The Size of the Financial Sector and its Contribution to Economic Growth/Productivity

A Submission to the Financial System Inquiry (FSI)

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Governments seem to like financial markets, usually giving the impression that more is always better. We see frequent calls for the development of capital markets, support of various kinds provided by Government, bail-outs, and funding for research. It is often unclear whether this affection is driven more by the employment and tax revenue generated, the associated prestige, or the contribution the financial sector makes to economic growth. This submission addresses the latter consideration: the relationship between the financialisation of the economy and economic growth. This was a clear priority of Government when establishing the FSI which it "charged with examining how the financial system could be positioned to best meet Australia's evolving needs and support Australian economic growth."

Early theoretical analysis regarding the direction of the relationship between the financial system and economic growth was mixed. Hicks (1969) argued the financial system was critical to the industrialisation of England and Schumpeter (1912) contended that a well-functioning banking sector is fundamental to technological innovation. On the other hand, Robinson (1952) declared that "enterprise leads and finance follows", while Lucas (1988) saw economists "badly over-stress(ing)" the role of financial factors in economic growth. Empirical analysis starts with Goldsmith (1969) who in a criticised study found a positive relationship between financial and economic development. The criticisms were addressed in several subsequent studies with the main conclusion of the Goldsmith paper being maintained (e.g. King and Levine, 1993; Gertler and Rose, 1994; Roubini and Sala-I-martin, 1992). In a 1997 review paper Levine concluded that "the preponderance of theoretical reasoning and empirical evidence suggests a positive, first-order relationship between financial development and economic growth."

By 1997, the financial sector in the US, and in most other developed countries, was already in a sharp growth phase when measured by almost every relevant metric. Its share of GDP grew from 2.8% in 1950 to 4.9% in 1980 to 8.3% in 2006 (Greenwood and Scharfstein, 2013), while according to the NBER its share of total corporate profits grew from 14% in 1980 to almost 40% by 2003. Philippon and Reshef (2013) found that salaries in the financial services industry were comparable to other industries until 1980 but have increased dramatically since then so now salaries in the finance industry are now on average 70% more than those in other industries. This growth in both the size and the salaries of the finance sector is referred to as 'the financialisation of the economy.' The first to really question whether this has been for the betterment of the economy was Rajan (2005) who at the Jackson Hole Symposium suggested that the development of the financial system was causing economies to be more risky. In a subsequent book (Rajan 2010) he argued that the propensity of the system to reward risk-taking would result in the economy proceeding from bubble to bubble.

Since the mid-2000s, an increasing amount of analysis has been undertaken that further questions whether the growth of the financial system has worked to the betterment of anybody other than those working in the industry. In perhaps the most telling study, Cecchetti and Kharroubi (2012), (2013) confirm that the development of the financial system is critical for economic growth in developing economies but that large and fast growing financial sectors have a clear negative impact on productivity and economic growth. They conclude that "big and fast growing financial sectors can be very costly for the rest of the economy . . . draw(ing) essential resources in a way that is detrimental to growth at the aggregate level". Talented people are perhaps the most crucial of the essential resources drawn away by the finance sector's glamour and compensation. As the former UK Minister Peter Mandelson argued, "We need more real engineers and fewer financial engineers." Orthangazi (2008) found a negative relationship between financialisation and real investment which he put down to the latter being crowded out by the increasing size and profitability of financial investment. Beck (2013) is led to similar conclusions, while even Glenn Stevens (2010) has questioned "whether all this growth (in finance) was actually a good idea; maybe finance had become too big (and too risky)." In a more explicit direction ISA (2013) questions the efficiency of the Australian financial sector by measuring the extent of capital formation attributable to finance. In 1990 for every dollar of labour and capital deployed in the financial sector about $3.50 of capital formation could be attributed to the sector. By 2012 that had collapsed to $1.50.

A number of researchers have examined the putative benefits of financialisation. Philippon (2013) finds that despite technological advances which one would expect to translate into lower costs for financial services, unit costs have actually increased over the last three decades and are higher now than they were in 1900. Philippon, Bai and Savov (2013) examined whether the much greater spending on price discovery in line with financialisation has resulted in "better" prices and consequently improved allocative efficiency. They found that despite a four-fold increase in expenditure and a large decrease in the costs of information processing, there is absolutely no evidence of pricing in markets having become more informationally efficient. Along the same lines, Malkiel (2013) found that despite US fund management fees rising 141 times between 1980 and 2010, there has been no improvement in pricing in equity markets nor evidence that it has translated into value added for clients. Other deleterious impacts of financialisation include increasing distortions in income distribution (Bakija, Cole and Heim, 2010), Piketty (2014), and the exacerbation of agency costs in corporations (Krippner, 2005).

We leave the last word to two industry luminaries: Adair Turner and Paul Volker. Turner sees "no clear evidence that the growth in the scale and complexity of the financial system in the rich developed world over the last 20 to 30 years has driven increased growth or stability." Volker, when commenting on the relationship between financial innovation and economic growth, claimed that the ATM was the only financial innovation to have improved society.

In summary, we query the proposition that bigger is necessarily better when it comes to the financial system. The mantra of the Paul Woolley Centre is that we do not need a *bigger* financial sector, what we need is a *better* financial sector. We encourage the members of the FSI to steer clear of the fallacy that size is positively related to performance and encourage them to ponder the evidence that financial systems in developed economies have grown beyond the point where they make a positive contribution to either economic growth or to those they are presumed to serve. It would be a bad starting point to presume that the Australian financial system is currently doing a good job. The starting point of the analysis should be to assess its effectiveness and to highlight where it is falling short and why. We doubt that sufficient insight is available from existing studies. We encourage the Inquiry to commission studies along the lines of the papers referred to above. We are happy to discuss these matters further with members of the FSI.

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