# Chapter 88
# The Need for News Forms of Financial Intermediation

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## ABSTRACT

*This chapter deals with intermediaries in the financial sector such as banks and institutional investors. These actors are expected to play a central role in economic growth via the funding of investment because they are supposed to match creditors' desires (households) with borrowers' needs (firms) at a macroeconomic level. It aims to reassess the theoretical role of financial intermediation related to the allocation of savings in a context of a structural decline in overall investment for thirty years. To achieve this goal, it studies the evolution of financial intermediaries' behaviour in their capacity to finance investment and identifies the weaknesses of our current financial system which does not allocate optimally savings to firms' productive projects. Then it suggests some policy implications defining new forms of financial intermediation in which public financial intermediaries would have to play a greater role.*

## 1. INTRODUCTION

Intermediaries are at the core of economic and social dynamics. When some actors strive for financing and others offer funds, it could be imagined that lenders and borrowers could meet directly. But creditors' desires rarely match borrowers' needs. This is the reason why a third part intrudes in the middle of these relationships: that's what financial intermediation is about. Indeed, borrowers aim to minimize expenses and take on debts in the medium and long term while lenders are concerned with having high yields, minimizing risk and maintaining liquidity by focusing on short-term investments. If, at the microeco-

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nomic level, the non-financial agents may have sufficient resources or not to fund their spending plans at a given horizon, at the macroeconomic level, households are agents with funding capacity (potential lenders) and the companies and States, are agents who need funding (potential borrowers). Therefore, this imbalance and diversity of economic agents' financing needs require to put in place a range of institutions and market mechanisms to not only organise the transfer of funds from the agents who save to those who wish to borrow, but also to make compatible their conflicting motivations in terms of price, maturities, yields or liquidity. Among these institutions, there are financial intermediaries which are predominantly banks and institutional investors (pension funds, insurance companies, mutual funds). This transaction mutually proves advantageous in so far as it allows the lifting of the budget constraint[1] from non-financial agents by allowing them a more satisfactory temporal scale of their spending.

By facilitating money transfer between borrowers and lenders, financial system and financial intermediaries in particular are considered to play a positive role in the economy via the funding of productive projects or investment. Financial system is supposed to allow an optimal allocation of savings to firms' productive projects. Indeed, at the macroeconomic level, there is a consensus among economists that investments[2], both private and public, are the driving force of the economy, through the investment multiplier: a rise in investment will increase national income more than proportionally thanks to the operation of a virtuous circle. When firms' investment expenditure increases, there is both an increase in demand for investment goods, and an increase in production of investment goods. Companies will therefore employ and pay income in order to produce. This income will then be spent by households. This will bring a new demand for companies, and companies will have to meet this demand by further increasing the production, that is to say by employing even more and paying more income... Conversely, we would get a vicious circle in case of initial investment decline. Thus investment appears to be the condition which revives strong growth and sustainable job creation.

Such a mechanism had worked well during the post-war boom. During this period, the macroeconomic dynamic was based on the traditional drivers of household consumption and business investment. Household consumption could be dynamic because it was based on the Fordist compromise aligning wage increases with the rate of productivity gains. On the investment side, the dynamics were embodied by business leaders primarily seeking growth. The dynamics of consumption also strengthened investment: businesses accumulate more productive equipment when they are able to increase their sales thanks to consumers whose incomes climb regularly. On the public expenditure side, the contribution was also positive: firstly, because we observe the rise of public expenditure to cover new needs which develop with the general enrichment (health and higher education in particular); secondly, because the constraints on public spending are weak thanks to a funding facilitated by strong economic growth. Externally, competition is low enough for the West, because the newly industrialized Asian countries (South Korea, Hong Kong, Singapore, and Taiwan) are not yet sufficiently developed, with the notable exception of Japan whose rise seemed inexorable at that time.

But from the late 1970s, the post-war boom that had gradually helped to establish a partly socialized economic system in Europe begins to slowdown. Thanks to these apparent limitations of the previous growth regime, radical changes are legitimized and implemented: limiting public spending, the conduct of a tight monetary policy, public finance through market mechanisms that would discipline the State, suppression of wage indexation, individualization of wage negotiations, strengthening control in the distribution of social benefits while exonerating companies, as much as possible, from the weight of social security "contributions"... Economic policies change priority from full-employment to the fight against inflation. The neoliberal revolution is not limited to public policies: corporations are also ordered

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