A collection of recent thought-provoking facts and findings on the relationship between finance and growth to feed the debate.

A minority of the activities of large EU banks contribute to the growth of the economy and these activities deserve the support of financial policymakers.
Since the financial crisis, the links between banks and growth are being re-examined. This factsheet looks at recent findings to ask which bank activities could best help the EU’s growth plans, and how they compare with the current activities of the EU’s large banks.

**Credit, but not too much**

At high levels of private credit to GDP (“financial deepening”), more finance is associated with less growth, something that researchers at the IMF refer to as the “vanishing effect of financial depth”.

**The inverted U-curve that links private sector credit and growth**

"The marginal effect of financial depth on output growth becomes negative when credit to the private sector reaches 80-100% of GDP. Our finding is robust to controlling for macroeconomic volatility, banking crises, and institutional quality."

Arcand et al 2012, using multiple cross-country datasets 1960-2010

**Marginal impact of private credit growth on GDP growth**

"Besides increasing volatility, a large financial sector may also lead to a suboptimal allocation of talents... Our analysis suggests that there are several countries for which smaller financial sectors would actually be desirable."

Arcand et al 2012
Some industries that rely on external finance are especially exposed to the negative effects of financial deepening.

“...In countries with a ratio of private credit to GDP of more than 0.589, a further expansion in credit results in industries dependent on external finance growing more slowly than industries not dependent on external finance. There are six such countries in the sample implying that the threshold is not a theoretical one: Austria, Germany, Israel, Japan, Netherlands, and Spain.”

Manganelli 2013

Financial deepening in the world’s advanced economies has increased dramatically, especially since financial deregulation began in the 1980s.
This coincides with a sharp increase in the size of bank balance sheets.

Eurozone banks’ total assets to nominal GDP

Eurozone bank assets have grown to around 350% of GDP

ECB, Eurostat, CLSA Asia-Pacific Markets

It also coincides with a rapid increase in pay for investment banking, relative to traditional banking and insurance.

Finance wages relative to non-farm private sector

“In 1980 the relative wage in Other Finance (including investment banking, securities and trading, private equity and hedge funds) starts a steep increase, until it completely dwarfs those of the other two subsectors”

Philippon and Reshef 2008
A drag on the economy

Although a growing finance sector is still considered good for growth in emerging economies, in advanced economies it is now correlated with weaker GDP growth.

![Negative correlation between finance sector size and GDP growth](image)

“Each percentage increase in the share of finance in total value added is associated with up to 0.12% slower growth”

Diversion of human capital

The relationship between growth and the financial sector’s share of employment - another inverted U

“There is a threshold beyond which a larger financial sector [i.e. employing more of the labour force] becomes a drag on productivity growth”


“Each percentage increase in the share of finance in total employment added is associated with up to 0.2% slower growth”


“...we are throwing more and more of our resources, including the cream of our youth, into financial activities remote from the production of goods and services, into activities that generate high private rewards disproportionate to their social productivity.”

James Tobin 1984

The implicit subsidy [to too-big-to-fail banks] makes the financial sector artificially more lucrative and this lead to increases in the size of the financial sector diverting resources (including human capital) from other sectors of the economy.

EC Impact Assessment 2014, Annex 4.2.4
It’s not all bad

While an overdeveloped financial sector is, in general, a burden on the economy, specific types of credit are linked with growth.

Bank lending to businesses outside the financial sector is positively linked with economic growth. It is more productive, for example, than bank lending to financial businesses or real estate.

In fact, bank lending in general is positively linked with GDP growth, more so than banks’ non-lending activities.

**Type of lending: correlation with growth**

“We find positive growth effects of credit flows to nonfinancial businesses and insignificant or negative effects of credit flows to asset markets including real estate.”

Bezemer et al 2014, using data from 46 economies 1990-2011

“In most cases, an additional euro of mortgage lending contributes less to overall economic growth than an additional euro of credit to a young innovative company.”

Benoît Cœuré, ECB 2014

**Type of bank activity: correlation with growth**

“Over the long run financial intermediation is positively associated with growth. Non-intermediation activities are not significantly associated with GDP growth (proprietary trading, market making, provision of advisory services, insurance and other non-interest income generating activities).”

What do today’s banks do?

The largest EU banks are today focused mainly on non-lending activities, such as trading and making markets in financial assets.

**Balance sheet structure of a typical large European bank**

“Loans represent less than a third of total assets. Financial assets account for more than a half.”

**Governor Liikanen, Bank of Finland**

Looking at their lending in more detail, banks lend mainly to real estate as they have moved away from business lending in recent decades.

**Share of real estate lending in total bank lending**

“With very few exceptions, the banks’ primary business consisted of non-mortgage lending to companies in 1928 and 1970. By 2007 banks in most countries had turned primarily into real estate lenders… The intermediation of household savings for productive investment in the business sector – the standard textbook role of the financial sector – constitutes only a minor share of the business of banking today.”

**Jordá et al 2014, using data from 17 advanced economies since 1870**
That leaves lending to businesses – the activity that most contributes to economic growth – as an increasingly small proportion of EU bank’s balance sheets.

![Graph showing the proportion of total loans to total assets and loan growth.

Lending to business is not the main business

In 2011, the stock of loans (excluding overdrafts) outstanding to European non-financial businesses was around EUR 5.9 trillion, equivalent to only 12% of total EU bank assets. EBF, Dealogic data cited by AFME

This picture is driven by a few large banks and the situation is different elsewhere. While their economic impact is limited, small banks lend far more of their balance sheets than big banks (and can produce better returns for their investors!)

### Small v large banks: lending habits and profitability

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<th>Lending</th>
<th>Return to investors</th>
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<tbody>
<tr>
<td></td>
<td>Ratio of total loans/total assets</td>
<td>Loan growth</td>
</tr>
<tr>
<td>G-SIFIs</td>
<td>37.80%</td>
<td>21.38%</td>
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<tr>
<td>Sustainable banks</td>
<td>69.50%</td>
<td>80.52%</td>
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</table>

Sustainable banks here refers to a group of 14 small and medium banks around the world with balance sheets between $66m and $14bn in size, all members of the Global Alliance for Banking on Values. G-SIFIs refers to the 29 banks designated by the FSB as global systemically important financial institutions. GABV 2012, data is averaged from 2007-2010
Capital markets, a luxury option?

Large banks have moved away from traditional business lending to focus on real estate loans and non-lending market activities, such as securitisation and market making. But despite the innovations and proclaimed efficiencies of market-based financing, the unit cost of financial intermediation has increased since the 1990s.

Unexplained increase in unit cost of finance

Before the 1990s, the unit cost of finance tended to rise and fall with interest rates. Since then, interest rates have fallen but the unit cost of finance has not, leading to an unexplained increase in the unit cost of finance. Over the same period, banks have evolved to earn more of their income from market activities such as securitisation and trading, and less from traditional lending (or “banking value added”).

Bazot 2014

Policymakers have identified several bank reform ideas to boost growth. Bazot’s finding on unit costs raises interesting questions, including about cost-effectiveness, for the EU’s growth agenda, for Capital Markets Union and the push to revive securitisation, versus other policy options.

“While finance per se is necessary for growth, an oversized financial industry can be detrimental to real economic activity. Of course, the question of what constitutes an “oversized” financial sector is a complex one.”

Benoit Coeuré, ECB 2014

Some facts about too-big-to-fail banks

- TBTF bank assets in recent years have been growing twice as fast as GDP: the 15 largest EU banks’ assets have grown x3 from 2000-2011 to EUR 20 trillion; EU GDP grew less than 1.5x in the same period (ECB and Eurostat)
- The growth of TBTF banks has been fuelled by implicit funding subsidies equivalent to up to half of their profits, or up to 0.8% of EU GDP (EC 2014)
- TBTF banking puts the economy at risk. The high exposure to wholesale funding (61% of liabilities) and high market dominance of TBTF banks means they can have a disproportionate impact on the economy in a financial crisis (Le Lesle 2012, Bremus et al 2013)
Banks do not primarily lend to non-financial business, and financial development may no longer be good for growth. These trends predate the 2008 crisis. They prompt a rethink of the role of banks in the process of economic growth.

Bezemer et al. 2014

Why is the effect of finance on growth non-linear? Recent academic research puts forward at least five possible explanations. (...) The financial system can grow too large relative to the real economy because it can extract excessively high informational rents and pay excessively high wages.

Benoît Cœuré, ECB, 2014

Bank structure reform would increase the private cost of engaging in excessive trading activities of primarily intra-financial nature, thus leading to a contraction of such activities as banks adjust to the new reality and hence, other things being equal, a reduction in bank size. It would thus contribute to a better deployment and allocation of resources towards the real economy.

EC Impact Assessment 2014, 2.3
REFERENCES


AFME, September 2014, ‘Funding the EU economy - The role of banks and financial markets’, available online at http://www.afme.eu/WorkArea/DownloadAsset.aspx?id=11361


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