Financial Stability and Financial Efficiency

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One can expect that growth is fostered by the government's ability to conduct counter-cyclical macroeconomic policies, aimed at stabilizing and smoothing business cycle fluctuations

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- Policies have been, in the main, counter-cyclical among industrial countries, but this is not the general situation in emerging market economies:

While macroeconomic policies tend to stabilize business cycle fluctuations in a number of EMEs in many others, fiscal and monetary policies display a strong ***pro-cyclical*** *pattern.*

WHY?

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- Traditionally, it has been claimed that the ability of EMEs to adopt optimal stabilization policies is hampered by a number of factors:

  - **Recurring credit reversals in world capital markets ("sudden stops)"**
  - **Political-economy constraints**
  - **Inappropriate exchange rate regimes**

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A couple of more interesting working hypotheses claim that the capacity to apply optimal, counter-cyclical, policies is related to:

a. <u>institutional</u> quality

b. <u>financial</u> instability, inefficiencies, and financial market imperfections

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- On a fundamental level, bank lending tends to be strongly pro-cyclical (credit booms and busts are positively correlated with the cycle)

- This correlation has been considered a source of financial instability and a justification for financial regulation and supervision.

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- Can prudential regulation eliminate **<u>excessive</u>** risk taking and cyclical instability?

- Basel II is expected to strengthen financial buffers and reduce financial uncertainty but will not solve (and could intensify) the cyclicality problems of macro policies.

- This is so because capital requirements will be based on more risk sensitive data--which is by definition cyclical.

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Is there any additional, complementary, way in which financial instability could be addressed without intensifying cyclicality?

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- The answer is to promote not just a ***stable*** but also an ***efficient*** financial sector.

- Financial system’s efficiency can be gauged by the efficiency with which it transforms resources into capital: the ***“comprehensive” cost of capital***

- The financial sector functions efficiently if it intermediates at a minimum price and reduces the comprehensive cost of capital to its optimal level.

THE ELEMENTS OF THE COMPREHENSIVE COST OF CAPITAL

- The cost of capital is the sum of the cost of
  - –*Raising* funds by selling capital claims
  - –*Monitoring* the users of capital
  - –*Managing* the portfolios of the capital claims themselves

Will the invisible hand get the financial market to optimal efficiency?

NO

Market forces alone will--in general--not lead to an efficient outcome

- In an inefficient market, outside participants pay inside participants a *higher than optimal price* for financial services
- Increasing efficiency therefore transfers wealth from insiders to outsiders
- Well, inside participants don't have much incentive to go along with that!

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- Inefficiencies arise, then, from imperfections related to inside information, scale issues--natural monopolies, and specialized skills.
- They arise also from "***Manipulation Risk***": The risk that one party acquires a corner and squeezes the market, driving the market price far above its fundamental value

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Efficiency Matters

- Countries with efficient financial systems are less prone to banking crises
  – Beck et. al. [2003]

- Countries with efficient financial systems are less prone to currency crises (even if they can't borrow in their own currency)
  – Bordo and Meissner [2004]

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- Countries with efficient financial systems suffer (much) less when a crisis does occur
  - Ongena, Smith, Michalsen [2003], for a discussion of why the Norwegian banking crisis ended quickly while that of Japan dragged on and on

- Countries with efficient financial systems grow faster
  - Beck, Levine, and Loayza [2000], Bekaert, Harvey, and Lundblad [2003], Ranciere, Tornell, and Westermann [2003]

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Financial Stability

- Welfare Gain
  - A systemic banking crisis costs c. 10% of GDP and occurs with prob 4% pa (in non-developing countries)
    - Bordo, Eichengreen, Klingebiel, Peria, *Economic Policy* 2001
  - Suppose that financial regulation reduces the probability of a systemic crisis from 5% pa to 4% pa
  - FS work thus yields 0.1% of GDP pa

➢ **PDV of CP2 = 5% of GDP**

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Financial Sector Efficiency

- **<u>Potential</u>** Welfare Gain
  - Reduce cost of running an efficient financial sector by 0.5% of GDP pa (conservative estimate)

➢ **<u>PDV of Enhancing FS Efficiency = 25% of GDP</u>**

There's More

- You don't have to choose just one:

Financial Efficiency $\Rightarrow$ Financial Stability

Without increasing cyclicality

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- Central Banks have concentrated on “the glamorous twins”: Monetary (Price) Stability and Financial Stability

- …and less in their poor neglected step-sister Financial Efficiency