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Financial Sector Regulation on the Agenda of Economic Policy Reforms

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ABSTRACT

The aim of the research is to identify trends that set the agenda of the structural reforms of OECD countries, as well as of the organization's partner countries, in the context of the place of financial sector reforms in it. The authors apply the following **methods**: content-analysis of sources, monitoring of directions and instruments of economic policy in the financial sector, analysis of approaches used by international organizations in order to determine reform priorities (benchmarking), and decomposition of the components of the financial sector reform agenda. The paper shows that the agenda of financial liberalization, formulated in the 1970s, is mostly exhausted, although a certain gap remains between countries with developed and emerging markets in terms of the financial liberalization index. Financial regulatory reforms focused on the goal of building a more resilient global financial system, formulated in the aftermath of the 2007–2009 crisis, are affecting all countries and are also ending. Reforms are now coming to the fore, focusing on areas of the structural transformation agenda such as inclusive growth and an environmental perspective. The paper **concludes** that the main components of financial reforms in an inclusive context are financial inclusion, financial and digital literacy. In terms of the environmental agenda, the countries are focusing on the tasks of directing financial resources to the implementation of the UN sustainable development goals, introducing ESG investment principles for financial institutions, and developing and implementing principles for issuing green financial instruments.

Keywords: financial regulation; financial market; financial institutions, financial sector; structural reforms; economic growth; ESG; green finance; financial stability; international organisations; OECD

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INTRODUCTION

Reforms in the financial sector have been the focus of researchers' attention for many years, while becoming the subject of lively academic and political discussion. They are an integral part of the general agenda of economic reforms, in the development of which the largest international organizations take part — the International Monetary Fund (IMF), the World Bank (WB), the Organization for Economic Cooperation and Development (OECD).

A number of organizations — the Bank for International Settlements (BIS), the Financial Stability Board (FSB), the International Organization of Securities Commissions (IOSCO) — operate with a narrower focus on the functioning of the financial market and its sectors. There are a sufficient number of works summarizing the directions for

reforming the financial sector developed by international organizations with such a narrower "specialization" [1–3, etc.]. At the same time, the question is of interest: how have certain aspects of financial sector reforms been reflected and are being reflected in the broader agenda of economic policy reforms? The answer to this question will help to place financial reforms on the economic agenda, trace their path, identify the relationship between reforms affecting different policy areas — commodity market, labor market, ESG issues, financial market, etc., and determine the factors that accelerate or hinder reforms, etc. This paper attempts to do this by looking at the economic reform agenda promoted by the OECD. To do this, we use a large number of sources, the main ones are regular studies of relevance and progress in OECD countries and partner countries of this

organization of economic policy reforms, carried out under the auspices of the OECD secretariat, united by a series of publications “Going for Growth”.¹

FINANCIAL LIBERALIZATION AND ITS COMPONENTS

It is not easy to review academic research on financial sector reform. Among the first authors who started a discussion about the role of the financial system, the awareness of which actualizes the issues of its development and reform, we single out J. Gurley and E. Shaw [4, 5]. The authors linked the level of development of the economy with the level and structure of the financial system, showing how the economy is moving from a self-financing model (when investment projects are financed from operating income and company reserves) to bank financing, to a model that involves a significant share of equity financing. Thus, a certain logic of the evolution of the financial sector was set, the implementation of which in practice required reformatory decisions from governments.

Considering that the “financial intermediaries plus stock markets” model is the most advanced one, one should ask the question: what are the conditions for its development and limitations? J. Gurley and E. Shaw, and later on the basis of their results, V. Bencivenga and B. Smith [6] showed that transaction costs, as well as monetary factors, are significant drivers of financial development and financial inclusion. This led to the conclusion, addressed in particular to emerging markets, that the cost of accessing banks and their services should be reduced,² as well as to the revision of monetary policy, which often led to high inflation and high nominal interest rates.

Two other significant works that outlined the contours of financial reforms in subsequent

years were published by R. MacKinnon [7] and E. Shaw [8]. The authors drew attention to the fact that there was a policy of “financial repression”, the components of which were ceilings on interest rates on savings (set under the pretext of providing banks with cheap resources for their subsequent transfer to firms and the government); state ownership of banks and financial institutions; high reserve requirements; control over the domestic market of public debt, carried out, in particular, by imposing requirements on financial institutions to hold public debt obligations, caused economic stagnation and crises in a number of countries. Based on these arguments, R. McKinnon and E. Shaw suggested that politicians implement a number of countermeasures united by the idea of financial liberalization.

Financial liberalization began to be seen as a state policy aimed at deregulating credit, removing control over interest rates, removing barriers to entry into financial services markets (including for foreign players), and privatizing financial institutions. In addition to these directions, in many works, financial liberalization began to include a policy of removing restrictions on transactions recorded in the capital account of the balance of payments (although this classification is disputed by a number of authors). In theory, such a policy was supposed to ensure the restoration and strengthening of the role of the price mechanism in the financial sector, improve the conditions for market competition with an eye to the benefits that these measures could bring to economic activity and growth. [9]. However, in practice, the measures taken in the indicated direction have not led to the desired success in all countries. In publications, there is significant criticism of the financial liberalization policy regarding the premature opening of the economies of weak countries to external capital flows, as well as in connection with the increased vulnerability of banking systems to crises [10, 11]. Even without addressing the oft-discussed issue of capital account openness, financial liberalization policies have proved vulnerable for a number of reasons, in particular the failure

¹ OECD Library. URL: https://www.oecd-ilibrary.org/economics/economic-policy-reforms_18132723 (accessed on 15.08.2022).

² At that time, 13% of families in the US did not have a transactional bank account, the reason for which about half of them indicated high commissions and other costs associated with using such an account [6].

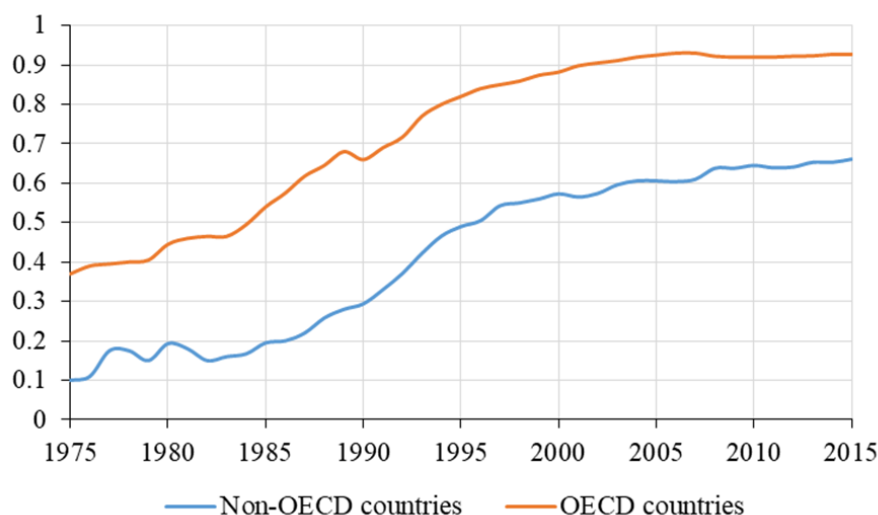


Fig. 1. The history of aggregate financial liberalization index

Source: O. Denk, G. Gomes [15].

to address asymmetric information problems [12, 13], which do not necessarily result from government intervention; can lead to an increase in moral hazard;³ may become the reason for a more aggressive and risky policy of banks seeking to compensate for lost profits with an interest margin [14], etc.

However, the benefits of financial liberalization outweigh its costs and disadvantages, which has shaped the course of incremental reforms affecting financial institutions and markets. An assessment of the dynamics of such reforms over a long period since 1975 in the form of an aggregate index, which takes the value of “0” for countries that have not progressed towards financial sector liberalization, and “1” for countries that have achieved full liberalization, is shown in *Fig. 1*. Components of financial reforms reflected in the Aggregate Financial Liberalization Index are disclosed in the *Table*.

Fig. 1 shows that countries of different groups over the past 40 years have advanced quite powerfully along the path of financial reforms. OECD countries have made the most progress

in the areas shown in *Table 1*. Non-OECD countries, on average, moved at the same pace of reform but from a lower starting position. The gap in the level of liberalization of the financial sector between OECD countries and non-OECD countries remains, which determines the relevance of continuing the course towards financial liberalization in non-OECD countries. We also note that the pace of financial reforms in the period from the mid-1990s slowed down in both groups of countries, and since about 2003 they have come to naught. This can be explained by the well-known rigid positions of the establishment of countries (including developed countries) on some painful reform issues, most often associated with privatization and liberalization of the foreign direct investment regime. The evolution of financial sector reforms over the past 12 years is analyzed below.

FINANCIAL SECTOR REFORMS ON THE OECD ECONOMIC REFORM AGENDA

Going for Growth, a series of reports, will be used as one of the main sources of information, summarizes the experience of OECD countries in implementing structural reforms in various areas of economic policy.⁴ Let us start by

³ Removing the interest rate ceiling may seem counterintuitive, as depositors whose assets were protected by state-sponsored deposit insurance programs (or brokerage services) lost the incentive to follow the choice of a bank or other type of financial intermediary while they were protected by fees in excess of the set rate on government bonds.

⁴ We emphasize that the choice of this source is due to the desire of the authors to place the problem of financial regulation in the context of a broad agenda of structural reforms. Another

Table

Basic aspects of the financial sector reforms and framework approaches to their operationalization

| No. | Policy focus | How policy content is disclosed in a specific indicator |
|-----|---|--|
| 1 | Credit control | The relative severity of bank reserve requirements, the presence of mandatory credit requirements or credit subsidies for certain sectors are measured |
| 2 | Interest rate control | The extent to which regulations restrict banks from setting rates on loans and deposits is determined |
| 3 | Barriers to entry into the banking sector | The existence of barriers to entry of foreign and domestic banks into the national banking system is recorded; restrictions on the geographical region in which banks can operate; restrictions on the scope of banking activities are highlighted |
| 4 | Capital account control | The degree of restrictions on the international movement of capital is assessed |
| 5 | Privatization | The degree of direct participation of the state in banking activities through the ownership of the bank's assets is assessed. |
| 6 | Regulation of securities markets | The policy pursued by the authorities to deregulate and encourage the development of markets for shares, bonds and derivative financial instruments is assessed |
| 7 | Prudential Regulation and Banking Supervision | The compliance of the country's capital adequacy rules with the Basel standard is outlined; the independence and scope of responsibility of the banking supervisory authority, the effectiveness of bank inspections are assessed |

Source: compiled by the authors based on O. Denk, G. Gomes [15, p. 8–9]; A. Abiad, A. Mody [16, p. 681].

Note: a study by A. Abiad and A. Modi [16] is considered basic in relation to areas of financial reforms. It suggests 6 of those directions listed in Table 1. At the same time, we find that before A. Abiad and A. Modi, a similar list of areas for financial reforms was formulated by M. Edey and K. Hviding. [17].

analyzing the 2009 report with the intention of finding the extreme point in it, when the degree of relevance of financial sector reforms was the greatest (in relation to the subsequent, but not the previous period). First, the measures taken during the crisis, as a rule, are associated with the deepening of state intervention, which requires subsequent policy adjustments to restore the operation of the market price mechanism [18]. Second, economies facing shocks of unprecedented magnitude (in the form of major bankruptcies, asset price collapses, credit market stalls, etc.) have exacerbated the need to develop a set of measures aimed at ensuring financial stability.

Indeed, the report states that the financial crisis of 2007–2009 revealed serious problems with the functioning of financial markets, demonstrated the inability of previous

approaches to regulatory and supervisory structures to ensure market stability.⁵ The crisis exposed weaknesses and failures in financial regulation and supervision, which contributed to increased risk appetite, private sector over-leveraging, and eventually recession. The authors stated that the financial sector is an area that will require major reforms in the coming years.⁶ The financial sector reform program that was taking shape at the time⁷ was designed to reduce the likelihood of financial catastrophes in the future. It covered the reform of regulatory and supervisory structures, the improvement of the functioning of financial markets and was aimed at ensuring the restoration of economic growth and improving living standards in the long term.

⁵ OECD. Economic Policy Reforms 2009: Going for Growth: Structural Policy Indicators, Priorities and Analysis, OECD Publishing, Paris, 2009, p. 4.

⁶ Op. cit. P. 35.

⁷ FSB. Improving Financial Regulation: Report of the Financial Stability Board to G20 Leaders, Financial Stability Board, Basel, September, 2009. URL: https://www.fsb.org/2009/09_r_090925b (accessed on 15.08.2022).

more specialized annual OECD report on the financial sector, The OECD Business and Finance Outlook, has been published since 2016 and does not contain a broader context that we are interested in.

Further presentation requires additional methodological explanations. We point out that in the OECD documents studied, the authors resort to a comparative cross-country efficiency and policy analysis, on the basis of which a set of *five structural policy priorities* is determined for each OECD country and the European Union.⁸ Policy priorities are selected based on standardized criteria and expert judgment from more than 150 possible ones. Earlier reports use the US economy as the benchmark, while more recent reports use the upper half of the distribution given by the OECD group of countries. Each country is compared with the benchmark based on the criterion of GDP per capita, and the size of the gap of this indicator in relation to two countries (one of which is always taken as a benchmark) serves as a guide and at the same time a working tool for measuring the effectiveness of adopted policy measures.

An additional step in the analytical procedures is to consider the GDP per capita gap in the countries included in the sample compared to the benchmark, broken down into two components representing the contribution of labor productivity and labor utilization, respectively. Hence, when considering the directions of structural policy, it is proposed to group them into two areas — a policy aimed mainly at increasing labor productivity, and a policy that ensures (expands) the use of labor.

In addition, starting from the 2017 edition, the scope for reform prioritization has been expanded to include a dimension of inclusion,⁹ and in the 2019 and 2021 reports, the environmental component is an additional dimension.¹⁰

Reforms affecting the financial sector are in the area of productivity. The range of policies that affect productivity is extremely broad. It

covers various options that contribute to the accumulation of physical and human capital, intangible assets, increase the efficiency of their use and distribution. The relationship between financial development and economic growth in the context of the impact of financial development on productivity is considered in a number of studies, in particular [19–21].

Analyzing the data and other theoretical and empirical studies, one can point to the consistency of the conclusions that productivity is the dominant channel for transmitting financial development into long-term output growth. This is a good reason to consider the level of development of the financial sector as an important factor in determining the rate of productivity growth at the country level.

In the following, we will continue to explore the directions and policies for the financial sector contained in the Going for Growth reviews. Thus, in the 2009 review, it was proposed to consider the following areas:

- deepening the integration of financial markets and improving the mechanisms of financial stability, addressed to the European Union as a whole;¹¹
- removing restrictions on foreign direct investment (FDI) (meaning not even the immediate benefits of these investments, but rather the side effects), addressed to the governments of Canada, Iceland, Japan, South Korea and Mexico;¹²
- privatization (this efficiency-enhancing tool should be used once financial markets “function normally”);¹³
- improving financial oversight, as noted in the case of the US;¹⁴
- financial openness¹⁵ as a general recommendation for countries with barriers to capital flows and investment.

⁸ In some cases, the authors offer a vision for more than 5 policy priorities.

⁹ OECD. Economic Policy Reforms 2017: Going for Growth, OECD Publishing, Paris, 2017. URL: <https://doi.org/10.1787/growth-2017-en>

¹⁰ OECD. Economic Policy Reforms 2021: Going for Growth: Shaping a Vibrant Recovery, OECD Publishing, Paris, 2021. URL: <https://doi.org/10.1787/3c796721-en>

¹¹ OECD. Economic Policy Reforms 2009: Going for Growth: Structural Policy Indicators, Priorities and Analysis, OECD Publishing, Paris, 2009. P. 35.

¹² Op. cit. P. 34.

¹³ Op. cit. P. 35.

¹⁴ Op. cit. P. 48.

¹⁵ Op. cit. P. 34.

Note that recommendations related to the financial sector were not included in the top five priority areas in 28 out of 31 country or unions. The exceptions are Iceland, the US and the EU as the regions most affected by the financial crisis of 2007–2009.¹⁶

Thus, despite expectations that financial sector reforms will be predominantly at the forefront, we find that they are among the priorities only in those countries whose financial markets have been hit hardest by the crisis. More recent reports add the caveat that financial market reforms are generally not among the top five priorities and are treated separately, as they are an urgent task in many OECD countries requiring extensive international coordination.¹⁷ Our explanation for this fact is that the financial sectors of a large number of countries have become deeply dependent on the state of the financial markets that distribute the capital of financial centers, and the supply of financial services in these countries is provided by global players representing these centers. This dependence reduces the role of domestic financial sectors in many countries, shifting the focus to regulatory issues related to the use of financial services on the principles of outsourcing. From this, in particular, it follows that the most common recommendations (apart from those that really affect the reform of financial markets and institutions agreed within the framework of international cooperation at the level of the BIS or the FSB) are incentives to open national financial markets for non-state residents, reduce the share the state in the capital of financial institutions, etc.¹⁸

¹⁶ We did not take into account cases where structural policy measures were addressed to governments in connection with the need to reform the pension system, since the goal of such reforms was declared to increase the efficiency of the public sector (Czech Republic) or improve the use of labor (Luxembourg, Turkey). *Op. cit.* p. 46–48.

¹⁷ OECD. *Economic Policy Reforms 2012: Going for Growth*, OECD Publishing, Paris, 2012, p. 43. URL: <https://doi.org/10.1787/growth-2012-en>.

¹⁸ See, for example, similar recommendations for Brazil and India, “where bank credit is not fully allocated by the market”, with the proviso that realizing the benefits of such liberalisations should be gradual and accompanied by strong prudential. OECD. *Economic Policy Reforms 2011: Going for Growth*, OECD Publishing, Paris, 2011, p. 32.

The 2010 report continues to highlight the importance of reforms affecting financial market regulation, adding that the financial response to the crisis has created new challenges in the form of moral hazard and reduced competition.¹⁹ An even more significant concern has been raised about the possible conflict between the demands for tighter regulation in the financial sector for the sake of stability and the primacy of competition, referring to the possible pressure on the competition when regulation is tightened (through channels to enter the market or satisfy participants — especially those who do not belong to the category large players — with more stringent standards). The conclusion is that, apart from a few specific areas of regulation, there is no evidence of conflict between the stability of the banking sector and the objectives of competition. Thus, the necessary regulatory strengthening in the financial sector is expected to maintain competitive advantages in terms of access to and prices for financial services.²⁰ Moreover, some areas of prudential regulation, primarily banking supervision, as the analysis showed, can increase competition in the banking sector²¹ due to the fact that strict supervision helps to level the playing field for all competitors. An important conclusion is also that the impact of prudential regulation on competition in the banking sector depends on the strength of supervision.²²

With regard to the long-term macroeconomic effects of the recent (2008) financial shock, the report shows that OECD countries are facing contraction in potential output. At the same time, 2/3 of this reduction will be caused by an increase in the cost of capital, 1/3 — by a decrease in employment. Fixed capital accumulation is one

¹⁹ OECD *Economic Policy Reforms 2010: Going for Growth: Structural Policy Indicators, Priorities and Analysis*, OECD Publishing, Paris, 2010, p. 5. URL: <https://doi.org/10.1787/growth-2010-en> (accessed on 15.08.2022).

²⁰ *Op. cit.* P. 13.

²¹ This conclusion, unfortunately, is not comprehensive. In some areas, such as entry restrictions, measures to strengthen prudential regulation do weaken competition.

²² Strong supervisors have been seen to mitigate the anti-competitive impact of tougher barriers to entry.

of the most vulnerable positions in the post-crisis period, when the level of risk aversion and premiums embedded in rates turned out to be high. This is a wake-up call, as lower investment growth (or even negative investment growth) weakens the foundation for future productivity growth.

Another concern is associated with the negative consequences of the measures that countries were forced to take to eliminate the financial shock and prevent an even deeper recession — the “nationalization” of some banking operations (Iceland, Ireland, the Netherlands, Portugal, UK, USA), the purchase of toxic assets (Germany, Ireland, Korea, Switzerland, UK, USA).²³ Indeed, long-term direct participation of the state in financial markets is fraught with negative consequences for competition, leads to a distortion of the price mechanism, including an incorrect assessment of risks, and in post-crisis conditions hinders the possibility of structural changes, reducing the potential for long-term growth.

The authors show that the future regulatory landscape is being shaped by proposals to reform prudential regulation put forward by the Financial Stability Board (FSB), IMF, Bank for International Settlements (BIS)²⁴ to strengthen financial stability (while maintaining competition objectives). The main directions here are changes in capital requirements for banks (including the introduction of a countercyclical buffer), new minimum global liquidity coverage standards designed to increase banks’ resilience to system-wide liquidity shocks and strengthen management of this risk, the formation of requirements for systemically important players to reduce moral hazard in their behavior, initiatives to expand the regulatory

perimeter and develop international cooperation between regulators, increase the stability of the derivatives market, improve accounting standards (including accounting for financial instruments, standards for creating reserves and depreciation recognition, standards affecting off-balance sheet operations), improving remuneration models.

Among the policies and measures aimed at the financial sector proposed in this review are the removal of restrictions on foreign direct investment (Canada); deepening and accelerating the integration of retail financial markets, updating and improving the system of financial regulation (EU); strengthening financial supervision (EU, Hungary, South Korea); anchoring housing finance guarantee mechanisms that create excessive incentives for excessive investment in the housing sector (Iceland, USA); improving macroprudential and microprudential supervision (Japan and other countries); reforming bankruptcy legislation (Hungary); increased privatization of financial institutions (South Korea); changes in prudential standards for systemically important financial institutions (USA).

Regarding the inclusion of financial sector reforms in the top five priorities, in this study this refers to three countries or unions — the EU, the USA, Japan, and if we add such a political priority as lowering barriers to foreign investment and expanding the number of priorities considered to eight, Iceland, New Zealand, Poland and South Korea will be added to the list.

The 2011 report continues to highlight the urgency of reforms in the financial sector “necessary to restore stability and protect living standards over the long term”.²⁵ In addition to changing capital requirements, the main directions were:

- developing macroprudential policies to mitigate the procyclical buildup of systemic risk and prevent credit-driven asset price bubbles;
- reducing moral hazard from systemically

²³ Op. cit. P. 21.

²⁴ See, in particular, BIS. Basel III: A global regulatory framework for more resilient banks and banking systems. Bank for International Settlements, Basel, December 2010 (rev June 2011). URL: <https://www.bis.org/publ/bcbs189.htm>, and more recent recommendations: IMF, FSB and BIS. Macroprudential Policy Tools and Frameworks, Update to the G20 Financial Ministers and Central Bank Governors, February 2011. URL: <https://www.bis.org/publ/othp17.htm> (accessed on 15.08.2022).

²⁵ OECD. Economic Policy Reforms 2011: Going for Growth, OECD Publishing, Paris, 2011, p. 18. URL: <https://doi.org/10.1787/growth-2011-en> (accessed on 15.08.2022).

important institutions and the associated economic damage; changes in financial infrastructure that reduce the risk of infection;

- introduction of a mandatory leverage ratio standard (maximum leverage ratios applicable to all types of assets);
- introduction of mechanisms for managing cross-border crises;
- reforming non-banking financial institutions (including insurance companies and pension funds) aimed at preventing the accumulation of systemic risk;
- implementation of reasonable compensation methods in large financial institutions to discourage excessive risk taking;
- improvement of accounting standards (including improvement and simplification of accounting for financial instruments, provisioning and recognition of impairment).²⁶

The inclusion of financial reforms among the priorities this year was due to Brazil, India and the EU. In addition, easing barriers to foreign direct investment has been ascribed as a structural policy priority to Australia, Canada, New Zealand and Japan.

An analysis of the 2012 review shows the following. Structural reform priorities for Brazil, India and the EU aimed at improving the efficiency of financial markets remained the same. Reforms to improve regulation and supervision of the financial sector have been a priority for Iceland. Improvement and rationalization of financial regulation has been identified as a priority for the US. Australia and Japan have been ordered to ease restrictions on FDI.

In the 2013 review, the authors continue to prioritize reforms to improve the efficiency of financial markets and reduce the state's share in banks, taking into account Brazil's recommendations. The weakening of state control over financial markets (including the deregulation of rates on deposits and loans, the liberalization of foreign investors' access to domestic stock and bond markets) was recommended by the PRC.

²⁶ Op. cit., P. 21.

One of the priorities for the EU remained the reform of financial regulation and supervision in order to create a more stable and integrated financial system within the Union.

India was recommended to ease restrictions on the banking portfolio, including by gradually reducing the share of government bonds held by banks, phasing out priority lending; allow greater participation of foreign investors in the financial services sector and facilitate the entry of new private banks into the market. Easing restrictions on foreign direct equity investors is recommended for countries such as India, Canada, Mexico, Russia, and South Korea.

Financial sector reform remained a priority for Brazil, China and India in 2014.²⁷ In general, it can be seen that for these three countries, financial sector reforms were considered a priority during the period under review. As these countries moved along the path of liberalization, the recommendations changed. Thus, the 2015 report notes that liberalized financial systems in these countries should be supported by stronger macroprudential regulation and supervision.²⁸ In addition, the PRC recommended building a more balanced regulatory framework covering alternative banking sectors, since grassroots liberalization has led to the emergence of financial institutions that compete with banks that are not subject to heavy banking regulation (the so-called "shadow" banking sector). A vulnerability that needed to be addressed was also found in the presence of implicit government guarantees that prevented correct risk assessment. The authors of the 2017 review note that although these countries have managed to address a number of issues that improve the efficiency of domestic financial markets, the pace of financial sector liberalization in these countries has slowed down.²⁹

²⁷ OECD. Economic Policy Reform 2014: Going for Growth Interim Report, OECD Publishing, Paris, 2014, p. 40. URL: <https://doi.org/10.1787/growth-2014-en>

²⁸ OECD. Economic Policy Reforms 2015: Going for Growth, OECD Publishing, Paris, 2015, p. 65. URL: <https://doi.org/10.1787/growth-2015-en>

²⁹ OECD. Economic Policy Reforms 2017: Going for Growth, OECD Publishing, Paris, 2017, p. 27.

The 2017 review contains a slightly larger list of countries for which financial sector reforms are recommended. Thus, the authorities of Argentina and China were recommended to reduce state intervention in the work of financial markets. Italy and Portugal are among the first countries where delaying resolution of problem bank loans threatens both to undermine confidence in financial stability and hold back economic growth. Increasing financial literacy is a priority for China.³⁰ India is encouraged to take steps to remove restrictions on the banking portfolio.³¹

The 2019 report states that the priorities of financial sector reform are addressed to Brazil (recommended to expand the range of financing models, including syndicated loans, structured finance instruments, project financing and infrastructure bonds), India and China (the recommendations of previous years have been duplicated to the authorities), Russia (in relation to which it is said that it is expedient to reform the regulation of the banking sector in terms of creating equal conditions for public and private banks and financial intermediaries).

Finally, the 2021 report highlights measures that could play a role in dealing with a potential wave of bankruptcies that could be a negative shock from the pandemic.³² With many companies vulnerable to lockdowns and fluctuations in demand, economies may need bankruptcy regime reforms that “could be deployed with tools to support equity financing to recapitalise firms and mitigate debt overhang via measures such as equity and quasi-equity injections (e.g. preferred stocks), phasing in an allowance for corporate equity and debt-equity

swaps”.³³ These reforms aim to preserve viable and productive firms that would otherwise go into liquidation, while at the same time encouraging the timely restructuring of unviable firms.

In terms of the areas of financial reform already highlighted above, the 2021 report points to the need to:

- removing barriers to entry in the financial sector and restrictions on business conditions for non-resident firms, improving financial literacy through financial education from an early age (PRC),³⁴
- implementing a strategy to address the problem of deferred tax credits and bad loans threatening bank balance sheets (Greece);
- improving the management of state-owned banks, intensifying efforts to address the problem of bad loans, improving insolvency and bankruptcy legislation and judicial practice in this area (India and other countries).

FINANCIAL SECTOR IN THE CONTEXT OF INTERCONNECTEDNESS OF STRUCTURAL REFORMS

An essential aspect of the analysis of financial sector reforms in the context of their significance for achieving the main policy objectives is the interconnectedness of these reforms with reforms affecting other policy areas. Two points can be touched upon: the importance of financial sector reforms for other priority policy areas and, in fact, the interdependence of reforms.

While discussing the importance of financial sector reforms (and therefore the quality of financial systems they achieve) when looking at other policy successes, let us look at some illustrations. For example, tax and product market reforms aimed at lowering costs and increasing corporate profits or achieving higher productivity are most effective when corporate successes are reflected in stock prices. This is important because, on the one hand, it creates a wealth effect and spurs consumer demand,

³⁰ Since this recommendation is based on the changes taking place in many countries — the expansion of digital financial services, the “spread of illegal schemes for attracting external financial resources, and the default of peer-to-peer financial service providers” (Op. cit., p. 130), the corresponding recommendation can be applied in a much wider range of countries.

³¹ OECD. Economic Policy Reforms 2017: Going for Growth, OECD Publishing, Paris, 2017, p. 28.

³² OECD. Economic Policy Reforms 2021: Going for Growth: Shaping a Vibrant Recovery, OECD Publishing, Paris, 2021, p. 15.

³³ Op. cit., P. 32.

³⁴ Op. cit., p. 99.

and on the other hand, it encourages companies to expand investment. It is fair to say that the transformation of expected income and profits into current consumer or investment spending is possible only with the correct functioning of financial markets, which is determined by the correct valuation of financial assets and the possibility of credit expansion when using these assets as collateral.³⁵

Returning to the question of the interdependence or interconnectedness of reforms, it is often difficult for countries to succeed in reforming the financial sector without progress towards strengthening the rule of law, developing the judiciary, etc. Indeed, an analysis of the Going for Growth reports shows that that a priority place on the reform agenda in a number of countries, such as Argentina, India, Indonesia, Italy, China, Mexico, Russia, South Africa, is assigned to such areas as strengthening the rule of law, strengthening the fight against corruption, improving the management of companies with state participation, increasing the efficiency of financial sector and bankruptcy procedures, prompt resolution of problem loans in the banking system.³⁶

A significant relationship is found when analyzing the impact of financial markets on global imbalances. It is known that global imbalances were one of the main causes of the 2007–2009 crisis. Their formation is associated, among other things, with different levels of development of financial markets in partner countries of international commodity exchanges. Regarding the role of financial reforms in correcting disparities, one should pay attention to the fact that household consumption in a number of countries (mainly emerging markets)³⁷ is constrained by a lack of competition and fragmentation of financial markets, which determine a higher savings rate with a

relatively smaller scale of household lending. Therefore, reforms that increase competition in financial markets in these countries (with proper prudential regulation and supervision) can stimulate consumption, lower the domestic saving rate, and weaken current accounts, creating new conditions for balancing the flow of goods and capital on a global scale.³⁸

FINANCIAL SECTOR ECONOMIC REFORM AGENDA: TIME FOR CHANGE?

As noted above, in recent years the focus of economic policy reforms has shifted towards inclusiveness and sustainability. In this regard, the view on the role of the financial sector in the economy and the policy pursued in relation to it may change (*Fig. 2*). However, before considering the role of the financial sector in achieving a more inclusive society and a cleaner environment, it is necessary to focus on its work quality in the context of traditional functions.

We believe that the financial sector needs more attention in terms of restoring its functionality. The greatest concern is his ability to qualitatively implement the allocative function. Empirical analysis indicates that there are problems with the performance of this function. Many studies show that the efficiency of OECD economies has been declining for more than two decades, so the potential growth in per capita output in the late 1990s and early 2000s decreased by about half. The reason for this lies in the slowdown in the growth of total factor productivity (TFP) and the fall in investment (mainly private). Confirming this, D. Andrews et al. report on the deviation of performance indicators of lagging firms from the global productivity frontier [22]. This effect is associated with the presence of barriers to the dissemination of knowledge and Schumpeter's idea of "creative destruction".³⁹ Although financial markets are designed to perform the

³⁵ This is highlighted in the report: OECD. Economic Policy Reforms 2009: Going for Growth: Structural Policy Indicators, Priorities and Analysis, OECD Publishing, Paris, 2009, p. 21.

³⁶ For example: OECD. Economic Policy Reforms 2017: Going for Growth, OECD Publishing, Paris, 2017, p. 6.

³⁷ With certain reservations, this also applies to other countries, such as Japan.

³⁸ OECD, 2011, p. 13. It should be added that success in this direction will also depend on reforms in other areas, primarily in pensions and health care. OECD Economic Policy Reforms 2010: Going for Growth: Structural Policy Indicators, Priorities and Analysis, OECD Publishing, Paris, 2010, p. 44.

³⁹ OECD. Economic Policy Reforms 2021: Going for Growth: Shaping a Vibrant Recovery, OECD Publishing, Paris, 2021, p. 19.

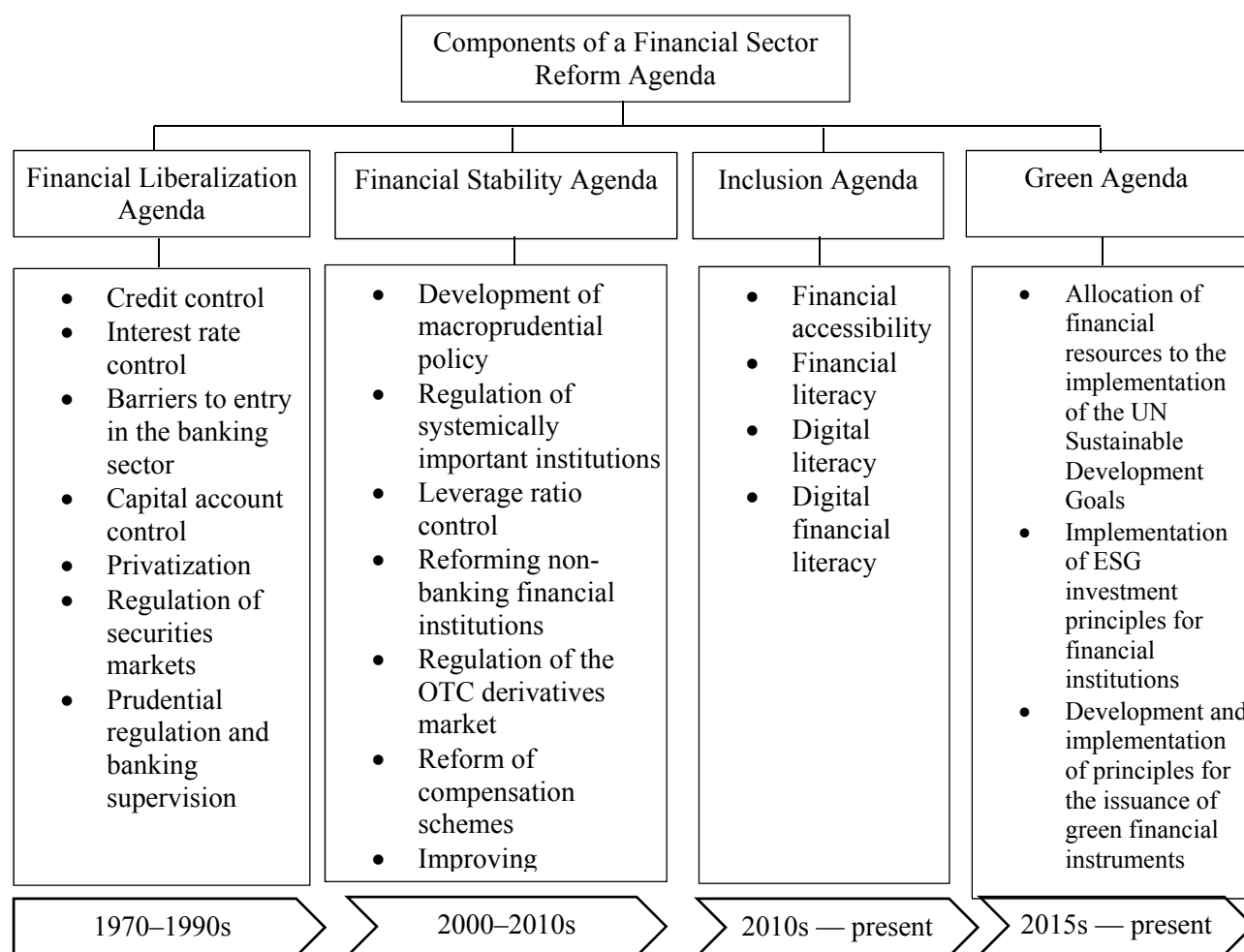


Fig. 2. Financial reforms agenda development

Source: author's design.

function of allocating resources, they do so with varying efficiency. In particular, countries whose financial markets are predominantly bank-based are less flexible in this respect. In addition, significant criticism of the functioning of financial systems arises in connection with the excessive accumulation of risks and the weakening of economies due to the chronic threat of a crisis.

In addition, the problems of dysfunctionality of the financial sector are implicitly articulated in the scientific literature, which examines the relationship between financial development, on the one hand, and economic growth and inequality, on the other. At the same time, there is practically no discussion of ways to overcome such dysfunction in this literature. Indirect evidence of the troubles in the financial sector should include those results of empirical studies

that reveal a negative relationship between financial development and economic growth [23], the “vanishing effect” of the impact of deepening financing on growth [24] or linearity, the assessment of the parameters of which testifies in favor of that many countries (primarily those with developed financial markets) have exhausted the resource for increasing the rate of long-term economic growth by increasing the depth of credit [25].⁴⁰

It is extremely difficult to track the role of financial reforms in overcoming inequality.

⁴⁰ While the role of the financial sector in spurring economic recovery and productivity growth is important, it is not critical. Achieving growth goals requires not only free access to capital, but also the supply of labor, skills development, infrastructure development, and, finally, the willingness of politicians to carry out structural reforms and quality state institutions is of great importance.

Initially, this can be explained by the non-triviality of the problem of identifying the relationship between financial development and inequality. Let us pay attention to some conclusions obtained by the authors in their studies. Thus, J. Greenwood and B. Jovanovic [26] showed that financial development and inequality are connected by a U-shaped relationship: when countries are just starting to build their financial sectors, only a small part of society wins, and income inequality increases. Once a certain level of financial development has been reached, an increase in external financing helps to reduce income inequality.

M. Brei et al. [27] conclude that this relationship is inversely U-shaped: up to a certain level, deeper financial systems are associated with less income inequality, but beyond that level, further financial development is correlated with higher income inequality. In addition, the results are sensitive to the financing model of the economy, so this finding only applies to countries with a predominantly market-based financing model of the economy and does not work in countries with a bank-based model.

Disappointing from the point of view of liberalization supporters, the results in their study were obtained by J. De Haan et al. They found that financial liberalization leads to increased inequality, and financial development exacerbates this effect [28]. On the contrary, I. Hasan et al. [29] argue that financial development is a particularly important determinant of wealth inequality between countries, therefore sound financial systems help to reduce wealth inequality.

In fact, there are several paths that can help tackle inequality through the financial sector (as well as mitigate the contribution of the financial sector to rising inequality). First, it is financial availability. A number of studies show that expanding access to credit for low-income groups creates incentives for entrepreneurship, equalizes educational opportunities, etc. Expanding the population's access to financial services (including through cost reduction),

such as remittances, savings, and insurance, is considered necessary to reduce poverty and income inequality, and reduce barriers to resource allocation; this makes financial systems more stable and leads to inclusive growth [30, 31].

Second, is to improve financial literacy. Indeed, there is influential literature arguing that more advanced financial knowledge is positively associated with wealth for the general population.⁴¹ For example, experiments performed by J. Choi et al. [32] showed that financial knowledge is positively associated with return on investment. A. Lusardi et al. [33] find a positive relationship between education (and financial education as its component), on the one hand, and income-normalized accumulated wealth, on the other. Specifically, we point out that the income received is capitalized with a much greater return by the category of persons who have deeper financial knowledge. The same authors argue that financial literacy is an endogenous variable so the ultimate distribution of income depends on how people invest in their financial knowledge over the life cycle. This conclusion is universal and does not depend on the type of economy. Translating the conversation into the language of politics, we emphasize that the results shown require more systematic work on the accumulation of financial knowledge by the population of different social groups, and therefore the policy in this direction should be strengthened in all countries without exception.⁴²

Third, increasing digital literacy is becoming a critical factor in creating the conditions for smoothing inequalities. In the context we are considering, digital literacy is a characteristic of a user of financial services, like financial literacy, indicating their ability to derive appropriate

⁴¹ One can even talk about the wider impact of financial literacy — its positive role in terms of more efficient allocation of resources, reducing the risks associated with episodes of financial instability, and, ultimately, participation in improving public welfare [35].

⁴² In the Russian Federation, the task of increasing the financial literacy of the population is a national priority. The study by O. Kuznetsova et al. is dedicated to the issues of increasing the efficiency of organizational measures to improve the level of financial literacy. [36].

benefits from some available pool of such services. Digital literacy is essential as there is a growing number of financial technologies (and players) in the market creating (offering) digital financial services and products. At the same time, access to both these services and traditional financial services is carried out via digital channels using remote access to the client's personal account or connection using a smartphone application⁴³ [36]. It should be noted that the COVID-19 pandemic has accelerated the transition of a significant part of the financial services market to digital channels. All this means that governments need a comprehensive program to achieve digital inclusion, which is a condition for reducing inequality.

Next, we consider the aspect of ecology. 6 of the 17 UN Sustainable Development Goals⁴⁴ are related to the solution of environmental (including climate) problems. The pandemic has sharply increased the relevance of the climate agenda. Environment-related priorities are featured at the top of *Going for Growth 2021* publications. These include combating pollution (and its attendant public health problems), taking action against biodiversity loss, and reducing clean water supplies. etc. "Left unaddressed, environmental pressures seriously threaten current wellbeing: each year well over 4 million people die from air pollution, natural disasters have more than doubled in the past two decades".⁴⁵

Solving the problems of sustainable development in the field of ecology, especially within the framework of the climate agenda, is in first place among dozens of countries in the world, including all EU states. In this regard, the OECD recommends that countries, especially

in the early stages of post-COVID recovery, pay special attention to environmental public investment and subsidies.⁴⁶

The OECD Financial Markets Trends "OECD Business and Finance Outlook 2020" is thematic and dedicated to the development of a sustainable financial system, and sustainable investment, defined by the abbreviation ESG (environmental, social, corporate governance).⁴⁷ The central place in this triad belongs to the first letter.

Mobilization of financial resources for adaptation and mitigation of climate change and the fight for environmental conservation requires the development of new strategies at the state and corporate levels, the launch of new tools, and the development of new markets [37].

According to OECD estimates in 2017, to achieve the UN Sustainable Development Goals and the Paris Agreement on climate change by 2030, annual infrastructure investments of USD 6.9 trillion are required, while current investments at the end of the decade amounted to USD 3.4–4.4, depending on the measurement metrics used.⁴⁸ The mobilization of such huge funds is impossible without restructuring the financial system. A set of ways to finance technological processes, projects, and companies related to environmental protection, as well as financial products/instruments and services (loans, bonds, shares, funds, etc.) with an environmental component, are collectively referred to as green financing (derivatives or closely related to it — environmental finance, climate finance, green finance, green investments, green banking, green insurance, etc.) [37–41].

The "greening" of the financial system, along with its digitalization, has become a key topic for the development of financial markets and their regulation even in the "pre-COVID" period. In 2020–2021, these trends have only intensified.

⁴³ OECD. G20/OECD INFE Policy Guidance on Digitalisation and Financial Literacy, OECD Publishing, Paris, 2018. URL: <https://www.oecd.org/finance/financial-education/g20-oecd-infe-policy-guidance-digitalisation-financial-literacy-2018.htm> (accessed on 15.08.2022).

⁴⁴ UN. URL: <https://www.un.org/sustainabledevelopment/ru/sustainable-development-goals/> (accessed on 15.08.2022).

⁴⁵ OECD. *Economic Policy Reforms 2021: Going for Growth: Shaping a Vibrant Recovery*, OECD Publishing, Paris, 2021, p. 26.

⁴⁶ Ibid.

⁴⁷ OECD. *OECD Business and Finance Outlook 2020: Sustainable and Resilient Finance*, OECD Publishing, Paris, 2020. URL: <https://doi.org/10.1787/eb61fd29-en>

⁴⁸ *Financing Climate Futures: Rethinking Infrastructure* OECD. The World Bank, UN Environment, 2018, p. 20.

In the spotlight is a set of issues related to the issuance of green financial instruments (primarily green bonds), the development and implementation of green taxonomies (they already exist and are used in the EU, China; in 2021, taxonomy for the Russian market was developed by VEB.RF); development of general requirements for non-financial reporting; creation of special indexes and ratings. The most important issue on the climate agenda is the inclusion of environmental factors in pricing (especially in relation to issues related to greenhouse gas emissions).⁴⁹

CONCLUSIONS

The era of financial reform since the 1970s is now at its tipping point. The reforms of the 1970s-1990s were mainly associated with the need to implement liberalization, more fully incorporate market mechanisms into the work of the financial sector, increase competition, create a wide variety of financial services, products, and instruments, and fill the market with sufficient liquidity. In the 2000s-2010s against the backdrop of increased turbulence and major losses incurred by the economy as a

result of the financial and economic crisis, we saw a different vector of reforms, set by the requirement to ensure the stability of financial markets and achieve proper stability of financial institutions. We are currently witnessing the formation of a modified financial reform agenda. Its most important components are the goals of inclusive and sustainable growth. This determines the need to develop appropriate reform instruments. At the same time, first of all, the environmental component of the agenda requires close international cooperation both in terms of developing tools and implementing the reforms themselves. In this regard, the role of the OECD is growing as an organization that has made a huge contribution to studying the experience of countries in terms of carrying out structural reforms and determining the broad agenda for such reforms. While other international organizations have been the main drivers of financial regulatory innovation, we highlight the important role of the OECD in the identified reform areas due to their complex and multi-component nature. In other words, the corresponding financial reforms are intended to complement a broader program of economic policy changes aimed at building a more inclusive society and maintaining a clean environment.

⁴⁹ OECD. OECD Business and Finance Outlook 2020: Sustainable and Resilient Finance, OECD Publishing, Paris, 2020. URL: <https://doi.org/10.1787/eb61fd29-en>

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