Financing Development: Lessons from Advanced Countries

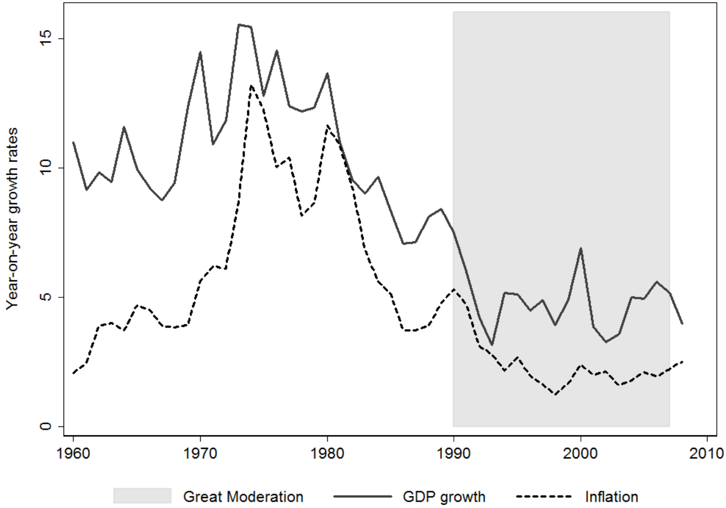
Karsten Müller

Warwick Business School, University of Warwick

phd14km@mail.wbs.ac.uk

Symposium on Finance and Development
University of the West Indies, Mona Campus, Jamaica
21 April 2015

Do Advanced Countries Have it All Figured Out?



Source: Data from Schularick and Taylor (2012)

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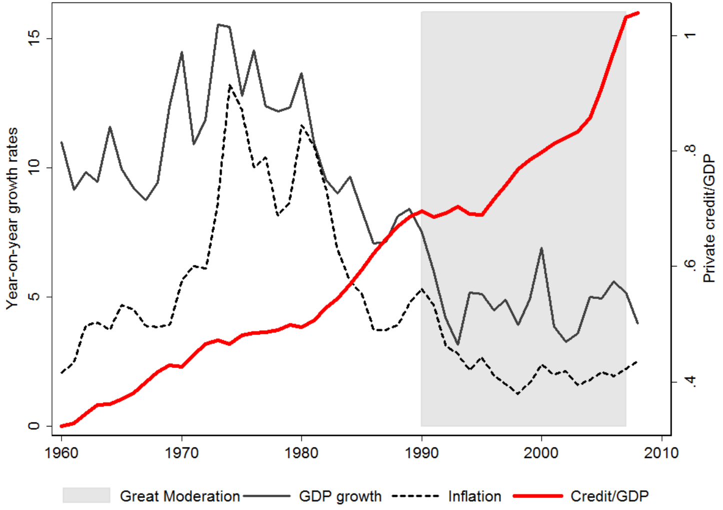

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Lesson 1: Banks create money and the money multiplier is a "myth".

The (stylized) textbook view

Bank	
(3) Loans	Deposits (2)
(1) Reserves	

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- Banks are financial intermediaries between savers and investors
- Savers deposit money, banks lend it to investors

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The (stylized) reality

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(1) Loans	Deposits (2)
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Sources: Bank of England/McLeay, Radia, and Thomas (2014), Bank of International Settlements/Borio (2014), IMF/Benes and Kumhof (2013), IMF/Zakab and Kumhof (2014), Kydland and Prescott (1990)

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- Banks create new deposits (“money”) when they make loans

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- Banks create new deposits ("money") when they make loans
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- "The deposit multiplier ... turns the actual operation of the monetary transmission mechanism on its head"
- "In no way does the aggregate quantity of reserves directly constrain the amount of lending or deposit creation"

Sources: Bank of England/McLeay, Radia, and Thomas (2014), Bank of International Settlements/Borio (2014), IMF/Benes and Kumhof (2013), IMF/Zakab and Kumhof (2014), Kydland and Prescott (1990)

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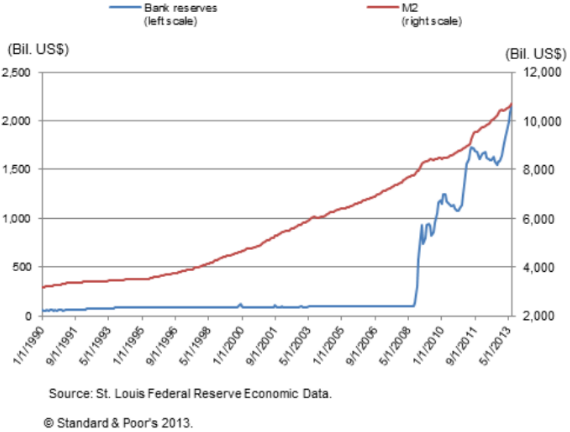
US M2 Money Supply and Reserves



Source: Sheard (2013)

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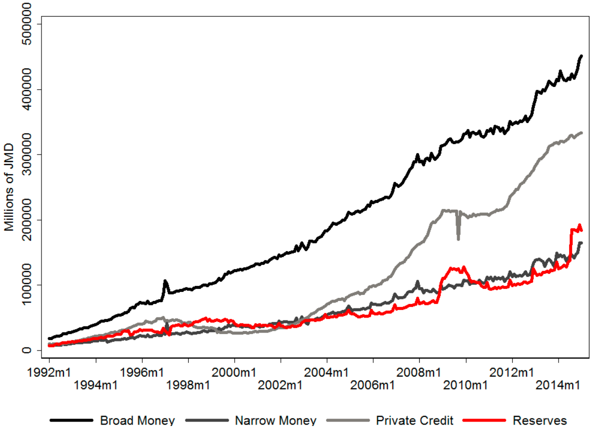
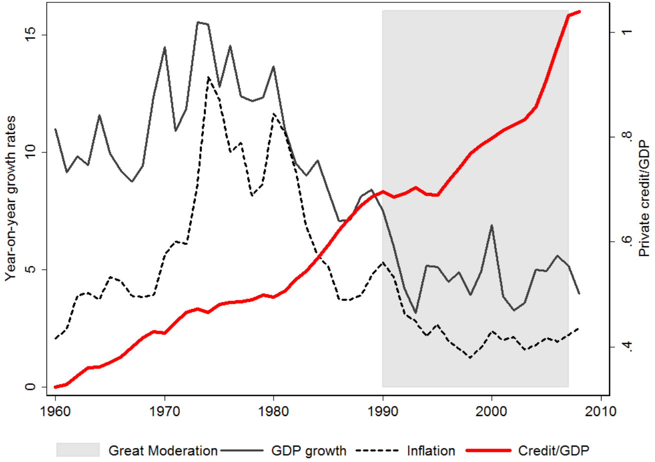
Jamaica Money Supply and Reserves



Data from BoJ. Narrow money: cash + demand deposits. Broad money: narrow m. + time, savings deposits.

Lesson 2: Inflation targeting, in its currently practised form, is dead.



Source: Data from Schularick and Taylor (2012)

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Major issues

- Price stability is no guarantee for positive economic outcomes
- Incorporating financial stability in policy rate setting a really bad idea: a single instrument (interest rates) too blunt

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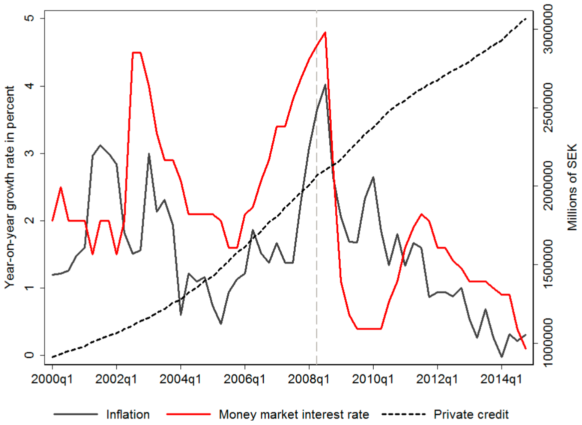
Interest rates and financial stability: the Swedish experience



Source: OECD, Sveriges Riskbank

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Major issues

- Price stability is no guarantee for positive economic outcomes
- Incorporating financial stability in policy rate setting a really bad idea: a single instrument (interest rates) too blunt
- Questionable for countries prone to supply and trade shocks
- Implies too small of a mandate for developing countries in need of credit for R&D and export-intensive sectors

Lesson 3: The allocation of credit matters.

Pre-crisis: more credit is really, really good[1]

- It leads to better resource allocation
- It leads to more investment and economic growth
- It can alleviate poverty levels

[1] e.g. King and Levine (1993), Rajan and Zingales (1998), Levine (2005)

[2] e.g. Schularick and Taylor (2012), Drehmann and Juselius (2014), Cechetti and Kharroubi (2014)

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Post-crisis: more credit is really, really bad[2]

- Credit growth is the best predictor of financial crises
- Recessions and crises preceded by credit booms are worse
- Growth in finance crowds out productivity in other sectors

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Can this contradiction be explained by credit allocation?

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The real effects of credit allocation

- Does it matter who gets a loan? Yes!

Sources: Büyükkarabacak & Valev (2010), Beck et al (2012), Jordà et al (2015), Tennant & Abdulkadri (2010)

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The real effects of credit allocation

- Does it matter who gets a loan? Yes!
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  - positively related to economic growth
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  - does not predict financial crises

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- *Mortgage credit*
  - strong predictor of financial crises
  - associated with exceptionally deep and long recessions

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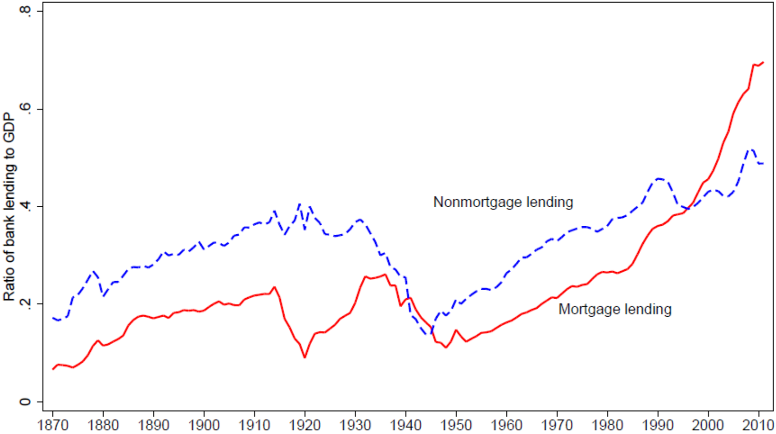
The great mortgaging in advanced countries



Source: Jordà, Schularick and Taylor (2014)

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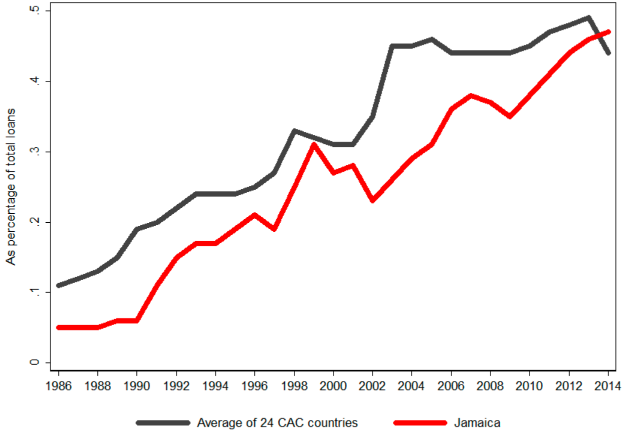
Personal credit in the CAC region: a great mortgaging?



Source: Müller (2015a). Data for Anguilla, Antigua and Barbuda, Aruba, Barbados, Belize, Costa Rica, Curacao and St Marteen, Dominica, Dominican Republic, El Salvador, Grenada, Guatemala, Honduras, Jamaica, Montserrat, Nicaragua, Panama, Saint Lucia, St Kitts and Nevis, St Vincent and the Grenadines, Trinidad and Tobago.

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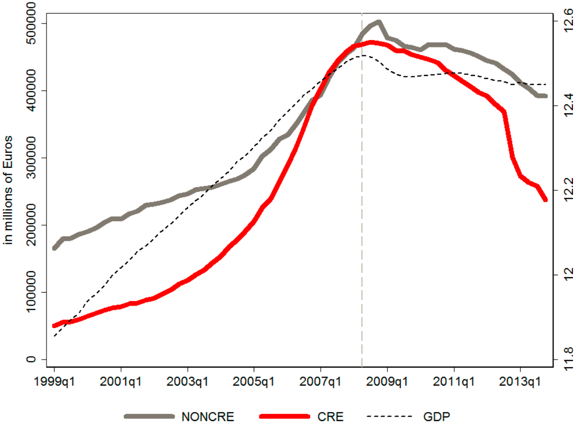
Not all corporate credit is the same: construction and real estate loans predict crises in the Eurozone (e.g. Spain)



Source: Banco de España, Müller (2015b)

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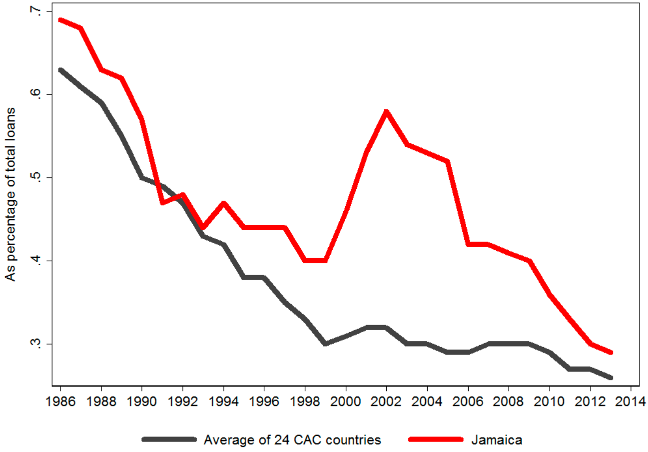
How much credit goes to the tradable sector in CAC countries?



Source: Müller (2015a). Total credit minus finance, real estate, construction, distribution, and individuals.

Lesson 4: The Basel III consensus on financial regulation is insufficient.

Bank capital requirements

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Macroprudential regulation

- Countercyclical capital buffer
- Loan-to-value/debt-(service-)to-income ratios

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- Does not directly address inefficient credit allocation
- Likely to choke off “good” credit booms
- May punish prudent institutions for macro developments
- Interactions with monetary policy
- Major political economy constraints (Spanish example)

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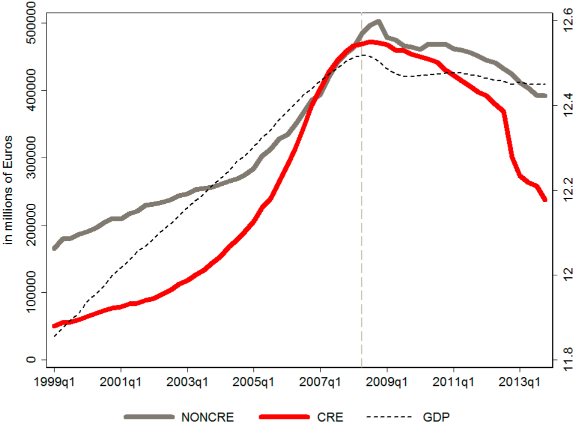
Political economy constraints of macroprudential regulation



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Conclusion

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- Banks create money, with macroeconomic consequences
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New and old tools for financial development and stability

- Nominal GDP targeting and a broad central bank toolkit
- Collateral laws that encourage lending to many sectors
- Non-interest rate instruments to address credit allocation
  - Sectoral reserve or capital requirements
  - Credit ceilings/controls

Thank you for your attention.