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Editors

The Financial Systems of Industrial Countries

Evidence from Financial Accounts

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To our parents

Foreword

The Great Recession of 2008/09 had two distinct characteristics: its financial origin and its global dimension. Over the last 20 years substantial changes have occurred in market openness, as well as in technology and demography. Financial integration has been very intense in the advanced economies and financial deepening has accompanied a marked increase in world economic growth.

The development of new information and communication technologies impacted all sectors of the economy. The financial system was affected to a significant degree in all its building blocks, from market exchanges to investment instruments, from payment and settlement infrastructures to the behaviour of intermediaries. The securitization of banks' assets expanded considerably, and with it the complexity of structured financial products. Contrary to most expectations, this meant that rather than being more distributed across a wider set of investors, credit risk ended up being extremely concentrated. Moreover, unlike traditional bonds these products were not generally traded in secondary markets and their valuation was often based on conjectures that were hard to verify. Over the years the values of traditional financial and real assets – such as equities and real estate – reflected the predominantly low interest rates generated by highly expansive monetary policies and large flows of investment in the financial markets of advanced countries from rapidly growing emerging economies. Eventually, this led to across-the-board reductions in risk premiums, a wide-ranging search for yields by financial institutions that made use, in very liquid markets, of the illiquid and opaque structured products assembled through financial innovations and innovation in finance, and – with lax regulation and supervision in many sectors of financial intermediation – to the booms and busts that have characterized the past decade.

The crisis has indeed shown that financial flows matter. It is precisely because of financial innovation and innovation in finance that during the years of the Great Moderation tracking quantities appeared less important and monetary transmission was basically summarized through term-structure equations in efficient capital markets. Efforts at incorporating in macro-modelling, for description as well as for interpretation, national income and product accounts, input–output interdependency tables, and flow-of-funds accounts were abandoned in the late

1970s in the wake of the so-called rational expectations revolution. With that, attempts to take explicit account of balance sheets in forecasting and policy evaluation were, with few relevant exceptions, also curtailed. I believe that it is fair to say that the possible interactions and feedbacks between the real and financial sectors of the economy did not receive sufficient attention and we were not prepared to address the non-linearities that emerge especially during crises. What has happened in the last 3–4 years has shown that interconnections have developed across institutions, markets and economies in ways that make financial systems very complex, corner solutions very costly, the consequences of excessive leverage and defaults very dramatic and the accumulation of systemic risk very dangerous. Much intelligence is currently being deployed to address these issues, and others that the depth and diffusion of the crisis have highlighted. But while theoretical advances may rapidly emerge, the risk is that on the empirical side our interpretation of the world remains essentially linear. Much of this is due to the limitations of the statistical apparatus that is available for the comprehensive and systematic study of the evolution of our economies.

While much useful information is now being assembled, and utilized in several empirical analyses that depart from the abused assumption of "representative" agents, there is a return of attention to the use of flow-of-funds data and the balance sheets of households, firms, governments and financial intermediaries to better assess financial positions and risks. Flow-of-funds are typically constructed and examined within central banks. They contain a wealth of useful information, at times not obvious to read and necessarily to be complemented by other sources of information on the real economy, asset prices and the balance of payments. For some time they may have been considered too detailed and difficult to use systematically and extensively. But now is certainly time to return to them.

This book is useful in tracking the history of flow-of-funds, pointing out interesting analytical and statistical uses, showing that financial flows matter and that they might have been used ahead of the crisis for a better understanding of the state and vulnerabilities of our economies. It is also honest in its conclusion that although financial accounts are important in helping to understand the potential effects of financial imbalances and mismatches on the real economy they would not have been sufficient to depict the actual size of the problems accumulated and masked during the years of macroeconomic stability that preceded the crisis. We learn how interconnections between the balance sheets of financial intermediaries increase in periods of booming financial conditions and how this may harm financial stability and economic growth. The presence of a common trend of financial deepening across different countries is highlighted, where and how households' indebtedness exploded in the years preceding the crisis, and how it was masked by the contemporaneous rise in net worth, made possible, however, not by the accumulation of saving but by unsustainable changes in asset prices. While this phenomenon was seen and acknowledged by several economists and policy makers as it was taking place, it is fair to say that its consequences were grossly underestimated. We also learn how households and firms have reacted to shocks in monetary policy by increasing their borrowing or reducing their financial investments in ways and with a timing that need to be examined carefully.

Balance sheets of households, enterprises and governments are fundamental to understand the complexities of the economy. In this sense we cannot do without good financial accounts, and as important aggregate ratios are summarized in flow-of-funds data these have to be carefully managed and compiled. With them, micro data are essential to understand and allow for the build-up of leverage, risks of default, interconnectedness. The links between flows and stocks and asset prices and rates of return also need to be better understood, as the measurement and role of capital gains and losses are paramount. Finally, we need to improve our awareness and information of cross-border transactions, as financial linkages are certainly no less important than linkages in traded goods and services. A weighty agenda, then, for economists and statisticians, one that needs to be addressed and to which this book offers a timely contribution.

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