A FINANCE CURSE?

(How much finance is too much?)

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Balanced Economy Project

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1. A FINANCE CURSE?

Some * food * for thought

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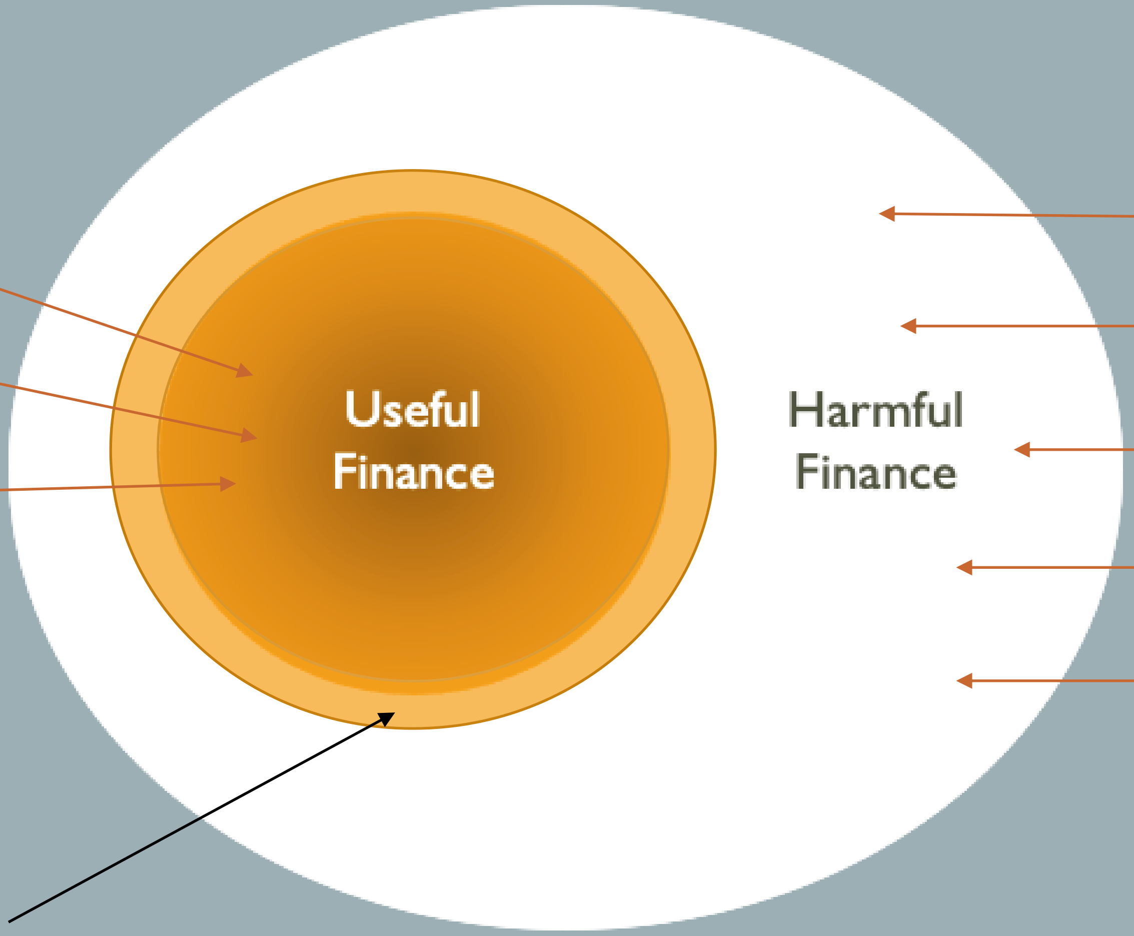
THE FRIED EGG OF FINANCE

Useful

- Savings accounts
- Lending to productive firms, SMEs, households
- Regular Stock market activity
- Etc.



(Fuzzy boundary)

Harmful

- Too Big To Fail
- Corrupt / criminal money
- Facilitate tax avoidance
- M&A: monopolisation
- Rent seeking
- Etc.

THE BANANA OF FINANCE?

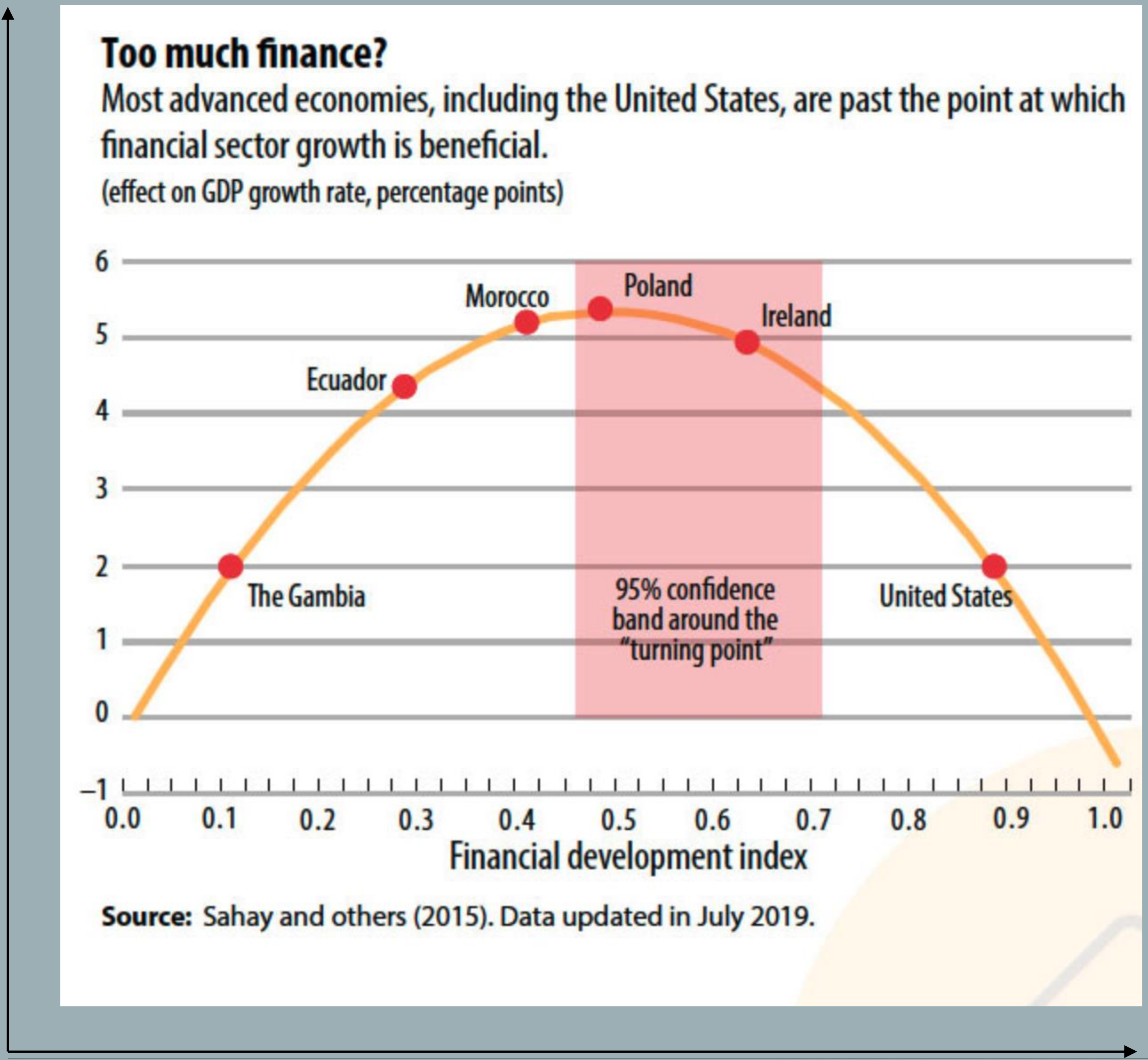
There is an optimal point for the size of a financial sector

Further growth of finance beyond this point may reduce economic growth

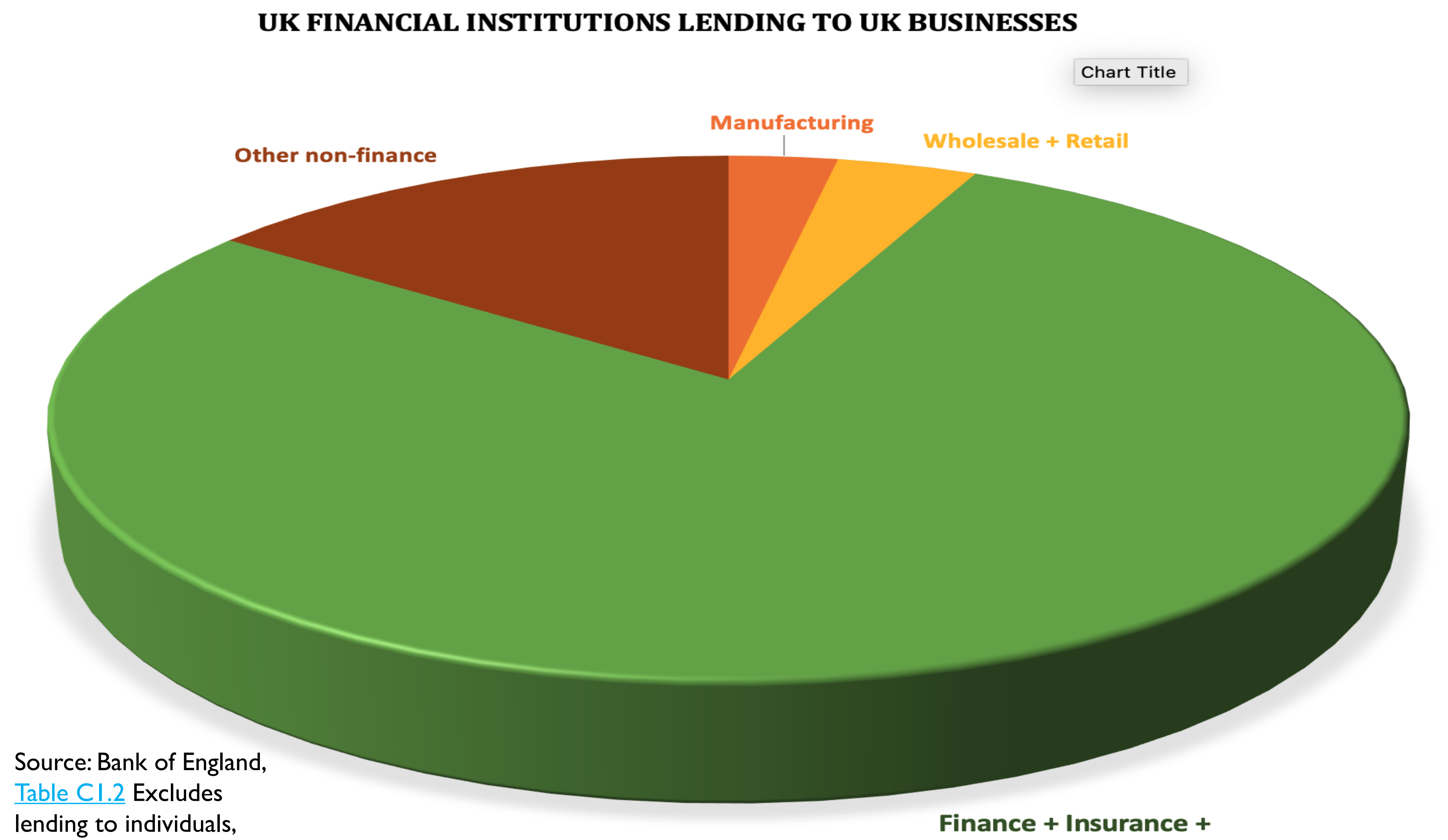
The "Too Much Finance" literature is contested, data is poor. (See e.g. Sturn/Epstein, 2021)

Obviously, the nature of finance matters too, not just size

GDP Growth



THE PIE OF UK FINANCE



Source: Bank of England, [Table C1.2](#) Excludes lending to individuals, Sept 2021

2. CORE "FINANCE CURSE" THESIS

1. **Every country needs a financial sector** to support its economy

2. Financial sector development/growth boosts economic growth, but **<u>only up to a point</u>**

3. If finance expands beyond its useful <u>functions</u> and <u>size</u>, **further financial development likely inflicts harm / reduces growth ("Too Much Finance")**

4. **"Excess" financial development:** inequality, economic instability, corruption/capture, reduced innovation, reduced competition, democratic damage, etc.

FINANCE CURSE THESIS II: INTERNATIONAL / CONCEPTUAL

A COMPARISON:

a) A **tax haven** is a financial centre that transmits harm outwards to other countries. E.g. Cayman financial secrecy may damage Brazil's tax system, its criminal justice system, and its democracy.

b) **Finance curse**: financial centre "excess" transmits harm inwwards, to the country that hosts it.

(Non-tax haven financial activity can also transmit harm outwards, but this is outside the finance curse thesis.)

FINANCE CURSE THESIS III

- What is good for finance may not be good for the whole economy
- No trade-off between economic prosperity and financial curbs
- Apparent Paradox: ”Too much finance makes you poorer”

PARALLEL WITH “RESOURCE CURSE” (OIL / MINERAL EXPORTS)

- **Weak** version: resources are squandered

- **Strong** version: makes matters even worse. My Angola, mid-1990s

Mineral-dependent countries lie on this spectrum

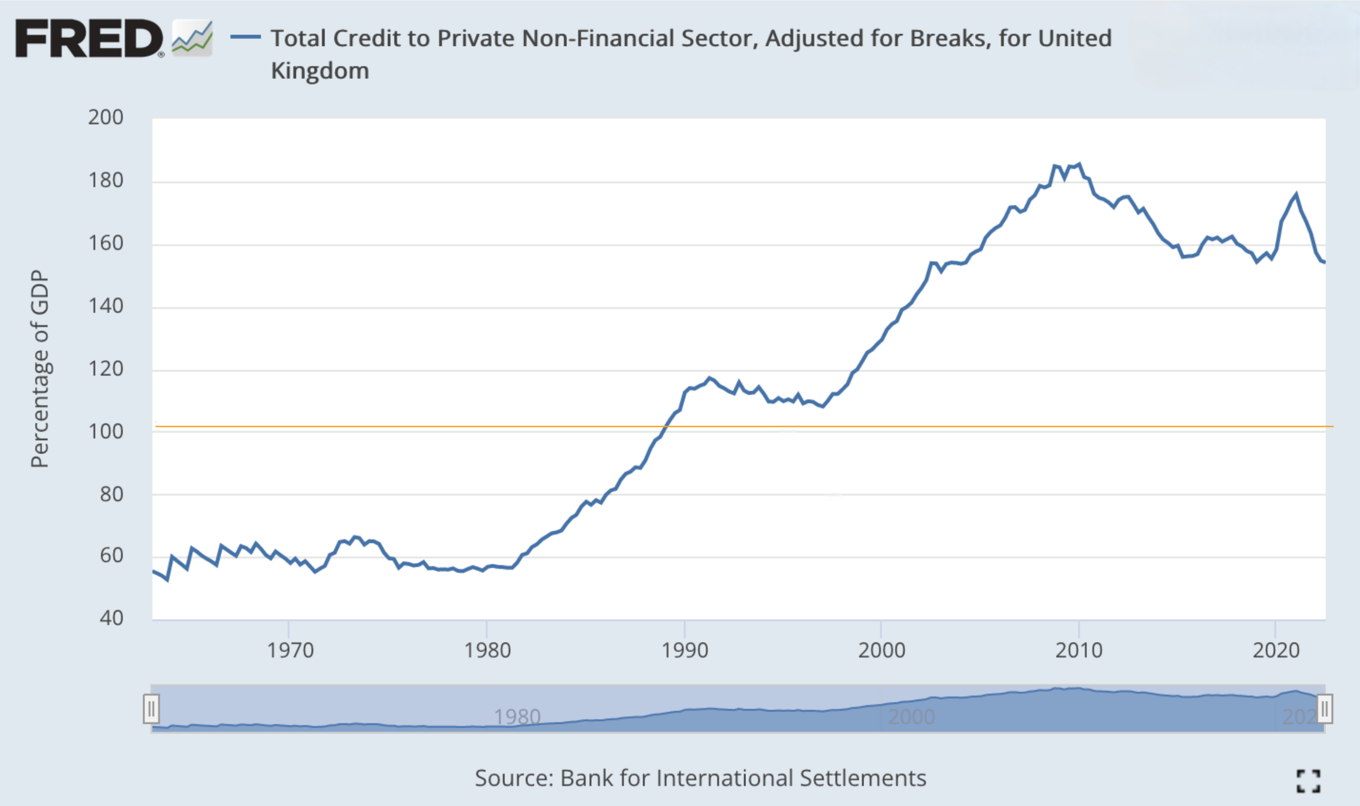
3. SIZE OF COSTS

What are the costs of "excess finance"?

Some estimates

WHAT IS THE OPTIMAL SIZE?

- E.g. Arcand/IMF: "finance starts having a negative effect on output growth when credit to the private sector reaches 100% of GDP."



100% OF GDP

SOURCE: St Louis Fed

COSTS OF OVERSIZED FINANCE?
UNITED STATES

"**Overcharged**" - Epstein + Montecino, Roosevelt Institute, 2016:

Total costs of 'excess finance,' 1990-2023:

(1) rents, or excess profits; US$ **3.6-4.2 trillion,** 1990-2005

(2) misallocation costs: diverting resources + people from non-financial activities; US$**2.6-3.9 trilion**, 1990-2005

(3) crisis costs: lost output due to crisis, (Federal Reserve estimates: **$6.5-14.5 trillion**, 2008-2023),

Total cost of excess finance: 1) + 2) + 3) :

$12.9 - $22.7 trillion, 1990-2023

COSTS OF OVERSIZED FINANCE? UK

- The UK's Finance Curse? Costs and Processes (Baker, Epstein, Montecino,) Oct 5, 2018

- **Misallocation costs** (rent extraction, gravitational pull / brain drain, "Dutch Disease" spillovers) **£2,700 bn** (€1 = £0.88, current)

- **Crisis costs: £1,800 billion**

- **TOTAL COST OF OVERSIZED FINANCE 1990-2015:**

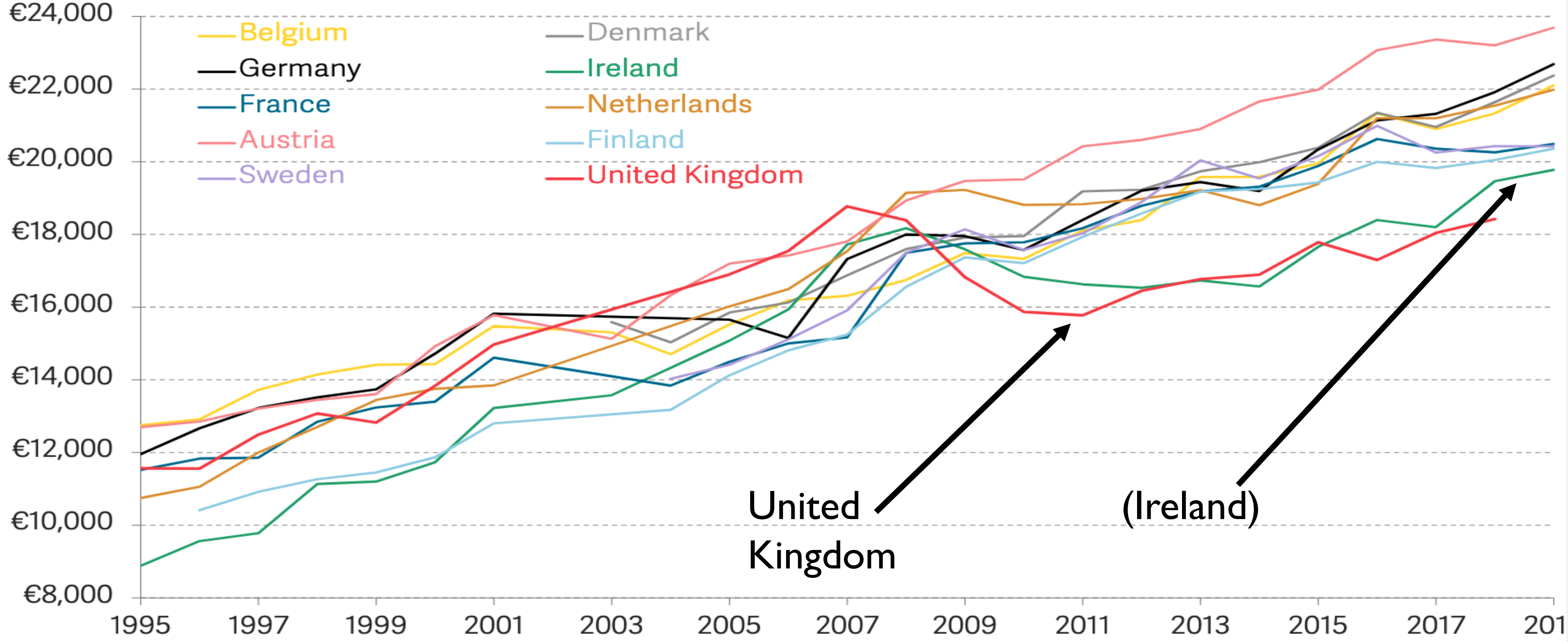
  UK£4,500 billion 1995-2015

- This is just one study, but still.

UK GROWTH / INCOME

FIGURE 4: **UK incomes have fallen behind those in neighbouring countries**

Median equivalised disposable income, before housing costs, adjusted for purchasing power

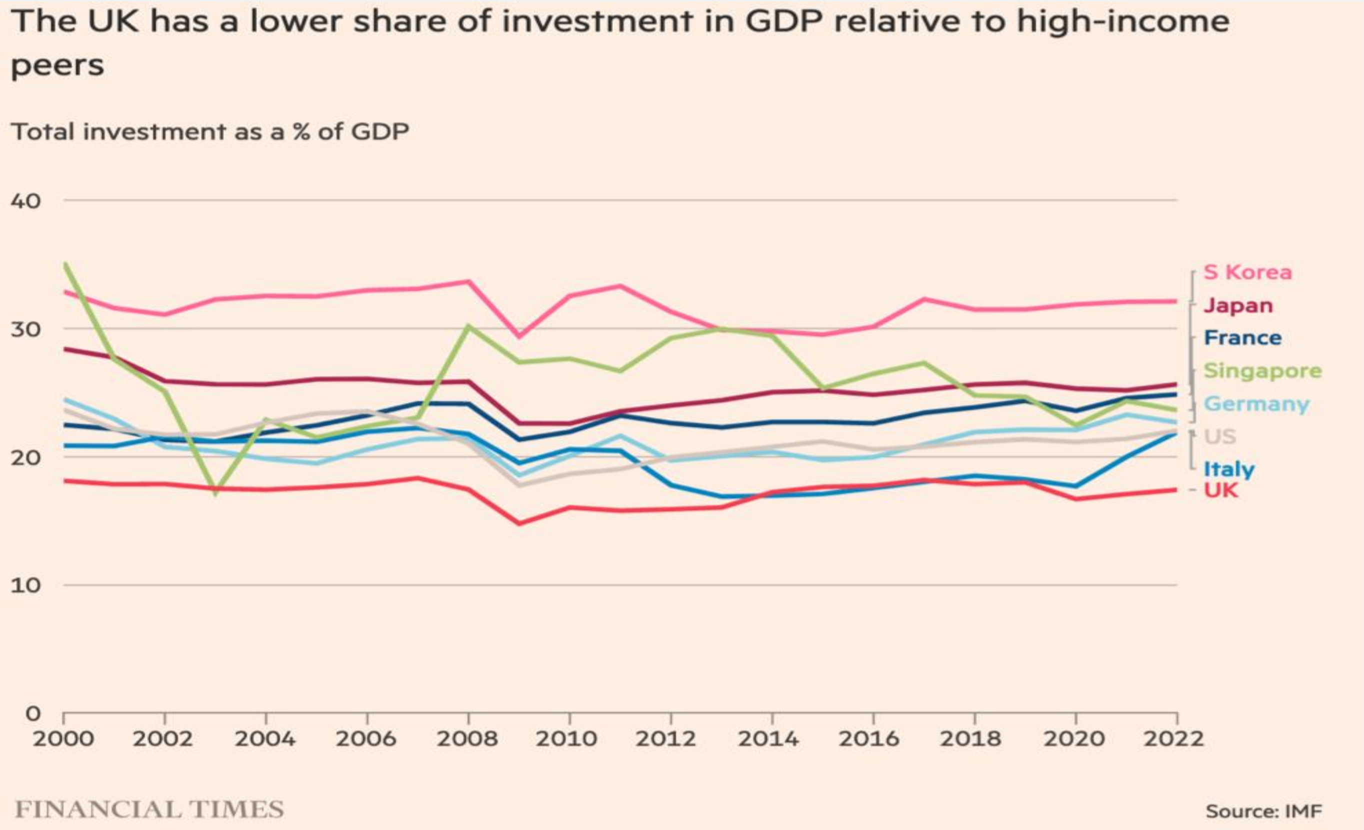


NOTES: Some gaps are interpolated, including all countries in 2002, and UK in 2003 and 2004.
SOURCE: Eurostat dataset ilc_di04.

Source: Resolution Foundation, Living Standards Audit, July 2022

FINANCE-DEPENDENT = LOW INVESTMENT

A financial sector is supposed to support investment. So what is going on here?



Source: Martin Wolf / FT, 2023

4. CAUSES?

What are the "excess" activities and causes that may contribute to a 'finance curse'?

HARMS / CAUSES 1

- **Extraction**: e.g.
  - Risk-taking at taxpayers' expense, GFC
  - Some private equity activities, derivatives, etc.
- **National security**: Handling organised crime, oligarch ££)
- **Tax / law avoidance** (e.g. banks facilitating tax schemes)
- **Increasing inequality** (e.g. high finance rewards + rent-seeking)
- (more)

HARMS / CAUSES 2

- "**Dutch Disease**" price / exchange rate effects, harms other sectors
- "**Brain drain**" as cancer researchers, engineers, are attracted into better-paid finance
- **Political capture** (see below)
- Monopolisation / damage to **SMEs (**as TTF knows! See below)

POLITICAL "CAPTURE"

- The usual **lobbying, revolving doors**, cultural influence, etc.

- **International competitiveness** – <u>threat to relocate </u>(to e.g. Geneva, Singapore, Dubai) if finance does not receive support (e.g. tax, regulatory, secrecy and other subsidies.

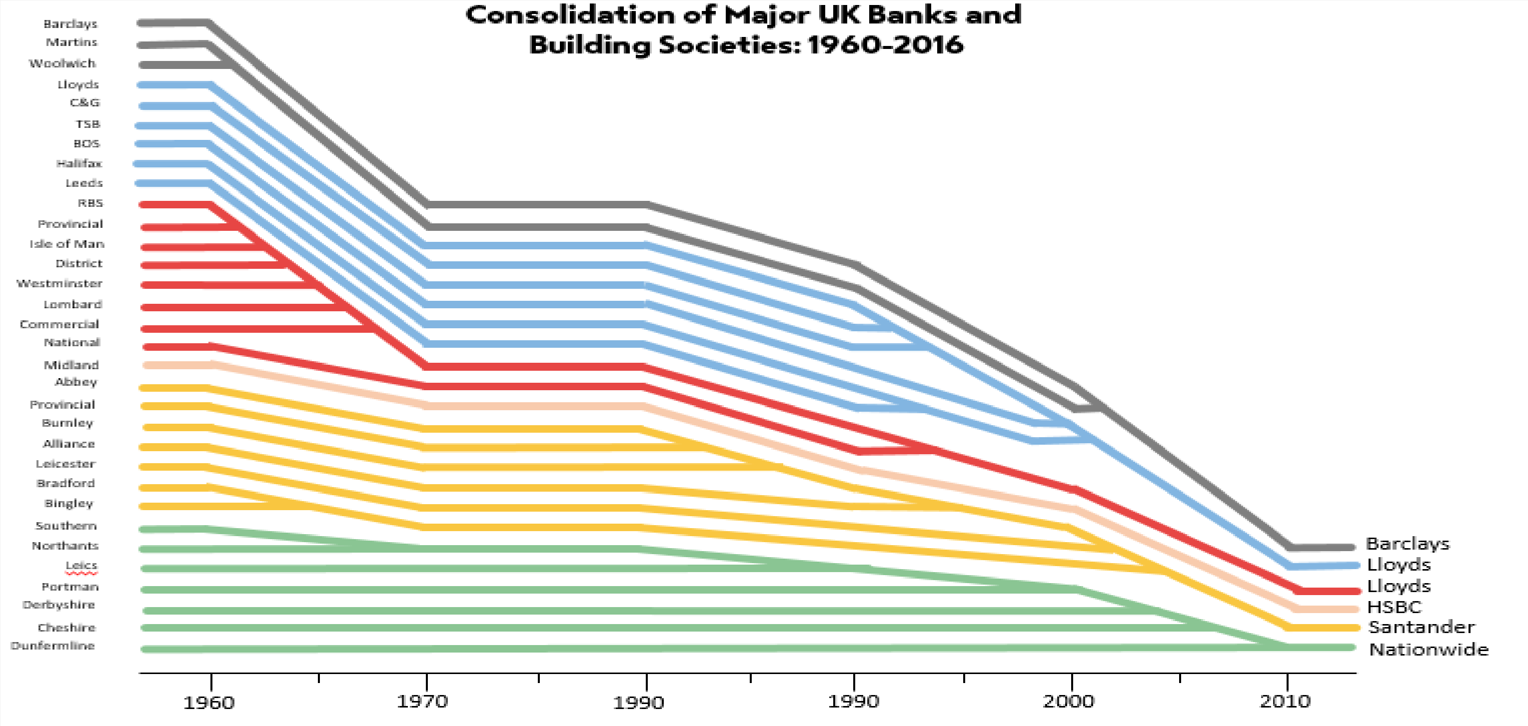
EXAMPLE: DAMAGE TO COMPETITION

“Excess finance” elements promote monopolisation, reduce competition:

- M&A dealmaking often builds market power
- Cheap finance for monopolists, “kill zones” or “valleys of death” for competitors
- Finances predatory pricing
- Private equity roll-ups in niches: market power ➔ Rent-seeking
- Finance cartels e.g. Libor, old U.S. ”money trusts”
- Big Tech merging with finance (leading to Big Tech dominating finance?)

DAMAGE TO COMPETITION II

- Consolidation / M&A in finance, e.g. asset managers, banks, builds market power:



5: FROM COMPETITION TO COMPETITIVENESS

- Competitiveness and competition are <u>not the same thing</u>.
  - Competition: private firms compete in markets
  - "Competitiveness" whole countries "compete."

"Edinburgh Reforms" / UK Financial Services and Markets Bill 2023: regulators get a **statutory objective to promote "competitiveness and growth."**

But this kind of "competitiveness" is <u>economic nonsense</u>.

COMPETITIVENESS II: WARNINGS FROM THE UK

- "The competitiveness of countries, on the model of the competitiveness of companies, is nonsense" – **Martin Wolf**.

- "A government wedded to the ideology of competitiveness is as unlikely to make good economic policy as a government committed to creationism is to make good science policy." – **Paul Krugman**

- **Massive opposition to UK competitiveness objective from former UK finance regulators etc**: Andrew Bailey, Adair Turner, Howard Davies, John Kay, Vince Cable, Martin Wolf, John Vickers.

- **59 economists** (e.g. Admati, Rodrik, Stiglitz, Tooze): "there is no place for "competitiveness" anywhere in the financial regulatory toolkit."

WHAT IS COMPETITIVENESS IN FINANCE?

- ***59 economists*:**

  "The **main purpose** of a financial sector is to support the economy as an intermediary.

  It can have **secondary purposes**, including as a source of export earnings. But these should not undermine the primary purpose."

6. RECOMMENDATIONS

What can we do with "Finance Curse?"

FC OVERTURNS THE DOMINANT NARRATIVE

Predominant narrative: City of London is the 'goose that lays the golden eggs.

TheCityUK: Finance provides x jobs, y trade surplus, z tax revenues.

"Don't tax / regulate / police the City too much or you'll weaken the golden goose / it will fly away to Geneva or Singapore."

Finance curse NARRATIVE overturns this.

TheCityUK outlines gross contribution, FC looks at net contribution – minus costs.

"SHRINK FINANCE FOR PROSPERITY"

ALTERNATIVE FRAMING

“Right-Sized Finance?”

<u>HOW</u> TO SHRINK FINANCE? UPGRADE, INSTEAD OF COMPETE

- **Protect consumers** better from scams
- Promote **regional / SME lending**
- **Tax finance actors** properly (=> health + education + public order + infrastructure)
- **Tackle conflicts of interest** e.g. break up "Too Big To Fail" banks, or Big 4 ,
- **Promote healthy competition** (e.g. work closely with DG COMP)
- **Enforce** public-interest laws across the board

Etc.

<u>None</u> of these involve winning any "race" with e.g. the UK or Switzerland.
Upgrading is a win-win (richer EU Citizens buy more UK cultural exports, Swiss cheese etc.)

Upgrading is good on its own terms, not usually known as "competitiveness".

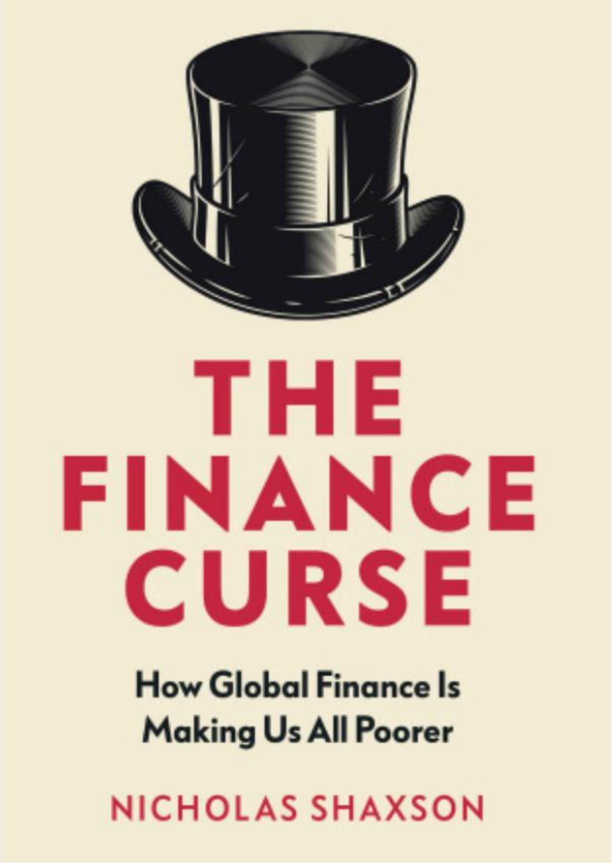
MEASUREMENT / STUDY

Further studies:

- X axis: not just credit to the economy, but a variety of measures of financial sector size / quality, different definitions
- Y axis: other measures of performance and wellbeing: not just GDP growth, but also inequality, sectoral productivity, political polarisation / democratic measures, innovation, etc.

- Better data overall (of course)

THANK YOU


THE FINANCE CURSE
How Global Finance Is Making Us All Poorer
NICHOLAS SHAXSON