CHAPTER 4

CHANGING GLOBAL FINANCIAL STRUCTURES: CAN THEY IMPROVE ECONOMIC OUTCOMES?

Summary

The global financial crisis has required policymakers to reconsider the role that the structure of their financial systems plays in achieving good economic outcomes. A number of forces can be expected to change financial intermediation structures in the period ahead, including crisis intervention measures and an evolving regulatory reform agenda. The changing structures for financial intermediation (through banks or nonbanks, funded by deposits or other sources, interconnected domestically or across borders) can be expected to affect economic growth, its volatility, and financial stability. This chapter investigates these potential relationships from 1998 to 2010 using the measures for financial structures developed in Chapter 3. With this knowledge, the chapter forms ideas about how the evolving financial structures relate to economic outcomes.

It is worth recognizing that forming concrete inferences about the relationship between financial structures and economic growth is difficult—as is most work on the determinants of growth. First, time series of detailed cross-country data on financial structures are short, circumscribing the ability to do long-term analyses. Second, the recent period for which data *is* available included a very severe financial crisis, and while some techniques can control for its influence, the ability to isolate structural effects is difficult. And third, data limitations mean that the series used for the concepts for financial structures are not perfectly aligned—they are proxies—and hence the interpretation of the results needs to factor in this potential imperfection.

Extensive care was taken to account for the limitations. In the end, the empirical results that withstand a battery of methods suggest that some financial intermediation structures are likely to be more closely related to positive economic outcomes than others. On the positive side, protective financial buffers within banks have been associated with better economic outcomes. On the negative side, a domestic financial system that is dominated by some types of nontraditional bank intermediation has in some cases been associated with adverse economic outcomes.

The results also suggest that there may be trade-offs between beneficial effects on growth and stability of some financial structures. For example, the positive association between growth and the size of financial buffers can diminish above a certain, relatively high, threshold—very safe systems may produce less economic growth. Similarly, cross-border connections through foreign banks are beneficial most of the time, but if these banks are not managed well, during a crisis they may import instability or limit growth. Hence, we cannot say that specific characteristics of a financial structure will *always* be associated with better outcomes. The chapter thus suggests where further work could usefully be conducted, particularly since causality between financial structures and economic outcomes cannot be assigned in this framework.

The following tentative policy implications emerge from the analysis:

- While some structures may be associated with both safety and efficiency, policymakers may also face a trade-off between the safety of financial systems and economic growth.
- Regulatory policies that promote financial buffers help economic outcomes, but they need to consist of high-quality capital and truly liquid assets.

In order to reap the benefits of financial globalization and nontraditional bank intermediation, these phenomena need to be well managed. Any measures to enhance growth and stability will only be effective if they are implemented correctly and overseen intensively. The analysis therefore reinforces the lesson from the crisis that high-quality (domestic *and* global) regulation and supervision should be at the forefront of reform efforts.