial stability and promoting growth. And, for those who are interested in analytical work rooted in the real world, the worst part is that there is complete lack of empirical evidence. We do not have any real good empirical evidence that relates financial stability to growth. So the conventional wisdom is not clear cut and highly debatable.

However, I will like to elaborate on these issues so we come to some conclusions on the basis of which to observe that, in general terms, it will be important to preserve financial stability if we want to have an environment that will promote growth. Then I will try to elaborate on some policy implications, particularly for countries that are in the process of integrating themselves into the international financial markets and developing the financial sector.

While a good relationship between financial stability and growth is not well established, what is established is that financial deepening is associated with growth; the level of financial development is indeed associated with growth, but we do not know whether financial stability is also associated with growth.

In contrast, financial instability, in the view of many, usually tends to retard growth, or to stop growth altogether in those cases when it is really dramatic. And there is some evidence to support this view. Instability could indirectly affect growth because an unstable financial system, that is one that is very prone to bankruptcies, or not functioning effectively in the intermediation of funds, will develop slowly and by developing slowly it will basically retard the growth rate. But where an already developed system is suffering from instability it is not known whether it would affect development or not.

What I now want to do is to discuss the definition of financial stability since that will serve as a framework for what can be said about the sources of instability. Then I will examine whether the evidence supports the assertion that instability affects growth and, if so, what are the channels? How can these channels be classified according to the different definitions? And, finally, what are the policy implications? That is where I would like to spend some time, especially on how to reduce financial instability particularly in countries which are at the level of developing the financial sector, which is also growing.

The definition of monetary stability is very clear. Generally, monetary stability refers to the stability of the general price level. So the fight against inflation has been recognized more or less as the objective of monetary stability and there is very little dispute about

it. There is no disagreement that monetary stability is measured in terms of stability of the price level.

But there is lesser consensus about financial stability. There are basically two definitions. The first definition is one by Mishkin, a famous economist from Colombia University, who defines financial instability basically by the consequence. There can be shocks in the system that basically impede or stop the financial sector from channeling funds, or resources, to productive investments - the shocks interrupt the good performance or effective operations of the financial sector. Financial instability sets in when the shocks are not absorbed in the system in a way that will insulate the financial sector from the shock itself. This, therefore, creates a situation in which the financial sector stops to perform its function in a way that is expected. Thus, according to Mishkin, financial instability depicts an interruption in the effectiveness of the financial sector.

There is a second definition by Andrew Crockett, formerly at the Bank of International Settlement in Basle. He makes a very important and interesting distinction between two types of stability, and this distinction will be very useful for much of the discussion that will follow. Crockett says that when one talks about stability in the financial sector one must distinguish between two types: the stability of financial institutions and the stability of financial markets. Stability of the financial institutions means the institutions themselves - the banks, pension funds, the stock exchange, etc - can meet their contractual obligations without interruption and without the need for external support. So the institutions themselves could respect contracts: the institutions are stable.

However, institutional stability is not enough, because there could be institutional stability but lack of financial market stability, which is the second type of stability and the one that we are sometimes more concerned with. It is about the stability of asset prices. Typically, if there is no stability in the financial market, asset prices will not reflect the fundamentals and, therefore, will oscillate or fluctuate, and will not follow any rational prediction path. They will fluctuate very randomly, reacting to changes and moods in a way that is not predictable. So instability in the financial market is fluctuation of

asset prices that cannot be explained, predicted, or forecasted by the fundamentals, whereas instability of financial institutions is when the institutions themselves cannot fulfill their role. I believe this is a very useful distinction.

What leads to financial instability? Generally speaking, in the last 20 years or so, we have seen an increase in the level of financial instability of the two types. Basically three general trends have been observed in the literature as contributing to the instability. First, there is more financial instability because the volumes of financial intermediation have grown dramatically. In fact, they have more than quadrupled in the last 5 years. Second, international financial institutions have become more integrated, thereby increasing the level of systemic risk. So when a shock occurs in one part of the system, this shock is more likely to propagate in a much more intensive manner. Third, financial instruments have become much more complex. We have all sorts of derivatives, all sorts of abstract financial instruments that the un-initiated cannot easily understand. So there is a general increase in financial instability because the flows are larger and more interconnected while the instruments are more complicated.

One can say that the impact of these three general trends - the larger, more interconnected and more complex financial system - will be temporary; over time, any problems associated with these will be solved. In other words, the system will absorb the instability. But there is one important issue that one needs to take into consideration, particularly when one is in the process of developing the financial sector, or when one is trying to convey to the financial sector the relevance of stability. It is that the financial sector is different from the rest of the economy because it has intrinsic characteristics that make the sector, in theory, more prone to instability. And there are three elements that we have to keep in mind.

One is the issue of asymmetric information, which basically means that those who ask for loans may know much more about their financial situation than those that give loans. Asymmetric information may be due to the size of the market. The second is the problem of moral hazard. We all know that one can be too big

to fail. The famous story is that ‘if you owe a hundred dollars to a bank it is your problem, but when you owe a million dollars it is the bank’s problem’. Obviously, the bank will try to avoid your failure! And the third issue is that of adverse selection. Many times, the selection of a client is basically done in a way which is perverse, because in order to get a higher return you have to take also a higher risk and therefore the system gets practically unstable. These are the intrinsic characteristics that we have to keep in mind when we come to making policy recommendations.

THE EMPIRICAL EVIDENCE

What then do we really know about financial instability? I have stated that there is very good evidence that the level of financial development affects growth. Increases in financial development, measured in various ways like monetization, bankarisation, how much of credit is formal, how much of the capital of a company is raised in the financial markets and pension funds, positively affect the rate of growth. This is evidenced by a number of papers. A famous paper by King and Levine (1993), based on analysis of 80 countries, found a positive correlation between financial development and capital accumulation, per capita GDP and future growth. The finding is very robust, because irrespective of the measure of financial development used, per capita income seems to be positively correlated with the level of financial development, as is future growth.

But what about financial instability and growth? There is no empirical evidence of a relationship, as far as I am aware. There is only one paper I have become familiar with that basically studied uncertainty in the financial markets. Looking at 70 to 80 countries, it found that uncertainty in the financial market may not be related to growth. It is a little strange that it did not find any correlation. In spite of this, one can adduce observational evidence to show that, in the extreme case of crises, financial instability affects growth.

Let me cite a few examples. The Mexican 1995 crisis, the ‘Tequila’ crisis, led to a fall of 12 percent in industrial production in the country. The Argentina crisis in 1995, which followed the Tequila

caused a 7 percent loss in GDP. And the recent crisis in Argentina in 2001 – 2002 led to a 17 percent fall in GDP. In Chile in the 80s, growth also fell from nine to 1 percent due to the crisis. This phenomenon is not peculiar only to the emerging markets. The crises in the Scandinavian countries also led to a fall in GDP while Japan had a negative GDP growth following their financial crisis. The only place one did not see too much of an impact was the US, where the savings and loans crisis did not have any noticeable effect on GDP. But the fact of the matter was that the United States government very heavily financed the crisis, in a sort of countervailing demand management policy.

This observational evidence suggests that instability may affect growth, but these observations relate to crisis situations, and not to levels of instability. What is the transmission mechanism between instability and growth? How do we expect financial instability to impact growth? Using Crockett's distinctions, one may first look at the impact of institutional instability - a decrease in the ability of banks, pension funds, etc. to stand and fulfill their commitments – on growth.

The first thing is that institutional instability erodes confidence. Confidence has been identified as a key variable for growth. Apart from loss of confidence it introduces disintermediation, institutional closures, and institutions cannot be trusted and therefore when confidence falls, investment probably falls too. The other problem is that it affects the organization of the financial sector and, as a direct consequence, increases the cost of transactions and increases the problems within the payments system. Since real resources have to be used to meet these transaction costs, it leads to misallocation of real resources and the rate of growth suffers.

The other interesting channel, which I think is of importance for countries which have a growing or surging financial sector, is the impact of institutional instability on informational channels, that is the relationships that the institutions create with the client. In countries where the sector starts moving, a lot of personal relationships are built that solve part of the problem of the adverse selection. Where the financial institutions cannot fulfill their roles

and have to close, a lot of the information collected is lost and long-term business relationships are ruined. This will increase the cost of borrowing and reduce the efficiency of the system. So these are the channels through which, if there are institutions that are prone to close and do not perform their roles, instability will cause the rate of growth to fall.

What about market instability, I mean volatility in the prices of assets - sustained volatility, not short term, but turmoil in the market: how will it reduce or affect growth? First of all it will tend to increase interest rates and we know that higher interest rates have a debilitating effect on growth. Higher interest rates lead to intensified adverse selection because higher interest rate, in fact, calls for more risky projects to be financed: only projects that are more risky can afford to pay the higher interest rates. That impacts negatively on growth, and at the same time the contracts are short term most of the time.

There are two other effects. One is the instability in the foreign exchange market that tends to increase dollarization. I understand that dollarization is an issue in Ghana, at least one third of the assets and liability of banks are dollarized. If this is stable it should not create a problem. The problem arises when there is a lot of instability and, therefore, the system is subject to a sudden and large increase in the demand for assets and liabilities in dollars. And that is how it could eliminate some efficient investment. And the other issue is that if asset prices are very volatile, it is much more difficult to formulate macroeconomic policies and, I know we will all agree, it is also difficult to formulate monetary policy.

It is, therefore, intuitively clear that crises have created very large losses on output and financial instability, at least theoretically, has a lot of channels to adversely affect the rate of growth. So what can be done in order to reduce instability?

If we talk about what can we do we are in effect talking about what the government can do. And what is the justification for a government intervening in institutional and market areas to increase stability? The main idea is that financial stability is a public good.

If policies create financial stability everybody can enjoy certain benefits. So there is a theoretical justification, at least from the public good theory or public finance theory, for government intervention to preserve the market and reduce instability.

The second argument is that the financial sector is different: it is subject to market failures. The three failures that were earlier referred to - asymmetric information, adverse selection and moral hazard. These three failures provide justification for government intervention.

The third reason for intervention, similar to the public good argument, is the fact that there are negative externalities, spillovers, from instability. The basic idea is that if you make a deposit at a dealer to buy a car and the next day you find that the dealer has disappeared, you may lodge a report, but if you were going to buy a car, anyway, you'll go to some other dealer to buy the car. Not so in the case of a bank. If you put a \$100 in a bank and the next day the bank disappears, probably you will not make any deposit for a long time and you will not trust any bank at all for a long time. That is the negative externality. These are the justifications for regulation, for intervention, for ways of preserving financial stability.

Now, as to how to intervene, one has to go back to the Crockett definition and distinguish between the institutions and the market. To foster institutional stability one can say 'let the market work'. Thus, those institutions that cannot preserve stability, that cannot fulfill their contracts, should disappear, close. I believe this is a dangerous proposition because of the issue of externalities. But, basically, the idea is that if market forces are strengthened, there will be a lasting informational characteristic in the system that will prevent this sort of failure from happening. The institutions that are not solid will not be able to operate in the first place. Nobody will take a \$100 to a bank that is going to disappear tomorrow, because there is information in the system. So you can strengthen the market forces. But probably that is not enough.

The second issue is the issue of safety net - deposit insurance, lender of last resort. I had the experience in my country to manage

for a few months one of the worst possible forms of financial crisis that you can imagine. I know that at the time there was a lot of criticisms about a policy that we adopted to exercise the lender of last resort to the maximum, to prevent the closing down of financial institutions, because we felt at that time that the system will disappear and it will be very difficult to recreate it. But that was during a crisis. To prevent the crisis, it is important to have a good facility, and to intervene in the markets in such a way that the use of the facility would not be necessary. One can conceive of a good lender-of-last-resort facility and a good deposit insurance scheme that may not necessarily be needed. However, having them in place would provide information and reassurances to the market and possibly prevent crises. These facilities could create moral hazard but they at the same time strengthen the institutional aspects of the market. And then, of course, proper, but not excessive, regulation will also strengthen the institutions.

Now in terms of the market, there are things one can do in order to preserve stability in some of the key asset markets. The one that everybody will agree on is that the predictability of macroeconomic policies will basically improve the performance of financial markets. Also one could have contingency regulation or so-called 'circuit breakers'. If one of the asset prices starts having problems, trading in that particular asset could be stopped. The New York Stock Exchange, for example, has something like that.

Then there is the option of direct intervention. If you have an asset bubble, like technological stocks in America before the DotCom bubble, what do you do? You can intervene and try to deflate the bubble.

SOME POLICY IMPLICATIONS

There are very practical policy implications of preserving institutional and market stability. But the question that I would like to ask, as far as growth is concerned, is whether there can be too much of a good thing? If we agree that stability is good, and if we agree that instability retards growth through some indirect

mechanism, is it possible to have too much stability? The answer, I think, is yes; there could be too much financial stability. Why? Because one has to be very careful not to confuse rigidity with stability, and this is very important for an emerging market that is developing the financial structure. This is extremely important in the allocation of resources. It is extremely important in the promotion of good investment. Rigidities are in general distortions. Stability is a public good. We have to be very careful not to confuse these two. We can discuss what it means, but we need flexibility in prices, we need flexible structures. We need financial institutions to go out of the system when they are not fulfilling their roles, or when they are not well managed and they have a problem of governance. But at the same time we have to avoid fluctuations that create instability in the system. So we have to be able to allow market prices of assets to adjust to circumstances, and be able to allow institutional structures to change with the circumstances, but at the same time we must be able to prevent instability in the sense of uncertainty or random change.

In conclusion, there is a role for government and for the central bank to support stability in the financial sector and to counteract market failure, but this has to be done in a way that by itself does not impose rigidities and also does not lead to moral hazards in the sense that the people will not take risks, or will take excessive risk. It is a difficult path to follow to balance the risks. But I think that it is important to understand the elements and imperfections that ought to be addressed.

* Mario I. Blejer: Director, Center for central banking studies, Bank of England .

