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Book Review

Financial Structure and Economic Growth: A Cross-Country Comparison of Banks, Markets and Development
Asli Demirguc-Kunt and Ross Levine (eds)
The MIT Press: Cambridge and London, 2001, vii + 436 pp., index.

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The connection between financial structure, the level of financial development, and economic growth has been a topic of analysis for decades. The contributors to this book address these relationships with both cross-country econometric analysis and individual case studies. In addition, the book includes a large multi-country data set on CD–ROM, documented in the second chapter, for readers to utilise in doing further analysis. The data focus on less developed and developing economies, omitting transition economies completely, but the analysis which follows may serve as a useful benchmark for the analysis of transition economies as well.

After their introduction, Demirguc-Kunt and Levine show how financial structures differ across countries and how these structures evolve as economies develop. Simple descriptive statistics on several different measures of structure and development demonstrate, unsurprisingly, that financial systems are more developed in higher income countries. However, perhaps more importantly, they also find a set of other systemic characteristics associated with the underdeveloped financial systems. Underdeveloped financial systems are frequently associated with French civil law, poor protection of minority shareholder rights and creditor rights, weak contract enforcement, greater corruption, poorer accounting standards, and greater regulation of banks and restriction of the range of their activities. It would be fascinating to know how transition economies fit into this pattern – an inviting task for future research.

Chapters 4–7 address issues primarily relating to structure and growth. Rene Stultz provides an excellent overview of growth and financial structure – defined as 'the institutions, financial technology, and rules of the game that specify how financial activity is organised at a point in time' (pp. 146, 147). The focus is on the way firms raise and manage capital. He considers deviations from a perfect market benchmark by working through entrepreneurial finance – staged financing and the role of intermediaries – as well as monitoring of established firms, which involves ownership, managerial discretion, control, and incentives. Poor financial structure makes the cost of capital high, limiting entrepreneurial activity and lowering the efficiency of any given investment. Furthermore, poor financial structure hinders the development of long-term relationships, encourages short-term debt that may be a source of instability in the banking system, and that may lead established firms to borrow off-shore. Although globalisation allows domestic agents to avoid the limits of poor financial structure to some extent, globalisation is not an adequate substitute for an efficient financial structure.

Thorsten Beck, Asli Demirguc-Kunt, Ross Levine, and Vojislav Maksimovic find that the market-based *versus* bank-based dichotomy of financial structure is not very useful in determining the impact of the financial system on growth or development. They do find that economies and firms grow more rapidly in economies with higher levels of financial sector development and in countries with legal systems that protect the rights of outside investors. In another chapter Demirguc-Kunt and Harry Huizinga show that financial structure, as such, does not influence bank profits or margins. In their chapter Ian Domowitz, Jack Glen, and Ananth Madhavan examine cross-country data on stock and bond issues and demonstrate that macroeconomic stability and market-specific factors such as the accounting framework, the level of investor protection, and access to foreign funds influence the formation of primary markets. Among the developing economies considered, there exists a strong correlation between privatisation and the development of domestic bond markets. This finding is of particular interest for economists interested in the determinants of successful privatisation programmes in transition economies.

The last three chapters are case studies. Francisco Gallego and Norman Loayza first provide a brief but excellent review of the remarkable changes in Chile's financial system and level of financial development beginning in the mid-1970s. Their sample of 79 firms reveals that firms faced significant constraints on external financing in the latter 1980s; the financial development of the 1990s relaxed these constraints as a result of the development of the banking system, decreased costs of issuing equity, and access to international capital markets. Sergio Schmukler and Esteban Vesperoni examine firm-level data from several East Asian and Latin American countries. While firms' financial characteristics vary in bank-based *versus* market-based systems, integration with international capital markets affects emerging economies similarly, regardless of financial structure. Finally, Andy Chui, Sheridan Titman, and K.C. John Wei examine the role of financial liberalisation in Indonesia. Again we see how a more open stock market promotes economic growth. Their findings also suggest that firms that belong to groups controlled by powerful families did *not* suffer relative to independent firms after liberalisation, as some have suggested.

Overall this book provides several valuable studies of the links between financial structure, development, and growth. The breadth and depth of analysis are commendable, and the studies will be of interest to economists studying developmental finance as well as transition economy issues. Further, the data provided remove a large start-up cost for anyone interested in pursuing research in this area.

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