Journal of Financial Stability 10 (2014) 1–6

Contents lists available at ScienceDirect

Journal of Financial Stability

journal homepage: www.elsevier.com/locate/jfstabil

Editorial

Finance, growth, and stability: Lessons from the crisis☆

ARTICLE INFO

JEL classification:
F6
G15
G18
G21
G28
O16

Keywords:
Financial development
Financial innovation
Globalization
Government policies

ABSTRACT

This article introduces a special issue on lessons from the recent crisis on finance, growth, and stability. The papers in the special issue discuss (i) the benefits and risks of financial innovation and regulatory responses to these risks, (ii) the effect of finance and globalization on the real economy, and (iii) the role of government in providing credit guarantees. This introductory article provides a broader view on these issues and closes with ideas on the future research agenda in this field.

1. Introduction

The global financial crisis of 2007–2009 and the on-going Eurozone crisis have shed doubts on the role of financial institutions and markets in modern market economies. There is not only a fundamental debate on the function and optimal size of financial systems in post-crisis economies, but also on their structure. Questions are raised on the role of financial innovation, the benefits and risks of financial globalization, and the role of government in the financial sector. The crisis has also sparked a regulatory reform process, which has led to tighter capital and liquidity requirements, with other dimensions, including activity restrictions and taxation, still being discussed.

This special issue comprises several papers addressing specific questions related to the global financial crisis and the on-going regulatory reform process. Specifically, papers in this special issue discuss the benefits and risks of financial innovation, including CDS protection and securitization, and regulatory frameworks for them; the impact of finance and globalization on real sector outcomes; and the role of government in providing credit guarantees. The special issue contains both theoretical and empirical papers, reflecting advances in both areas for better understanding the relationship between financial innovation and deepening and economic growth and stability, as well as the role of regulation and of the government in the financial sector, in general.

The pre-crisis consensus was that market-based finance can only be good and that the expansion of the financial system, triggered by technological advances and deregulation, bears high upsides with little downside risk. However, even the pre-crisis literature documented that while the level of financial depth is positively associated with economic growth, rapid growth in credit is a reliable crisis predictor (Demirguc-Kunt and Detragiache, 2005; Kaminsky and Reinhart, 1999). And while financial innovation has contributed to the rapid expansion of financial systems around the world, with important benefits for households and enterprises, this expansion has also created new risks, most importantly tail risks not taken into account by individual investors (Rajan, 2005). The financial crisis has helped swing the pendulum toward a rather negative view of the financial system, overemphasizing the risks of financial innovation and financial markets, in general, and calling for strong regulatory responses. Frustration about taxpayer financed bail-outs and the high economic cost of the recent crises has been channeled into calls for restraining if not downsizing the financial system.

If there is one major lesson coming out of the very different papers and out of the more recent literature on financial institutions and markets in general, it is that finance can be as much a force for economic development as the root cause of systemic crises. Often the same mechanism that helps overcome agency problems and improve resource allocation can be a source of fragility. It might be thus difficult for the financial system to settle for the Goldilocks level of financial depth, neither too cold nor too hot. While financial deepening requires risk taking and risk transformation, agency problems, herding trends, and self-enforcing cycles push market participants to take on more risks than sustainable, effectively shifting risk, which ultimately results in financial fragility (e.g., Acharya, 2009). The objective of achieving the ideal level of financial depth thus requires focusing on the incentives of all market participants and thus ultimately the regulatory framework. Critically, however, this and related research suggests that the challenge

☆ I would like to thank Iftekhar Hasan, the managing editor of the journal, for comments and suggestions and support in putting this special issue together.

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http://dx.doi.org/10.1016/j.jfs.2013.12.006

is not so much to restrain finance, but rather to harness it for the benefit of the real economy.

Incentives of key players in the financial system are important, including those of investors, borrowers, regulators and politicians. The challenge for the regulatory reform process, currently under way on both sides of the Atlantic, is thus to structure incentives in a way that private and social benefits and risks of market participants are aligned. To be more specific, the downside risks with potential losses of risk-taking decisions by financial institutions and market participants have to be internalized. This requires adjustments to both micro- and macro-prudential regulatory frameworks and a dynamic approach that adapts to new structures and risks in the financial system. However, this reform process also has to take into account that regulators are not benevolent social planners, but face their own set of incentives and constraints (Barth et al., 2012).

While the regulatory reform discussion and debate on the future structure of the financial system often focuses on high-income countries in North America and Europe, the papers in this special issue make clear that the repercussions of this discussion affect financial systems as much in the emerging and developing world. Given the strong evidence of the positive transformational effects of finance, including global finance, on economies in the developing and emerging world, even taking into account the risks of rapid deepening or opening up, the challenge is to develop institutional and regulatory frameworks that allow harnessing the potential benefits of financial deepening, rather than restraining it.

The remainder of this introductory article is structured as follows. The next section discusses research on different forms of financial innovation, including their benefits and risks for credit markets and regulatory implications. Section 3 presents recent evidence on the effect of financial development and globalization on real economy outcomes. Section 4 offers a critical view of the role of governments in the financial sector. Section 5 concludes with a forward-looking view on the future research agenda. While I will discuss each of the papers in the special issue, I will not go into detail, but rather invite the readers to explore the papers.

2. Financial innovation – the bright and dark sides

The global financial crisis of 2007–2009 has spurred widespread debates on the "bright" and "dark" sides of financial innovation. The traditional *innovation-growth view* posits that financial innovations help reduce agency costs, facilitate risk sharing, complete the market, and ultimately improve allocative efficiency and economic growth. The *innovation-fragility view*, by contrast, has identified financial innovations as the root cause of the recent global financial crisis, by leading to an unprecedented credit expansion fueling a boom-bust cycle in housing prices, by engineering securities perceived to be safe but exposed to neglected risks, and by helping banks and investment banks design structured products to exploit investors' misunderstandings of financial markets and exploit regulatory arbitrage possibilities.

A series of recent theoretical and empirical papers have addressed the benefits and risks of financial innovation. To quote just a few examples, Laeven et al. (2009) show that financial innovation has been a driving force behind financial deepening and economic development over the past centuries, as the emergence of specialized lenders and investment banks to finance railroad expansion in the 19th century, the emergence of venture capital firms to finance high-technology firms in the 20th century, and the financing of biotech firms through pharmaceutical companies in the 21st century show. Beck et al. (2012b) show that financial innovation allows economies to better exploit growth opportunities and helps especially industries relying on external finance and R&D. Dynan et al. (2006) suggest that financial innovation has played a key role in reducing the volatility of economic activity in the early parts of the 21st century. Focusing on a specific form of financial innovation, Norden et al. (2013) show that banks with larger gross positions in credit derivatives charge significantly lower corporate loan spreads.

On the other hand, several recent papers have focused on the negative aspects of financial innovation. Wagner (2007a,b) shows that financial innovation that reduces asymmetric information can actually increase risk-taking due to agency problems between bank owners and managers, or because of lower costs of fragility. Ashcraft and Santos (2009) confirm this hypothesis, showing that firms with high default risk face higher loan spreads after they become traded in the CDS market, an effect that might be driven by reduced incentives for banks to monitor these borrowers. Gennaioli et al. (2012) use a theoretical model to show how financial institutions can cater to risk-averse investors' preferences by engineering securities perceived to be safe but exposed to neglected risks, ultimately leading to fragility when these risks are exposed. Dell'Ariccia et al. (2012a), Mian and Sufi (2009), and Keys et al. (2010) show empirically that securitization resulted in reduced lending standards in the U.S. in the early 2000s in the run-up to the crisis and increased loan delinquency rates. Beck et al. (2012b) show for a cross-section of countries that higher financial innovation is associated with higher risk-taking and more volatile returns of banks and resulted in higher bank losses during the crisis.

This special issue contains three theoretical papers that gauge the design and effect of specific forms of financial innovation. First, Arping (2014) focuses on protection of lenders against default risk through CDS protection and shows that the use of this instrument can have both positive and negative repercussions for credit market efficiency. Specifically, Arping embeds CDS protection into a model of corporate lending with borrower moral hazard and derives implications for credit market efficiency. On the one hand, credit default swaps insulate lenders against losses from forcing borrowers into default and liquidation. This improves the credibility of termination threats, which can have positive implications for borrower incentives and credit availability ex ante. On the other hand, lenders may abuse their enhanced bargaining power vis-a-vis borrowers and extract excessive rents in debt renegotiations. Arping shows that if this hold-up threat becomes severe, borrowers will be reluctant to agree to debt maturity designs or control rights transfers that would have been optimal in the absence of CDS protection. The introduction of CDS protection can thus tighten credit constraints and ultimately lead to a break-down of the credit market. Arping discusses several contract and policy levers that can prevent such a break-down, including disclosure requirements for CDS trades. Critically, his model shows that the benefits of financial innovation vary across borrowers with different characteristics; firms with low asset tangibility and where debt renegotiation is thus more cumbersome stand to benefit more from the use of CDS.

Another tool for credit risk management is the securitization of loans. While the pooling and sale of loans by financial institutions has a long history, the amounts involved in this market exploded in the years leading up to the global financial crisis (reaching $10.24 trillion in the United States and $2.25 trillion in Europe as of the 2nd quarter of 2008)[1] and, as already discussed, the securitization of sub-prime loans is often quoted as a critical factor in the boom-bust cycle of the 2000s in the U.S. critics point to

[1] Data are from the ESF Securitization Data Report Q2.