Regulating for Prosperity

Ross Levine
University of California, Berkeley

Outline

Preamble: Don’t forget the long-run.

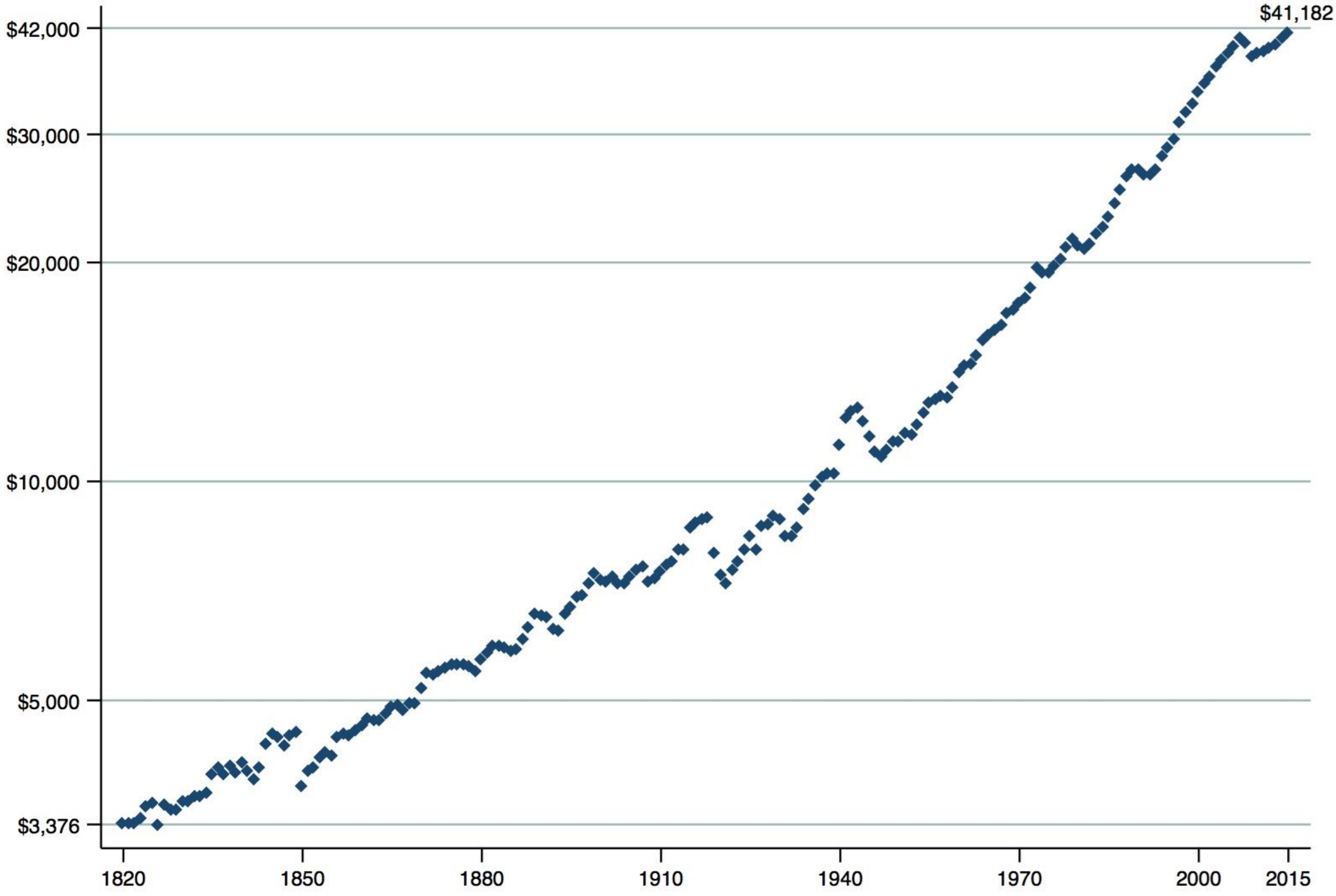
Finance matters beyond crises: It shapes growth, poverty, inequality, and economic opportunities.

Regulating for prosperity: There are things we can do, but most countries are not doing them.

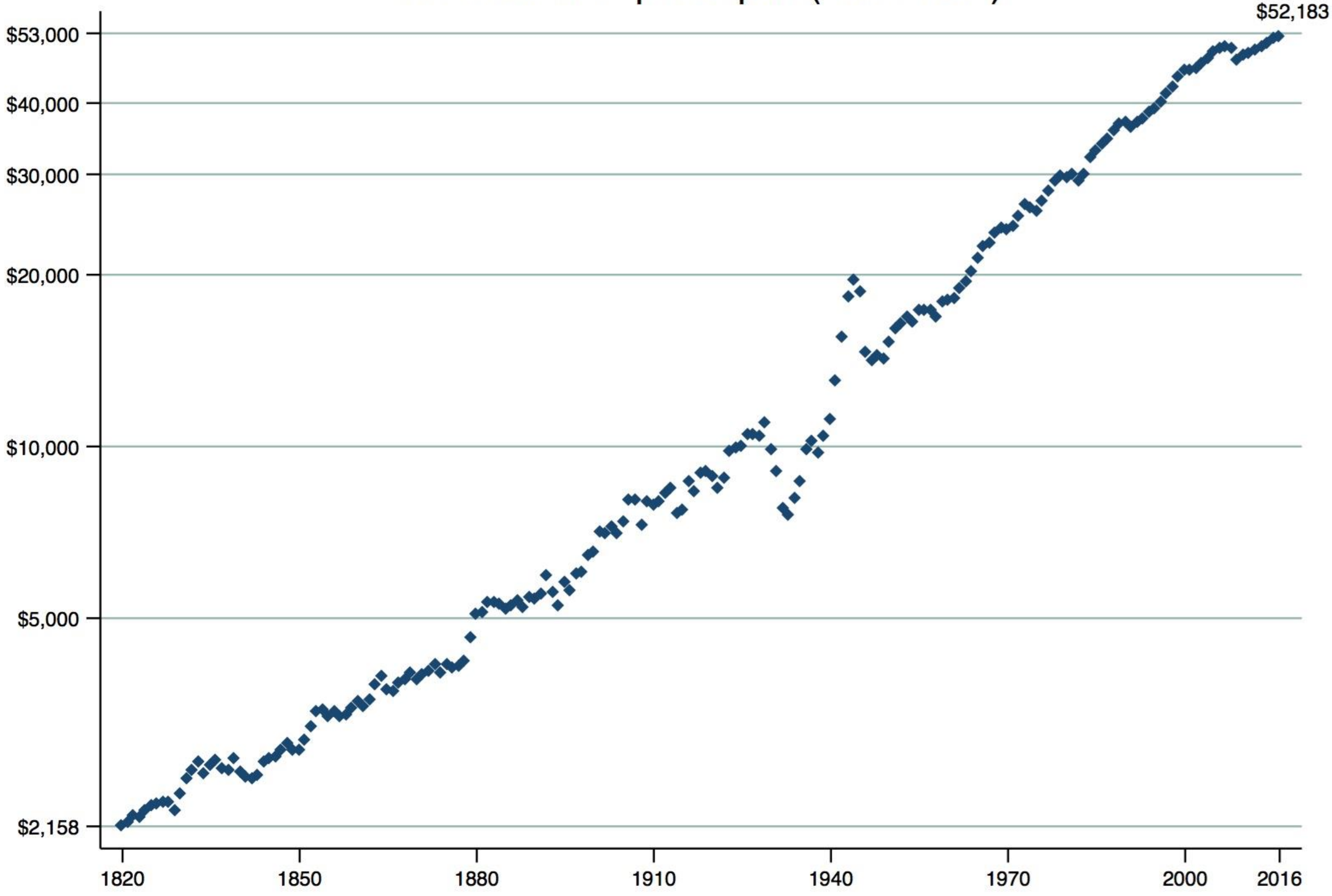
Don’t forget the long-run

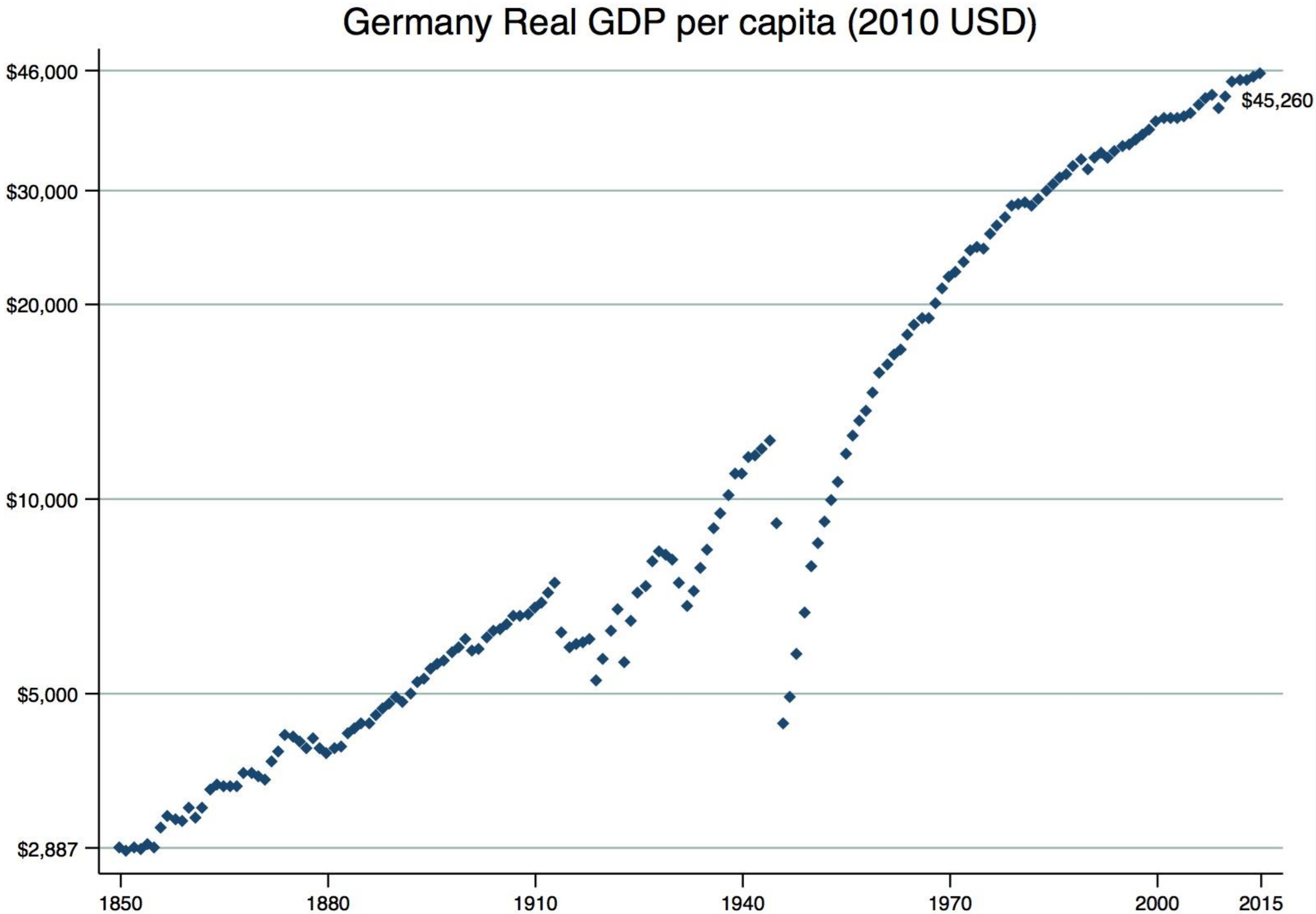
A graphical reminder.

UK Real GDP per capita (2010 USD)



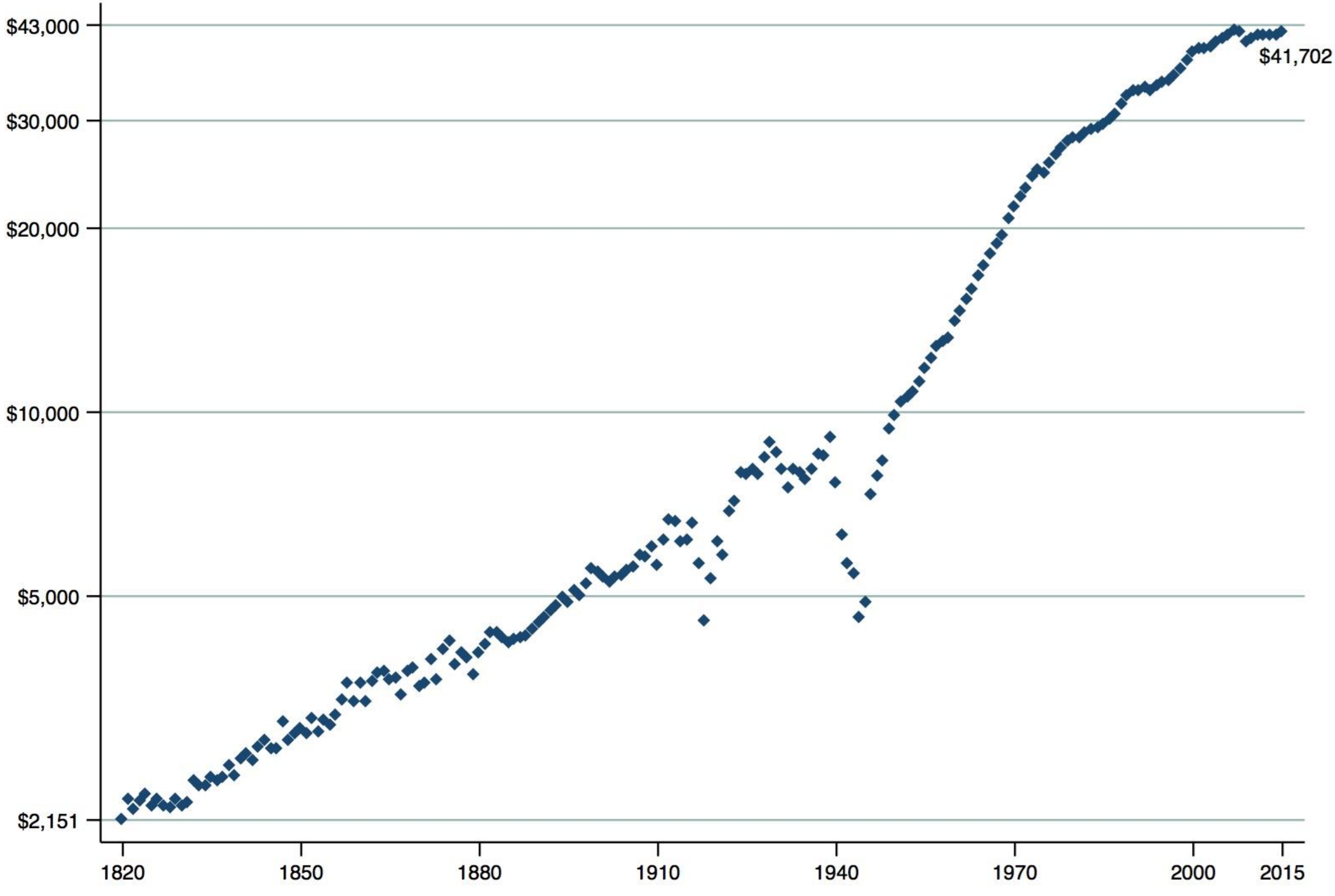
US Real GDP per capita (2010 USD)

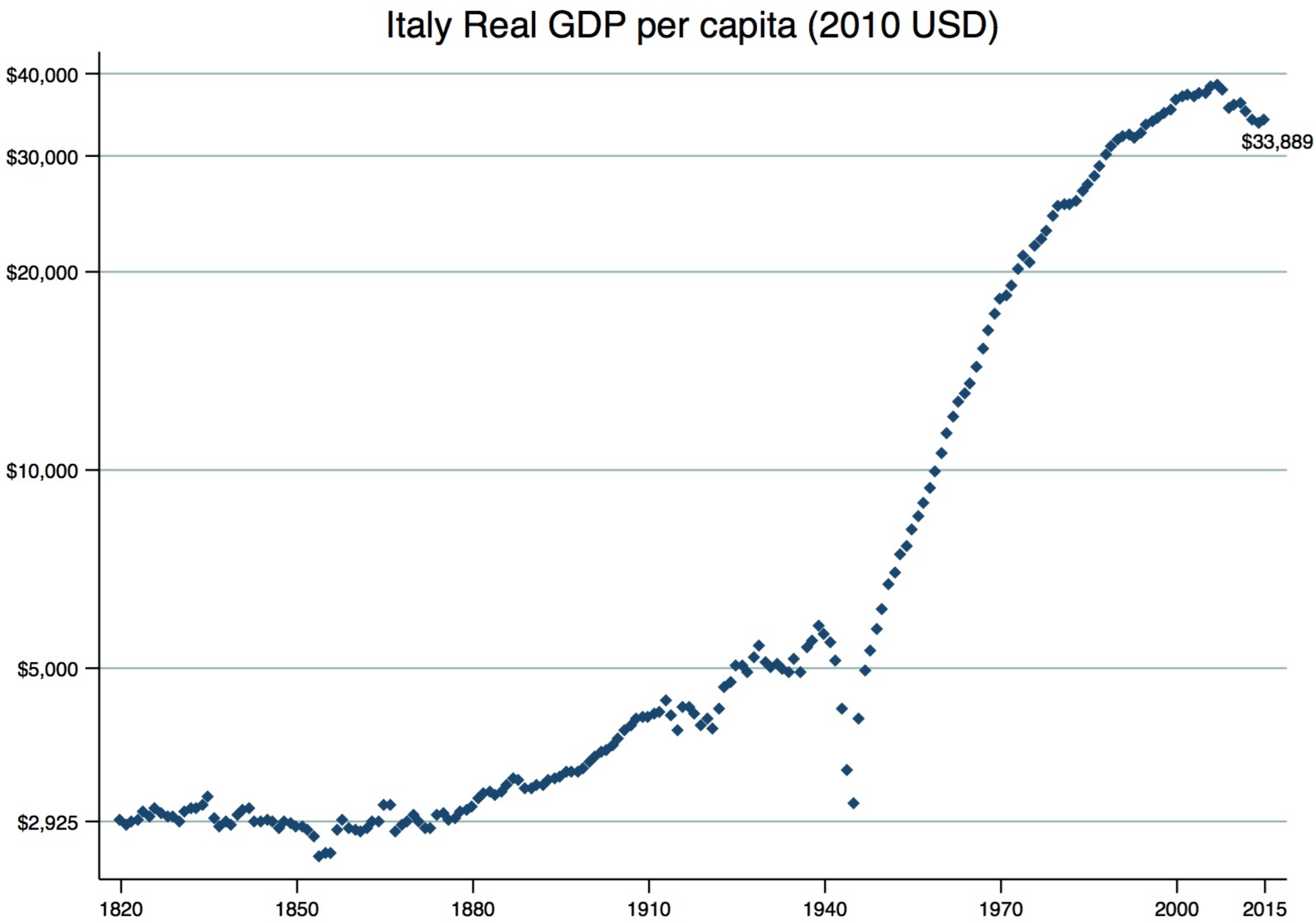




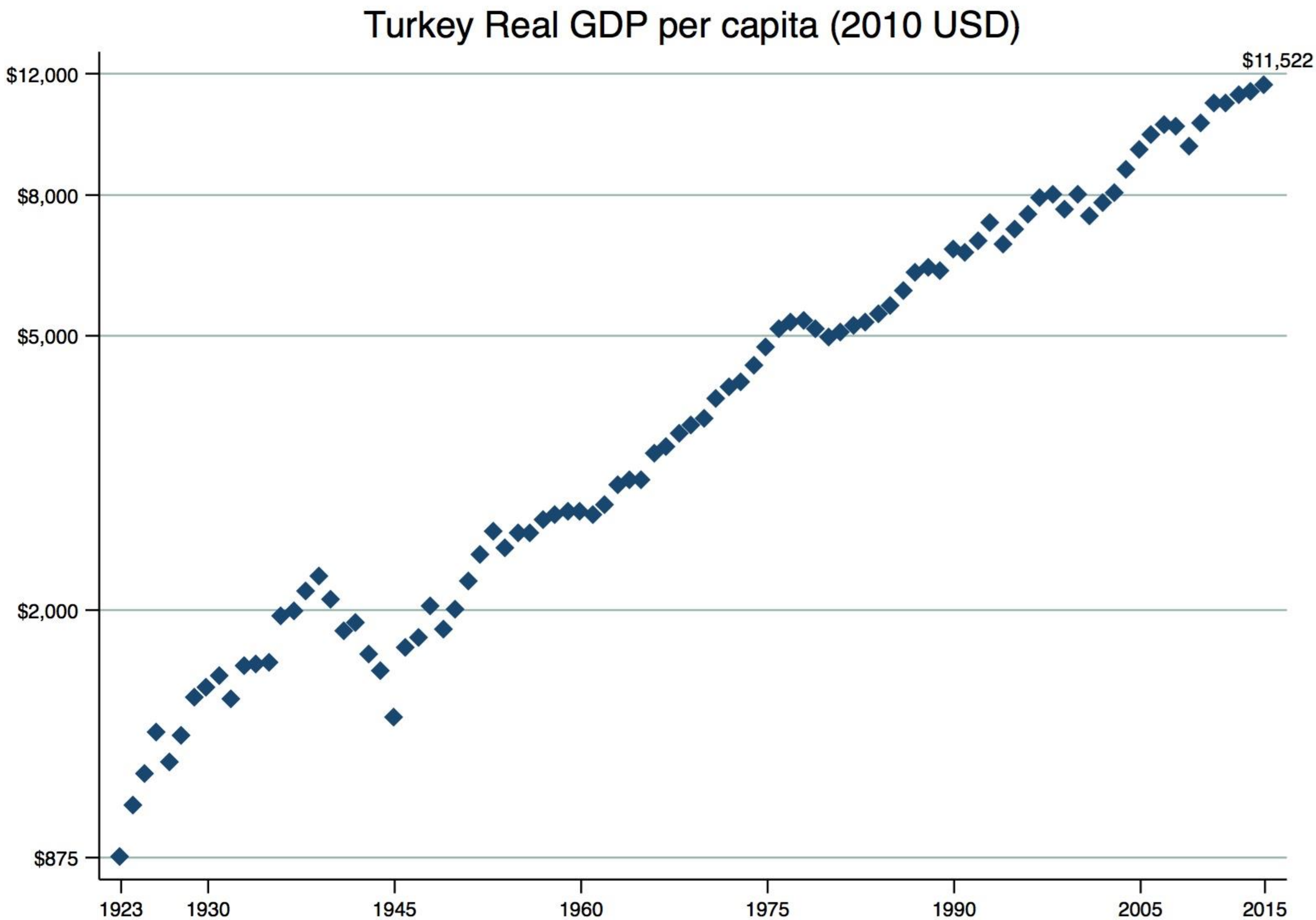
Germany Real GDP per capita (2010 USD)
$46,000
$30,000
$20,000
$10,000
$5,000
$2,887
$45,260
1850
1880
1910
1940
1970
2000
2015

France Real GDP per capita (2010 USD)




Italy Real GDP per capita (2010 USD)
$40,000
$30,000
$20,000
$10,000
$5,000
$2,925
$33,889
1820
1850
1880
1910
1940
1970
2000
2015


India Real GDP per capita (2010 USD)
$1,751
$1,800
$1,500
$1,000
$500
$300
$211
1870
1895
1920
1945
1970
1995
2015



Turkey Real GDP per capita (2010 USD)
$11,522
$12,000
$8,000
$5,000
$2,000
$875
1923
1930
1945
1960
1975
1990
2005
2015

Don’t forget the long-run

- Lucas: After raising questions about the impact of government actions on long-run growth, wrote:

  “The consequences for human welfare involved in questions such as these are simply staggering.”

- Do financial regulations alter the trajectory of long-run growth and prosperity?

Does finance shape prosperity?

Debate.

Evidence.

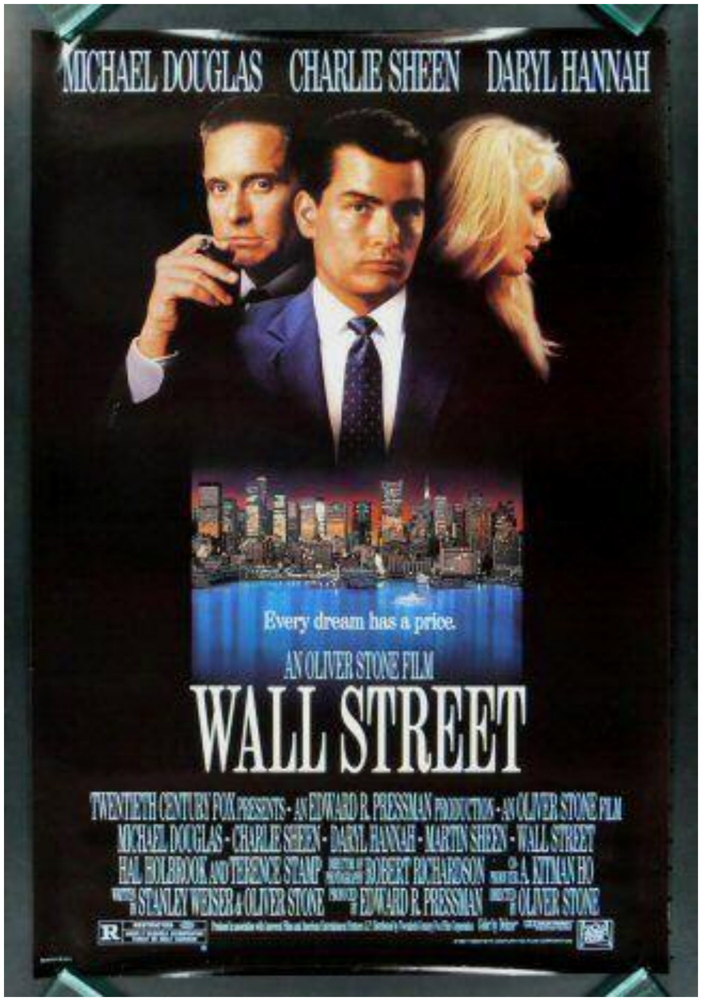
The debate: Casino view

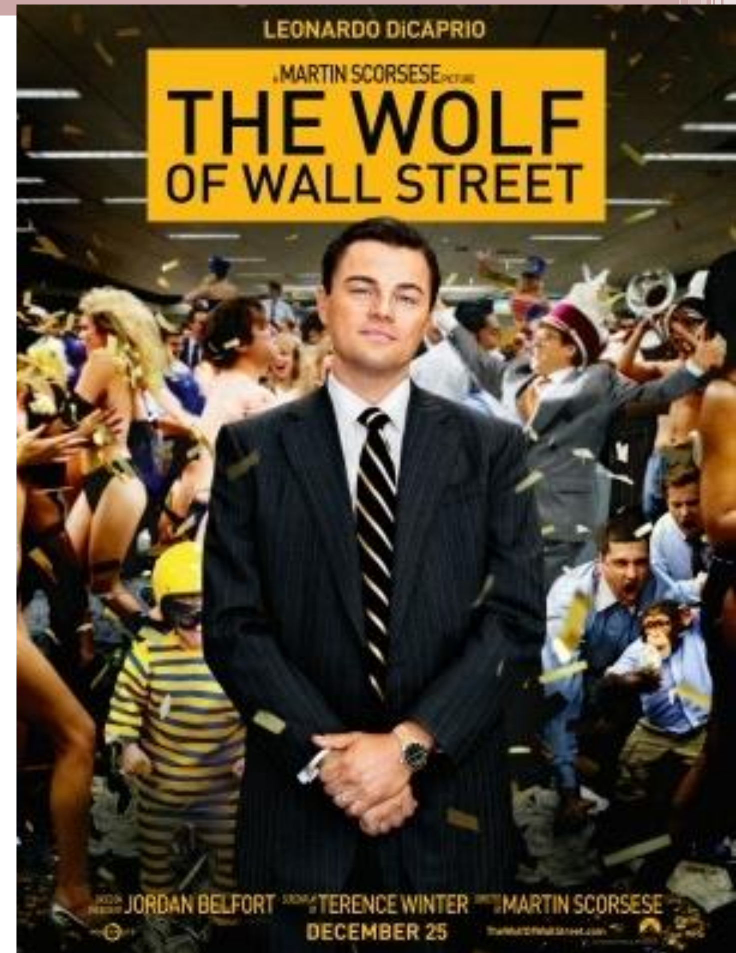
Financial markets are unproductive casinos, where the rich come to place their bets.

- If they win, we lose.
- If they lose, we still lose.

➢ Regulations should protect us from them.

This view is popular in Hollywood





It is also popular at regulatory agencies, international institutions, & with academia

The casino view:

- The fundamental determinants of prosperity are savings, education, and innovation.
- Finance plays little role in shaping these determinants.
- Finance's bigger role is in shaping fragility.

➢ Protect the economy from financial crises

The debate: Bagehot view

"The banker authorizes the entrepreneur in the name of society to innovate." Schumpeter (1912)

Bagehot view

Regulations influence the degree to which financial systems:

- Mobilize savings for “immense” works.
- Allocate capital to those with the best entrepreneurial ideas, rather than to those with more wealth & connections.
- Exert sound governance over the use of that capital.
- Provide mechanisms to manage risk.

This suggests regulatory reforms can

- Accelerate growth.
  - Ease credit constraints and facilitate entrepreneurship.
  - Enhance resource allocation and innovation.
  - Spur competition.
- Disproportionately help the poor.
  - Loosen link between access to credit and wealth.
  - Increase the dynamism of labor markets.

Does finance shape prosperity?

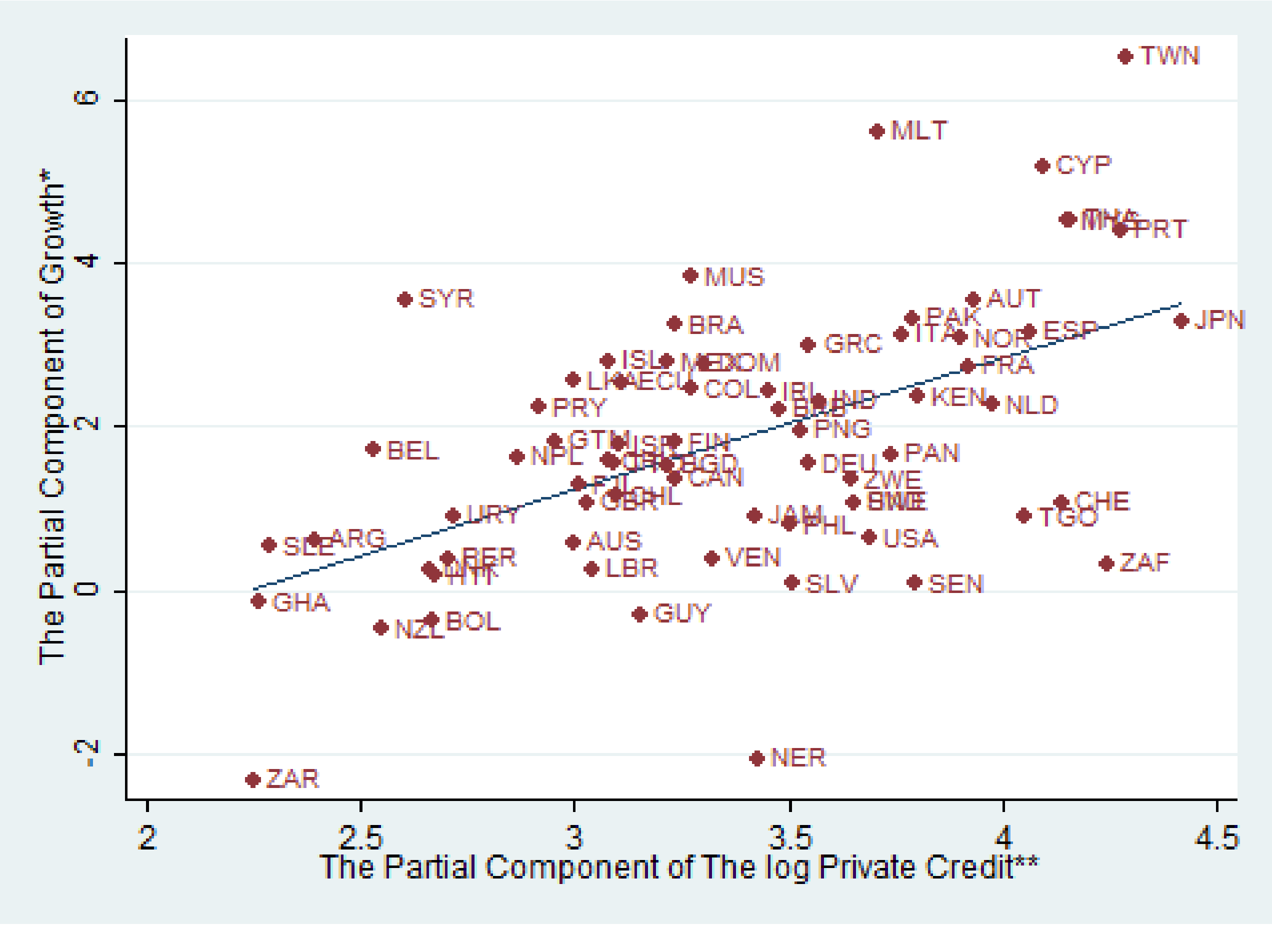
Is the Casino view or Bagehot view correct?

Cross-country regressions

$$Y = \alpha + \beta F + \gamma_1 X_1 + \gamma_2 X_2 + \cdots + \gamma_{n-1} X_{n-1} + \gamma_n X_n + \varepsilon$$

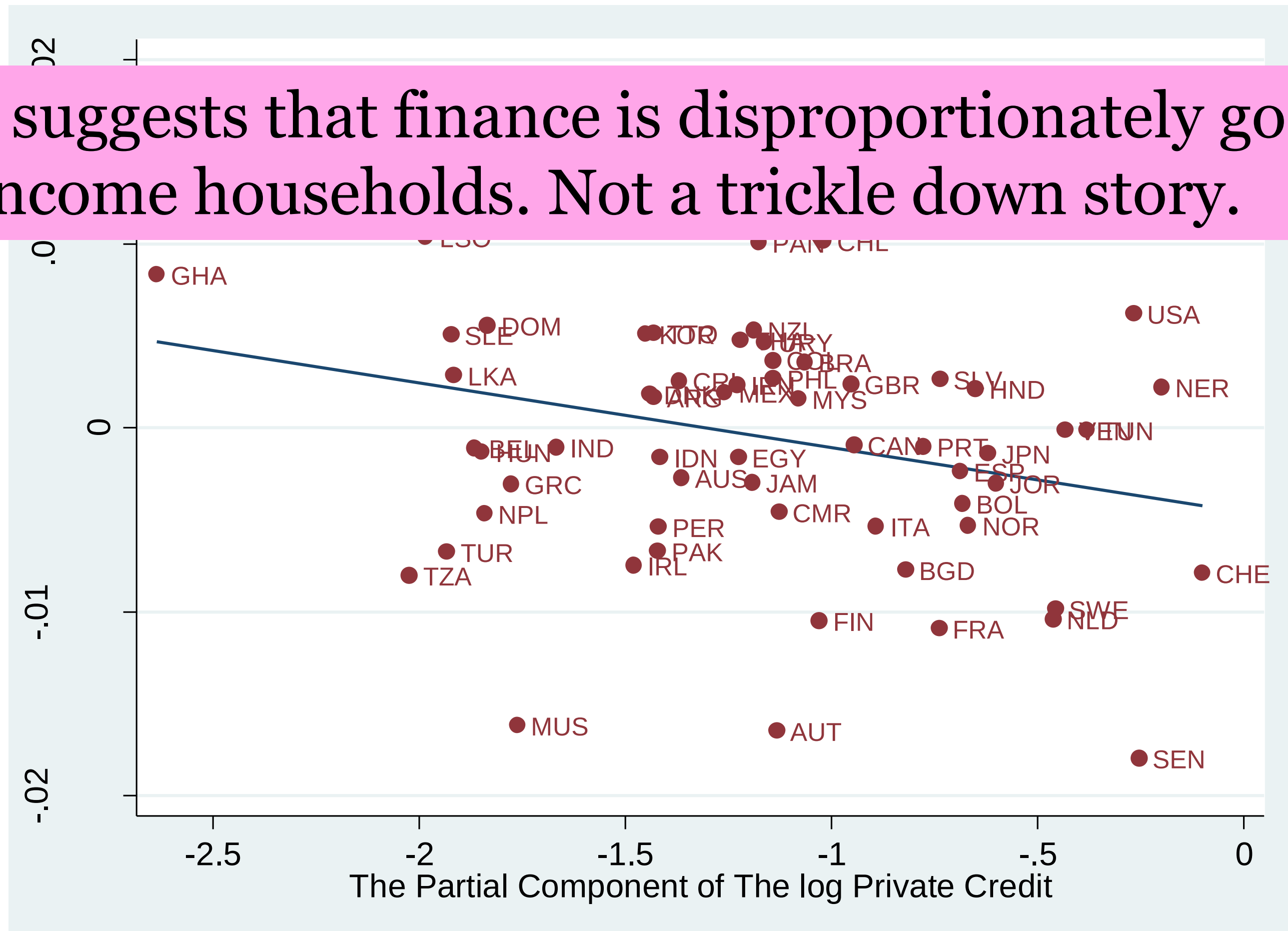
- Y = either economic growth, growth of income inequality, the income of the poor, extreme poverty.
- F = Measure of financial development.
- $X_1 \ldots X_n$ = control variables, such as the level of GDP per capita, education, inflation, deficits, black market exchange rate premia, openness to trade, revolutions and coups, political assassinations, etc.
- Then, I graph the resultant relationship between Y and F: β
- Over the same period, 1960-2005 data permitting.

Finance and growth

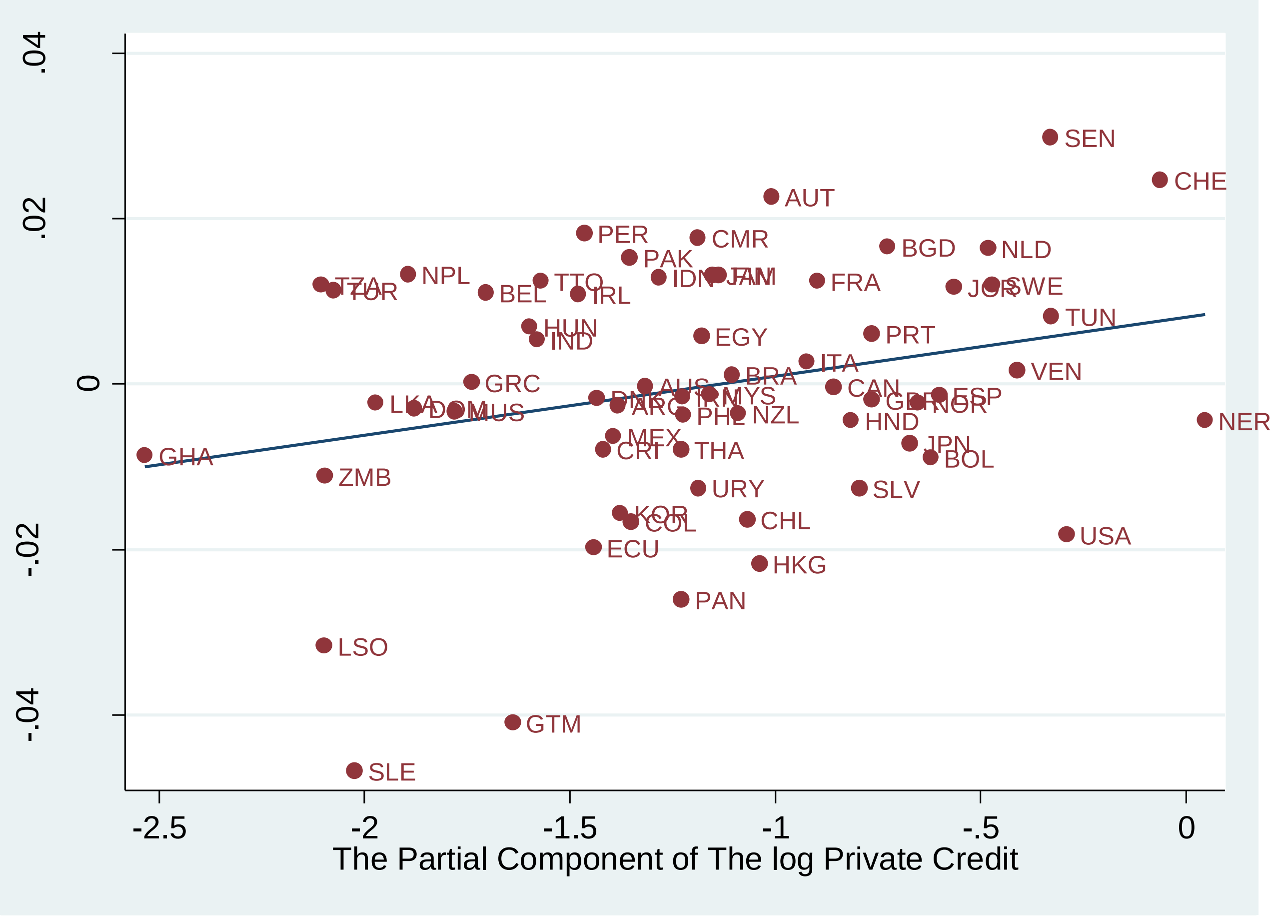


Finance and inequality growth

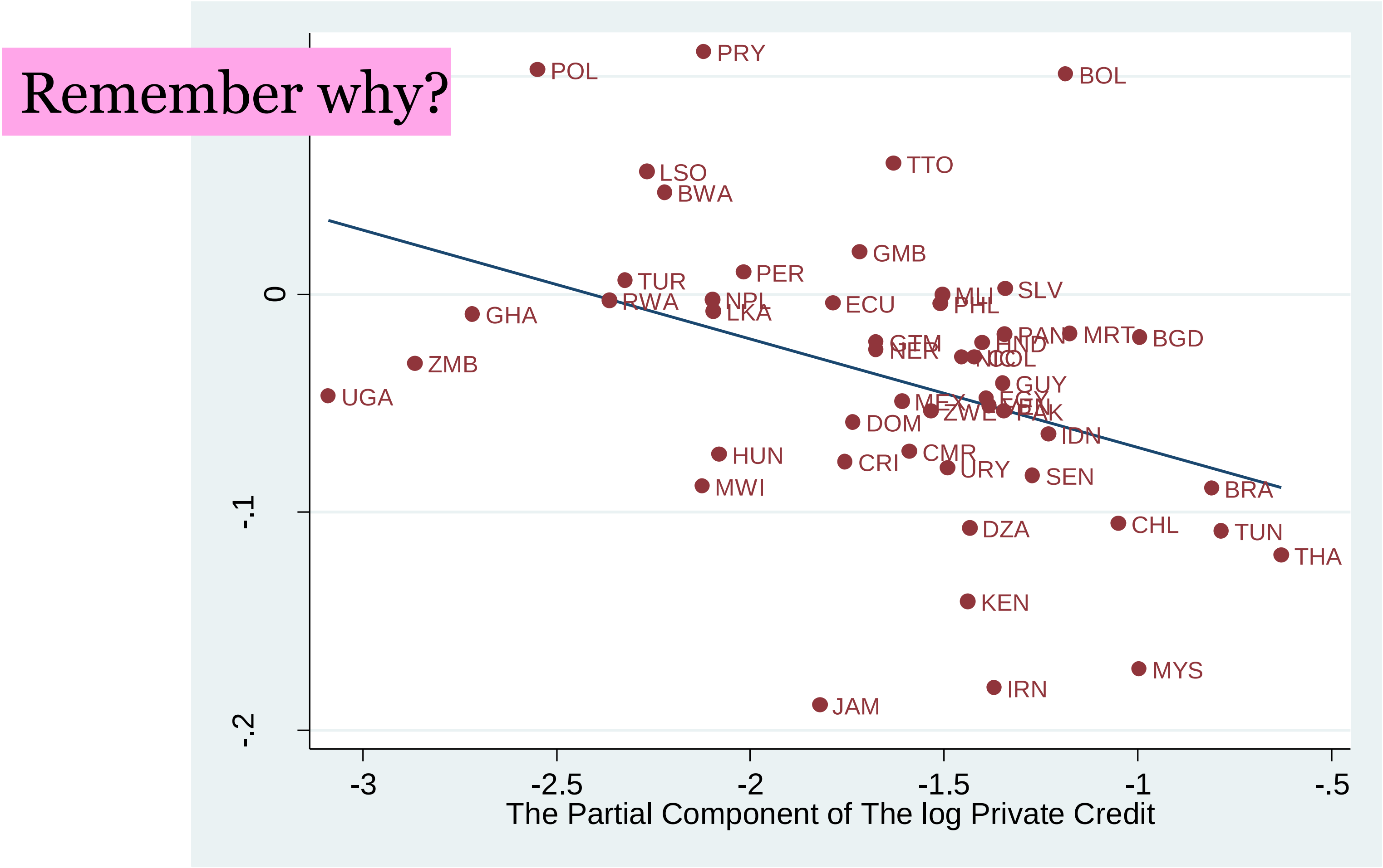
Note: This suggests that finance is disproportionately good for lower income households. Not a trickle down story.



Finance and the incomes of the poor



Finance and extreme poverty



Let's do a different test

- Let's conduct a "quasi-natural" experiment
- We will examine a policy change than improved banks in the different states of the United States in different years.
- Then, we can assess the effect of this "treatment" on outcomes.

A little history

- From the 1800s – 1995, U.S. states controlled:
  - New banking licenses.
  - Branching.
  - Entry of banks from other states.
- They sold local banking monopolies.
  - States sold banking licenses to banks.
  - States protected those banks from competition.
    - Intrastate protection through branching restrictions.
    - Interstate protection by limiting “foreign bank” entry.

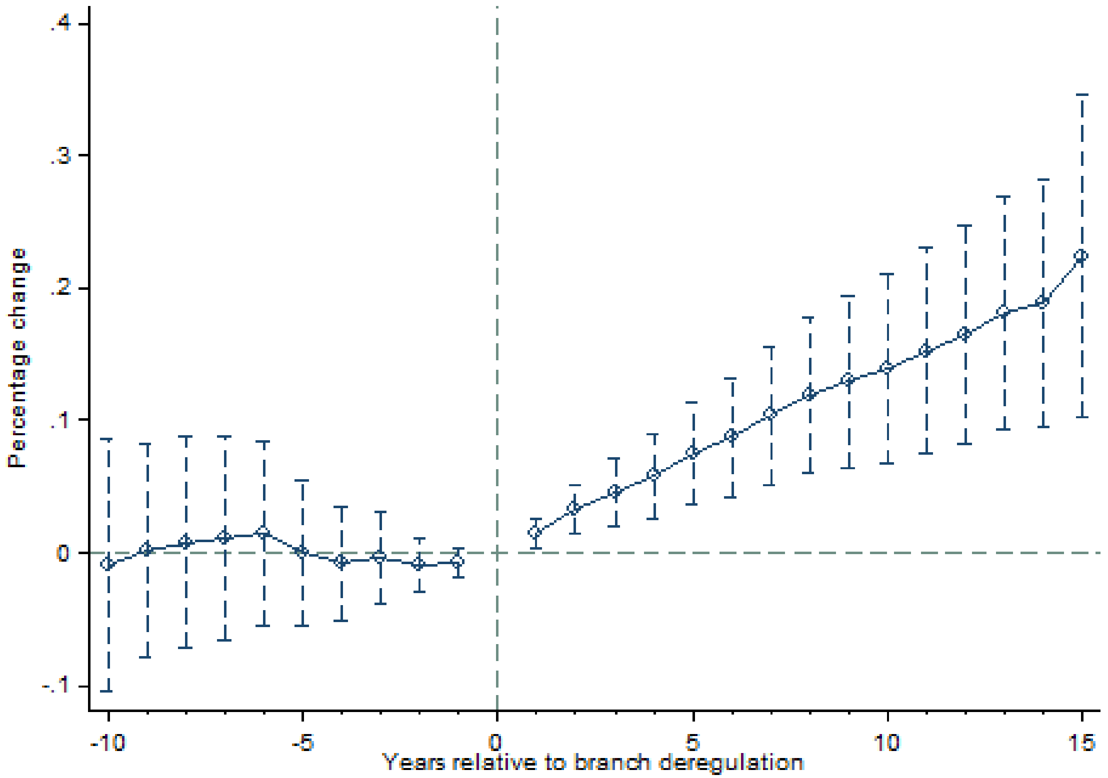
A little more history

- This produced LOTS of banks: ≈30,000 banks! But, little competition.
- Local monopolies created inefficiencies:
  - Good ol’ boys network.
  - Perhaps, restricting opportunities, hurting entrepreneurship, slowing growth, reducing the demand for labor, etc.
- Local monopolies also created:
  - large profits for protected banks and hence
  - a rich constituency for keeping those regulatory protections.

The end of history

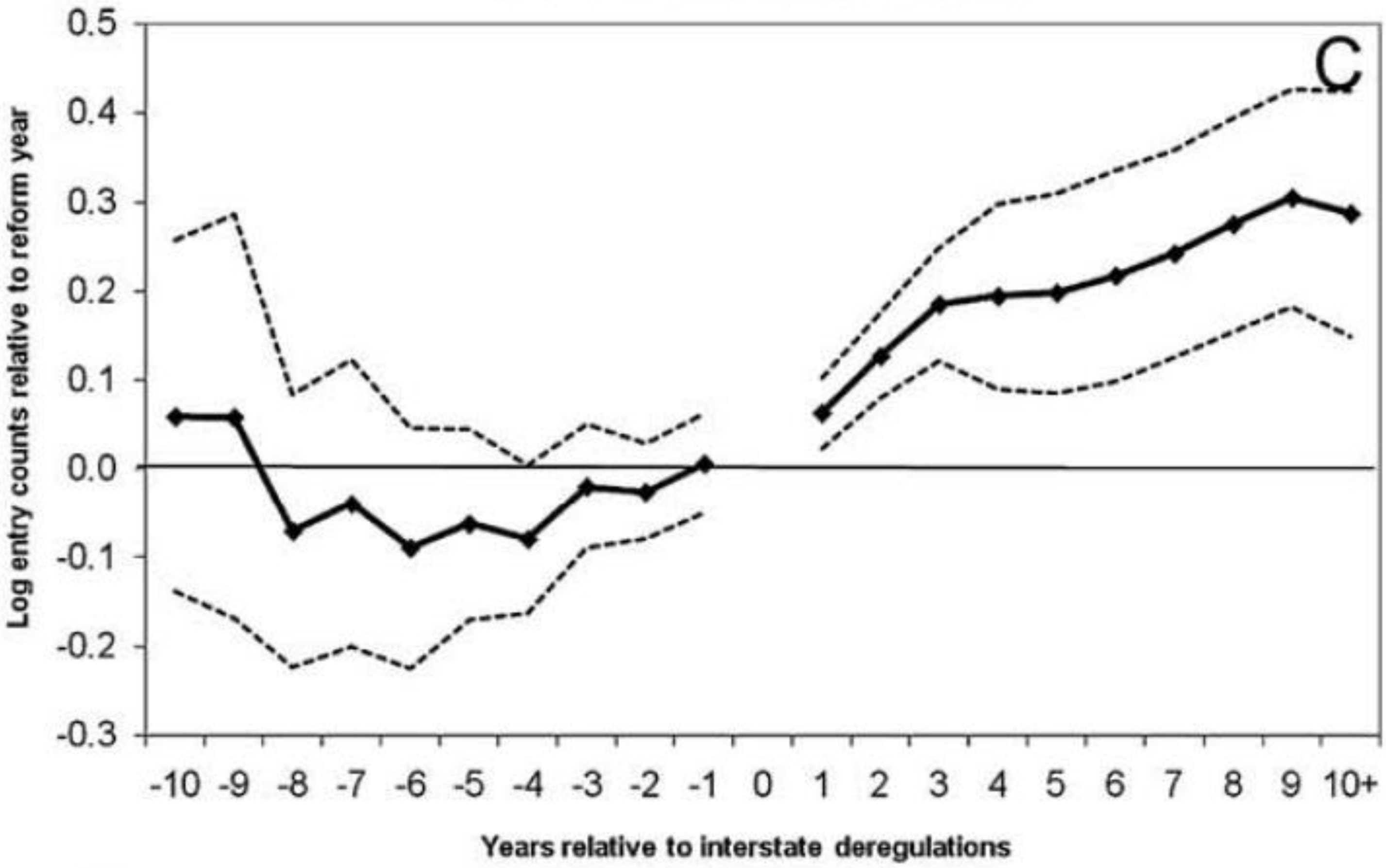
- What changed? Was it a recognition of the inefficiency of those regulatory protections?
  - No. People knew, but the bankers thwarted reform.
- Technology changed.

Competition and state growth

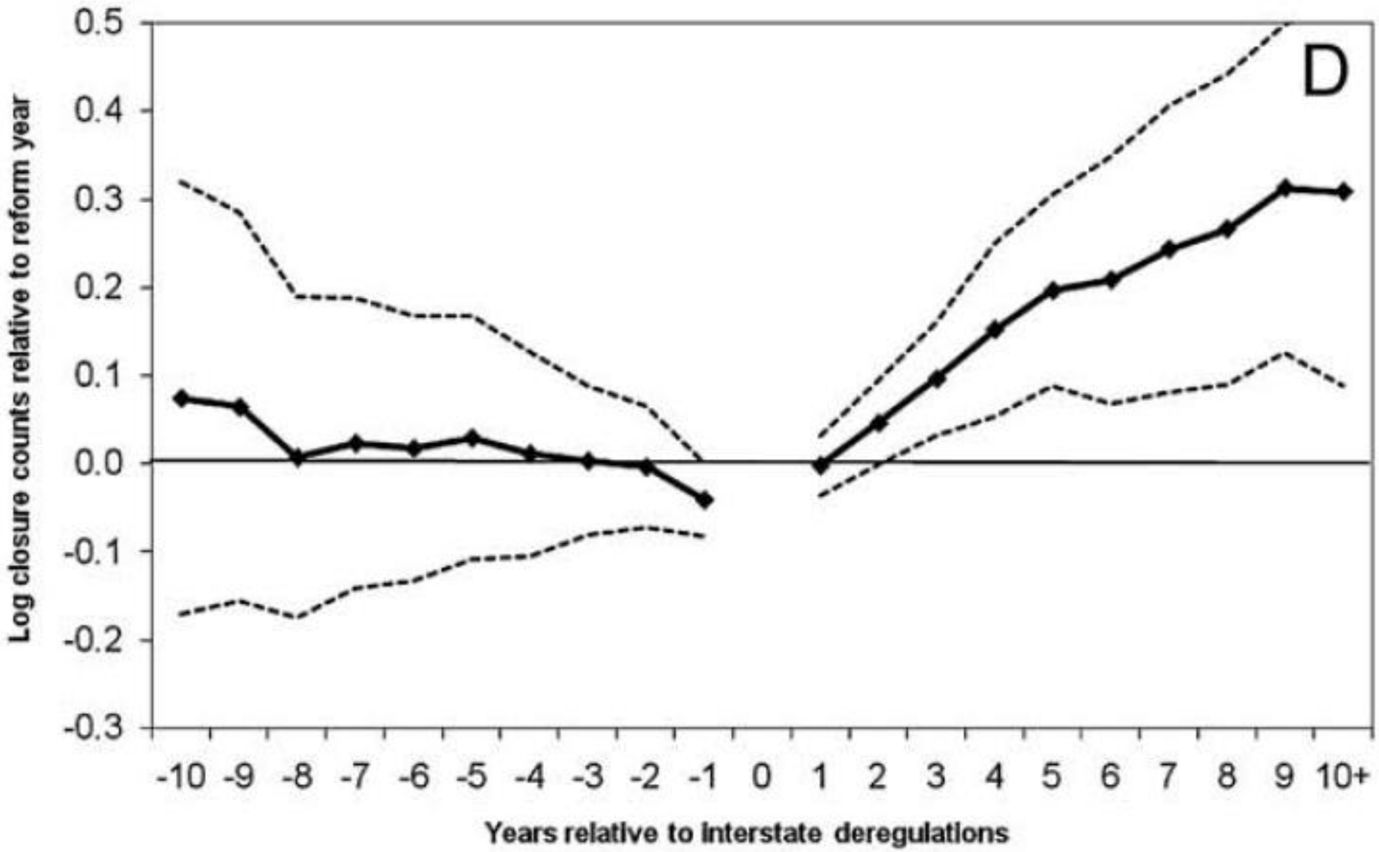


$$\log(GSP)_{st} = \alpha + \beta_1 D^{-10}_{st} + \beta_2 D^{-9}_{st} + \ldots + \beta_{25} D^{+15}_{st} + \mathbf{A}_s + \mathbf{B}_t + \varepsilon_{st}$$

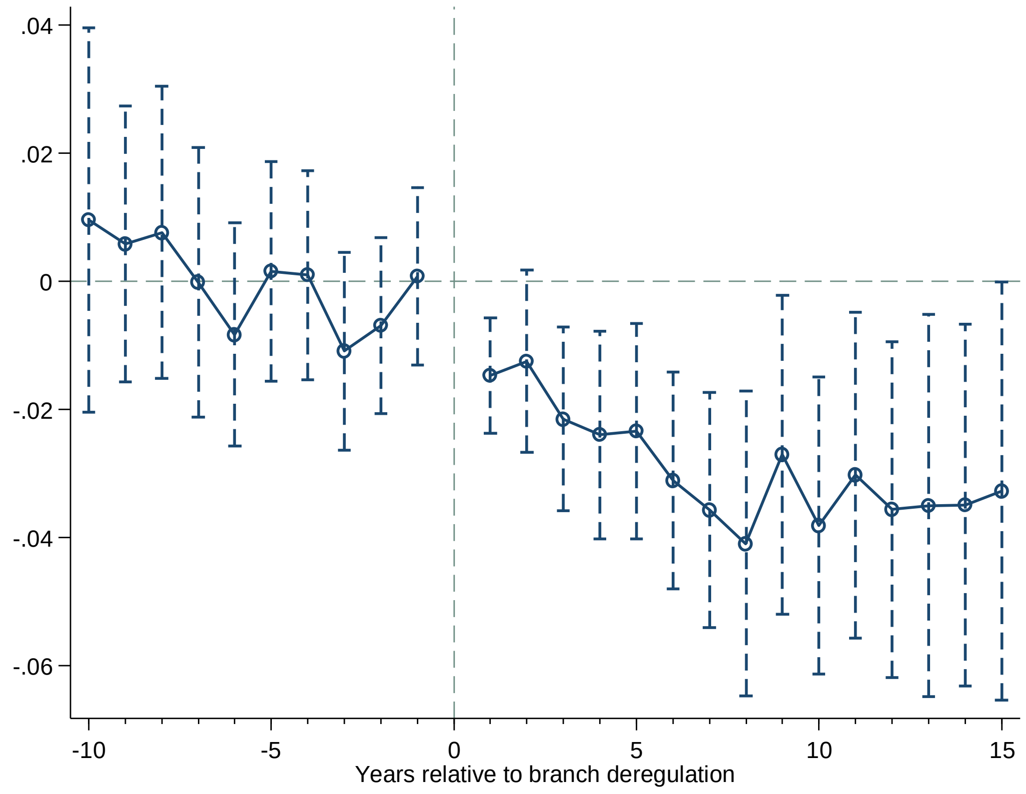
The entry of new firms?



The exit of old firms?

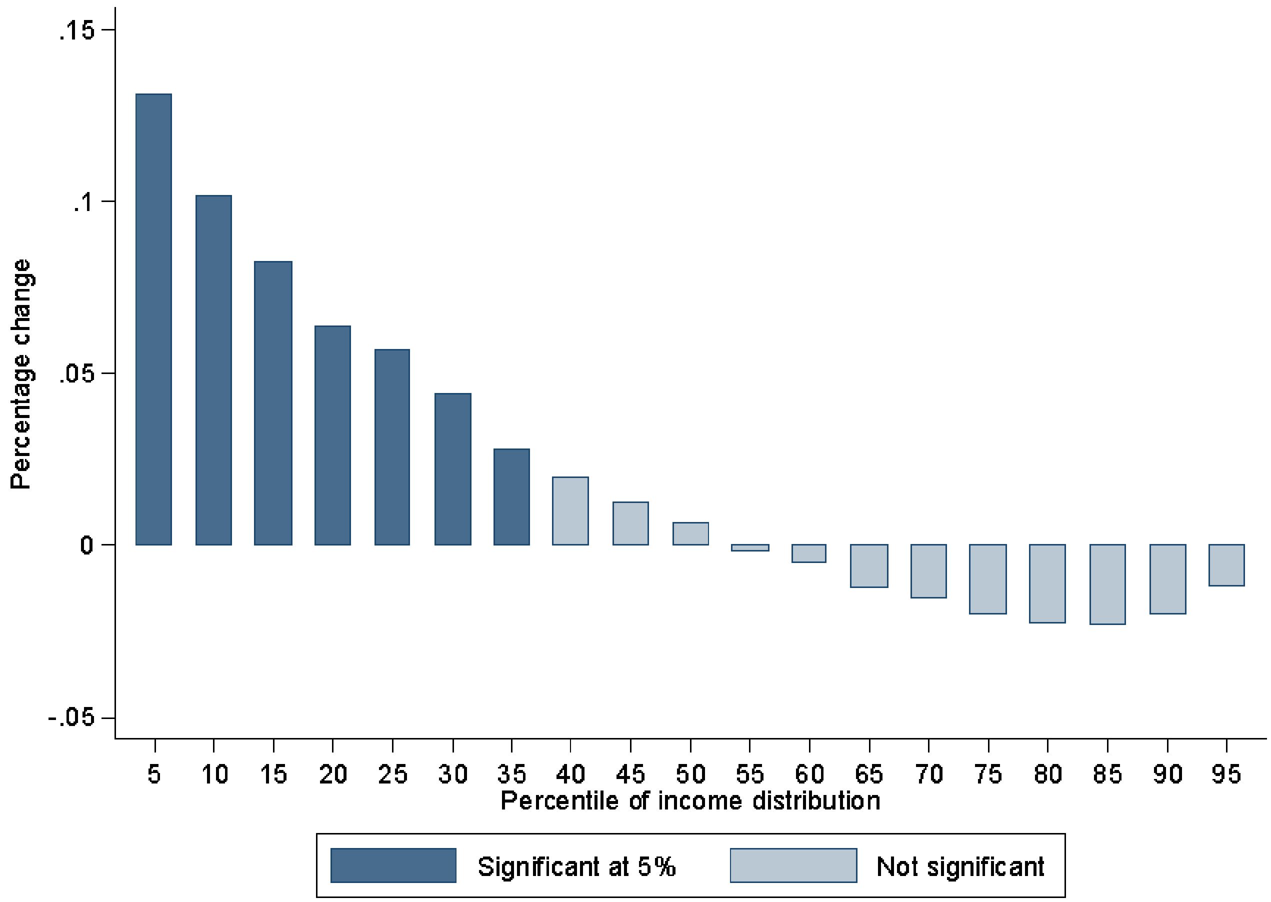


Competition & state inequality



$$\log(\text{Gini})_{st} = \alpha + \beta_1 D^{-10}_{st} + \beta_2 D^{-9}_{st} + \ldots + \beta_{25} D^{+15}_{st} + \mathbf{A}_s + \mathbf{B}_t + \varepsilon_{st}.$$

Competition and wage growth



This reports the estimates of γ from 19 separate regressions of the following form:

$$Y(i)_{st} = \alpha + \gamma D_{st} + A_s + B_t + \varepsilon_{st}$$

where $\mathrm{Y(i)}_{st}$ is the logarithm of ith percentile of income distribution in state s and year t.

Does finance shape prosperity?

Yes.

Regulating for prosperity

- A few thoughts on better, worse, and worst approaches.
- (TBTF is a prosperity issue, not just a crisis issue.)

Regulating for prosperity strategies

- Better
  - Focus on incentives of decision makers to address TBTF and other problems.
  - Cautious official involvement.
  - Facilitate competition and transparency.
- Worse (EU and much of the world)
  - Don't focus on incentives of decision makers.
  - Massive official involvement.
  - Don't foster competition and transparency.
- Worst (US?)
  - Don't focus on incentives of decision makers.
  - Don't focus on direct regulatory & supervisory oversight.
  - Don't foster competition and transparency.


That's all Folks!