The European Union is in its deepest crisis since its inception. This is on the one hand a financial crisis, and on the other hand a real sector crisis with stagnating economies, rising inequalities and increasing divergence between the countries of the European Union. In the run up to the European elections of 2014 it is of fundamental importance for the European left to clearly define and promote a set of alternative economic and financial policies that can address the long-term structural problems in Europe and their impact on growth, equality and employment.

To this end the Foundation for European Progressive Studies, the Jean Jaurès Foundation and the AIRE research centre of the Leeds University Business School are organizing a roundtable discussion with academics and policy makers to present and discuss ideas for policy measures that can break the nexus between the growth of finance, inequality, and the job drought in Europe. These ideas encompass changes in regulation, financial structure, and financial and investment policies.

The roundtable discussion is aimed at stimulating the intellectual exchange between academics and policy makers and refining the policy proposals in light of policy makers’ experiences. This is considered particularly important in light of the European elections of 2014.
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PROJECT INFORMATION

Finance and Inequality

FEPS, in collaboration with Foundation Jean Jaurès and Leeds University Business School (United Kingdom) have set up a research project with the aim to generate a detailed multi-layered, and multi-locational analysis of the European financial system. Objective of this research project is to formulated concrete policy recommendations for its reorganization and restructuring.

The project brings together scholars from different disciplines (economic and geography) and geographies (both within and beyond Europe) to complement, extend and deepen existing analyses of the European financial sector.

This project aims to answer the following research questions:

1. What is the quantitative and qualitative access to finance of different economic actors in Europe? How does this access relate to different geographic areas and socio-economic characteristics?
2. What are the connections between financial crises, global financial competition, and too-big-to-save megabanks?
3. How viable are smaller, locally based financial intermediaries as sustainable vehicle for carrying out economically-productive loans and for making financial transaction services widely available?
4. Can cross-border capital flows unbalance core-periphery relations?
5. How have the inequality dynamics shaped the changing structure of the European financial system?
6. What concrete policy measures - both in terms of regulation and alternative financial system design - make finance work for all segments of society?

The project will span two years and will include a series of roundtable discussions and policy related writing.

Principal Investigators

Prof. Gary Dymski, Divisional Director of Research, Leeds University Business School (United Kingdom)
Dr Giovanni Cozzi, Economic Advisor, Foundation for European Progressive Studies
Blaise Gonda, External Relations, Foundation Jean Jaurès
Dr Annina Kaltenbrunner, Lecturer, Leeds University Business School (United Kingdom)

Project administrative coordinator: Ischi Graus, Foundation for European Progressive Studies
Selected background material


PROGRAMME

Location: FEPS Office, Rue Montoyer 40, 1000 Brussels

Thursday 23 January 2014

10:30 Opening
Ernst Stetter, Secretary General of the Foundation for European Progressive Studies (FEPS)
Gerard Fuchs, Director of the International Department at the Jean Jaurès Foundation

10:45 Intervention by
Elisa Ferreira, Member of the European Parliament, the S&D Group
Followed by Q&A

11:15 A financial sector to serve a dynamic and fair economy
Stephany Griffith-Jones, Professor and Director of the Financial Markets Program at the Initiative for Policy Dialogue at Columbia University

11:35 Introduction to the “Finance and Inequality” Project
Annina Kaltenbrunner, Lecturer in Economics at Leeds University Business School

11:45 Session 1 - The nexus between inequality and finance and back
What is the nexus between finance, financial crisis and inequality? How have inequality dynamics shaped the changing structure of the European financial system? Has inequality contributed to financial instability at European level? What is the quantitative and qualitative access to finance of different economic actors in Europe? How does this access relate to different geographic areas and social-economic characteristics?

Chair
Thomas Theobald, Researcher at the Institute for Macroeconomic Policy (IMK – Institut für Makroökonomie und Konjunkturforschung) in the Hans-Böckler Foundation

Experts
Rémi Bazillier, Assistant Professor in Economics, Univ. Orléans, LEO, CNRS, Member of the FEPS Scientific Council and the Next Left Focus Group and Jérôme Hericourt, Assistant Professor in Economics, Univ. Lille, EQUIPPE and Research Fellow at CEPII
Marica Frangakis, member of the European Economists for an Alternative Economic Policy in Europe (EuroMemorandum Group)
Shaun French, Lecturer in Economic Geography, Faculty of Social Sciences of the University of Nottingham
13:30  Lunch

14:15  **FESSUD Project: Presentation of results from detailed studies of the financial systems of European countries**
Andrew Brown, Senior Lecturer in Economics at the Leeds University Business School

15:00  **Session 2 - Financial architecture, behavior and regulation: policy proposals for a more stable and equitable financial system**
What financial sector policies will stabilize the European financial system and create a sound and more equitable environment? What is the role of multilateral, regional and national development banks in fostering equitable growth and job creation in Europe? How do we tackle shadow banking practices in order to create stability in the financial sector? How can we regulate financial transactions in order to increase stability of the financial system?

Chair
Giovanni Cozzi, Economic Advisor at the Foundation for European Progressive Studies (FEPS)

Experts
Gary Dymski, Professor in Applied Economics at Leeds University Business School
Daniela Gabor, Associate Professor at the University of the West of England

16:45  **Summary sessions and next steps**
Annina Kaltenbrunner, Lecturer in Economics at Leeds University Business School
Blaise Gonda, External relations at the Jean Jaurès Foundation
Our project aims at investigating how rising inequalities may affect the dynamics of debt and financial crises. While there is an emerging theoretical literature emphasizing the influence of inequalities on the dynamic of the current financial crisis (Rajan 2010, Kumhof, Rancière & Winant 2013), empirical studies are still scarce, especially at the micro level. Our goal is to provide an extensive view of the academic literature on this topic. In addition, we would like to contribute by providing an extensive set of empirical evidences for European countries, showing how the rise of income inequalities has been observed in parallel with the boom of household indebtedness.

**Background**

The boom of top incomes, especially strong in the US and in some European countries have been strongly criticized by an increasing share of public opinion, especially so in countries where they concentrated in the financial sector. The emergence of the 99% movement in the US was a direct reaction to these evolutions and brought debates on the appropriate fiscal policy. Similar movements in...
Europe (The Indignados in Spain) also put a strong emphasis on inequalities. This topic of inequalities did not reach the front page of the newspaper only because inequalities are less bearable in times of crisis. It is also following recent advances in research that show a breakdown in the trend of declining inequalities that was observed in most industrialized countries after the Second World War. Atkinson, Saez or Piketty (see for a review: Atkinson, Saez and Piketty 2011) contribute to the re-emergence of such topic in their researches showing the long-run evolutions of top incomes and inequalities in various countries and the resurgence of growing inequalities after the eighties.

The newest research topic of our project deals with the importance of income inequalities to explain the dynamics of financial crises. Only addressed very recently (since 2010) by few top researchers, this issue points out that the evolutions of inequalities observed after the eighties may constitute a fundamental explanation of the current crisis. Our project builds upon the contribution of Kumhof, Rancière & Winant (2013). They show that a shift of income from the workers to the investors lead to a large increase in leverage and an eventual financial and real crisis. Conversely, Bordo and Meissner (2012) provide macroeconomic evidence against the existence of relationship between finance and inequalities: no robust causal relationship between financial crises and inequalities emerge from their sample. Challenging empirically their results using microeconomic data will be, among others, an important task.

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**Finance, Inequality and Crises: some disturbing stylized facts**

*This is not the first time ! And we know how it ends...*

**Comparison with the Great Depression (30's)**

*Source: Kumhof, Rancière & Winant (2013)*

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**Figure 3. Wealth Inequality**
FIGURE 1. INCOME INEQUALITY AND HOUSEHOLD LEVERAGE

FIGURE 2. DEBT-TO-INCOME RATIOS BY INCOME GROUP

FIGURE 6. DEBT-TO-NET-WORTH RATIOS BY INCOME GROUP

FIGURE 7. UNSECURED DEBT-TO-INCOME RATIO BY INCOME GROUP
Figure 4. Size of the Financial Sector (Value Added/GDP)

Figure 5. Leverage and Crisis Probability
Not only in the US...

Figure 5. Countries with Large Financial Sectors (2006). This figure plots the 2006 level of credit to the private sector over GDP (PC) for all countries that in 2006 had values of PC > 90%. The vertical line is at PC = 110%.

Source: Arcand et al. (2012)
Too much Finance?
Figure 1. Marginal Effect Using Cross-Country Data. This figure plots the marginal effect of credit to the private sector on growth obtained from the regression of Table 1, column 6.

![Graph showing the marginal effect of credit to the private sector on growth.]

Source: Arcand, et al. (IMF WP, 2012)

Figure 2. Semi-Parametric Regressions. The solid black line plots the relationship between credit to the private sector obtained by allowing credit to the private to take a generic functional form. The dotted lines are 90% confidence intervals and the light solid line plots the quadratic fit of columns 6, Table 1.

![Graph showing semi-parametric regressions.]

Source: Arcand, et al. (IMF WP, 2012)
Financial architecture, regulation, and behavior: 
Policy proposals for a more stable and equitable financial system

Gary A. Dymski 
Leeds University Business School

This brief paper proposes a 10-point reform agenda for creating a more diverse, less crisis-prone, more economically productive European banking ecosystem. The financial system in Europe (and indeed in much of the global economy) as currently configured – both reflects the effects of three decades of worsening inequality and operates in such a way that it deepens inequality, rather than easing it. The financial markets and practices that have matured in these years of deindustrialization, declining or stagnant real wages, financialization, and deregulation have responded to – and thus naturalized – these trends, rather than arresting them. Profound change is needed. What follows is a proposed list of reforms for addressing the inequality-finance nexus in Europe. This list reflects discussions held to date, and is subject to further improvement.

The reforms proposed fall into three categories: regulation and oversight of the overall system; the structure and functioning of European banks; and the financial rights and security of individual Europeans. These reforms are first briefly listed. There then follows a brief discussion of the trajectory of European banking and a more detailed elaboration of this ten-point agenda.

A proposed 10-Point Policy Agenda for Inequality and Finance in Europe

Regulation and oversight of European banking and financial markets
1. Reform the mandate of the European Central Bank (ECB) to include employment (unemployment rate) targets, and make the ECB democratically accountable.
2. Reform financial supervision so that it limits risk-taking and fills in regulatory gaps.
3. Establish a financial transactions tax on short-term position-taking, and an excess profits tax on large banks operating in Europe.

Structure and functioning of European banking and financial markets
5. Establish more pluralistic banking systems that better meet local community banking needs.
6. Reinvent the European Investment Bank (EIB) so that it functions more effectively as a tool for economic and social development throughout Europe.
7. Create a set of national development banks that function as strategic allies of both the EIB and of member countries’ governments.
The financial rights and financial security of everyday Europeans

8. Set trans-European limits on predatory lending.
9. Establish the concept of financial citizenship for Europeans.
10. Create and begin to implement a timetable for standardizing unemployment compensation benefits, public pensions, and old-age care across Europe.

Context: The past, present and future of banking in Europe

Since 2008, financial crisis followed by macroeconomic austerity policies have created a toxic global trajectory of stagnant macroeconomic growth, redundant and insecure labor, widening inequality, and asset-market bubbles.

One of the roots of this toxic path is the behavior of megabanks and of the web of shadow banking with which they are linked. The collapse of the leveraged system of subprime securitization from 2007 onward compromised liquidity in global money markets, shook confidence in global bond markets, and rocked the hyper-leveraged derivatives (interest-rate swaps and credit-default swaps) markets with which these markets had become intertwined. Public authorities were forced to take unprecedented emergency actions – including buying underwater instruments at par (quantitative easing), using public resources to bolster bank equity, and expanding too-big-to-fail protection - to prevent the collapse of their financial markets and of their national-champion megabanks.

These measures have not restored credit availability for businesses, especially small and medium enterprises; nor have housing markets normalized. In much of Europe, bank credit has dried up. The vacuum is being filled by predatory lenders and by hedge funds, largely outside effective regulatory oversight. Spanish, Greek, and other housing markets have become the site of extensive speculative housing purchases by new sets of investors, including hedge funds and megabanks. UK housing markets have recovered through public underwriting of low-down-payment (and thus lightly collateralized) mortgage loans.

In consequence, most of Europe has been transformed into a low-interest rate, low aggregate-demand, high-unemployment environment in which few non-financial businesses dare to invest – and those that do often lack the finance to carry it out. Households are navigating slim employment prospects while their anticipated future income from privatized retirement schemes shrinks. European Megabanks have largely survived: they are shedding lower-return activities and recalibrating their leveraged shadow banking activities for the post-crisis landscape. With one eye on Wall Street and another on the City of London, they are fending off re-regulation efforts in Basle and Brussels and protecting their freedom of action (to take on leverage, to go long or short on European nations’ sovereign debt, to keep or shed non-performing assets).

In short, Europe’s financial system has not returned to ‘normal;’ it will not, and it cannot. The normal banking system we carry in our heads died in the 1980s and 1990s. It was replaced by a system that hurtled into the originate-to-distribute, securitization-driven, risk-hedged future so fast and furiously that no stability – no ‘new normal’ – was ever achieved. This new system of finance fed off the special circumstances of the neoliberal era: declining wages and rising living costs; the shift from social housing to market-based housing and the ‘ownership society’; an emerging pool of largely unregulated
(or offshore) investors seeking the above-market-rate returns available from holding – and making zero-sum derivatives bets on – higher-risk assets.

So it is no use thinking of restoring the ‘normal’ functioning of the banking system via an appropriate set of regulatory offsets and guidance bulletins. The financial system should be rethought and rebuilt from the bottom up, working from first principles regarding what purposes it serves in the broader economy.

**Policy proposals for a more stable and equitable financial system**

The following list elaborates the ten proposals for reshaping European finance in more detail than was provided above. The idea is to develop a comprehensive agenda and to respond to current debates. Some of these proposals would require changes in the treaties underlining the European Union; others would require changes in national laws and regulation.

**Regulation and oversight of European banking and financial markets**

1. Make three critical reforms to the mandate of the European Central Bank (ECB). First, the ECB’s policy objectives should be broadened to include, alongside price inflation, employment (unemployment rate) targets. Second, the ECB must also be made democratically accountable to the citizens of Europe; it should regularly report on and explain how it is meeting its inflation/employment targets. Third, it has to be made clear that the ECB has lender-of-last-resort responsibilities that entail protecting the liquidity of the money markets of all European member nations.

2. Reform European banking and financial-market supervision so that it is forward looking, establishes firm limits on bank/non-bank risk-taking, controls the interconnectedness among different financial functions and markets, and fills in regulatory gaps. Split Europe’s financial markets and institutions off from the global-megabank competition in which Wall Street and the City of London are engaged by setting limits on banking activities, over-the-counter derivatives, trading on ‘own account’, leveraging of risky activities, credit-default swaps, and similarly risky financial vehicles. Require more balance-sheet transparency and outlaw tax-haven activities within the European Union. Further, it is crucial to establish regulations on – or to prohibit – hedge funds, limiting their penetration of European credit or asset markets. These shifts should make it feasible to reform Europe’s money markets and interbank markets so that they are clear, transparent, and de-complexified.

3. Establish a financial transactions tax on short-term position-taking; and establish an excess profits tax on large banks operating in Europe. For the latter tax, profits should be calculated prior to the payout of bonuses or dividends. These taxes’ proceeds should be used to finance development banks, CDFIs (community development financial institutions), and European Union unemployment insurance.
Structure and functioning of European banking and financial markets

4. Eliminate the too-big-to-fail problem by setting size limits on banks’ on-balance-sheet and off-balance sheet activities. Size limits should be set based on each member nation’s GDP. Establish a centralized, rapid resolution mechanism for banks in danger of becoming insolvent. The resources for this mechanism should be provided through establishing uniform Europe-wide deposit insurance and, in turn, a percentage pay-in to a deposit insurance fund for European banks.

5. Establish more pluralistic banking systems designed to respond to local community banking needs – especially the working-capital needs of small and medium enterprises. Revitalize financial institutions that draw on traditional national forms. Encourage cooperatives and community-based initiatives (CDFIs). Develop criteria for more economically-functional banks and apply them at the national regulatory level.

6. Renew the mandate of the European Investment Bank (EIB) so that it embodies more characteristics of the Brazilian National Bank for Economic and Social Development (BNDES). Specifically, make EIB as a vehicle for nurturing European infant industries in potential growth areas for the global economy; ensure that the EIB supports social as well as economic activities, and that it supports SMEs as well as larger enterprises. Permit the EIB to take equity positions in the industries it supports. Also ensure that the EIB receives a fiscal injection from the European Union budget.

7. Create a set of national development banks that function as strategic allies of both the EIB and of member countries’ governments. National development banks’ interventions into credit and venture-capital markets should be aimed at building industrial capacity and equitable development.

The financial rights and financial security of everyday Europeans

8. Set trans-European limits on predatory lending. There is a need to rein in unregulated lenders who set payday lending rates at very high rates, as they do the lending rates on other short-term loans for lower-income people. Given the Single Market principle, it would be useful to ensure that informal and lower-income lenders must comply with standardized limits.

9. Establish the concept of financial citizenship for Europe, including voice and exit rights for European citizens. The citizenship concept should include the idea of a right to a bank account no matter the level of income, the right not to be subjected to predatory lending, and the right to be protected from the threat of duplicitous, misleading lending offers and excessive fees.

10. Create and begin to implement a timetable for standardizing unemployment compensation benefits, public pensions, and old-age care across Europe. The ever greater mobility of workers across Europe suggests the need for unemployment compensation and pension funding schemes that encompass
the whole of the Eurozone and are funded at the federal (Eurozone) level. Pension levels should be set based on living costs in individuals’ home nations, and pensions should be co-funded by the European Union and by national governments. The demographic shifts that are now underway in most countries suggests the need to harmonize these policy changes with healthcare policies across the Eurozone.
The nexus between inequality and finance and back

Marica Frangakis
Alternative Economic Policy in Europe (EuroMemorandum Group)

The outbreak of the financial crisis in 2007/2008 has been attributed to a host of factors, proximate and fundamental. Thus, the excesses of finance constitute a proximate factor, i.e., one that is clearly discernible. On the other hand, more than five years later, the fundamental causes of the crisis remain a contested area. Inequality in the distribution of income and wealth is such a fundamental factor. Distributional issues have been largely outside the mainstream discussion of economic ideas in the past thirty years or so. They were first expelled with the onset of Neoclassical economics in the 19th century and again with the displacement of Keynesian economics from the 1970s onwards. As a result, the significance of distribution for the workings of the economy and its implications for economic and social stability are overlooked both in economics as a discipline and in the formulation of policy. In fact, it may be argued that the manifest inability of mainstream economists to detect the coming of the crisis can be attributed to this gross omission! The global financial crisis and the economic crisis that ensued have led to a renewed interest in the field of distribution and its links to finance, the currently dominant form of capital.

The financial crisis of 2007/2008 was indeed preceded by the exorbitant growth of the financial services sector, closely associated with the spreading use of information technology and the deepening inequality of the distribution of income and wealth.

Thus, finance acquired a dominant position in the economy and its governing institutions both at the national and international level, a phenomenon which has become known as ‘financialisation’. Indeed, financialisation is an important part of the neoliberal setup that prevailed after the 1980s, while, in turn, economic policy enhanced the role of financial capital at the expense of labour and of small businesses. As with distribution, attention has refocused on the area of finance and its role in economic and social developments, not only by academics, but also, and even more importantly, by social actors.

The tendency of deepening financialisation started in the USA, only to spread to Europe within a short while, as the European elites emulated the US model. Thus, the notion of the single market was formalized and diligently applied across the E.U., while special effort was made to encompass the financial sphere. In this respect, a monetary union based on strict fiscal criteria was set up, while the financial services sector was lightly regulated and even more lightly supervised.

The increasing weight of finance in the EU economy was combined with a changing structure of the sector, as well as nature of banking, as disintermediation prevailed over relationship banking, while the role of the financial markets was enhanced. As a result, the banking sector has become highly concentrated, while securitization (‘originate and distribute’ model of banking) has given rise to shadow banking, that is, an array of institutions providing financial services, albeit operating outside the regulatory framework. Corporate governance in the financial sector has adjusted accordingly, pursuing the short-term maximization of profit and recording impressively high rewards. The financial elite that
thus emerged are directly involved in formulating policy, whether by way of lobbying or by way of taking on government office.

These arrangements were called into question when the financial crisis broke out. The response of the EU was to rescue the banking sector with national means, even if this meant violating the EU competition rules, and to turn the screw of austerity on European society, in an attempt to contain the mounting public debt. The brunt of this policy was felt especially hard by the people in the European periphery, which is being coerced into severe deleveraging both on the private and on the public level, irrespectively of its implications for social cohesion and democracy. By contrast, financial policy reform in the EU has been slow and so far ineffective in changing the rules of the game. The power of finance in influencing policy explains to a large extent the ineffectiveness of the EU.

The flipside of the increasing dominance of finance in the EU is the worsening distribution of income and wealth. More specifically, the EU policy of ‘wage moderation’ has intensified the long-run phenomenon associated with capitalism, viz. the declining labour income share, which, in turn, has weighed heavily on growth and employment. The austerity policies pursued widely in the EU and, with special vehemence, in the periphery countries has exacerbated these tendencies, while the resistance put up by organized labour has been subdued. Finance has been instrumental in these developments. For example, the I.L.O. estimates that a little less than one-half of the decline in the labour income share in developed countries is due to financialisation.

Understandingly, the inequality in personal income distribution is also high and increasing, especially in relation to the tails of the distribution, while there are large divergences across the EU member states. Poverty and household indebtedness are on the rise as wages are pressured downwards. On the other hand, employee compensation in the financial sector is both higher than the national average in most EU countries, and more resilient to pressure. However, it is the scandalously high rewards of financiers, in combination with a favourable tax regime, that are driving the high end of income distribution.

Overall, economic and social developments in the EU since the 1970s have led to the rise of finance as a dominant area of economic activity and political influence. This has exacerbated the inherent tendency of capitalism towards inequality both indirectly, through the workings of the economy, and directly, through the outright intervention of finance. The financial crisis had only a temporary dampening effect on the ever expanding financial sphere. EU policy has generously supported finance, as opposed to society at large, which is expected to pay the price of the crisis through strict austerity policies. These trends and the policies supporting them are however destabilizing the economy, while they are undermining social cohesion and democracy. They have to be stopped as a matter of urgency and to be reversed, as far as possible. This is the challenge faced by the Left in Europe. Taking up this challenge will shape the future of Europe and of the world, insofar as the influence of European affairs extends well beyond Europe itself.

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Capitalising on Financial Precarity: Rethinking the Finance/Inequality Nexus

In contributing to the roundtable discussion I want to address the fundamental question of the relationship between finance and inequality, in the context of the changing structure of the European retail financial system, and broader debates about access to finance. More particularly, I want to argue that the financial crisis has not only drawn critical attention to the role that indebtedness plays in the production of inequality, but has also acted as a catalyst for a more general reconfiguration of the nexus between finance and inequality. In so doing the financial crisis has called into question the efficacy of the financial exclusion discourse that has dominated progressive academic and policy debate since the mid-1990s. Instead I want suggest that the concept of financial precarity offers a more productive basis for formulating policy measures to break the nexus between finance and inequality.

There are two important caveats to this argument. First, my focus is primarily on the relationship between the mass or retail financial services sector and processes of inequality. Second, in making this argument I draw principally upon the experience of the UK. While caution clearly has to be exercised when generalising from the particular, the UK is instructive in two respects. First, the UK is an exemplar neo-liberalised European economy, at the vanguard of processes of financialisation. Second, and as a consequence, the problem of financial exclusion is particularly acute in the UK and has long been recognised as a critical manifestation of, and causal factor in inequality.

Pre-crisis: Financial exclusion and financial inclusion policy

Financial exclusion is used to refer to the way in which particular individuals and social groups are explicitly or implicitly denied access to mainstream financial services, and the consequent detrimental impact this can have on the life chances of those so excluded. Individuals, households and communities are excluded from mainstream finance by a range of physical and institutional barriers that include practices of ‘red lining’, the withdrawal of financial infrastructure from poor and deprived communities, pricing and marketing strategies, and a lack of knowledge of products and services. In order to address such barriers to access and thus facilitate the social and economic integration of excluded individuals and communities a consensus has emerged, since the late 1990s, of the need to promote and facilitate financial inclusion. Not only as a means to reduce the dependence of the poorest and most vulnerable in society on the high-cost services of fringe and often illegal financial services providers, but because there is an assumption that the financially included are better equipped to address other vectors of inequality such as unemployment. In the UK the focus of financial inclusion policy has been two-fold. First, much effort has been put into reducing the number of people without bank accounts through such initiatives as the introduction of basic bank accounts. Second, wide ranging programmes of financial education designed to improve rates of financial literacy. Financial literacy
programmes have, in turn, become central to wider international policy efforts (see, for example, OECD, 2009).

The record of financial inclusion programmes in the UK, however, is mixed. On the one hand, there has been a significant and welcome reduction in the number of the unbanked. On the other hand, financial inclusion programmes have been much less effective in tackling other aspects of exclusion such as geographical barriers to access. Banks in the UK have, for example, been able to continue to close a disproportionate number of branches in poorer communities’ largely unimpeded (see Table 1). Moreover, a number of contradictions have become apparent that challenge the financial exclusion/inclusion paradigm. Two are of particular note. First, there is little hard evidence to suggest that the reduction in levels of financial exclusion has had a significant impact on levels of inequality. Inequality in the UK has continued to rise not only in spite, but partly as a consequence of efforts to increase rates of inclusion. Indebtedness has arguably become as much a contributory factor, as a manifestation of inequality. Second, financial institutions have become increasingly adept at extracting profits from those on lower incomes, especially in relation to the sale of debt products. As more and more of those on lower incomes have become integrated into the circuits of mainstream finance so banks and other providers of credit have developed sophisticated technologies for stratifying and segmenting borrowers, the potentially catastrophic consequences for low income households are starkly illustrated in the case of the sub-prime mortgage crisis in the US.

Post-crisis: From exclusion to precarity

The financial crisis has been the catalyst for both a sustained attack on real household incomes as well as a rise in forms of underemployment and labour market precarity. Faced with growing public sector deficits, as a consequence of state bailouts of the banking sector, falling tax receipts and rising welfare spending governments throughout Europe have embarked on a series of neo-liberal reforms. The corporate sector has similarly responded to the crisis by adopting a strategy of wage deflation and increasing the flexibility of labour through the greater use of part-time and zero hour contracts, for example, driven in many cases by the financialised logic of shareholder value.

Rising inequality and precarity have in turn led to a double movement in the retail financial services sector. On the one hand, there has been a new round of credit rationing whereby those poor, precariously employed, and marginally included in the banking system have found it more difficult than before the crisis to access mainstream forms of credit such as mortgages, loans and credit cards. On the other hand, we have witnessed a redoubling of efforts on the part of finance to capitalise on rising inequality. This is exemplified by the extraordinary growth of the high-cost, short term payday lending market. Alternative providers of high cost financial services and products such as payday lenders, cheque cashiers, pawn brokers and logbook loan companies have rapidly expanded in the UK (see Table 2) in a bid to profit from the growing number of people whose lives have become increasingly precarious. Whereas in the past those excluded from mainstream banking services had to rely on nefarious providers of fringe finance such as loan sharks and the home credit company Provident Financial, in the post-crisis present the provision of high-cost credit and other services such as cheque cashing has gone mainstream. The transformation of fringe finance into a more respectable and highly
lucrative billion pound industry, driven by and in the image of the US payday lending industry, represents a significant step change in longer run processes of financial segmentation. A new development that serves to further destabilize the financial exclusion/inclusion dichotomy in at least two ways. First, it is clear that alternative financial services providers are intimately bound up with, and are indeed dependent on the coordinates of mainstream retail finance. The payday lending business model is premised, for example, on the fact that borrowers have a bank account to ensure efficient and cost effective - at least from the perspective of the lender - debt service and repayment. In this sense payday lending represents a form of capitalisation of financial inclusion. Second, the payday lending sector in the UK is itself financed in part by the very same high-street banks, eager to share in the profits of precarity without directly bearing the risks, whose credit rationing practices have played a significant part in the rapid growth of the high-cost, short-term credit sector in the first place. In this sense the payday lending sector operates more like an extension of the mainstream retail financial services sector, than a separate sphere.2

Conclusion: Towards a concept of financial precarity

This brief analysis of the current reconfiguration of the UK retail financial services sector raises fundamental questions about how we should understand the nexus between retail finance and inequality, and the appropriate policy response. The experience of subprime mortgage markets in the United States in 2007-8, coupled with the tightening of the prudential regulation of financial institutions, has undoubtedly engendered a renewed phase of credit rationing to the detriment of those on lower incomes. However, the crisis has also provided a catalyst for a further deepening of the segmentation of retail financial services in increasingly complex ways that are not easily reconciled with the concept of financial exclusion. In concluding I want to argue that the logics of the current conjuncture, and the complex and differentiated relationships that are emerging between retail finance and inequality might be more fruitfully captured by the concept of financial precarity. Drawing inspiration from the literature on precarious labour markets (cf. Gill and Pratt, 2008), I use the term financial precarity to refer to all forms of financial relations, products and/or services that produce or reproduce precarious, unstable and insecure forms of living. By focusing on the development of policies to address financial precarity - for example in terms of the introduction of a European wide cap on interest rates or new regulations on rolling over personal loans - rather than attempting to reduce financial exclusion, offers greater potential to break the complex relays that now exist between retail finance and inequality. This is not least because it lays bare, and forces us to attend to the many ways in which retail finance intersects with other forms of precarity, whether that be in the sphere of employment, housing or education.

2 There are strong comparisons here with the manner in which many UK mortgage banks have sought to profit from self-certified and buy-to-let mortgage markets by establishing shell companies (Leyshon and French, 2009).
References

Table 1: Branch network changes of the major bank and building societies by supergroup area, Great Britain, 1989-2012.

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</thead>
<tbody>
<tr>
<td>Industrial Hinterlands</td>
<td>1,873</td>
<td>1,524</td>
<td>1,431</td>
<td>-349</td>
<td>-18.63%</td>
<td>-93</td>
<td>-6.10%</td>
<td>-23.60%</td>
<td>12.62%</td>
<td>13.83%</td>
</tr>
<tr>
<td>Traditional Manufacturing</td>
<td>1,677</td>
<td>1,303</td>
<td>1,022</td>
<td>-374</td>
<td>-22.30%</td>
<td>-281</td>
<td>-21.57%</td>
<td>-39.06%</td>
<td>11.30%</td>
<td>9.88%</td>
</tr>
<tr>
<td>Built-up Areas</td>
<td>1,832</td>
<td>1,424</td>
<td>1,117</td>
<td>-408</td>
<td>-22.27%</td>
<td>-307</td>
<td>-21.56%</td>
<td>-39.03%</td>
<td>12.35%</td>
<td>10.79%</td>
</tr>
<tr>
<td>Prospering Metropolitan</td>
<td>1,431</td>
<td>1,111</td>
<td>892</td>
<td>-320</td>
<td>-22.36%</td>
<td>-219</td>
<td>-19.71%</td>
<td>-37.67%</td>
<td>9.64%</td>
<td>8.62%</td>
</tr>
<tr>
<td>Student Communities</td>
<td>1,829</td>
<td>1,442</td>
<td>1,183</td>
<td>-387</td>
<td>-21.16%</td>
<td>-259</td>
<td>-17.96%</td>
<td>-35.32%</td>
<td>12.33%</td>
<td>11.43%</td>
</tr>
<tr>
<td>Multicultural Metropolitan</td>
<td>1,040</td>
<td>795</td>
<td>678</td>
<td>-245</td>
<td>-23.56%</td>
<td>-117</td>
<td>-14.72%</td>
<td>-34.81%</td>
<td>7.01%</td>
<td>6.55%</td>
</tr>
<tr>
<td>Suburbs and Small Towns</td>
<td>2,651</td>
<td>2,209</td>
<td>2,073</td>
<td>-442</td>
<td>-16.67%</td>
<td>-136</td>
<td>-6.16%</td>
<td>-21.80%</td>
<td>17.87%</td>
<td>20.03%</td>
</tr>
<tr>
<td>Coastal and Countryside</td>
<td>2,341</td>
<td>1,942</td>
<td>1,793</td>
<td>-399</td>
<td>-17.04%</td>
<td>-145</td>
<td>-7.67%</td>
<td>-23.41%</td>
<td>15.78%</td>
<td>17.33%</td>
</tr>
<tr>
<td>Accessible Countryside*</td>
<td>164</td>
<td>128</td>
<td>159</td>
<td>-36</td>
<td>-21.95%</td>
<td>31</td>
<td>24.22%</td>
<td>-3.05%</td>
<td>1.11%</td>
<td>1.54%</td>
</tr>
<tr>
<td>Total</td>
<td>14,838</td>
<td>11,878</td>
<td>10,348</td>
<td>-2,960</td>
<td>-19.95%</td>
<td>-1,530</td>
<td>-12.88%</td>
<td>-30.26%</td>
<td>100.00%</td>
<td>100.00%</td>
</tr>
</tbody>
</table>


Table 2: Top five high-street alternative financial services providers ranked by number of branches, Great Britain, 2013.
<table>
<thead>
<tr>
<th><strong>AFSP</strong></th>
<th><strong>Services</strong></th>
<th><strong>Branches</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. The Money Shop</td>
<td>Payday loans; Cheque Cashing</td>
<td>541</td>
</tr>
<tr>
<td>2. Cheque Centre</td>
<td>Payday loans; Cheque Cashing</td>
<td>401</td>
</tr>
<tr>
<td>3. Cash Converters</td>
<td>Buy Back; Payday loans</td>
<td>227</td>
</tr>
<tr>
<td>4. Cash Generator</td>
<td>Buy Back; Payday loans</td>
<td>223</td>
</tr>
<tr>
<td>5. Albemarle Bond &amp; Herbert Brown</td>
<td>Pawn broking; Cheque Cashing; Payday Loans</td>
<td>188</td>
</tr>
</tbody>
</table>

**Source:** Authors own research.
Shadow Banking – Slowing down reform

Daniela Gabor
UWE Bristol

Since the global financial crisis of 2007-2009, it is well established that we need to improve our scholarly understanding and regulatory oversight of the shadow-banking world. Indeed, the crisis brought to light global networks of credit and risk intermediation connecting financial markets and institutions in novel ways, often with limited or no regulatory oversight but that create bank-like risks to global financial stability. With these concerns in mind, the G20 at the November 2010 Seoul Summit mandated the Financial Stability Board (FSB) to ‘develop recommendations to strengthen [its] oversight and regulation’ (FSB, 2011). In early 2012, the European Commission similarly embarked on the process of creating a new European regulatory framework for shadow banking.

Three factors underpin this sense of urgency. First, shadow banking is a serious rival to regulated banking. Estimates indicate that the shadow banking system supported flows of $60 trillion in 2011, revised upward to $67 trillion in 2012, approximately half the value of regulated bank balances (FSB, 2011; 2012). Second, drawing borders between shadow and regular, taxpayer-backed banking is not straightforward. Both the FSB and the European Commission have stressed interconnectedness in recognition that the shadow banking system relies on close links with the regulated, global banking sector – in particular globally systemic financial institutions (G-SIFIs)- and vice versa. For example, repo markets, the key funding markets for shadow banking, had grown to reach a similar size in the US and Europe prior to Lehman’s collapse the European repo market, however, is dominated by large, regulated European banks. In other words, in Europe, shadow banking occurs both outside and within the banking system. Third, regulators recognize that shadow banking was both a response to regulatory initiatives and a ‘testing field’ for financial innovations (see European Commission, 2012). Global and regional reform efforts may not be ineffective if banks continue to offload risks into the shadow banking system.

Research agenda: what we know

Scholarship first identified shadow institutions: hedge funds, special purpose vehicle, structured investment vehicles, securities lenders, leasing corporations, money-market funds. Then, a focus on shadow activities (securitization and collateral intermediation through the repo market) was important to start theorizing the channels through which shadow banking generates financial instability, how instability turns into a full-blown crisis of shadow banking, and what crisis responses are necessary to stabilize shadow banking.

Research identified several sources of shadow pro-cyclicality (including mark-to-market accounting; practices of securitization through which uncertainty is transformed, with the help of credit rating agencies, into measurable risk; pro-cyclical haircuts in repo transactions; interconnectedness through practices of re-use/re-hypothecation of collateral; demand pressures for money-like instruments from large institutional investors on the back of growing income inequality; fiscal prudence that limits the production of high-quality collateral); several channels of systemic contagion (fire sales;
liquidity and haircut spirals; runs on collateralized funding markets; pyramids of opaque exposures through over-the-counter connections between shadow actors); crisis policies to mitigate shadow instability (central bank collateral swaps; outright purchases of securitized instruments to restart frozen markets; central bank liquidity access for shadow banks) and regulatory measures to reduce future systemic risk (FSB’s mandatory haircut floors; Basel III liquidity rules; move from bilateral OTC to central counterparty clearing for derivatives and repos; additional requirements for G-SIFIs; Dodd-Frank/Liikanen/Vickers re-organization of bank business models and constraints on proprietary trading; European financial transactions tax).

Reform agenda: limited progress
While the pre-crisis consensus of self or light regulation has been eroded, the push back against regulatory reform constructed as a question of market liquidity in government bonds. Best example of this strategy in the global and European discussions of regulating shadow-banking activities, particularly on the repo market. Government bond markets are crucial to shadow-banking as the manufacturers of collateral used in repo transactions. The repo instrument used both for risk-management and for leveraging. Collateralized finance improves the liquidity of sovereign bond markets during ‘risk-on’ periods because repo actors treat government bonds as ‘safe assets’, high-quality collateral that reduces the costs of leverage. During crises, fragile repo connections generate a constant scrutiny of governments’ ability to continue to supply safe assets. Collateral-intensive finance makes governments – as suppliers of safe collateral responsible for financial stability, and in doing so, it entangles macroeconomic relationships between central banks, governments and private financial institutions. It also poses serious challenges to the regulation of shadow activities.

- Global reforms in the FSB repo rules - exempting intra-bank repos (dominating in Europe) and government bonds as collateral: ‘a framework of numerical haircut floors that will apply to non-centrally cleared securities financing transactions in which entities not subject to regulation of capital and liquidity/maturity transformation receive financing from regulated financial intermediaries against collateral other than government securities’. The likely consequence will be a stronger interconnectedness of G-SIFIs through repos collateralized with government bonds, higher re-hypothecation rate for government bond collateral and systemic risk.
- European reforms: the Financial Transactions Tax + European Shadow Banking: from a radical AAA approach to the repo (and derivatives) exception.
I Introduction
The international community sees sustained and inclusive growth as its main economic aim. At a national level, governments are broadly committed to the same goal. Additionally, in a globalized world economy, countries and enterprises need to be internationally competitive to sustain such growth. A well-functioning financial sector, both national and international, needs to play important roles to achieve these aims. Indeed finance has been compared to the blood circulating in the body, enabling it to live and function well.

To achieve this key positive role, the financial sector needs to encourage and mobilise savings (for example by protecting the safety of savings), intermediate these savings at low cost, ensure savings are channelled into efficient investment, as well as helping manage the risks for individuals and enterprises. Because the financial sector has such important effects throughout the economy it also needs to adhere to a key principle of the Hippocratic oath that medical doctors swear to, which is to do no harm to the rest of the economy. Therefore there should be as few and as small crises that stem from the financial sector, as these have huge costs, both fiscal and on growth, employment and investment.

It could be argued that the financial sector performed these functions relatively well both in developing and developed countries in the post-World War II period. Domestic financial sectors were relatively small and fairly tightly regulated, partly because after the Great Depression a number of regulatory measures were applied, including the Glass-Steagall Act that separated investment and commercial banking as well as the existence of requirements for liquidity. At the same time, capital accounts were relatively closed, especially in developing countries. Developed countries liberalized their capital accounts, but most did so very slowly (Griffith-Jones et al, 2003).

However, from a policy perspective there were concerns that “financially repressed” systems, as they were then called, did not deliver sufficient finance to important sectors at low enough cost and at long enough maturity. From a more theoretical perspective, the idea that financial markets were efficient encouraged financial liberalization, with light or no regulation. This covered both domestic and external liberalization. Latin America was a first mover on liberalization in the late seventies, especially in the Southern Cone. This process was followed by frequent and costly crises, including the major Latin American debt crisis, which led to the “lost decade” in terms of growth and development. Diaz Alejandro (1985) already then perceptively synthetized this as: “Good-bye financial repression, hello financial crisis.” Increasingly frequent crises in different parts of the developing and emerging world followed, including the East Asian crisis which involved some of the most successful developing countries. The idea

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3 This paper was prepared for the EUDN Conference on Finance and Development, held in Berlin on December 11, 2013.
that these crises were transitory problems, which would be overcome once these financial markets matured and deepened (and became more like those of the developed countries, especially the US and the UK one) was profoundly challenged when such a major crisis hit the developed countries, starting in 2007 in the US, which had the most liquid and deepest financial market in the world.

Furthermore, increased sustainable access to credit at low cost did not seem to improve as expected as a result of financial liberalization, especially for SMEs and for long term investment (e.g. in infrastructure). Indeed, during and after crises, credit channels became blocked, especially for long-term credit to the private sector. The pro-cyclical nature of domestic finance, as well as of capital flows, became extremely evident.

An early insight on why liberalized financial markets can be particularly damaging and much more so than the liberalization of other markets, comes from Stiglitz (1994) who argues that market failures in financial markets are likely to be endemic as those markets are particularly information intensive, thus making information imperfections and asymmetries as well as incomplete contracts (Stiglitz and Weiss, 1981) more important and disruptive than in other economic sectors. Therefore in important parts of financial markets, market failures tend to be greater than government failures. In such cases government interventions are more desirable than in other sectors (for example via regulation of domestic financial markets and banks, as well as management of the capital account) if their benefits outweigh their costs.

This approach to finance is consistent with far freer markets in the rest of the economy, in sectors where markets are more efficient than governments. Indeed, it can be argued that the prevalence of market failures in financial and banking markets makes sufficient regulation a key precondition for the successful operation of the market in the rest of the economy. The link with the real economy is clearly put by Mishkin (1996), who writes that a “financial crisis is a non-linear disruption to financial markets in which adverse selection and moral hazard problems become much worse, so that financial markets are unable to efficiently channel funds to those who have the most productive efficient opportunities.”

A key market imperfection in the operation of financial markets, basically across the board, is the tendency to “boom-bust”, thoroughly analysed in historical terms in the book by Reinhart and Rogoff (2011). Building on the theoretical tradition of Marshall (1923), Keynes (1936) and Minsky (1977), Kindleberger (1978) had earlier developed an approach which considers financial crises as a response to previous excesses. Such excesses seem clearly far greater in financial and banking markets that are more liberalized and not properly regulated. An interesting recent insight on private capital flows is provided by the IMF (2011) which gives evidence that financial market volatility has increased over time and has spread to transactions and flows which are generally considered to be less volatile (such as foreign direct investment).

In the case of “booms and busts” of capital flows to developing and emerging economies, this was first seen in the post- World War II era in a major way in Latin America, starting in the late 1970s and ending in the major debt crisis of the 1980s, called the “lost decade” to development. This pattern was characterized by Ffrench-Davis and Griffith-Jones (1994) as surges and reversals of capital flows; more famously the reversals were called “sudden stops” by Guillermo Calvo and associates. In an
important paper Calvo, Leiderman and Reinhart (1993) showed that an important part of the surge was being caused by factors external to the region, especially the US interest rate. Calvo (2013) later described how this paper and its’ main conclusions were challenged particularly at the IMF, who then attributed such flows only or mainly to “good fundamentals” in the countries, and did not contemplate the role of global capital markets and their imperfections in the origin of major capital flows surges and reversals. The IMF has, however, increasingly accepted the role of international capital market imperfections in generating boom-bust cycles of capital flows and has begun - especially more recently - to draw important policy implications from this experience, as discussed below.

As Devlin, French-Davis and Griffith-Jones (1994) argued, an important part of the explanation of both the surges, and the subsequent reversals, were due to intrinsic features on the “supply side” of capital flows. This included institutional features, such as very short term incentives to key actors, such as internationally active pension and mutual funds as well as investment bankers, that contributed to herding behaviour (for more detailed analysis see Griffith-Jones, 1998). There were - and still are - many such institutional features which contribute to this pattern of capital flows, such as the pro-cyclical methodologies and behaviour of rating agencies (see Reisen, 2003; Goodhart, 2010).

It is interesting that there is a recent econometric literature showing that financial crises are often preceded by booms of capital flows (for example Agosin and Huaita, 2012 and Borio, 2012). In the case of Latin America, net capital flows during the pre- 1980’s debt crisis years (1977-1981) reached 4.5% of GDP annually (Ffrench-Davis and Griffith-Jones, op cit.). It is important to stress a somewhat neglected fact that capital flows (in this case mainly intra-European ones) have played a major role in the origins of the recent European sovereign debt crisis. Indeed, it is not often emphasized that in Europe capital flows were numerically larger than in Latin America. Thus, in Greece, the cumulated capital flows grew from around 30% of GDP in early 2002 to around 80% of GDP in early 2008 (almost 10% of capital flows as proportion of GDP annually). In Spain this stock grew from just over 20% of GDP in early 2002 to 60% mid 2008, around 7% of capital flows as proportion of GDP annually, with similar increases reported for Portugal (Pisani-Ferry and Merler, 2012, based on Eurostat data).

From this comparison, it can be seen that capital flows were on average higher to the periphery European countries during the 2002-2008 years then they were to Latin America in the 1977-1981 pre-debt crises years. These massive capital flows were accompanied in Europe, as they had been previously in Latin America, by very low spreads as lenders and investors massively under-estimated risk. As crises started in both cases, spreads either shot up, often to unsustainable levels, or credit rationing occurred so that countries became unable to raise new funds or loans.

In section 2 we will examine the policy issues around domestic financial sectors (their size and structure) as well as that of their regulation. Section 3 will examine the policy issues of capital account management, building on the analysis of this introduction. Our analysis will be framed by the two aims of the financial sector: to fund in an efficient and sustainable way the needs of companies and households (thus supporting inclusive growth) and to avoid damaging crises by supporting financial stability. This analysis will be done in a context where we have been brutally reminded that financial and banking markets in developing, emerging and developed countries are riddled with imperfections and
are prone to boom bust cycles. Though reference will be made to developed economies, we will focus here more on developing and emerging economies.

2. The domestic financial sector
As regards the domestic financial sector, we will base our analysis more on issues from the perspective of low income countries (LICs) but drawing on lessons from emerging and developed economies. The financial sector and its regulation is a particularly challenging and important field for policy-makers in LICs, in the pursuit of both inclusive growth and financial stability, for two reasons.

Firstly, LICs face the traditional challenge of expanding access to the financial sector to large parts of the population and important segments of enterprises that have been excluded from it. Furthermore, where access is available, it is often too short-term and very costly. These features are an important obstacle for growth. Overall, financial sectors in low income African countries are still relatively shallow. Based on World Bank data, the average credit to GDP ratio in 2010 for Sub Saharan African LICs was below 20%, though higher in some countries (see Griffith-Jones with Karwowski, 2013). It is interesting that Sub-Saharan (SSA) LICs have a lower credit to GDP ratio than non-SSA ones (see, for example Beck, 2013). Furthermore, according to World Bank surveys, only 17% of small enterprises in SSA have access to credit, the lowest among all developing country regions, with for example 41% of small enterprises in Latin America and the Caribbean reporting access to credit. Indeed, 48% of small enterprises in Sub-Saharan Africa report that lack of access to credit is a major constraint for their investment, with 41% of even medium enterprises in SSA saying that lack of credit hinders their investment.

Another important issue is the cost of credit, especially for SMEs. In countries like Ghana, reportedly the cost of SME lending, and especially the spreads banks charge, has hardly come down in the last two decades, even though the number of banks has increased significantly which should have increased competition and lowered spreads. This puzzle requires further research, including on policy measures to be taken which could be effective to change that.

Secondly, internationally there is a rethinking of the scale and structure of a desirable financial sector and a major reform of its regulation in light of the major financial crisis that started in 2007/8. An increasingly accepted perception has arisen that banking and financial markets have deep seated imperfections. There is a large literature on the reform of financial regulation, especially in developed and emerging economies (see for example, Griffith- Jones, Ocampo and Stiglitz, 2010, as well as IMF, 2012) with Haldane and Madouros (2012) emphasizing the need to simplify regulation in developed countries, the latter resonating very well with LICs. Three well-known commissions also analyzed the sources of the crisis and the need for new policy responses. See the reports of the Larosière Commission (2009), the Stiglitz Commission (United Nations, 2009) and the Warwick Commission (2009). National reviews, such as the UK Turner Review, also provided very insightful analysis. A great deal of work has been done by international regulatory bodies, such as the Basle Banking Committee and the Financial Stability Board, which have become G-20 bodies since the global financial crisis. This expansion was very welcome, but where there is no representation in them of smaller and especially poorer economies.
There is a need to understand the implications of the analytical rethinking, and major regulatory changes being agreed, for low income countries’ financial sectors and their regulation. As the Governor of the Central Bank of Ghana Henry Wampah (2013) eloquently puts it, the financial sector is a “double-edged sword”, with potentially very large positive effects for inclusive growth, but also - if not robustly regulated - very large risks, “because the absence of this [regulation] could have disastrous outcomes as observed during the recent global financial and economic crises.”

Because financial sectors for SSA LIC countries are still at an early stage of development, lessons from the global financial crisis as well as of previous emerging economies’ crises, could inform their financial sector development strategies as well as their financial regulation. The advantage of being a latecomer to financial development is that African LICs can learn both positive and negative lessons from financial development and crises in other regions.

LICs financial sectors, while generally still shallow, are experiencing in some countries fairly rapid growth. This growth is often concentrated in credit to real estate or households more generally (see for example, Griffith-Jones with Karwowski, op cit.). Combined with African countries’ vulnerabilities, such as to external shocks, this might pose risks to financial system stability in the future. Whilst it is very positive that in the last ten years in Sub-Saharan Africa there has been only one major banking crisis (in Nigeria) - a country that had seen a very rapid increase in the ratio of credit to GDP from 11% in 2000 to 30% in 2010 - care must be taken that such a positive record does not generate complacency that financial stability is ensured as has occurred so frequently in most other regions of the world. One important area for financial regulation, in LICs as elsewhere, is therefore for financial regulation to be counter-cyclical, that is to lean against the wind, when credit increases at too fast a pace for SSA (Bagyenda, J., Brownbridge, M. and Kasekende, L., 2011, also see Griffith-Jones and Ocampo, 2010, more generally). Important analytical research is beginning in Sub-Saharan Africa itself, on how such counter-cyclical or macro-prudential regulation should be implemented in LICS (see Kharkar, 2012, writing for Bank of Uganda Financial Stability Report).

One positive advantage of regulation in several African countries may be that they have developed a different approach, which seems better suited to African realities than internationally adopted regulation rules that are extremely complex. Bagyenda, J., Brownbridge, M. and Kasekende, L. op cit., analyse this approach, which includes limiting the amount banks can lend to individual borrowers and encourages banks to have a structure of assets that are less risky rather than relying on extremely complex models to try to measure risk, partly because data is not available for such models for a sufficient period of time. A challenge for LIC regulators is how to combine these and other existing elements of their existing regulations with the suggestions and rules coming from the international discussion, particularly from the Basle Banking committee, and adapt them to their own realities and policy objectives.

More broadly, there are issues about the desirable size and structure of the financial sector in both low income and middle income countries. The traditional positive link between deeper as well as larger financial sector and long term growth, that started in the literature with Bagehot and Schumpeter, and was reflected in quite a large part of the empirical literature, such as Levine (2005), is being increasingly challenged. Authors like Easterly, Islam and Stiglitz (2000) had already early on
suggested that financial depth (measured by private credit to GDP ratio) reduces volatility of output up to a point, but beyond that (possibly around 80-100% of GDP) actually increases output volatility. More recently, a number of papers are showing an inverse relation between the size of financial sector and growth, especially beyond a certain level of financial development. Thus, Bank for International Settlements (BIS) economists (Cecchetti and Kharroubi, 2012), based on empirical work, reach the following conclusions:

“First, with finance you can have too much of a good thing. That is, at low levels, a larger financial system goes hand in hand with higher productivity growth. But there comes a point, where more banking and more credit lower growth. Secondly, looking at the impact of growth in the financial system on real growth, clear evidence is found that faster growth in finance is bad for aggregate real growth. This implies financial booms are bad for trend growth. Hence, macro prudential or countercyclical regulation is important.”

Along similar lines, an IMF Discussion Paper (Arcand, Berkes and Panissa, 2012) suggests empirical explanations for the fact that large financial sectors may have negative effects on economic growth. It gives two possible reasons. The first has to do with increased probability of large economic crashes (Minsky, 1974, Kindleberger, 1978 and Rajan, 2005) and the second relates to potential misallocation of resources, even in good times (Tobin, 1984). De la Torre et al. (2011) point out that "Too much finance" may be consistent with positive but decreasing returns of financial depth which, at some point, become smaller than the cost of instability. It is interesting that the IMF Discussion paper (op cit.) results are robust to restricting the analysis to tranquil periods. This suggests that volatility and banking crises are only part of the story. The explanation for the "Too Much Finance" result is not only due to financial crises and volatility, but also misallocation of resources.

It is also likely that the relationship between financial depth and economic growth depends on whether lending is used to finance investment in productive assets or to feed speculative bubbles. Not only where credit serves to feed speculative bubbles but also where it is used for consumption purposes, as opposed to productive investment, the effect of financial depth on economic growth seems limited. Using data for the period 1994-2005, Beck et al. (2012) and Beck et al. (2011) show that enterprise credit is positively associated with economic growth but that there is no correlation between growth and household credit. Given that the share of bank lending to households increases with economic and financial development, and household credit is often used for consumption purposes whereas enterprise credit is used for productive investment, the allocation of resources goes some way towards explaining the non-linear finance-growth relationship. In African countries, only a small share of bank lending goes to households; however as financial sectors and economies grow, this will change, as has been the case in South Africa and Mauritius (see below).

Crucial in the LIC context is the extent to which the findings on the relationship between the structure and size of the financial sector and growth in more developed economies are relevant for - and apply to - African LICs because their financial systems are markedly different, and above all are much smaller in absolute size and in proportion to the size of their economy. Whilst the argument and evidence that “too big” a financial sector is bad for growth may be less relevant for countries with very shallow financial sectors (and indeed policies to gradually deepen these financial sectors may be
desirable), the need to avoid too rapid growth - even from relatively small levels - seems equally relevant for any economy. Furthermore (as discussed below) the importance of an appropriate structure of the financial sector, so it helps fund inclusive and sustainable growth, is also highly relevant for both low income and middle income countries.

Fast credit growth might exacerbate vulnerabilities and enhance the risk of financial crises, as it has done in most countries and regions of the world, both emerging and developed. In the African context, the case of Nigeria provides an illustration that banking crises might also cause a negative link between rapid growth of the banking sector and economic growth, even at relatively low levels of financial development (Nigeria saw a very rapid increase in the ratio of credit to GDP from a very low level, 11% in 2000 to 30% in 2010). In 2004/2005 the Central Bank of Nigeria (CBN) mandated a steep increase of minimum bank capitalisation with a view to create large internationally competitive banks and increase financial depth (Soludo, 2004). Banks achieved this capitalisation, which was high even by international standards, by means of equity investment, mergers and acquisitions, resulting in the consolidation of the banking system. The consolidation in the domestic banking sector, along with abundant capital in the wake of rising oil prices, reportedly increased the speed of credit creation with significant flows to sectors with little growth impact. This included loans used to finance share purchases, setting the stage for a financial asset bubble, particularly in bank stocks (Sanusi, 2010). The financial sector boom ended in a bust with a systemic banking crisis in 2009 as financial sector growth had not been accompanied by the corresponding regulatory and supervisory upgrade. The cost of cleaning up the balance sheets and recapitalising the banks concerned is estimated at almost 8 per cent of GDP (IMF, 2011).

Rapidly growing credit to households - even though desirable when strengthening reasonable levels of domestic demand and financial inclusion in a sustainable way - might cause financial instability if not regulated prudently. This is also the case if lending is excessively channelled into the construction sector, creating a housing bubble. The two most advanced African economies which are both upper middle income countries - South Africa and Mauritius - have recently experienced or are currently experiencing a construction boom. Both economies possess relatively deep financial markets with strong private domestic lending, including significant consumption credit extension. Figure 1 shows that private credit in high income economies was around 100% of GDP on average in 2010 while it accounted for 60-80% of GDP in Mauritius and South Africa.
Comparing it internationally, South Africa was the country in Africa which experienced the strongest house real price gains between 2004 and 2007, by far exceeding even the price growth in the booming residential property markets of the US and the UK (see Griffith-Jones with Karwoski, op cit.). In South Africa the ratio of household to business credit is approximately 1:1. The large majority of household borrowing takes on the form of mortgage finance. During the early 2000s this led to an unprecedented housing boom in South Africa fed by growth in housing loans of over 500% in real terms between 2000 and 2010 (see Figure 2). This was largely absorbed by upper income South African households accounting for three quarters of total household credit created (DTI, 2010). In an attempt to reduce inflation, asset price increases and potential macro-economic over-heating, the South African Reserve Bank gradually initiated monetary tightening in 2006.

The subsequent economic slowdown in South Africa was to a large extent based on domestically accumulating economic and financial imbalances while the Global Financial Crisis merely intensified the recession of 2008/09. A positive aspect was that there was no financial crisis, perhaps because of the policy response from the economic authorities. However, as and if mortgage credit picks up in the future, and especially if it does at a very fast pace, care has to be taken to regulate this. The South African experience reiterates that private sector credit expansion at very high levels might lead to output volatility and adverse growth effects, as discussed in the literature above. In order to prevent future crisis and foster economic development a re-orientation towards more business credit, particularly for productive investment, might be needed.
In Mauritius, almost one third of private sector credit flows to households, equalling 20% of GDP by late 2012. The majority of household borrowing is mortgage finance (60% of total household credit) with the rest used to fund consumption (40%). Given sustained demand for residential property, housing credit has been growing close to 20% annually on average over the past 5 years (Bank of Mauritius, 2012). Simultaneously, foreign direct investment (FDI) flows into the country concentrate on real estate activities, with the bulk in tourist resorts, real estate and invest hotels schemes. The construction industry accounted for approximately half of FDI inflows in recent years (2008-2012). Mauritius’s construction boom should be monitored with caution, which has also been pointed out by the IMF Article IV Mission Consultation. Financial vulnerabilities appear to be accumulating in the industry with potential adverse impacts on balance sheets of domestic commercial banks. Even though non-performing loans as share of total credit are at reasonably low levels (they have increased from 2.1% to 3.1% between 2010 and 2012), non-performing loans in the construction industry (excluding housing loans) as share of sectorial credit are more than twice as high, rising from around 5% in 2010 to 8% in 2012. Year-on-year growth in construction credit shot up sharply during 2012, exceeding 35% by September 2013 (see figure 3). These trends seem worrying and imply the economic authorities may need to consider counter-cyclical regulation, possibly focussed in lending to construction.
Limited data availability makes it difficult to measure to what extent consumption credit is on the rise in other African economies. This would seem to more urgently make the case for more disaggregated credit data as well as monitoring by regulators and policy-makers. One of the few low income SSA countries providing disaggregated domestic lending data is Mozambique (Banco de Moçambique, 2013). Private sector credit has increased significantly between 2000 and 2010 in the Southern African country from 15% to 23% of GDP (World Bank data). During this period consumer borrowing almost tripled as share of total credit, while it grew almost eightfold between 2001 and 2012 in real terms (see figure 4). Mozambique has had a strong growth performance implying a robust medium-term economic outlook according to the IMF. It seems important that financial regulators consider the need for tighter regulation of consumer credit to avoid any risks to financial stability.
As regards the structure of financial systems in low income countries, a number of issues arise, including the balance between consumer and enterprise credit (partly discussed above) as well as the proportion between national and foreign banks. Here we want to focus on two others. First, should specialized lending institutions, like leasing or factoring companies, as well as low-end financial institutions, such as cooperatives, credit unions and microfinance be promoted, as suggested by Beck, Demigurc-Kunt and Singer (2011)? If the insights of imperfect and asymmetric information are central, such information tends to be local and specialized. This may provide an important theoretical and practical justification for greater use of more low-end and more decentralized institutions. Would the latter, for example, be particularly effective for the financing of SMEs, and more broadly for the so-called missing middle? For many African households such low-end financial institutions constitute the only form of financial access. In Uganda for instance only 21 percent of adults above the age of 15 have an account at a formal financial institution (Demirguc-Kunt and Klapper, 2012).

A second issue relates to a possible increased role for development banks. Since the 2007/2008 crisis, there has been increasing interest in expanding the role of national development banks (if well-functioning), to provide counter-cyclical lending when private credit falls. Also, good public banks can be valuable for incorporating environmental externalities, to give LICs the opportunity to “leap frog” by adopting low-carbon technologies, for example in renewable energy. More broadly, public development banks can be a valuable mechanism for financing particular strategies of development.

Public development banks also have the advantage that they can leverage public resources, as they fund their loans in the private capital markets, as well as co-financing with private banks and/or private investors or on-lend via private banks, as typically done for SMEs. The key issue is what are the incentives and governance arrangements that are required to make such development banks effective.
and efficient in LICs, as well as more broadly in developing and emerging economies? What lessons can be learned from successful banks in developed countries (e.g. at a national level, the best example perhaps being German KfW) and emerging economies (e.g. BNDES in Brazil, as well as several Asian development banks)? Most research on the experiences with development banks in Africa dates from the 1980s and 1990s and evaluations report fairly negative experiences (Brownbridge et al., 1998). Are there today well-functioning development banks in some low income countries? How can their performance be improved and how can good development banks be created? Returning to the theoretical issues, what are the specific market gaps and failures which need addressing in specific LIC contexts, and how best can government failures be minimised?

More broadly, having a more diversified financial structure for developing and emerging economies, than one just focussed mainly in private (often large) banks may have several advantages. Firstly, it may encourage competition between different types of financial institutions, which could lead to them being more efficient, for example in the spreads they charge. Secondly, a more diversified financial system, especially if not having inter-connected risks, could lead to less systemic risk and therefore contribute to financial stability. Though this seems logical, it may be useful to do careful empirical analysis, including of case studies, to see to what extent this is true. Thirdly, if different varieties of financial institutions have different strengths\(^4\), having a more diverse system could make it more likely that the financial sector functions needed to help achieve inclusive growth are achieved, than if the structure of the financial sector are determined spontaneously, or dominated by one type of financial institutions, be they small or large, private or public, national or foreign.

Indeed, given that financial sectors (particularly liberalized, very lightly regulated ones, but also very repressed ones) can be very problematic for inclusive growth, the need to pursue pragmatic policies in financial sector development, as well as its regulation, and not be driven by ideology or conditioned too much by the interest of agents in the financial sector is especially important. It is important not to adopt an “either/or” attitude, but look at the best ways of building synergies amongst institutions of different type (e.g. private and public) as well as encourage best practice within them. As described above, public development banks co-finance, and increasingly lend, via private banks. Furthermore, much of their lending is done to private firms. The ability to combine private and public creatively, ideally working constructively together, is an essential feature of a financial system if it is to serve the needs of inclusive and environmentally sustainable growth. In this sense, though by no means perfect, the way the German financial sector has developed and operated, for example to successfully help fund renewable energy via public and private banks (as well as cooperative banks) and private investors acting together, provides a very good example. An interesting issue, beyond the scope of this paper, is how path dependent are the evolution of financial systems. For example, a question increasingly asked in the UK is: can the UK effectively emulate Germany in certain aspects, for example by establishing a successful public bank such as KfW, and what difficulties could it initially face given the history and structure of the UK financial system? Perhaps more relevant in the context, especially for

\(^4\) To include some stylized facts, development banks are good at counter-cyclical lending and at providing long-term finance for private investment in infrastructure; private banks are good at providing international trade credit as well as financing the needs of foreign companies; low end institutions are good at giving credit to MSMEs, especially in specific localities.
LICs, to what extent can countries with perhaps weaker institutions and governance, create or expand good (or well-functioning) development banks that can work well with the private sector (both with private banks as well as with enterprises) to support inclusive growth. Can they successfully follow in the path of developed and emerging economies, that have done so fairly effectively, and what are the detailed lessons to learn from successes and failures?

3. Managing the capital account
Since the revival of international capital markets in the 1960s, and the subsequent liberalization of capital controls, cross border capital flows have increased exponentially. Though most cross-border flows happen among developed economies, emerging and developing countries are increasing participants in these flows. It is widely recognized that capital flows (and particularly certain categories within them) may, under certain conditions, be a valuable supplement to domestic savings to finance investment, as well as have other benefits, like bringing technology and access to markets, in the case of foreign direct investment. However, there is growing evidence and agreement that certain capital flows can - and often do - have negative effects on growth (for a good recent review of the empirical literature, especially focussed on low income countries, see Massa, 2013).

Indeed, it can be argued (see French-Davis and Griffith-Jones, 1994, op cit. and 2011) that several pre-conditions need to be met so capital flows, especially debt based ones, contribute to produce sustained growth, that is create a virtuous cycle:

a) a high proportion of inflows should go into investment;
b) the additional investment should be efficient;
c) a large proportion of the increased investment should go into tradeables, to help generate the foreign currency required for servicing the debts;
d) creditors and investors should be willing to provide stable and predictable capital flows on reasonable terms.

Unfortunately, it is difficult and quite rare for these conditions to be met. If they are not met, then the likelihood increases that if capital flows, especially if they are very large and easily reversible, will not contribute to sustained growth.

As discussed in the introduction, the essential problem is that capital flows, like finance in general, are pro-cyclical. Agents perceived as risky borrowers are subject to the strongest swings in the availability and costs of financing. These perceived “risky” borrowers include developing and emerging economies. Pro-cyclical capital flows are major determinants of cycles in emerging economies, and also can contribute to cycles in low income countries. Currency mismatches, to an important extent originating in capital flows, are particularly damaging for emerging and developing economies. The massive size of capital flows in proportion to the size of their economies and financial sectors is also a very problematic aspect.

An important feature of capital flows patterns, stressed for example by Ocampo (2012), is that the cyclical pattern of capital flows goes beyond volatility of short term flows, as even more problematic are medium-term cycles in availability and cost of external finance. The major problem with these medium-term cycles is their impact on key macro-economic variables, such as exchange rates,
interest rates and domestic credit and asset prices (especially property prices and stock markets). Instead of disciplining macro-economic policies, as some theorists thought capital flows would do, capital flows de facto may distort macroeconomic variables and policies, and restrict the range of manoeuvre for counter-cyclical macroeconomic responses. For example, the overvaluation of exchange rates that occurs as a result of major capital inflows often leads to large increases in current account deficits, which in turn increases the likelihood of future costly crises. Overvalued exchange rates also discourage exports, with adverse impacts on growth, as exports are meant to be one of the most dynamic sectors in a market economy. Furthermore, the additional volatility of key macro-economic variables produced by volatile capital flows can have a negative effect on private investment, as they create uncertainty about future profitability.

During boom periods, capital account regulations can be justified as a way to help macro-economic authorities manage booms, by helping avoid excessive exchange rate appreciations, reducing risks of large current account deficits as well as expensive self-insurance, via accumulation of foreign exchange reserves. During crises, regulations on outflows may avoid or diminish capital flight by residents or foreigners. These regulations are widely seen to play a dual role: as a complementary macroeconomic policy tool and to help improve the structure of liabilities, by discouraging short-term, and thus more reversible, capital flows (see for the riskiness of short-term capital flows, Rodrik and Velasco, 2000).

However, as mentioned in the Introduction, an interesting recent insight on private capital flows is provided by the IMF (2011), which gives evidence that financial market volatility has spread to transactions and flows which are generally considered to be less volatile (such as foreign direct investment). One of the key ways in which the “hierarchy of volatility” of capital flows has been eroded is via the fact that foreign direct investors, as well as other actors, use derivatives markets, both to hedge their foreign exchange risk and to speculate. Especially if they do this pro-cyclically, this can imply that the net effect of foreign direct investment (though having other positive effects) can contribute to boom and bust cycles of capital flows (for more, see Griffith-Jones and Dodd, 2006 and 2007). The importance of derivatives instruments (such as non-deliverable forwards for foreign exchange), widely used in the carry trade on currencies implies new challenges for capital account regulations so they are effective, especially in emerging economies. Countries like Brazil and South Korea have de-facto started to regulate derivatives on capital flows, and it is important to evaluate their effectiveness, as well as learn lessons from them.

After the global financial crisis the Basle Committee for Banking and the Financial Stability Board led major initiatives to re-regulate finance, mainly at the national level. However, the risks associated with cross-border capital flows were left out almost entirely both from that regulatory discussion, and related analytical analysis, almost as if cross-border finance was not part of finance (Ocampo, 2013). In fact, it seems best to analyse the impacts of the domestic financial sector as well as international capital flows to and from emerging and developing countries in an integrated fashion, and to think of their regulation also in an integrated framework. This includes giving attention to regulations on transactions in foreign currencies in domestic markets, as well as regulations on capital flows proper — generally called “capital controls” but which could more adequately be called capital account regulations or
management. Regulations on capital flows can be complementary with, or even be partly substituted by, domestic prudential regulations when they involve domestic financial intermediation (e.g. of currency mismatches), but not when they involve access to external capital markets by non-financial corporates. For this reason, it is important to coordinate domestic and capital account regulations nationally, and their discussion internationally.

Oversight of this issue was initially a gap in the efforts to strengthen financial regulation overall in the wake of the global financial crisis, and one which is particularly critical for emerging and developing countries, as capital account volatility plays a major role in determining boom-bust financial cycles and therefore macroeconomic as well as financial stability risks. It is very encouraging that this issue was acknowledged by the IMF in 2011-2012, which came to recognize the appropriateness of capital account regulations and recommended a set of guidelines for their implementation. The IMF rightly conceived this regulation or management of the capital account as part of broader measures on macro-prudential regulations.

The official IMF documents on this topic (IMF, 2011 and 2012) underscore the positive role that regulations on capital inflows can have but take a more critical view of regulation of outflows. In the first case, they consider that regulations are effective in changing the composition of capital inflows toward less volatile sources of finance, and thus have stability effects, but are more sceptical on their macroeconomic effects. In this regard, they consider that there is stronger evidence on the capacity of regulations to increase the room of manoeuvre for restrictive monetary policies but that there is very little evidence that they reduce the total amount of inflows or that they affect the exchange rate. In the case of regulations on outflows, the IMF considers that they are generally ineffective. The official documents have been backed by significant technical work in the institution, several of which have been favourable to the active use of these interventions (Ostry et al., 2010). The IMF documents quoted above have also argued that capital controls were effective in reducing the vulnerability of emerging economies to the North-Atlantic global financial crisis.

On the basis of this analysis, the IMF proposed some guidelines on the use of these regulations. These guidelines indicate, correctly, that these regulations should be seen as a complement and not as a substitute for macroeconomic policy. However, they visualize them as a sort of “intervention of last resort”, once countries have exhausted all other alternatives to manage booms, thus first letting exchange rates appreciate, accumulate foreign exchange reserves and adopt contractionary fiscal and monetary policies; the latter is paradoxical, as a restrictive monetary policy may actually encourage additional capital inflows. The final “institutional view” adopted in 2012 (IMF, 2012) was somewhat more favourable to the use of these regulations, but according to some analysts the IMF did not go far enough in dispelling the conception of them as interventions of last resort (Gallagher and Ocampo, 2013).

Many experts, particularly from emerging economies consider that capital account regulations should be seen as part of the normal toolkit of macroeconomic authorities and that they should be used simultaneously with other interventions to avoid the potential overheating of the domestic economy and overvaluation of the exchange rate generated by excessive capital inflows as soon as a surge becomes apparent (see, for example, the three chapters by Mohan, Nogueira Batista Jr and Zhang in
Gallagher, Griffith-Jones and Ocampo, 2012). In fact, they should be conceived as part of a continuum that goes from regulations of domestic finance in domestic currency, domestic financial transactions in foreign currencies and cross-border flows, which should be regulated in a way that is consistent with the characteristic of different financial systems.

More generally, the careful analysis of experiences with capital account regulations leads to a number of conclusions by a range of observers (including Ocampo, 2012, op cit; IMF 2011, op cit; Ostry et al, 2010; Magud and Reinhart, 2007, and Kawai and Lamberte, 2010). Firstly, for capital account regulations to work, the authorities need to have good information about flows as well as administrative capacity to manage them, which includes the ability (and willingness) to close loopholes, especially by responding to the use of instruments like derivatives designed to circumvent or avoid them. Ocampo (2012) persuasively argues that permanent regulatory regimes that tighten or loosen regulations in response to external conditions may be better than building them up from scratch in times of shocks. Basic problems of data collection are key for any regulation, and would be better overcome with a permanent register. Indeed capital account regulations are difficult to implement if systematic recording of flows are not available. Secondly, regulations help increase monetary autonomy, and improve debt profiles, with the latter reducing external fragility. Some of these effects may be temporary, due to greater evasion, as time passes. Thirdly, and very important, there is agreement that capital account regulations are a complement and NOT a substitute to sound macroeconomic policies.

Under Brazil’s initiative, the G-20 approved in 2011 an alternative set of guidelines to those of the IMF that have a somewhat more pragmatic view of the use of these regulations. Gallagher, Griffith-Jones and Ocampo (2012: box 2) proposed another alternative set of guidelines, which also emphasize that they are a complement and not a substitute of other macroeconomic policies, and that they should be adjusted dynamically to avoid their evasion. They underscore that there is no reason to favour price-based (taxes or unremunerated reserve requirements) over quantitative or administrative regulations (limits or prohibition of certain transactions), if the latter are more effective in practice in certain cases. Though it is very positive that there is a great deal of agreement (including by the IMF) on the desirability of discouraging excessive inflows by capital account regulations (which will be very helpful for when the next surge of major capital inflows hit emerging and developing economies), the main policy challenge for emerging economies (and possibly also for low income countries, which have seen very large inflows in recent years, especially via bonds, see for example, Massa, op cit.) may be what to do about capital outflows in the wake of “tapering” of Quantitative Easing (QE) in the USA, especially once it starts.

Though regulations on capital outflows may be part of the policy response, they may not be enough, particularly as on the whole regulations on capital outflows are more difficult to work effectively in the moment of major pressure for outflows, even though there are some exceptions, like the Malaysian controls on outflows implemented during the East Asian crisis, which are widely seen as relatively effective. It is to be hoped that emerging and developing economies will not feel obliged to use contractionary fiscal and monetary policies as the only alternative to discourage or compensate for capital outflows. Here lies a potential large challenge for the near to medium term.
A final point on capital flow management is that measures taken by recipient emerging and developing countries may not be enough, as the sheer wall of money coming towards them is at times so large. Therefore it may be desirable to complement capital account regulation measures taken by recipient countries, with those taken by source countries, especially the US. Though the scale may be greater now, there have been previous episodes of very loose monetary policy contributing to surges in capital flows to developing and emerging economies. For this reason, the author of this paper and a co-author (D’Arista and Griffith-Jones, 1998) argued for measures to discourage large portfolio outflows from source countries, via unremunerated reserve requirements on such outflows.

In the recent period of very loose US monetary policy (including QE), following the global financial crisis, the US could have introduced measures to discourage the carry trade flows going to the rest of the world, especially to developing and emerging economies (Gallagher and Griffith-Jones, 2012). This could be done by taxing such flows (on the spot market), as well as putting higher margin requirements on derivatives that mimic spot transactions; alternatively such foreign exchange derivatives could be taxed to a level equivalent to a tax on foreign exchange spot transactions. Such measures would have not just benefitted emerging and developing economies, but would also have benefitted the US economy, as the purpose of the monetary easing was to encourage more lending and risk-taking in the US, for example higher bank lending to US SMEs. Therefore such measures to discourage outflows would have implied a WIN-WIN element, benefiting recipient emerging and developing countries as well as source developed countries. This is the reason why many observers, including Olivier Blanchard, Chief Economist at the IMF, found the case for measures in source countries persuasive. Naturally, when US monetary policy is tapered, as pointed out, the policy dilemma will be the opposite: how to avoid large outflows form emerging and developing countries.
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