Financial Structure and Economic Growth: A Non-Technical Survey

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In any modern economy, a primary economic function of the financial system (financial markets, intermediaries such as commercial banks, and payments systems) is to transform household savings into productive investments. This function can be separated into three basic subfunctions: the mobilization of savings, the acquisition of information, and the management of risk. Financial markets (stock and bond markets) and intermediaries (which include banks, insurance companies, and mutual funds) are two alternative types of agents that perform more or less the same functions but in different ways and with different degrees of success. Financial systems that rely mainly on the former are deemed market-based, while those that rely mainly on the latter are called intermediary-based.

Many researchers have presented evidence from cross-country, industry-level, firm-level, and time-series studies to show that financial development exerts a positive impact on long-run economic growth. This raises an important question: Which specific types of financial systems are more growth-enhancing? There are four competing views of financial structure and its relationship to long-run economic growth:

- The *intermediary-based view* asserts that intermediary-based systems are more growth-promoting than market-based systems. This is mainly explained by the fact that close relationships between intermediaries and firms reduce information costs and ease financing constraints on firms, with positive ramifications for investment spending and economic growth.
- The *market-based view* argues that market-based systems encourage long-run economic growth better than intermediary-based systems. This view stems primarily from the fact that markets, by allowing people with similar views to join together to finance projects, are effective at financing new technologies which, in turn, boost economic growth.
- According to the *financial services view*, the issue is not intermediaries *versus* markets, but rather the creation of an environment for the optimal functioning of intermediaries *and* markets, or for the efficient provision of financial services generally, regardless of the mixture of intermediaries and markets. What matters for growth is the overall level and quality of financial services and not the distinction between markets and intermediaries.
- The *law and finance view*, a subset of the financial services view, also rejects the intermediary-versus-market-based distinction, but instead emphasizes that legal and regulatory systems play the key role in determining growth-fostering financial services. For example, a well-developed legal system that enforces property rights and contracts reduces the cost of external financing by lowering the costs of acquiring information about firms. This increases external financing and enhances economic growth.

According to the first two views, markets and intermediaries are *substitutes*, whereas the last two views stress the *complementarity* of markets and intermediaries in providing growth-promoting financial services.

Which of these competing views of the link between financial structure and growth are consistent with the data? Investigating the link between financial structure and long-run growth involves complex relationships, and it is therefore not surprising that there are no straightforward conclusions. A survey of the literature, however, suggests that there is more empirical support for the financial services and the law and finance views than for either the intermediary-based view or the market-based view. The majority of empirical researchers on this topic argue that financial structure (the degree to which the financial system of a country is intermediary-based or market-based) is not important for explaining differential growth rates across economies. For example, countries do not grow faster, and firms' access to external financing is not systematically easier, in either system. This conclusion is in line with the broad empirical analysis of financial structure and economic growth by Demirgüç-Kunt and Levine (2001), who use the most complete existing data set and a variety of econometric methods and yet consistently find that financial structure is not important for economic development. They argue that "through a diverse set of analyses, the answers are surprisingly clear.… Overall financial development [efficient financial services, well-developed intermediaries and well-functioning markets] matters for economic success, but financial structure per se does not seem to matter much" (p. 12).

Another reason to view markets and intermediaries as complements is that intermediaries are key participants in markets, and they tend to play a supporting role in ensuring that financial markets function properly. Investors need considerable expertise to participate in financial markets, which makes their participation costly in terms of time and money. Financial intermediaries help to reduce these costs. More precisely, by bundling investors' funds together, the costs of participation in markets for each investor are smaller (*economies of scale*). That is, because of the economies of scale, there is a reduction in the cost per dollar of investment as the size of transactions increases. In facilitating participation in financial markets, financial intermediaries contribute substantially to the effective functioning of markets. The most obvious example of a financial intermediary that emerged because of economies of scale and that supports markets is the mutual fund. Because the mutual fund buys large blocks of stocks or bonds, it can take advantage of lower transactions costs. This argument is supported by Allen and Gale's (2001) survey of financial systems. They present evidence on the ownership of corporate equities in the U.S. economy. They find that in the year 2000, households held less than 40 per cent of corporate equities, while intermediaries, particularly pension funds and mutual funds, held over 40 per cent of total corporate equities. They conclude that "it is no longer possible to consider the role of financial markets and financial institutions (intermediaries) separately. Rather than intermediating *directly* between households and firms, financial institutions have increasingly come to intermediate between households and markets, on the one hand, and between firms and markets, on the other" (p. 1).

We argue that the relationship between financial structure and financial stability provides another reason for focusing on the need for both well-developed intermediaries *and* markets. In the event of a crisis in one system, the other system can perform the function of the "spare wheel." Greenspan (1999) advocates this view and argues persuasively that

> What we perceived in the United States in 1998 may reflect an important general principle: multiple alternatives to transform an economy's savings into capital investment act as backup facilities should the primary form of intermediation fail. In 1998 in the United States, banking replaced the capital markets. Far more often it has been the other way around, as it was most recently in the United States a decade ago. When American banks stopped lending in 1990, as a consequence of a collapse in the value of real estate collateral, the capital markets were able to substitute for the loss of bank financial intermediation. Interestingly, the then recently developed mortgage-backed securities market kept residential mortgage credit flowing, which in prior years would have contracted sharply. Arguably, without the capital market backing, the mild recession of 1991 could have been far more severe (p.1).

These arguments suggest that it is not a question of markets *versus* intermediaries but of markets *and* intermediaries.

This implies an important policy message. Policy-makers should focus their attention on legal, regulatory, and other policy reforms that encourage the effective functioning of both markets *and* intermediaries, rather than concerning themselves with the degree to which their national financial system is market-based or intermediary-based.

References

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