Project Summary

Project title:
Nordic Finance and the Good Society

Subproject title:
Financial Sector Structure and Economic Growth: A Fresh Look With a Focus on Denmark

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A recent research report by the Copenhagen Business School advocates for initiatives that promote a capital market-culture in Demark. The report argues along two lines. First, growth firms with risky but probably intangible business models may benefit from access to market finance, e.g. public equity. This will result in prospering firms and employment. Second, on a more macro-economic level a well-developed capital market can fuel economic growth of an economy, while mitigating volatility.

In the aftermath of the financial crisis around the world a debate about the future role of the financial sector emerged and many commentators have called into question whether the financial sector creates value for the wider society. Simultaneously, growth rates plummeted and many developed economies faced limited or even negative real growth over the last years. As a result, governments around the world are challenged by the trillion dollar question that concerns many of us in these days: What does it need to boost economic growth? A recent research by Marc Steffen Rapp, an Associate Professor in International Banking and Finance at the Center for

Corporate Governance at Copenhagen Business School, argues that strengthening capital market financing may be part of the solution.

Despite recent criticism, most economists consider a well-functioning financial sector to be of first order importance for a modern (capitalist) economy and its prospects. Beside the direct contribution to economic growth (e.g. through employment), the financial sector adds value to the economy by providing finance to the corporate sector, by allowing banks to raise equity, and by allowing private investors to allocate and manage their savings. In the research, Marc Steffen Rapp concentrates on the first channel, i.e. the financing of the corporate sector, and the overall impact of the financial sector on economic growth. This provides him with two propositions that support his claim that strengthening capital markets may be part of the solution:

The first proposition argues that firms may benefit from access to market finance. The author argues that with globalization and increasing product market competition firms in developed economies are challenged by increasing uncertainty in product and capital markets on the one hand, and increasing pressure to innovate on the other hand. Relatedly, firms increasingly rely on intangible assets. Adding to that, recent regulatory initiatives like Basel III put banks under pressure in their lending activities. This all suggests that equity – as provided by the stock market – is becoming more important in firms' capital structure. An indeed, the research documents that European firms de-lever their balance sheets. Moreover, firms have started to hoard cash in their balance sheet, such that parts of the corporate sector have actually become net lenders. And finally, firms started to substitute bank debt with market-near debt solutions.

The second proposition is an empirical one. Therefore, the research examines economic activities in OECD counties over the 1994-2013 period and finds that capital markets, and in particular a well-developed stock market, can fuel economic growth of an economy and mitigate economic fluctuations. The author hypothesizes that this result might be driven by

multiple reasons, which all have to do with the risk-sharing opportunities offered by capital markets. First, capital markets provide long-term risk capital to the corporate sector, which facilitates innovations as they are inevitable risky. Second, households may use the capital market to re-allocate and manage their funds and to earn a risk-premium on their savings. Finally, the capital market provides banks with the opportunity to increase their equity capital. The research also finds, that the private credit volume, e.g. the volume of bank credit, may actually be detrimental to economic growth – a fact that may be particularly relevant to Denmark.

As a result of his research, Marc Steffen Rapp argues that the provision of capital funds to the corporate sector and the associated allocation of risk is an important issue for regulators – and society as a whole. With regard to Denmark, his analysis suggests that while the private credit volume – among other due to the large mortgage market – is relatively large in Demark, the Danish capital market is relatively underdeveloped. Moreover – and somewhat alarming – the research documents that the number of listings in Denmark has decreased over the last two decades and in these days Danish firms find it more difficult to access finance than prior to the financial crises. The author thus advocates for initiatives that promote a capital market-culture in Demark. Thereby, he argues that the various stakeholders must aim to ensure that the benefits of capital market financing are not outweighed by the costs of accessing the capital market, e.g., with respect to the stock market the cost of the IPO process in case the firm is not yet listed, and the cost of being public. To positively influence the decision that firms will approach the capital market, the infrastructure (trading facilities, research, broker services) must ensure a sustainable level of liquidity. Liquidity is important from two perspectives. First, liquidity is often a fundamental prerequisite for institutional investors, either due to external regulations or due to internal (risk management) procedures. Second, liquidity is important for the issuing firm, as liquidity will reduce the cost of capital. With a lower capital, the firm might find more investment opportunities valuable, realize more of them and thus will

growth faster. Finally, attracting investors to invest in the capital market is also a challenge. Here two issues warrant attention: Taxation as well as regulation. Taxation of corporate profits and capital income drives a wedge between a firm's (pre-tax) operating profits and the (after-tax) return earned by investors. And regulation causes direct and indirect costs that may eventually prevent capital market engagements of some investors.

About the project and the author

This research is part of a broad research project "**Nordic Finance and the Good Society**" initiated by the Center for Corporate Governance at Copenhagen Business School. The project aims to propose a fresh, new look at the Nordic financial sector with a view to finding a way forward towards growth and value creation. The project will focus on business strategies and governance, but will also address policy and regulation issues.

For more details please visit: https://sf.cbs.dk/nfgs_uk.

Marc Steffen Rapp is an Associate Professor in International Banking and Finance at the Center for Corporate Governance at Copenhagen Business School (Denmark). He is also a Professor at Philipps-Universität Marburg (Germany), where he is affiliated with the Accounting and Finance Group and the Marburg Centre for Institutional Economics (MACIE), and serves as an Academic Co-Director of the Center for Corporate Governance at Leipzig Graduate School of Management (HHL). His research interests comprise all aspects of corporate finance related to institutions, regulation, and corporate governance.

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