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Flash Economics

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Towards a new model of financial macroeconomics

The traditional model of financial macroeconomics is well known:

- Households have a lending capacity; companies and the government have a borrowing requirement;
- Household savings must therefore be channelled, via financial markets and banks, into financing the government (via the government bond market) and companies, either in a disintermediated (via equity and bond markets) or intermediated manner (via bank credit);
- This raises the question as to whether the government crowds out companies if fiscal deficits are large, and of the choice between intermediated and disintermediated corporate finance;
- Monetary policy affects the economy mainly by modifying the cost of corporate finance.

But this traditional model is no longer suited to contemporary analysis of OECD countries. In these countries, income distribution has been skewed heavily in favour of companies, which self-finance their investment. The only economic agent with a borrowing requirement is therefore the government, and the only role of finance is to channel household savings into financing fiscal deficits.

This raises very different questions:

- What is the role of equity and corporate bond markets if companies no longer use them to raise finance?
- What use are banks if they only have to transform household deposits into government bond purchases?
- Is monetary policy ineffective if companies fully self-finance their investments?

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ECONOMIC RESEARCH

The traditional model of financial macroeconomics

We will assess the situation of **the OECD as a whole** (which, to simplify, we define as United States + United Kingdom + euro zone + Japan) since the start of the 1990s. **The traditional model of financial macroeconomics corresponds to the situation in these countries in the 1990s and early 2000s:**

- **Companies and the government have a borrowing requirement** (fiscal deficits and corporate self-financing rate below 100%, which shows that external financing is needed to finance investments, **Charts 1A** and **B**);

Chart 1A
OECD*: Fiscal deficit (as % of nominal GDP)

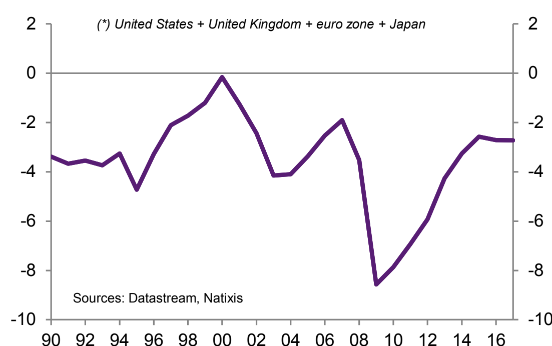
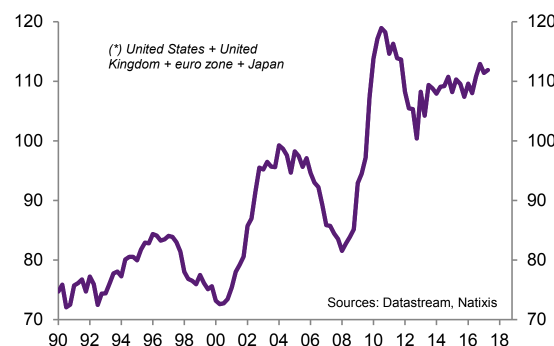


Chart 1B
OECD*: Self-financing rate (as %)



- **Households' financial savings** (excluding their housing purchases, **Chart 2**) **must therefore be channelled into financing both the government** (which takes place when households, directly, or institutional investors buy government bonds, **Charts 3A** and **B**) **and companies**, which is **either disintermediated** (share and corporate bond purchases by households and institutional investors, **Charts 3A** and **B**) **or intermediated** via bank credit **(Chart 4).**

Chart 2
OECD*: Household financial savings rate (as %)**

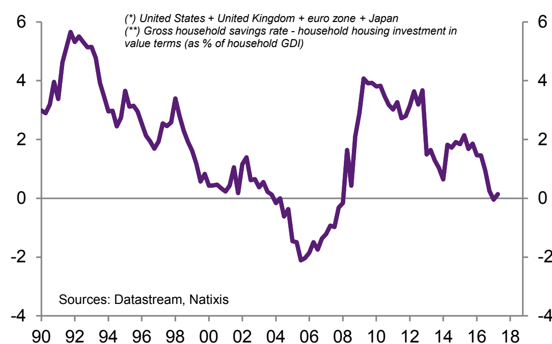
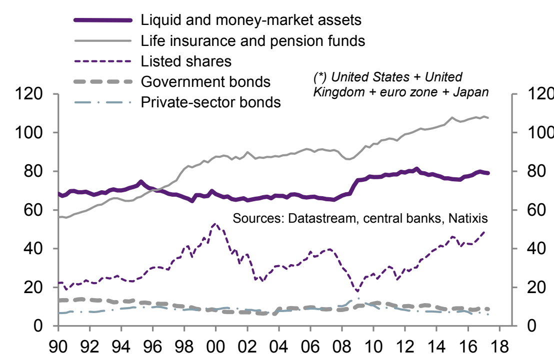
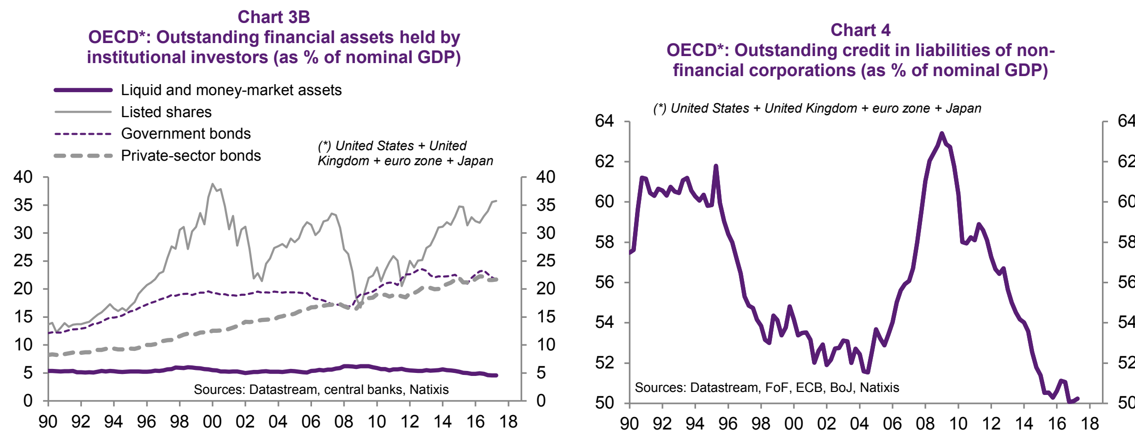


Chart 3A
OECD*: Outstanding financial assets held by households (as % of nominal GDP)

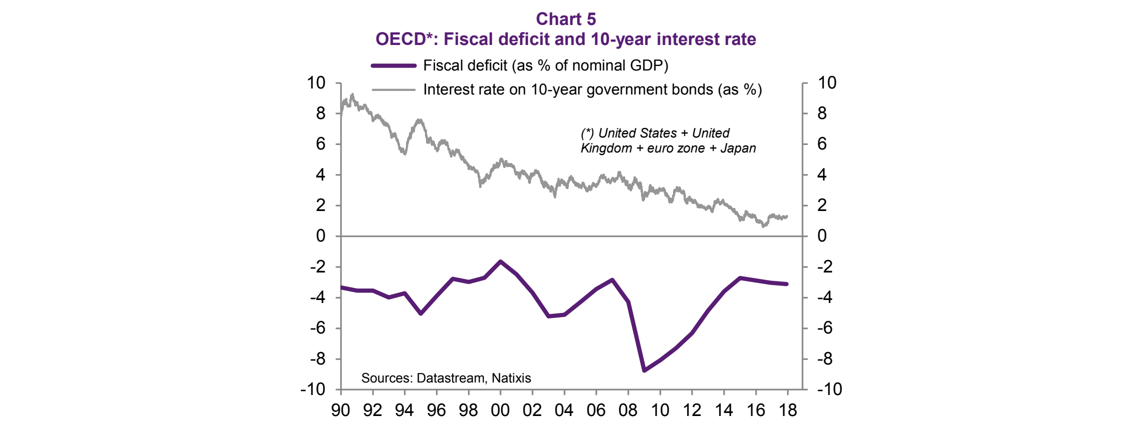




The questions raised in the traditional model of financial macroeconomics

The questions usually raised by this framework (which corresponds to the macroeconomics of the 1990s and early 2000s) are:

- **Do the government's fiscal deficits crowd out companies from financial markets**? This happens if the fiscal deficits result in higher interest rates. **Chart 5** shows that this happened in the 1990s;



- **Is it better if corporate finance is intermediated by banks or disintermediated, i.e. takes place in the financial markets?** In particular, there is debate over how the costs of each form of financing change during crises **(Charts 6A** and **B)**;

Chart 6A
OECD*: Investment Grade and High Yield credit spreads (asset swaps, in bp)

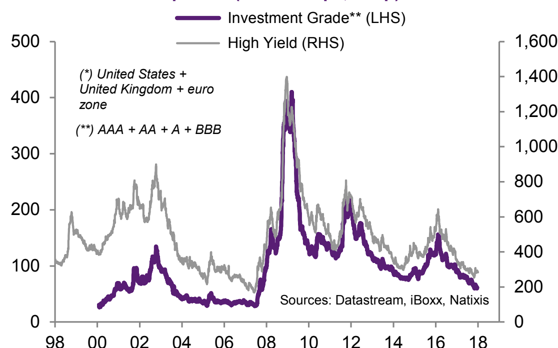
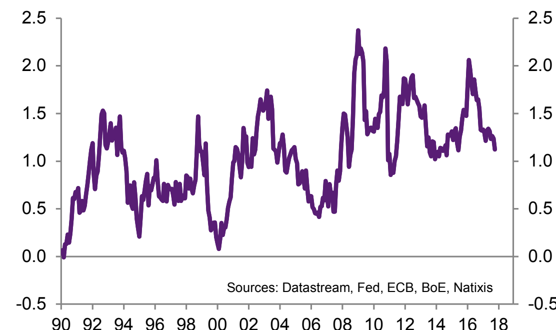
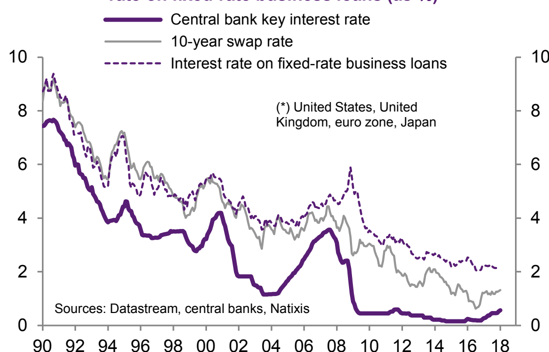


Chart 6B
OECD*: Interest-rate margins on business loans against 7-year swap rate (as %)



- **Is the credit channel of monetary policy effective?** In this traditional macrofinancial model, monetary policy affects the economy mainly via its effect on the cost of corporate finance **(Chart 7).**

Chart 7
OECD*: Key interest rate, swap rate and interest rate on fixed-rate business loans (as %)



But this traditional model of financial macroeconomics is no longer suited to contemporary analysis of OECD countries

Since 2010 in OECD countries, companies have been self-financing (and beyond) their investments (Chart 1B above), thanks to **the pronounced skewing of income distribution in favour of profits (Chart 8A)** and the resulting increase in cash flows **(Chart 8B).**

Chart 8A
OECD*: Per capita real wage and productivity (1990:1 = 100)

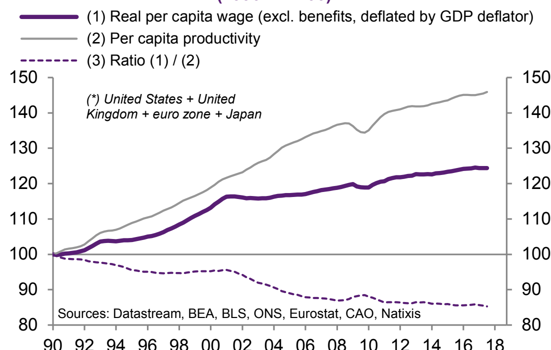
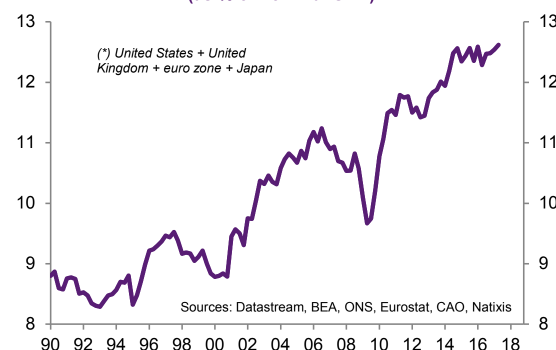
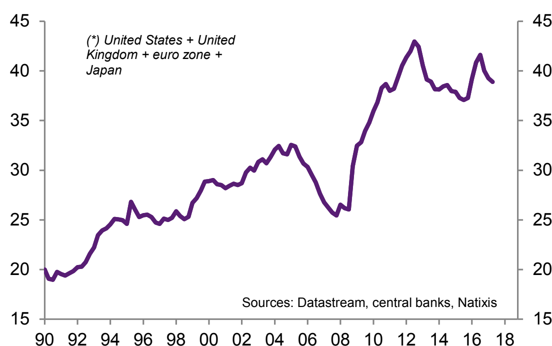


Chart 8B
OECD*: Profits after tax, interest and dividends (as % of nominal GDP)



The only economic agent with a borrowing requirement is therefore the government (Chart 1A) and the question for finance (financial markets and banks) is how to **channel household savings into financing the government.** This may take place as in the past **(Charts 3A** and **B)** in the financial markets, but also by **banks accumulating government bonds (Chart 9).**

Chart 9
OECD*: Outstanding government bonds held by banks (as % of nominal GDP)



This raises very different questions:

- **What is the role of equity and corporate bond markets if companies no longer use them to raise finance (Chart 10)?**
- **What are banks for if they only have to finance governments (Chart 9)?**
- **Is monetary policy still effective if companies self-finance their investment** and no longer use external financing **(Charts 10** and **11)**? **An increase in interest rates now affects corporate investment only via its effect on the opportunity cost of corporate profits.**

Chart 10
OECD*: Net issuance of bonds and listed shares by non-financial corporations (as % of nominal GDP)

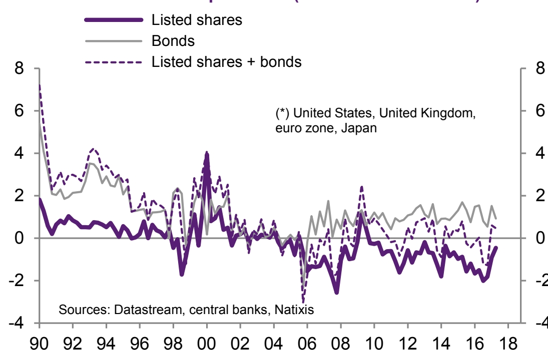
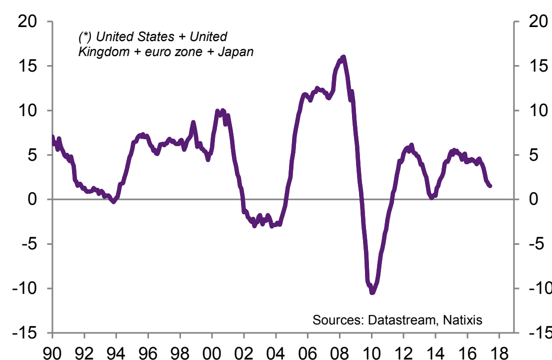


Chart 11
OECD*: Business loans (Y/Y as %)



Conclusion: A very different model

So **the macrofinancial model must therefore shift**:

- From a model where household savings finance companies and the government and are split between disintermediated and intermediated corporate finance;

- To a model where household savings finance only the government, either in the bond market or via bank intermediation.

This raises doubts over the point of complex finance (banks, markets, institutional investors, etc.) if it merely transfers households' financial savings to the government.

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