The Importance of Financial Services

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I am honored to participate in this conference and chair this session that brings together prominent individuals from so many nations.

Our countries have financial structures that differ in many ways. Some, including most in continental Europe, rely heavily on banks. Others, like Britain and the United States, the so-called Anglo-Saxon countries, rely more on financial markets. And, our banks are of different shapes and sizes. Most Western European countries are served by a small number of large financial institutions. In the U.S., we have thousands of them. In some countries, people depend on government savings institutions, like postal savings system in Japan. In other places, like the U.S. and the Euro Zone, private sector banks clearly dominate.

Nonetheless, while institutions differ greatly across countries, the need for financial services is universal. All developed economies require financial services to facilitate the creation and transference of assets. And, while these financial services may be provided through different institutional structures, the transfer of value among economic agents across space and time is a necessary and important part of the economic infrastructure.

Each country's system has been shaped by its own unique political goals, social values, and cultural practices. But, there is a commonality of need that transcends our differences, and I would like to open our session with a few thoughts about that commonality.

The linkage between economic development and the financial sector

The universal need for financial services is driven, not surprisingly, by simple economics. Research linking a nation's economic development to the sophistication of its financial sector has a long tradition, dating back at least to the work of Bagehot in 1873, and continuing with contributions by Hicks, Robinson, Chandler, McKinnon, and more recently King and Levine, and Allen and Gale. This linkage is well established theoretically and statistically, and leads to the clear conclusion that efficient financial intermediation is essential to economic development.

I would add that, in all likelihood, efficient intermediation will be even more crucial in the years ahead, as economies become more reliant on capital-intensive processes and innovative technologies.

The role of the financial sector

In short, the financial sector is an essential infrastructure for transferring resources across people and over time. Owners of resources use the financial system to transfer those resources to those who will allocate them to their most efficient and productive use. The resource owners can then reclaim them in the future --- along with compensation for their contribution. And along the way the financial system will allocate the attendant risks to those most willing and able to bear them.

Resource allocation, wealth accumulation, risk management are all services performed by the financial sector. Let me add one more -- one so basic that we sometimes forget it: payment services. Money and methods for moving money in the course of everyday commerce are part of the financial system, and a crucial part.

While the list of services provided by the financial sector seems simple and intuitive, the systems needed to provide them are not. As information and communications technologies advance, financial markets respond to borrower and investor needs with greater speed and increasingly sophisticated financial instruments.

And, while we can list the services provided by the financial sector individually, we find that they are most often provided jointly in the real world. Occasionally, a financial services firm will specialize in one product or service. But, because of perceived substantial economies of scale and scope in providing financial services, large, multi-product financial institutions have emerged around the globe.

The underpinnings of the financial infrastructure

I would like to pick up on this idea of the interplay between the financial sector and the economy. The financial system does not operate apart from the economy. It is part of the economy. Indeed it is part of the nation's culture. And for the financial sector to function properly, it must be supported by sound social institutions and business practices. Let me be more specific by mentioning three important elements of the business environment that work to enhance the ability of the financial structure to deliver on its potential to improve on an economy's growth.

First, at a basic level, in order for financial assets -- which are essentially legal claims on organizations -- to be of any value at all to investors, they must be able to rely on a legal system that can define property rights and enforce contracts.

Second, for potential investors to value a borrowers' financial commitments properly, the borrowers must adhere to established accounting standards for stating their financial position, and provide a reasonable degree of transparency concerning their financial situation.

And third, given the size, reach, and complexity of modern corporations, the rules of corporate governance must provide a clear path from equityholders to management control. The responsibility of the organization to various stakeholders must be clearly defined and controls easily exercised.

The role of regulation

These things are essential to a sound financial system. Establishing property rights and enforcing contracts. Establishing proper standards for financial statements and financial disclosures, and seeing that corporations exert proper control over management. These things are essential to a sound financial system. But, will these things emerge from the unaided private sector? Or, must government take on these responsibilities?

I believe that prudent regulation by government is essential to the integrity of the financial sector. Adam Smith's "invisible hand" cannot fashion an effective, efficient financial sector on its own. There are too many parties involved, motivated by their own incentives, and with their own objectives at stake. The invisible hand works best when market information is complete and equally accessible by all parties. But in the financial sector, information is costly to process, and it is not equally accessible to everyone. Indeed, if the individual saver knew everything there was to know about every corporate borrower, there would be little reason for financial intermediaries like banks or investment funds to exist.

Thus, asymmetric information, opaque rather than transparent financial statements, and the potential for contagion caused by bad news are endemic to the financial sector. Given these realities, participants cannot rely solely on the invisible hand of the marketplace. They also need a helping hand from government.

In discussing the proper role of regulation, it is useful to make the distinction between regulation of financial markets and the regulation of financial institutions. Each addresses different issues. Each provides different solutions. And, as a practical matter, each is often in the hands of different government agencies

With financial markets, the focus is on ensuring full disclosure, complete transparency, and the enforceability of contracts. The essence of a financial market is that it affects the exchange of a standardized financial claim -- a bond, or a share of stock-- between two parties. The role of regulation in financial markets is to assure that the buyer have reasonable access to complete and accurate information about what the claim represents, and that both buyer and seller will live up to their responsibilities in the exchange.

With financial institutions, regulators' focus is on limiting the individual institution's risk exposure and insulating the financial system from contagion, should an individual institution falter. As intermediaries between ultimate borrowers and lenders, institutions' balance sheets are necessarily less than transparent. This opens the door both to excessive risk-taking and to a potential loss of public confidence in the entire system. Since they cannot eliminate the cause, regulators concentrate on limiting the effects by imposing prudential rules on institutions and providing deposit insurance and other guarantees on liabilities.

Of course, there is considerable overlap between financial markets and financial institutions. Institutions trade in markets; and there are markets for claims on institutions. Nonetheless, the distinction is useful. As I mentioned a moment ago, countries often establish separate regulatory agencies for each. In the U.S., for example, the Securities and Exchange Commission, or SEC, regulates markets, and the Federal Reserve regulates institutions.

Government regulation of the financial system, imposed to ensure the integrity of the financial system itself, is essential. But often, governments impose regulations on, or otherwise intervene in, the financial system in order to achieve broader social goals.

Governments may seek to support a particular industry or economic sector. For example, intervening in the financial sector in order to bolster housing has a long history in the United States.

Or, governments may seek to help certain segments of the population. Again using the U.S. as an example, we have regulations designed to provide low-income people with broader access to financial services. And, whether you call it Social Security or by another name, virtually every nation intervenes in the financial system to protect the retirement income of its citizens.

Finally, another regulatory goal may be to preserve fair competition in the marketplace, and to dilute a perceived concentration of market power.

It is not for me to say whether governments' decisions to intervene in the financial system for social purposes are wise. But I will say this: they are not costless. Policies that bend the financial sector to better serve one constituency inevitably divert it from serving other constituencies. Choosing among policies amounts to allocating costs and benefits among competing interests. Those are political decisions for each country to make.

So, financial sector regulation has traditionally had two goals: first and foremost, to make the financial system as efficient as possible in providing its core services, and second, when the financial system is called upon to meet other social goals, to minimize the costs of doing so.

Conclusion

So, to summarize, economic research and our shared experience lead us to two conclusions. First, for a market economy to evolve and prosper it must have a financial system that delivers a core nexus of financial services: savings allocation, wealth accumulation, risk management, and means of payment. Second, creating and maintaining that financial system is the ongoing work of both the invisible hand of the marketplace and the helping hand of government.