Why does financial sector growth crowd out real economic growth?

Notes from the outside

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Conference Elteville

May 2, 2014

This discussion does not reflect the views of the Deutsche Bundesbank, the Cleveland Federal Reserve Bank, or the Board of Governors of the Federal Reserve System.

Just mine.

Thanks for the opportunity to discuss this paper at this conference. I am honored. I liked the paper.

The “English Disease”

- Like the Dutch disease coined by the Economist in 1977, this shows the paradox of what looks like a benefit being a social harm.
- Discovery of a natural resource chokes off resources from the real sector by drawing skilled labor into the resource sector through an FX mechanism.

One of those (rare?) instances where policy is enacted because of formal economic theory.

Offshore sovereign wealth funds that promote a healthier non-tradable sector in Norway, Indonesia, Russia, and even imposed in Cambodia.

The “English Disease” has similar aspects

- Often has an income distribution face that makes it popular. (For example, oil wealth versus Nigerian poverty. Financier mansions versus the price of a home in London.)
- Often “skilled labor” is used as the scarce resource, although it does not always stand up as an empirical test.

So how does this model work?

Skilled Financiers

$\rightarrow$ Cheaper Funds

$\rightarrow$Growth in Higher Collateral Low Productivity Firms

$\rightarrow$Skilled Labor into Financial Firms (And out of High Productivity Low Collateral Industries)

$\rightarrow$Lower Growth

But Really…

- Industries $i=a,b,$ where a is high growth, high return, low pledgable.
- Entepreneurs are randomly selected into either industry and
- can get funds from a financier who funds the two industries according to a constraint of what can be recovered in a default.
- Or they can self fund.

Note the friction needed

- At the end of the first period, the financier has invested more in the low growth sector because of pledgability of industry *b*. The entrepreneurs of *a* invested more in *a*.
- At the beginning of period 2, entrepreneurs are randomly assigned to be in either *a* or *b* again.

Otherwise the *a* entrepreneurs would invest more in a and this sector would grow more

So the model needs a friction so that the financiers use the low pledgability to finance low growth and the entrepreneurs can not use their knowledge to finance high growth.

In the endogenously determined system, Skilled labor becomes the wedge between the Entrepreneurs' knowledge and their financing.

Each period the entrepreneur must bid for skilled labor to finance *a*, and bid against the financiers who wish to finance *b*.

I am not sure that this is really an "externality." More a information wedge that keeps the entrepreneur from taking advantage of his wealth in the next period.

Then this being a growth model…

2 Equilibria, one high growth, one high finance.

Paper has an empirical side

Establishes a relationship between low growth, high financial dependence using 15 (or 16?) advanced countries and 33 industries.

Two comments from the outside.

An interesting contrast to a similar model from the finance side.

Cream skimming in financial markets, by Bolton, Santos, and Scheinkman (2011, NBER)

In this paper, skilled labor can become Over-the-counter dealers or entrepreneurs.

If they are dealers, they can extract the informational monopoly rents from the entrepreneurs due to their position as information handlers. This causes the financial sector to be too large in a socially optimal sense.

There are advantages to this model for empirical work.

My second comment is that I am not sure that the empirical work is that convincing.

A bit of a cheap shot perhaps?

Skilled labor

- In the Dutch disease case, skilled labor became a problem to the empirical implementation of the models.
- Resource sector was typically not a large employer.
- So now we need a service sector servicing the resource sector.

Here, I am not sure that the commercial lending sector is taking away that many skilled laborers from the other sectors.

Employment of loan officers in commercial lending is flat or falling. Human capital in this sector is flat or falling. So are salaries.

However,

- Over-the-counter traders are doing better (although here, too, I would be careful. Salaries are very volatile and cyclical. Life cycle salaries are also uncertain.)
- Note the advantages of a unique equilibrium for empirical work.

But larger issues loom in the careful empirical work.

Look at the DGP

Comparing a high financial dependent (in the sense that investment is provided by outside funding) time or industry with a low one, and then comparing growth rates.

What generates a high financial dependent (in the sense that investment is provided by outside funding) time or industry?

Financial independence is generated by a successful product that makes Apple cash rich.

Great care is needed to empirically model and identify this process.

Also, does pledgability and low growth make sense in terms of this model?

Holmström and Tirole pledgable return based pm ex ante moral hazard may not make sense in a cross sectional industry sense.

This is an ambitious paper.

- It delivers a simple theoretical construction of a “paradox of plenty”
- It is very spare so that the parts are all transparent in giving insight.
- More work could be done to use some of this structure for identification.
- I look forward to the next round of empirical work.

Thank you.