

Financial Stability, Efficiency, and Growth

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The Creation of Economic and Corporate Wealth in a
Dynamic Economy

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Road Map

- In finance, stability and efficiency are not easily separable concepts
- Financial instability is associated with short-term volatility in economic efficiency and growth
- Key question: Does ability to maintain financial stability improve growth potential?
- Is this an important issue in Europe today?

Three characteristics of economies that maintain financial stability

- Financial resources are more-or-less efficiently reallocated from savers to investors
- Financial risks are assessed and priced reasonably accurately and effectively managed
- Financial shocks are comfortably absorbed and financial imbalances dissipated

Three related Implications

- Finance facilitates efficient resource and risk allocation.
- Financial stability, financial efficiency, and economic efficiency are closely intertwined.
- Policies aimed at financial stability may involve trade-offs between efficiency and resiliency

FS and Growth: Business cycle impact well documented

- Financial instability affects economic growth in the short term
 - Introduces inefficiencies in pricing and allocation of resources and risks
 - Can temporarily affect growth rates and employment via business cycle impact
- Highlights importance of preventing financial instability and of having a diversified, flexible, and resilient financial system.

FS and Growth: Three related unresolved questions

- How does finance affect the potential growth rate of an economy? By promoting economic efficiency?
- How does financial architecture affect a country's potential rate of growth? By establishing stability and credibility?
- How can financial architectures be adapted to improve finance's facilitative function and thereby enhance credibility and stability?

FS-related factors that might impinge on European growth potential

1. European financial system still emerging from national financial systems.

- Money markets fully integrated and 'efficient'
- Bond and equity markets still have national orientations and remain fragmented.
- Aspects of infrastructure still highly segmented

2. Securitization expanding rapidly but bank financing still dominant.

- Could restrain efficiency
- Could discourage investment and innovation

Financial-stability related factors . . . ? (continued)

3. Venture capital supply still relatively low.

- Could inhibit innovation and investment, and thereby productivity growth.

4. Architecture for European financial stability yet to emerge.

- Creates uncertainty about ability to safeguard financial stability and manage crises
- Could, thereby, reduce capacity to facilitate efficient investment, innovation, and growth

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