How countries can avoid the financial resource curse

By Noah Smith

October 26, 2015 – *The Globe and Mail / Bloomberg News*

For a long time, and especially since the financial crisis, many people have suspected that financialization is bad for an economy. There is something unsettling about watching the financial sector become a bigger and bigger part of what people do for a living. After all, finance is all about allocation of resources – pushing asset prices toward their correct value so businesses can know what projects to invest in. But when a huge per cent of a country's effort and capital are put into finance, there are less and less resources to reallocate. We can't all get rich trading houses and bonds back and forth.

Critics will probably dismiss these concerns as a relic of the past. We transitioned from agriculture to manufacturing, so why shouldn't we now transition from manufacturing to services? If the market is willing to pay finance 7 per cent of our total national output, then finance must be earning its keep.

This debate goes back and forth. There are a few studies that claim to find a link between financialization and slow growth, but the connection is very hard to prove. For example, a 2008 paper by Turkish economist Ozgur Orhangazi found that finance tended to grow when investment in the rest of the economy slowed. But that doesn't really prove causation – what if finance and other industries are simply a little out of step? The same difficulty plagues similar studies. A Bank for International Settlements paper by Stephen Cecchetti and Enisse Kharroubi claimed to find a nonlinear relationship between finance and growth – once finance grows past a certain point, economic growth seems to slow down. But this analysis shows only correlation, not causation – perhaps as growth slows, countries simply need to put more resources into finance in order to ferret out the investment opportunities that remain.

The question is just very hard to resolve without some idea of the mechanism by which an overexpansion of finance might slow countries down. Alternatively, we might find that financialization and slow growth are both the result of some third factor.

Interestingly, though, a team of economists may have just found that third factor. Gianluca Benigno, Nathan Converse and Luca Fornaro have a new paper in which they propose something called the "financial resource curse." This theory says that the real culprit behind slow growth might not be finance itself, but rather large influxes of financial investment from foreign countries.

To understand the financial version of the so-called resource curse, it helps to remember what the original version was. The resource curse is the name economists give to the bizarre fact that countries with more natural resources tend to grow more slowly than countries without such endowments. A lot of the reason is political, but some is due simply to the math of exchange rates. The more oil or copper that a country exports, the more expensive its currency gets, and the more difficult it then becomes to export anything other than oil or copper. That's called the Dutch disease.

Prof. Benigno et al. postulate that capital inflows cause a sort of Dutch disease variant. When foreign money flows into a country, it redirects the country's resources toward things such as construction, or other non-tradeable goods such as finance. Manufacturing is starved for resources, and contributes less to the economy. Capital inflows in particular tend to lead to a burgeoning finance sector, since

banks and other financial businesses are necessary to direct and manage the incoming cash.

In the short term that causes a boom. But in the long term it's deadly. Manufacturing is the sector that has seen the highest productivity gains in recent decades. That means that by depriving manufacturing, foreign capital inflows have the capacity to reduce productivity.

Prof. Benigno et al. use Spain as their prime example. Starting in the late 1990s, Spain began to experience a huge influx of capital from outside its borders. Much of this capital went to the housing sector. About this same time, productivity took a dive – Spain actually became less efficient. A bounty of foreign money seemed to leave the economy spinning its wheels.

Does this mean that free trade might be a bad thing for some countries? Frankly, yes. Standard arguments for free trade are all about the short-term boost to economic efficiency. But if investors think in the short-term, growth could be hit in the medium to long term.

If that's true, it would add to growing unease among economists about the free movement of capital between national borders. Capital mobility is a key component of international trade, but economists now worry that it destabilizes financial markets and causes crashes and recessions. To that worry, we can now add the possibility that capital inflows end up starving the real economy.

So financialization may often be merely one symptom of a larger disease – the curse of too much foreign money. The cure, as suggested by Prof. Benigno et al., is for governments to counteract capital inflows by buying foreign assets. If they send you money, maybe the right thing to do is to send it right back.