Sustainable finance for sustainable development

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Introduction

The spirit of international co-operation was at its historical peak in 2015. Among other significant decisions, especially by the G20 and the United Nations (UN), the adoption of the ambitious Sustainable Development Goals (SDG) by more than 190 countries was a landmark event.

The global financial crisis (GFC) of 2008–2009 was among the main reasons behind the SDG decision of the UN. Other significant changes, like the establishment of the Financial Stability Board (FSB) by the G20, also took place shortly after the GFC. Unfortunately, the connections between financial and social sustainability become evident only after financial crises hit major economies – to that end, the GFC was an important wake-up call.

In this essay, I will reflect on the relations between sustainable finance and sustainable development. Both concepts are rather new in terms of their broad acceptance and use. Yet, their significance for global well-being are high. I will argue that sustainable global finance needs inflation targeting, floating exchange rate regimes, and a bit more effort.

Sustainable development can be defined as a continuous improvement in the quality of life of everyone in a society. In the language of economists, it is an uninterrupted sequence of strict Pareto improvements in our life standards. This may sound utopic at first. Yet, it is feasible and is worthy of pursuing by policy makers as a set of continually improving goals.

An economic crisis can be defined as an economic outcome that makes a significant part of the society significantly worse off. Sustainable development policies and institutions should therefore, at least, be able to avoid major economic crises. Financial sustainability, by avoiding economic crises, captures one important aspect of sustainable development.

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[2] All views and opinions expressed in this chapter are those of the author and do not necessarily represent the official views of the Ministry of Foreign Affairs or of the Central Bank of the Republic of Turkey or of the OECD.

Here, I will focus mainly on financial sustainability. First I will share my thoughts on the relation between stability and sustainability. Then I will reflect these thoughts on the relation between sustainable finance and sustainable development.

Stability versus sustainability

Sustainability has a long-term connotation compared to stability. The Bretton Woods agreement (July 1944) was designed to bring economic stability. Indeed, it was pretty stable early on. But that lasted only a few years at the initially pegged exchange rates and survived for only two and a half decades (until 1971), even after many adjustments of the (temporarily) pegged exchange rates. A sustainable international financial arrangement should be more long lasting. The reasons related to flaws in design were studied and understood much later (one is known as the Triffin dilemma).

A typical unsustainable financial cycle starts with rapid credit growth in its first phase. In its second phase a rapid rise in risk premium quickly turns into an economic crisis. The two major global financial crises (1929 and 2008) taught us how to deal with the later phase. Now it is time to think about how to deal with the former.

Risk premium as an unsustainability indicator

Risk premium is a reliable crisis indicator. If financial markets are sufficiently developed, a rise in the probability of a previously unanticipated bad credit event will immediately be reflected in real time on the borrowing cost of a relatively weak borrower. This can immediately be distinguished from that of a strong, and hence riskless, borrower. The difference is known as the risk premium. This difference is also affected by the broader market conditions, like the risk appetite, which is usually called the price of risk.

Currency risk premium

Fixed exchange rate regimes are always prone to sustainability questions. I will call this the "fixed but not" (FBN) problem. The survival of a fixed exchange regime depends on an extraordinary policy effort, together with a credible institutional backing. When these are lacking, it is not surprising to see a currency risk premium on local currency borrowing rates. This risk premium is very dangerous since its dynamics are unstable and destructive, with no strong policy commitment behind the regime.

As the probability of a depreciation rises, the cost of borrowing in the local currency rises while the maturity of borrowing shortens. This very quickly leads to a vicious cycle, which is so costly for the society that the peg cannot be

sustained. This means a big credibility loss together with its associated economic, social and political damages.

Inflation risk premium

Floating exchange rate regimes may be prone to sustainability questions as well. These, however, would arise only under major policy mistakes, almost always related to the loss of confidence for price stability. Expectation of a high price inflation can easily and quickly transform to an unstable dynamic, known as hyperinflation (Cagan, 1956), in the absence of any corrective policy measure. This can be traced from a worsening in the real local currency borrowing costs (due to a rise in the inflation risk premium) and terms to unsustainable levels. This is always associated with a sustained sharp depreciation of the local currency exchange rate.

Expectation of a very low, especially negative, price inflation is also unsustainable. In this case there is an unstable dynamic labeled as "debt deflation" by Irving Fisher (1933) in an attempt to explain the Great Depression. In this case the real risk premium rises because nominal interest rates cannot fall to accompany a fall in expected inflation. This is typically associated with an appreciation of the local currency under a floating exchange rate regime.

The remedy of the FNB problem associated with the fixed exchange rate regimes has therefore been found in a more sustainable regime called "inflation targeting" (IT). This is a combination of a sufficiently low inflation target under a floating exchange rate regime. The experience of the 1970s and 1980s has shown us that this is technically more feasible when the main monetary policy instrument is the short term local currency interest rate (rather than a monetary aggregate), and is politically more feasible when the monetary authority operates independently of the political election cycle.

Default risk premium

The human desire for a guaranteed fixed income is now well documented. In terms of labor income, this exhibits itself in the form of a strong demand for job security and unemployment insurance. In terms financial income, there is a strong demand for securities that promise a fixed income stream.

Yet, financial assets that provide a guaranteed fixed income are typically scarce. In fact, as with the fixed exchange rate regimes, there is a FBN dilemma here as well. Debt contracts have a zero-risk premium only if you are an extremely prudent borrower. But a zero-risk premium makes borrowing very attractive and provides a strong temptation to borrow imprudently. If you cannot resist that temptation, the likelihood of your default on your fixed payment promise increases. As a result, your risk premium rises, deteriorates your financial strength, potentially leads to a vicious cycle and finally to default. So fixed income securities are inherently not fixed income, unless there are strong institutional safeguards behind them. Typical safeguards are collaterals and other borrowing restrictions.

Before it is too late

Late indicators of environmental unsustainability are easily measurable like global warming, deforestation, air and water pollution. Late indicators of social unsustainability are also measurable, like income and wealth inequality. Likewise, easily measurable late indicators of financial unsustainability are financial risk premia, as I argued above.

For purposes of policy development and institutional design, discovering early indicators of unsustainability would be worthwhile. For example, in the case of the environment carbon emissions, and in the case of society rapid technological change, are the well-known early indicators. Similar early indicators of financial unsustainability have been worth exploring.

Early indicators of financial unsustainability

Budget deficits and the associated debt accumulation have been the focus of economists since the beginning of the profession.
In the case of governments, debt accumulation has been a frequently observed pattern in financial history. This immediately brings in the question of sustainability of government finances. Simple arithmetic shows us that a path of ever increasing debt for a government, together with a path of permanent budget deficits, can be sustainable for a growing economy – provided that speed limits are observed.

Economist Robert Barro in his seminal theoretical work (Barro, 1974) "Are government bonds net worth?" and others following his sophisticated reasoning have added to our understanding that the growth of government debt can be desirable in addition to being sustainable, again for a growing economy, provided that certain speed limits are observed.

The rules of the "Stability and Growth Pact" (SGP) of the European Monetary Union (EMU) were designed under these inspirations on desirability and sustainability. A double strong safeguard mechanism was introduced to provide speed limits on the pace of government debt accumulation, at the outset. Total gross general government debt should not exceed 60 per cent of the value of the gross domestic product (GDP) and the general government budget deficit should not exceed 3 per cent of the GDP of any member country.

One can argue with hindsight that the 60 per cent limit has been set too tight and that the 3 per cent limit has been set too loose (given the low economic growth potential and the constitutional balanced budget rule imposed by Germany) for the EMU. Yet, especially nowadays, I guess nobody would argue against the presence of some speed limit to ensure fiscal sustainability.

How about speed limits for private borrowing? Financial sustainability of the overall economy of any country can likewise be summarized by its external

(current) account deficit and its total external debt. Since the Bretton Woods agreement, the International Monetary Fund (IMF) has been following these two external accounts for all of its members, while providing policy guidance in cases of unsustainability. Yet, the European Union felt the need to introduce an additional set of speed limits after the Eurozone debt crisis of 2011. The "Macroeconomic Imbalance Procedure" (MIP) introduced in 2012, asks corrective policy measure from its member governments in cases of detected external unsustainability. The main MIP early warning indicator is again a speed limit, this time on the current account deficit, set at 4 per cent of the GDP.

Both the 3 per cent deficit limit of the SGP and the 4 per cent deficit limit of the MIP are rules of thumb based on past crisis experiences, together with some assumptions on the expected future economic growth rates. Although the judgements the arithmetic behind these precise figures can be questioned, it is very useful to have a formal but simple early warning indicator, especially in the form of deficits. This approach not only facilitates the identification of corrective measures for the current period but also simplifies the analysis of long term sustainability.

Early political action to correct a fiscal unsustainability trend that will become a pressing issue only after a decade or two is not easy. Public pensions and healthcare systems are two typical examples. The projections on tomorrow's fiscal deficits to arise from existing unsustainable social protection schemes visa vis the speed limits introduced by the SGP or the MIP would make early awareness and communication easier for European policy makers to make the tough decisions of today. Policy makers outside Europe also welcome and use these new simple rules based European sustainability safeguards.

More complex questions arise when it comes to finding the right set of corrective policy measures. The relatively new "macroprudential" approach aims at bringing in a much needed policy dimension in order to ensure financial sustainability.

Financial sustainability policies

A very simple message, "do not borrow too much" if delivered properly, would ensure financial sustainability in most cases. This can be done by financial education, financial regulation or by both.

Financial education is perhaps the least costly and the most effective way of ensuring financial sustainability at the individual level. If all economic agents were to act prudently and rationally in their financial choices this would have immediate macroeconomic benefits of sustainability. Nowadays there is a tiny but growing body of work on financial education.

Regarding measurement, the well-known PISA test run by the OECD has recently been exploring financial choice patterns and skills of students in various countries. The results point to a huge knowledge gap in finance. Regarding

theory, the seminal paper by Becker and Mulligan (1997), "The Endogenous Determination of Time Preference" lays a rationale for private and public financial education. Regarding policy, the efforts, coordinated by her excellency Queen Maxima of Netherlands, at the international level are noteworthy. Yet, financial regulation is also necessary for sustainability.

While financial education can address the "I don't know" type problems, it cannot solve the "I don't care" type problems. Agency problems and negative externalities are examples to the later that are well studied by economists. The most prominent problem, the "aggregate demand externalities" arising from excessive leverage was introduced to the economic literature only after observing the GFC.

Financial regulation is needed to address the "I don't care" type problems. The use of prudential policy instruments for macro-financial purposes is recently labelled as macroprudential policy. (The volume published by the Bank for International Settlements, BIS, on September 2016, "Macroprudential Policy" is a good collection of papers written mostly by the practitioners of the field.)

When you want to convey the message, "do not borrow too much" by means of policy, you need to be more specific than that. How much is too much? With regard to what? In which currency unit? In which maturity? In fixed or variable rates? How to achieve it? are some questions to start with.

To avoid excessive currency mismatches, direct restrictions on residents for their borrowing in foreign currencies have been used by some countries. Other countries have used indirect, cost based measures in order to increase the domestic cost of foreign currency borrowing. A floating exchange rate regime also helps, by increasing the risk awareness.

To avoid excessive maturity mismatches, direct restrictions are introduced mainly by the FSB on financial intermediaries. The internationally set floors on the newly defined liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR) of Basel III are two examples.

To avoid excessive leverage for banks, the minimal capital requirements are also revised under Basel III. For households and firms, direct restrictions like ceilings on loan-to-income or loan-to-value are now widely used as macroprudential instruments by many countries. For governments, fiscal rules are considered and in some cases implemented.

All this complicated machinery of financial regulation aims at financial stability. Yet, it comes at a cost. Part of the cost is the regulatory burden of implementation. Another part is related to the objective of reducing bankruptcies and related social bankruptcy costs. This objective inevitably reduces both entry and exit to the financial sector, possibly reducing its economic efficiency.

Is there an alternative way to promote financial sustainability for financial development? A promising venue would be to increase the attractiveness of equity finance vis-a-vis debt finance. Equity finance is known to be superior to debt finance from a sustainable development perspective. It is clearly more resilient to shocks. Moreover, as Bent Holmström (2015) argues convincingly it allocates risk more efficiently. It is well suited to finance innovation and facilitates entry and exit.

Equity finance, although socially superior to debt finance, is not preferred that much by economic agents. One important reason is related to its higher monitoring costs. Any institutional or technological improvement to reduce the monitoring costs for the provider of funds would help.

A second important reason has been the debt bias in the tax code. The tax deductibility of mortgage loans for instance is now more widely recognized as a distortion and a policy mistake. Likewise, the corporate tax deductibility of interest payments is also scrutinized for the unnecessary debt bias that it leads to. Reducing or eliminating it would help both financial sustainability and sustainable development. The report "Corporate Funding Structures and Incentives" prepared by related international organizations under the coordination of the FSB and submitted to the G20 on August 2015 studies the debt bias problem extensively.

Concluding remarks

Serious effort at all levels is needed if we want to achieve the ambitious set of sustainable development goals before 2030. Any effort in improving the sustainability of finance would also help sustainable development.

We now know the links between finance and economic sustainability better. By experimenting with them all, we eventually learned which monetary and exchange rate arrangement is more sustainable. We also learned our lessons on the value of prudence, right policies and institutional safeguards in the area of finance.

What we know less about are links between finance and environmental sustainability as well as links between finance and social sustainability. Very little research exist in these two areas, although there is more awareness of the need, as summarised in the title of this year's (2017)OECD Ministerial Council Meeting: 'Making globalisation work: Better lives for all.' There are reasons to be hopeful.

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