



Is more finance better? Disentangling intermediation and size effects of financial systems[☆]



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ABSTRACT

Financial systems all over the world have grown dramatically over recent decades. But is more finance necessarily better? And what concept of financial system – a focus on its size, including both intermediation and other auxiliary “non-intermediation” activities, or a focus on traditional intermediation activity – is relevant for its impact on real sector outcomes? This paper assesses the relationship between the size of the financial system and intermediation, on the one hand, and GDP per capita growth and growth volatility, on the other hand. Based on a sample of 77 countries for the period 1980–2007, we find that intermediation activities increase growth and reduce volatility in the long run. An expansion of the financial sectors along other dimensions has no long-run effect on real sector outcomes. Over shorter time horizons a large financial sector stimulates growth at the cost of higher volatility in high-income countries. Intermediation activities stabilize the economy in the medium run especially in low-income countries. As this is an initial exploration of the link between financial system indicators and growth and volatility, we focus on OLS regressions, leaving issues of endogeneity and omitted variable biases for future research.

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1. Introduction

Financial systems all over the world have grown tremendously over the decade leading up to the Global Financial Crisis of 2008/9, both in absolute terms and relative to the size of the real sector. Financial sectors are largest in advanced countries but financial systems in developing countries have been catching up. Especially offshore financial centers have developed large financial sectors relative to the size of their underlying economies. The growth of the financial industry has long been considered a positive development by academics and regulators and has been facilitated by policies of financial liberalization. But is more finance necessarily better? And what concept of financial system – a focus on intermediation activities, or a focus on its size, including both intermediation and other auxiliary “non-intermediation” activities – is relevant for real sector outcomes?

This paper assesses the relationship between the size of the financial system, as gauged by its value added share in GDP,¹ and the degree of intermediation, as proxied by private credit to GDP, on the one hand, and GDP per capita growth and growth volatility, on the other hand. We contrast the effect of financial sector size with that of financial intermediation, and analyze whether intermediation and other non-intermediation activities have differential effects on growth and volatility.

Our analysis is motivated by two different views of the role of finance in an economy: the financial system as facilitator for the rest of the economy versus the financial system as a growth

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¹ Several authors have recently used value added of the financial sector, including Philippon (2008), Philippon and Reshef (2012), and Cecchetti and Kharroubi (2012). Measuring the value-added (and therefore the size) of the financial sector, however, is challenging. Basu et al. (2011), for example, show that current national accounts guidelines attribute the spread between the gross loan interest rate and a risk-free rate to banks' output. They argue that the relevant comparison is not the risk-free rate but the rate on similar market debt. They show that adjusting the US national accounts in this fashion reduces banks output by 21%. See also Haldane et al. (2010) for a critical discussion of measuring value added of the financial sector. In Section 5, we therefore also rely on other indicators for size, i.e., employment share, compensation share and hour share. These data are from the EU KLEMS dataset and are therefore only available for fewer countries and a shorter time period.

sector in itself which also performs non-intermediation activities. The ‘*intermediation or financial facilitator view*’ emphasizes the importance of the financial sector in mobilizing funds for investment and contributing to an efficient allocation of resources across households and enterprises (i.e., the “traditional” interest generating business).² In doing so the financial sector supports capital formation and productivity growth, and ultimately economic growth. It also encompasses additional, more or less public services such as providing access to basic payment and transaction services that are important for the participation of the whole population in a modern market economy. The ‘*intermediation or financial facilitator view*’ thus highlights the role of the financial sector in facilitating the proper functioning of the modern market economy specifically in serving the other – non-financial – sectors of the economy. This view implies that the financial sector and the economy somehow develop in sync; i.e., the size of the financial sector adjusts to the economy at large. We would expect that the contribution of the financial sector to GDP develops with certain regularity, as the economy develops.

A very different view is one that focuses on financial services as a growth sector in itself, therefore also performing many to-the-home-country non-intermediation services. This view toward the financial sector often also sees it as an export sector, i.e. one that seeks to build a nationally centered financial center stronghold based on relative comparative advantages such as skill base, favorable regulatory policies and subsidies. Economic benefits also include important spin-offs coming from professional services (legal, accounting, consulting, etc.) that tend to cluster around a financial center. We refer to this focus on financial services as a business in itself as the ‘*financial center view*’ encompassing intermediation but also non-intermediation activities. This therefore also includes all non-interest fee business stemming from the view of the financial system as an export sector.

The belief that a big financial system is beautiful has been reconsidered against the backdrop of the Global Financial Crisis of 2008/9 and the sharp output declines brought about by this event. Representatives of financial authorities in advanced countries have voiced their concern regarding the excessive size of the financial sector and called for regulatory restrictions (see e.g. Turner, 2010; Smaghi, 2010; Trichet, 2010). It has been claimed that an oversized financial sector could result in misallocation of resources and instability. Imperfect competition and rent extraction (Bolton et al., 2011; Cahuc and Challe, 2012), implicit insurance due to bailouts (Arcand et al., 2011), and negative externalities from auxiliary financial services which may be useful for some clients but not for society as a whole may lead the financial sector to grow too large relative to its ‘social optimum’.³

Recent empirical research has also embraced the idea that there might be limits to the benefits of finance. This literature focuses on financial intermediation and tests for nonlinearities in the finance-growth relationship (Rioja and Valev, 2004; Shen and Lee, 2006; Favara, 2003; Arcand et al., 2011; Cecchetti and Kharroubi, 2012). It neglects however that at least in advanced countries, the financial sector has gradually extended its scope beyond the traditional activity of intermediation between providers and users of funds toward non-intermediation financial activities. The importance of traditional financial intermediation relative to these non-intermediation financial activities has declined over time as

financial institutions have diversified into non-lending activities (Demirgüç-Kunt and Huizinga, 2010; Baele et al., 2007). Financial institutions have focused increasingly on proprietary trading, market making, provision of advisory services, insurance and other non-interest income generating activities. As a result, the traditional measures of intermediation activities have become less and less congruent with the reality of modern financial systems and recent papers are not very informative about the effect of financial sector size on growth and volatility. Given that non-intermediation activities may not exhibit the same profitability and stability as intermediation activities and given that they do not serve to perform the same functions as financial intermediation, it cannot a priori be assumed that these activities have the same effect on growth or volatility.

In addition to its direct contribution to GDP (as a growth sector) and its indirect effects via the functions provided to the rest of the economy, the financial sector may affect growth through its impact on volatility.⁴ While high growth volatility is not necessarily bad as it may be a sign of firms and labor markets being very flexible and adjusting to change, it could also be a sign of periodic excesses and welfare-destroying financial instability. The different activities of the financial sector have different effects on volatility. Trading by financial institutions can for instance drive asset price bubbles. Rajan (2005) points out that the incentive structure of investment managers and intense competition lead investment managers to accept exposure to tail risks and to adopt herding behavior. These behaviors can reinforce each other in an asset price boom and drive prices away from fundamentals, creating the conditions for sharp realignment. Non-intermediation activities of the financial sector may, however, also dampen fluctuations in economic activity to the extent that they reduce agency problems and asymmetric information which amplify shocks to the real economy (Bernanke and Gertler, 1989). Further, depending upon the specific situation, intermediation may reduce volatility by alleviating firms’ cash constraints (Caballero and Krishnamurthy, 2001), by reducing the dependence of financial contracts on borrowers’ net worth (Aghion et al., 1999) and through its effect on the cyclical composition of investment (Aghion et al., 2010).⁵ Financial deepening can also promote diversification which in turn reduces risk and dampens cyclical fluctuations (Acemoglu and Zilibotti, 1997). Financial intermediation could, however, also increase volatility by increasing leverage, thus making firms more vulnerable to shocks (Kaminsky and Schmukler, 2008).

This paper aims to shed light on several issues. First, we document trends in the financial industry over the recent past. We show that the size of the financial sector has increased dramatically in both advanced and emerging market economies. We also document the high volatility of the financial sector relative to the economy as a whole. Second, we analyze whether this increase in size has been beneficial for the real economy. We assess how variation in financial sector size is associated with growth and volatility, employing different proxies for financial sector size from

² See Levine (2005) and Merton (1995) for a discussion of the different functions of financial institutions and markets in a modern market economy and the channels through which they can foster economic development.

³ An example of financial services which only benefits clients is the restructuring of firm finance to reduce tax payments.

⁴ Theory suggests that volatility affects growth but predictions about the sign of this effect are ambiguous. In the presence of diminishing returns to investment endogenous growth models predict a negative relationship between business cycle volatility and growth. The opposite holds if precautionary savings, creative destruction, liquidity constraints or high-return high-risk technologies are taken into account (Imbs, 2007). The empirical literature has documented a negative correlation of growth and volatility at the country level (Ramey and Ramey, 1995). In our sample we find a negative or zero correlation depending on the time horizon considered.

⁵ Aizenman and Powell (2003) also suggest that costly intermediation stemming from costly state verification with imperfect enforcement power multiplies initial increases in volatility.

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