CAPITAL MARKETS AND ECONOMIC GROWTH

Long-term trends and policy challenges

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Alternative Investment
Management Association

Introduction

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The financial crisis of 2008 threw into sharp relief the weaknesses of the banking sector, prompting massive state bail-outs and decisive supervisory action by G20 nations: banks have been forced to reduce the size of their balance sheets and build up stronger capital buffers, with a view to ensuring that they are better able to withstand any future shock.

But this leaves policymakers across the globe with a dilemma. How do they ensure that building a more stable, resilient financial system does not come at the expense of economic growth? New rules have required banks to scale back the amount of money that they lend, which in turn means that firms – particularly small and medium enterprises (SMEs) – are less able to access the capital that they desperately need to be able to invest in and grow their business.

This has led to increasing interest on the part of policymakers in the role that market finance – sometimes referred to as part of the 'shadow banking' system – could play in terms of filling the lending gap and allowing firms to access the capital that they need for growth.

In its simplest form, market finance is based on a model whereby businesses are able to raise capital from investors by issuing shares and bonds – by accessing capital markets. In some regions, like North America, capital markets already dominate, contributing more to the supply of finance than the banking sector. In other regions, such as Asia, the primary source of capital is banks, with capital markets playing a more peripheral role.

Europe is an interesting region to consider, because it is characterised by differences between countries in terms of the balance between market-finance and bank-based lending. We at AIMA were keen to explore these differences, to see whether this could provide broader insights into global financial structure and its future evolution. Specifically, what do differences in the balance between bank lending and capital markets mean for economic growth? Do capital markets offer a source of finance that has positive spill-over effects on the economy?

AIMA asked two leading academics in this field, Christoph Kaserer and Marc Steffen Rapp, to explore these questions, resulting in the publication of the study 'Capital Markets and Economic Growth – Long-term trends and policy challenges'.

The study's key finding is that the balance between market finance and bank lending does matter and that overreliance on banks comes at a cost in terms of reduced economic growth. The study estimates that growing capital markets by one-third could fuel a long-term real growth rate in per capita GDP of around 20 percent.

The study also highlights the positive role that hedge funds can play, using their expertise and willingness to create positive governance changes in the firms in which they invest. Hedge funds are also important providers of liquidity, risk management and price discovery in capital markets.

The study goes on to explore how policymakers could build a policy programme that aims to support the development of capital markets and tap into their under-exploited growth potential – a vision that AIMA strongly endorses. Ultimately, embracing the financing possibilities associated with capital markets can help to ensure that the global economy is on a sure footing for future growth.

Jack Inglis
Chief Executive Officer
AIMA

About AIMA

Founded in 1990, the Alternative Investment Management Association (AIMA) is the global representative of the hedge fund industry. We represent all practitioners in the alternative investment management industry – including hedge fund managers, fund of hedge funds managers, prime brokers, legal and accounting firms, investors, fund administrators and independent fund directors.

Our membership is corporate and comprises over 1,400 firms (with over 7,000 individual contacts) in more than 50 countries. They all benefit from our active influence in policy development, our leadership in industry initiatives and our outstanding reputation with regulators.

We are a dynamic organisation that reflects our members' interests and provides them with a vibrant global network. We are committed to developing industry skills and education standards, and we are a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the industry's first and only specialised educational standard for alternative investment specialists.

Key findings at a glance

Deeper capital markets enhance economic growth

- Having a larger capital market relative to the banking sector is associated with a higher rate of economic growth. The study's authors estimate that growing combined stock and bond markets by one-third could fuel a long-term real growth rate in per capita GDP of around 20 percent, as stock and bond market liquidity allows for cost-efficient reallocation of capital across industries.

- The report suggests that the positive impact of stock markets is related to two major channels: (1) the availability of funds for long-term risky investments; and (2) the incentives for improving corporate governance.

Europe is becoming less reliant on banks

- On a macro level, there is a well-established, significant trend of capital market growth. By way of illustration, average stock market capitalization in European economies with bank-based financial systems, historically known to be much lower than in economies with market-based financial systems, was 35 percent of GDP during the nineties, but increased to 58 percent over the period 2000 to 2012. Over the same period stock market capitalization in market-based European economies only increased from 110 to 117 percent. Hence, in relative terms stock market growth was much more pronounced in bank-based European economies.

- Convergence is also evident at the micro level. Today, European firms tend to rely much more on equity financing than in the nineties. Also, differences in capital structures between different European countries have become less pronounced in recent years. Similarly, the level of ownership concentration in listed firms, historically known to be higher in bank-based economies, has become more balanced over time as ownership has become more dispersed in firms located in bank-based economies.

Asset managers support capital market growth

- The regulatory environment for funded pension schemes is shown to be an extremely important driver for capital market size. The authors estimate that increasing the size of pension funds by 10 percentage points of GDP could lead to an increase in stock market size of 7 percentage points of GDP. Similarly, the broader spectrum of asset managers – from passive investors through to dynamic and active investors such as hedge funds – further complements the effectiveness of capital markets, both in terms of enhancing market liquidity and in terms of providing capital for potentially riskier business investments.

Capital markets are good for Research and Development (R&D)

- Examining the financing decisions of firms, the study documents that firms' R&D intensity is positively correlated with the level of equity financing. The study provides evidence that firms in bank-based economies have less flexibility in their financing decisions and therefore follow a more conservative financing strategy. This might lead to underinvestment in R&D.

Corporate governance rules are still fragmented

- Minority shareholder protection rules still differ substantially across Europe with many bank-based European economies still lagging behind the market-based economies. Simultaneously, the report provides evidence that institutional investors are more reluctant to invest in firms that are based in countries with weak shareholder protection. This is especially true for independent institutional investors. These investors play an important role in corporate governance, complementing the positive contribution of capital markets to the economy at large. In particular, active shareholders, such as hedge funds, are able to effect positive governance changes in the firms in which they invest, by virtue of their expertise and willingness to engage with a firm's management.

How to strengthen capital markets

- The report concludes that capital markets could make an important contribution to the EU growth strategy, which has been developed by the leaders of EU member states. Capital markets could be strengthened by improving the quality of minority shareholder protection rights, just as the role of independent institutional investors could be enhanced.

- The study also notes that retirement savings rules and tax laws could be designed in a way that encourages a larger part of national savings to be invested via capital markets, which would also help funded pension schemes to provide for an ageing population. And, finally, it is worth considering how tax rules could enhance the role played by stock markets.

An EU policy programme to support capital markets

AIMA hopes that policymakers will form their own view on the research that we have commissioned and that is the spirit in which we have supported it. But we also think it right to draw some tentative conclusions from the work:

- Governments, and the EU in particular, would benefit from a well-developed capital markets policy that recognises that a critical feature of a stable financial system is having strong capital markets with a necessary diversity of key participants.
- In terms of translating this into legislative and regulatory action, we believe that the following concrete steps could be considered:
    - Development of a pension fund vehicle that can be marketed across Europe under a harmonised set of rules.
    - Reform of European corporate governance requirements with a view to strengthening shareholder protection.
    - Development of a harmonised framework for loan origination outside the banking sector.
    - Development of a harmonised and strengthened insolvency framework across the EU.
    - Review of the existing rules for securitisations to ensure that the market can function effectively.
    - Avoid homogenisation of financial markets participants which extends regulatory approaches from one sector to sectors with radically different business models.

Ultimately, we believe that a co-ordinated and ambitious policy programme along these lines could help to provide additional sources of financing for the real economy, whilst making for a stronger financial sector.

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