Can financial services drive growth?

***Martina Garcia** argues that it is wrong to assume a larger financial services sector will lead to more economic growth for the UK*

In December last year, the UK government announced the Edinburgh reforms, a wide-ranging package designed to stimulate the growth and competitiveness of financial services. It is also intended as a key plank of the government's overall economic growth strategy. The aim is that the UK should 'be the world's most innovative and competitive global financial centre'.

Is that wise? Critics of the reforms fear deregulation will lead to financial instability, while its supporters clamour for quick action to stop any further erosion of UK competitiveness. But there is little debate about whether a larger financial sector is truly beneficial for the real economy.

At one level, a focus on financial services is understandable. The UK financial sector represents an important part of the economy. Without including associated professional services, in 2021 it represented 8.3% of total economic output, 3% of jobs, 4% of tax receipts and generated a trade surplus of £44.7bn.

> *Once a country develops a sophisticated financial sector, the benefits of further expansion fizzle out*

Moreover, financial services are crucial for all other sectors. They deliver the means to allocate capital efficiently and they carry out maturity transformation, turning short-term deposits and easy-access savings into longer-term loans. Access to efficient capital intermediation is vital for the productivity of the UK economy, which limps behind that of Germany, France and the US. Finally, the sector is heavily regulated and so amenable to reform. Leaving aside financial stability risks, it seems a no-brainer that the growth of the financial sector will benefit the whole country.

Unfortunately, empirical evidence and economic analysis show us that this assumption is far from correct. In fact, unless the structural market failures entrenched in the sector are addressed, the assumption that more financial services make for more economic growth is wrong.

Why more may be less

They are two main empirical findings that show why we should pause for thought. The first is that increasing the share of financial services in an economy is only positively correlated with higher economic growth in developing countries. Once a country develops a sophisticated financial sector, the benefits of further expansion fizzle out. Research by Stephen G Cecchetti and Enisse Kharroubi on growth rates finds evidence that higher rates of growth in the financial sector are a drag on the rest of the economy and hamper productivity gains.

The UK has one of the most sophisticated and proportionally largest financial services sectors in the world. It is already well past the point where further development of financial services on its own will stimulate growth in the real economy.

There is one caveat to that: the role of financial services in UK trade. The UK has a comparative advantage in financial services and they are a key export. But they have been particularly affected by Brexit, with exports to the EU, the largest destination market, down by 19% since 2018. Without a significant dismantling of regulatory trade barriers in key export markets, an uptick in exports will be too small to soak up the growth of the sector – particularly if the government strategy to attract more foreign entities to the UK to produce financial services is successful.

The cost of financial intermediation

The second key finding is how much financial intermediation costs other sectors, despite all the technological developments of the past 100 years. In his seminal work, 'Has the US Finance Industry Become Less Efficient?', Thomas Philippon estimated how the cost of financial intermediation in the US has evolved since the end of the nineteenth century. The cost has remained remarkably stable. On average, it costs 2% to intermediate an asset, whether it is to finance railways in 1890 or fund a start-up company in the twenty-first century.

Guillaume Bazot analysed the post-war cost evolution of financial services in 20 countries and found that, although unit costs had declined over time and productivity had increased, most productivity gains had been captured by the financial sector itself in Canada, the US and the UK.

How can the great technological and management innovations of the twentieth century have had so little impact on the end-price of financial services? Imagine if a voice call cost the same today as it did in 1876 when the

first phone call was made by Alexander Graham Bell.

We know innovation doesn't always translate into lower prices for consumers. In markets characterised by thin competition, asymmetries of information and agency-principal problems, productivity gains are instead captured by rent-seeking and zero-sum activities. In financial services, computerisation led to banking concentration and an explosion of secondary trading but not to a more accurate pricing of assets. Derivatives helped financial markets to improve and to monetise risk management better but also created additional complexity for economic agents.

The originate to distribute model of lending, in which loans are securitised rather than held on the books, thrived on exploiting agency power and ended up distributing hidden risk to those less able to manage them, fuelling the 2008 financial crisis.

So, what are the lessons for reform today, in the midst of another technological revolution that has enormous potential to increase financial services productivity? Focus on competition, not competitiveness. Reform should tackle the structural market failures of the sector. As a minimum, it must reduce barriers to entry – as the Competition and Markets Authority mandated with open banking.

Opening up the market means slashing information asymmetries across the board – not by just by increasing disclosure requirements but by forcing transparency on fees. Consumers also need to be better protected through access to the right financial education. Where consumers are likely to be overwhelmed, there has to be regulation to prevent the use of abusive behavioural methods. There also have to be concerted efforts to tackle the principal-agent problems that persist in the sector.

If the UK were to harness technological innovation successfully to cut financial intermediation costs for end-users, not only would the whole economy benefit, but the financial sector itself would become truly competitive and regain its mojo as a global financial centre.

Meanwhile, to assess the success of the Edinburgh package, I would advise you to monitor the share of financial services in the economy and its export success. If export growth is too small to compensate for the growth in financial services, expect further declines in UK overall productivity. ■

Martina Garcia *is Director of the Centre for the Study of Financial Innovation at the London Institute for Banking and Finance. Her career in financial services spans over 20 years and includes senior roles at the London Stock Exchange Group, HM Treasury and the OECD*