Finance, growth and inequality

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Finance is the lifeblood of modern economies, but too much of the wrong type of finance can hamper economic prosperity and social cohesion. We have taken a holistic approach to study the consequences of finance for the inclusiveness of growth, in the spirit of the OECD New Approaches to Economic Challenges initiative.

The UN’s Sustainable Development Goals (SDGs) are looking at finance in a similar way. They specify the target of better financial regulation under Goal 10, “Reduced Inequalities” and thereby directly recognise the importance of finance for inequality. Our research thus provides an empirical foundation for the SDGs’ target to improve the regulation of financial markets and institutions to attain greater economic prosperity and income equality.

Credit intermediation and stock markets have seen a spectacular expansion over the past half-century. Since the 1960s, credit by financial institutions to households and businesses has grown three times as fast as economic activity. Stock markets too have expanded enormously. These secular changes to the financial landscape have taken place amidst a global economy in which growth has declined and inequalities have widened. They have therefore raised deep questions about the role of finance: What are the effects of changes in the size and structure of finance on economic growth? How do financial developments influence income inequality? Which policies can improve the contribution of finance to people’s well-being?

The development of credit markets boosts economic growth when it starts from a low base, and many developing countries have a lot to gain from further financial expansion. Nevertheless, looking at the data over the last 50 years, our empirical analysis shows that credit expansion has reduced economic prosperity on average across OECD countries. An increase in credit by financial institutions by 10% of GDP has been associated with a 0.3 percentage point reduction in long-term growth. At the levels now reached in most OECD countries, further credit accumulation is therefore likely to lower long-term growth. On the other hand, further expansions in equity finance are found to promote economic growth.
We identify three main channels linking the long-term expansion of credit with lower growth:

➤ **Excessive financial deregulation.** OECD countries relaxed financial regulation in the 40 years preceding the global financial crisis, and this initially benefited economic activity. Relaxation of regulation however went too far and resulted in too much credit.

➤ **The structure of credit.** Our research decomposes credit by lending and borrowing sectors. These breakdowns show that, on the lender side, bank loans have been linked with lower growth than bonds. On the borrower side, credit has dragged down growth more when it went to households rather than businesses.

➤ **Too-big-to-fail guarantees.** Our findings of excessive financial deregulation and over-reliance on bank credit suggest that too-big-to-fail guarantees to banks have been one channel encouraging too much credit. This is further supported by evidence that the link between credit and growth is not as negative in OECD countries where creditors incurred losses due to bank failures as in those where they incurred no such losses.

Finance may also exacerbate inequalities, a concern that comes out very strongly in the formulation of the SDGs. Our work finds that this has indeed been the case. Expansions in bank credit and stock markets are both linked with a more unequal distribution of income. We suggest three underlying mechanisms:

➤ **The high concentration of workers in finance at the top of the earnings distribution.** There are few financial sector employees in low-income brackets and many higher up in the income distribution. The strong presence of financial sector workers among top earners is justified as long as very high productivity underpins their earnings. However, our detailed econometric investigations show that financial firms pay wages well above what employees with similar profiles earn in other sectors. The premium is especially large for top earners.

➤ **Unequal bank lending.** Banks generally concentrate their lending on higher-income borrowers. Credit is twice as unequally distributed as household income in the euro area. This may reduce credit risk,
but it also means that well-off people have greater opportunities than the poor to borrow money and fund profitable projects. In this way, lenders are likely to amplify inequalities in income, consumption and opportunities.

➤ Unequal distribution of stock market wealth. Stock market wealth is concentrated among high-income households who thus get most of the income and capital gains generated through capital markets.

The evidence base from our research therefore suggests that the SDGs’ target of reforming finance is likely to contribute to greater economic prosperity and income equality. Reforms should involve avoiding credit overexpansion and improving the structure of finance.

➤ Avoiding credit overexpansion. Macro-prudential instruments can provide tools to keep credit growth in check. Caps on debt-service-to-income ratios have been identified as effective in this regard. Strong capital requirements on banks and other lenders help limit the extent to which financial institutions can fund lending through liabilities that benefit from public support. Further reforms are necessary to reduce explicit and implicit subsidies to too-big-to-fail financial institutions and level the playing field for competition between large and small banks. This could be achieved through break-ups, structural separation, capital surcharges or credible resolution plans. In the short term, however, measures to avoid credit overexpansion may temporarily hurt economic activity.

➤ Improving the structure of finance. Tax systems in most OECD countries currently encourage corporate funding through loans rather than equity. Tax reforms can improve the structure of finance, by reducing this so-called debt bias, which leads to too much debt, and not enough equity. They would help make finance more favourable to long-term economic growth. Measures to encourage broad-based participation in stock holdings, for instance a wider application of nudging in pension plans, can allow for a better sharing of the benefits from stock market expansion.
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