Finance matters for growth

- Mobilizes savings
- Chooses where to allocate those savings
- Monitors the use of that capital after it is allocated
- Provides mechanisms for pooling and diversifying risks
Finance matters for growth

- By affecting the allocation of resources
  - By shaping the rate of technological change
  - Not, by altering the savings rate
- By boosting competition in the nonfinancial sector
  - Facilitating the entry of more efficient new firms
  - Facilitating the exit of less efficient old firms
Finance matters for equality of opportunity

- Finance influences
  - Who can start a business.
  - Who can acquire a good education
  - Who can live in a neighborhood conducive to the healthy development of children

- Finance influences the degree to which a person’s economic opportunities are bounded by individual skill and initiative, or whether familiar wealth, social status, and political connections largely delineate the contours of one’s economic horizons.
Finance matters for equality of opportunity

- Evidence
  - Greater competition in finance yields disproportionately positive effects for the poor
  - Finance expands economic opportunities indirectly, by improving labor market conditions.

- Political challenges are clear
Financial innovation and growth

- Growth literature focuses on technological innovation
- New technologies frequently require new financial arrangements
  - Financial innovation assists technological innovation
- Historical evidence:
  - Ancient development of tradable debt contracts
  - Railroad required new financial intermediaries, financial reporting, and accounting systems
  - Venture capital supported information technology
  - Amendments to venture capital model have supported biotechnologies.
Some initial policy implications

- Improvements in finance will generate winners and losers. Politics matters for which policies are actually implemented.
- Finance matters for human welfare beyond crises.
- Financial regulation must adapt to financial innovation
Financial regulation and growth

1. What did we think worked best?
2. Does the crisis reject this wisdom?
What works best? Some basic lessons

- Don’t forget what 30 years of research suggests about the grabbing hand of government in finance.
- The evidence does not support laissez faire either.
- The evidence stresses the value of:
  - Forcing transparency
  - Regulations that compel equity and debt holders to oversee financial intermediaries.
  - Regulations that facilitate the ability of equity and debt holders to monitor and influence financial intermediaries.
  - Regulations that refrain from impeding the ability and incentives of equity and debt holders to govern financial institutions.
Does the US crisis reject these lessons?

- I don’t think so.
- U.S. policies:
  - hindered transparency,
  - erected barriers to shareholders and creditors effectively monitoring the activities of financial institutions, and
  - created incentives for financial institutions to take excessive risks.
- The U.S. did not follow the basic lessons.
Conclusions

1. Finance affects the major engines of economic growth
2. There are guidelines for growth-enhancing financial policies
3. Politics is the greatest challenge in implementing these guidelines