ISSN 2181-3187

FINANCIAL STABILITY AND LOCAL ECONOMIC DEVELOPMENT: THE EXPERIENCE OF ITALIAN LABOUR MARKET AREAS

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Abstract: Regulators should ensure the smooth functioning of the system and promote regional development. Making the health of financial institutions is therefore a prerequisite for a sustainable economic development. This paper contributes to the literature on the relationship between the financial stability and growth within the area of one country. This implies that institutional, legal, and cultural factors are more adequately controlled for and financial markets are more accurately bounded.

Keywords: Banks · Local economic development · Financial stability · Labour market areas

Financial stability represents a condition in which the financial system can withstand shocks without major disruption in financial intermediation and in the efective allocation of savings to productive investments (ECB 2012). In other words, the financial system is stable when it succeeds in transferring resources from savers to investors, in assimilating financial and real economic shocks, and in managing financial risks. Financial stability is a prerequisite for sustainable economic performances (see Dudley 2011). The recent financial crisis prompted policymakers and regulators to analyse whether the level of bank distress can infuence economic development. Indeed, the core of the financial system—major banks, non-bank financial intermediaries, and financial market infrastructures— should be made more resilient to adverse shocks and less susceptible to runs. This is true even though the openness of markets, the increased mobility of capitals, the growth of integration between countries, and the complexity of the financial instruments make the financial markets more vulnerable to several risks. Among the main sources that make the financial system unstable, there is the risk-taking of banks. When financial institutions take more risks and allocate capital less efciently, then the banking system is more vulnerable to economic shocks, producing negative efects for the economy as a whole. Other risks faced by the financial institutions, such as that of credit, may depend on the discretion of managers who may take unnecessary risks in the interest of the bank. The existence of risky assets entails additional monitoring and screening costs that banks must sustain in order to quantify them. It follows that concentrated markets can count on higher capital, part of which is invested in monitoring and screening processes to reduce the share of risk-taking (Berger and

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DeYoung 1997). In the European context, regulators have tried to make banks more reliable (i.e. Basel II reform) to allow more lasting relationships for both frms and households. Indeed, fnancial stability induces a better and a smoother allocation of resources, mobilizes savings, reduces risks, facilitates transactions, and ensures the emergence of innovative frms.

In turn, economic performance can improve by converting the liquidity from deposits and savings to long-term investments. On the other hands, this mechanism might also create damage if deregulation and the presence of information asymmetries encourage banks to take more risks. The main contribution of this paper is investigating both the direct and indirect efects of bank soundness and fnancial stability on local economic development. More specifcally, the paper is closely related to the less-debated strand of the literature that considers the role of fnancial markets at the local level within countries (Usai and Vannini 2005; Valverde et al. 2007; Hasan et al. 2009; Destefanis et al. 2014; Coccorese and Silipo 2015; Cavalcante 2018). It is very difcult to underline the role played by fnancial stability across countries with diferent backgrounds. We believe that investigating whether and how a high degree of bank soundness afects economic growth using data at the sub-national, rather than the national level, is particularly relevant. It is, instead, more appropriate to focus on local territories within a single country where history, institutions, and legal framework are more homogenous. If the presence of a stable and efcient fnancial system can have a specifc economic-stimulus impact, it is much more likely that this is more evident at the local level. In this framework, the money is tied to practical actions and interventions near where it is used for growthenhancing purposes, such that the interaction between fnancial intermediaries, households, and frms is more accurately defned and resources can be mobilized more efciently. To capture this perspective, we rely upon highly territorially disaggregated data such as Italian labour market areas (LMAs) corresponding to a deeper territorial disaggregation than NUTS 3-level subdivisions (see Sect. 2.2 for details on LMAs).

To capture the fnancial vulnerability of banks and to predict their distress, bank soundness is frstly calculated through the Z-score (the number of standard deviations by which returns would have to fall from the mean to wipe out all equity in the bank). We then make use of the accounting-based CAMELS variables (which stand for capital, asset quality, management, earnings, liquidity, and sensitivity to market risk). A two-step system GMM estimator with Windmeijer (2005)-corrected standard error in dynamic panel specifcation, over the period 2001–2012, is used to deal with the suspected endogeneity between the stability of the fnancial system and economic performance. Results show that fnancial stability positively afects local economic development (Destefanis et al. 2014; Coccorese and Silipo 2015), and these results are robust to the use of more widely used indicators of fnancial stability, such as return on

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equity and return on assets, and to alternative variables capturing fnancial vulnerability (Chiaromonte et al. 2015). Stable banks, located in the territories that grow more, act as a stimulus to reach higher levels of operations. The fnancial stability of banks still has a positive and signifcant efect on local economic development, but lower in magnitude, in the years after a crisis. Finally, while the introduction of spatial efects does not modify the main conclusions, results also provide evidence that the presence of more efcient banking services in the geographic vicinity generates a pull efect due to the possibility that borrowers and investors may be attracted to these nearby services, take out credit, and consume in neighbouring areas (Hasan et al. 2009). The rest of the paper is organized as follows. Section 2 overviews the literature on the relationship between fnancial stability and economic development and the relative channels, highlighting the importance of a local perspective in the analysis. Section 3 describes the empirical approach, the measures of fnancial stability, and the data used in the analysis. Section 4 shows the main fndings, underlining the accuracy of diferent sources of fnancial stability afecting economic development. Section 5 provides some robustness checks. Finally, Sect. 6 concludes The literature highlights a positive relationship between fnancial development and economic growth (Bumann et al. 2013), drawing on cross-country (King and Levine 1993), time series (Arestis et al. 2001), and panel studies (Beck and Levine 2004). Due to a better allocation of resources, risks, and transactions, the stability of the fnancial sector can be an engine of growth. Several measures of fnancial development, defned as the policies, factors and institutions that lead to efcient intermediation and efective fnancial markets (WEF 2012), are used. The size of fnancial intermediaries is considered through the proportion of liquid liabilities (King and Levine 1993; Huang 2005) and the ratio of bank deposit liabilities to gross domestic product (Demetriades and Hussein 1996). The importance of the banking sector is also taken into consideration by using the ratio of credit issued to the private sector to liquid liability (Saci and Holdied 2008). Proxies for banking sector development include bank deposits over gross domestic product, banks' overhead costs, banks' concentration, and banks' net interest margins (Antzoulatos and Thanopoulos 2008).

The concept of liquidity preference is also used to analyse the efect of money behaviour on the regional economic performance of regions (Crocco et al. 2005). Despite the above-mentioned measures of performance and activities of fnancial institutions, the importance of making the financial system stable has to be defned. How should changes in banking sector soundness afect economic development? The higher the fnancial stability of the system, the larger the level of capital held by the banks, and the greater their proftability. This ensures a substantial distribution of loans to households and frms. In turn, the higher the borrowing levels, the more sizable are the investment projects, with positive consequences on growth levels. Therefore, one important channel is that of credit. Since Schumpeter, research and development

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activities, and likewise patents, are considered as new ideas and pieces of knowledge that may turn into innovation when commercially exploited (Schumpeter 1934, 1942). Entrepreneurs need credit to fnance their innovations, and banks as well as fnancial markets could facilitate this mechanism. Bank-based systems (diferently from marked-based systems) create more stable relationships and convince entrepreneurs to invest in innovation (Stiglitz 1985). In this prospect, fnancial development refers to the increased functionality of local fnancial institutions in intermediating services related to investment and growth (Cavalcante 2018). More specifcally, the relationship between fnance and growth depends also on the frm's reliance on external funds (Guiso et al. 2005; De Serres et al. 2006). Regional concentration and centralization of the banking system are relevant for frms' investment choices (Cavalcante 2018). The ability of frms to better capture growth opportunities, thanks to the funding for investment, is relevant (Fisman and Love, 2004), as is frms' probability of entry and survival in the market (Aghion et al. 2007; Beck et al. 2008).

Fig. 1 Territorial location of LMAs and regions in Italy— Year 2011. Notes: our elaboration

Several features of the tax and spending regime help to stabilise the economy over the economic cycle. As the economy strengthens, incomes tend to rise, resulting in higher income and corporation tax receipts. At the same time, lower unemployment rates reduce social security spending. As the economy weakens, the opposite effects occur. This means that government borrowing tends to fall when growth is relatively high, and

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rises when growth is relatively low. These 'automatic' effects help to reduce volatility in output over the cycle, by boosting aggregate demand when the economy is below trend, and reducing aggregate demand when the economy is above trend.

The Government's objectives for fiscal policy are to ensure sound public finances, while allowing the automatic stabilisers to operate over the cycle. This permits fiscal policy to support monetary policy in smoothing the path of the economy in the face of variations in demand, and explains why the fiscal rules are set over the economic cycle. For the golden rule, it means the surpluses in the current budget in periods of stronger growth can offset deficits in periods of weaker growth, helping to stabilise the economy. Public debt will tend to rise as a proportion of GDP during periods of weaker growth, and fall as a proportion of GDP during periods of stronger growth. The strength of the automatic stabilisers depends on the characteristics of the tax and spending regime, such as the progressivity of taxes, as well as the composition of changes in demand in the economy. Their impact can be seen by examining the difference between actual public sector net borrowing (PSNB) and the cyclically-adjusted PSNB position. Attempting to balance the current budget at all times would significantly increase swings in output over the economic cycle, damaging economic stability.

The Government has set out five economic tests which must be met before any decision to join can be made. An assessment of the five tests will be made within two years of the start of this Parliament. This assessment will be comprehensive and rigorous. On the basis of the assessment, the Government will take a decision on whether the five tests have been met. If a decision to recommend joining is taken by the Government, it will be put to a vote in Parliament and then to a referendum of the British people. In June 2001, the Chancellor explained that, before the assessment of the five tests is started, the Treasury would continue to undertake necessary preliminary and technical work to inform it. The scope of this work was set out in the original October 1997 assessment. This preliminary and technical work includes: • the cyclical behaviour of the UK economy relative to the Euro-area and their relative responses to economic shocks;

• the mechanisms by which product, labour and capital markets adjust and how well and how quickly they work;

• the impact of the single currency on the cost and availability of capital, macroeconomic stability, the stability of the real effective exchange rate and the location, quality and quantity of investment;

• the effect of the single currency on financial services, including the changes that have occurred in this sector in the UK and the Euro-area since 1997; and

• the impact of the single currency on trade, competition, productivity and employment. More detail was published in the Treasury paper, “Preliminary and

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technical work to prepare for the assessment of the five tests for UK membership of the single currency".

The Government is actively helping UK businesses prepare for working with the euro. At the same time, preparations for possible UK entry continue under the outline National Changeover Plan. Further information is available in the Treasury's Fifth Report on Euro Preparations (see www.euro.gov.uk). Economic stability means that people have the resources essential to a healthy life. Factors affecting economic stability include affordable housing; employment that provides a living wage; things that support employment, like worker protections, paid sick leave, and child care; and access to reliable transportation. People experiencing economic instability are more likely to experience health risk behaviors, chronic health conditions, and premature mortality. These conditions have led to worse outcomes for people experiencing economic instability during COVID-19, and disproportionately impact people of color. Laws and policies that ensure equitable access to resources will lead to better health outcomes for marginalized communities. Additional resources are in development. Check back from time-to-time for updates or subscribe to the Network Report e-newsletter for information on the latest Network resources. The OECD has been working on the measurement of well-being beyond GDP since the 1970s. Over 50 years, we have seen the concept of well-being develop from an interesting side-note into a well-established agenda for policy. The OECD's Well-Being Framework has further developed the concept by providing us with a clear definition and rigorous analytical basis. The Framework for Policy Action on Inclusive Growth has helped identify the channels through which governments can promote greater well-being and sustainable economic growth for all their citizens.The Economy of Well-Being highlights the need for putting people at the centre of policy. it is important to move away from an attitude of "grow first, redistribute and clean up later", towards a growth model that is equitable and sustainable from the outset.Failure to do so has economic and social consequences. Take the pressures building up on the middle class, a traditional source of growth and stability in Europe. In 2016, for example, nearly 50% of middle-income households experienced difficulties making ends meet. In EU countries, this ranges from under 10% to over 70%.The political consequences are also clear. Across 15 EU countries surveyed in 2018, 70% of respondents believed government should be doing more to ensure their economic and social security.

What do we mean by an economy of well-being?

This brings us to the importance of an economy of well-being. This is defined as a 'capacity to create a virtuous circle in which citizens' well-being drives economic prosperity, stability and resilience, and vice-versa those good macroeconomic outcomes allow to sustain well-being investments over time'.

ISSN 2181-3187

An economy of well-being has several key characteristics. (i) Expanding opportunities for upward social mobility and for improving people's lives along the dimensions that matter to them; (ii) Ensuring these opportunities translate into well-being outcomes for all society, including those at the bottom of the income distribution; (iii) reducing inequalities; and (iv) ensuring environmental and social sustainability.

How to build an economy of well-being

An economy of well-being has four main pillars. The first pillar is education and skills. Skills are the most important driver of long-term economic growth. For instance, one additional year of schooling in all society increases GDP per capita by around 12%. And what is true at the macro-economic level also holds at the individual level. Returns to education more than double once health and employment benefits are accounted for.

Policy can help leverage the benefits of education. For example, higher attendance in pre-primary education, greater autonomy of schools, reduced gaps between academic and vocational branches of education and higher funding for tertiary education can all boost human capital, while also improving the efficiency of education systems. At the same time reducing inequalities of access and opportunity at school is essential to promote better educational outcomes, as countries with high levels of inequality in education and skills also record lower average educational performance.

The second pillar is health. Evidence shows that good health fuels economic growth, productivity and individual earnings. The total costs of mental ill-health are estimated at over 4% of GDP – more than EUR 600 billion – across the EU28 . Around 550 000 people of working-age die prematurely every year in the EU due to non-communicable diseases. Good health is also a key factor for people's well-being. It allows them to invest in education and skills, access quality jobs and enjoy better quality of life.

Increased spending has driven much of the improvement in health outcomes, but we need to go beyond. This means looking at the range of services covered by primary healthcare, as well as addressing new or persistent risk factors. Reducing inequalities of access is also essential to promote better health outcomes, as the proportion of people in poor health weighs heavily on key health indicators. Moreover, health inequalities are often stratified along economic, educational or occupational lines. For instance, unmet care needs are substantially higher for low-income groups.

The third pillar is social protection and redistribution. Both play an important role in reducing economic volatility and fostering resilience. They also prevent inequality today from translating into inequality of opportunities for the next generation. Recent OECD research confirms that lower inequality is associated with higher GDP growth.

Combining income-support schemes with active labour market policies provides

effective protection and supports employment. Promoting more progressive tax and benefit systems can help countries promote equality of opportunity and social mobility. Social protection systems also need to adapt to a changing world of work, notably by improving coverage for non-standards workers, and to evolving social risks, notably the increasing prevalence of lone-parents and frail elderly.

The fourth pillar is gender equality. Raising women's employment and hours worked can deliver productivity gains and higher GDP growth. It can also reduce income inequality, strengthen resilience and consolidate the middle class. In the EU, improving gender equality could increase total GDP by up to 19% by 2050.

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