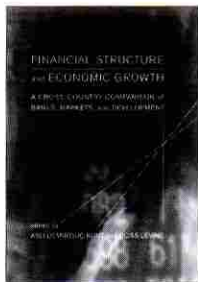
Financial Structure and Economic Growth: A Cross-Country Comparison of Banks, Markets, and Development

Edited by Alsi Demirguc-Kunt and Ross Levine. 2002. Cambridge, MA and London, England: The MIT Press. Pp. 444. $45.00 hardcover with CD-ROM.



Raymond W. Goldsmith's 1969 book, *Financial Structure and Development*, had three objectives: to document how financial structure changes as economies grow, to assess the impact of financial development on economic growth, and to evaluate whether financial structure influences the pace of economic growth. Goldsmith was successful in documenting the evolution of national financial systems, especially the evolution of financial intermediaries. However, lack of statistical evidence hampered drawing conclusions to answer the other two questions.

The book under review adds considerable empirical evidence to answer Goldsmith's three questions. The first part of the book updates Goldsmith's documentation of the evolution of financial structure during the process of economic growth. The cross-country dataset that accompanies the book is then used to address the relationship between economic growth and the level of financial development and the structure of the financial system. Finally, a collection of detailed country studies examines the relationship between economic development and financial structure.

The editors, who also contributed substantially to the chapters of the book, have excellent backgrounds. Alsi Demirguc-Kunt is a lead economist at the World Bank. Ross Levine is a professor of finance in the Carlson School of Management at the University of Minnesota.

The dataset for the book is taken primarily from World Bank data, which are described in detail in the book and also are on a CD that comes with the book. The quantity of data made available is considerable. The data cover 175 countries for the period from 1960 to 1997. (Of course, data are not available for all countries or for all years.) The first set of measures compares the size and activity of central banks and other financial institutions relative to each other and relative to GDP. Another section provides indicators of the efficiency and market structure of commercial banks. A section covers the size and activity of other financial institutions, such as savings banks, cooperative banks, mortgage banks, building societies, finance companies, insurance companies, private pension funds, pooled investment vehicles, and development banks. The final area measures the size, activity and efficiency of primary and secondary stock and bond markets.

An additional contribution in the book is a discussion and analysis of the advantages and disadvantages of bank-based financial systems vs. market-based systems. The former are exemplified by Germany and Japan, where banks play a leading role in mobilizing savings, allocating capital, overseeing the investment decisions of corporate managers and providing risk-management vehicles. England and the United States are market-based financial systems, where securities markets as well as banks facilitate society's savings to firms, exerting corporate control and easing risk management. The comparisons in prior research focused on countries with similar levels of GDP per capita; this book uses a broader cross-section of countries to widen the national experiences.

The book also provides information on the legal, regulatory, tax, and macroeconomic determinants of financial structure. The conclusions are not surprising. Financial systems are more developed in richer countries, and stock markets become more active and efficient relative to banks. Interestingly, as a broad generalization, countries with a common law tradition, strong protection of shareholder rights, good accounting regulations, low levels of corruption, and no explicit deposit insurance tend to be market-based. By contrast, countries with a French civil law tradition, poor protection of shareholder and creditor rights, poor contract enforcement, high levels of corruption, poor accounting standards, restrictive banking regulations, and high inflation tend to have underdeveloped financial systems.

The overall conclusions of the book are summarized as follows: "Overall financial development matters for economic success, but financial structure per se does not seem to matter much. Thus, policymakers may achieve greater returns by focusing less on the extent to which their country is bank-based or market-based and more on legal, regulatory, and policy reforms that boost the functioning of markets *and* banks."

The editors hoped that the data provided would be a base for further

researchers in the field of financial structure and development, and in this goal they have succeeded admirably. They certainly have provided the raw material for significant further research. Their conclusions are well supported and provocative. The idea that financial structure does not matter much does give financial analysts, especially in the United States, some reason for reflection. But for the researcher looking for a valuable data source or for anyone interested in a broad overview and analysis of the international financial landscape, this book is an extraordinarily valuable source of information.

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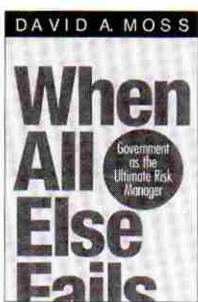
When All Else Fails—Government As the Ultimate Risk Manager

By David A. Moss. 2002.
Cambridge, MA: Harvard University Press. Pp 456 , $39.95, hardcover.



This book is a historical political economy study of government risk management in the United States. Professor Moss recounts the historical evolution of government risk management initiatives to reallocate risk based on seminal events and the statements of policymakers and advocates present at the creation. In general, reallocation refers to risk shifting and spreading but not reduction, and the story is initially framed in an Arrow-Debreu markets model in the spirit that "any risk—no matter how small or unusual—can be bought and sold in the marketplace" (p. 35). Then the author discusses market failure models, burnished by the insights of behavioral economics. The result is a good read.

The organization of the book begins with an introduction and "A Primer on Risk and Its History." They are followed by seven chapters on major government risk management initiatives that include limited liability, money, bankruptcy, workers' insurance, Social Security, and "security for all", described below. A summary chapter "The Foundations of American Risk Management Policy" and an epilogue conclude the book.

Evolution of Government Risk Management Initiatives

According to Professor Moss, the political economy of government risk management passed through three imperfectly defined, but conceptually informative, phases:

- The first phase, Security for Business, lasted until about 1900 and was motivated by a conviction that "well-conceived risk management policies can foster economic development and growth" (p. 4). These policies included limited liability, banking and insurance regulation, bankruptcy law, fixed exchange rates, and property rights.
- The second phase, Security for Workers, lasted from about 1900 to 1960 and represented a risk management shift in emphasis from business to labor. Social insurance legislation for worker's compensation, unemployment insurance, and Social Security was passed by the 1960s.
- The third phase, Security for All, began in the 1960s. The "very heart of Phase III" was "shifting risks away from individuals and onto firms and governments" (p. 253). In pursuit of "security against catastrophic loss" this phase emphasized federal disaster relief, state-level insurance guaranty funds, and environmental liability, among others (p. 257).

Main Findings

There were three main findings of his investigations into American risk management policy:

- "First, the historical record reveals risk management to have been an exceedingly flexible policy tool, used to address a wide range of social problems and to serve a diverse set of social objectives".
- "Second, the historical record reveals a remarkable degree of economic sophistication in the way leading policymakers thought about risk and about the government's role in managing it."
- "Finally, the historical record helps us understand why public intervention in markets for risk was so prevalent in the United States, despite the country's reputation as a bastion of laissez-faire" (pp. 293-295).

Professor Moss summarized "Instead of redistributing income or capital as good socialists would, U.S. lawmakers have actively redistributed risk…" (p. 325). He emphasized that "…the history of public risk management suggests several ways in which Americans seemed to reconcile their laissez-faire and anti-statist sentiments with their pragmatic inclination to employ state power to solve social problems". First, "certain risks simply fell outside the bounds of laissez-fair philosophy." Second, risk reallocation "tended to require little in the way of invasive bureaucracy and could easily be cast in the rhetoric of contract." Third, social insur-

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