

# IEA Panel on Development Strategy and Finance

## Optimal Financial Structure and the Role of the State



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# Structure of Presentation

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- What is the optimal financial structure for economic development?
- What is the role of the state in finance?
- Concluding Remarks

# Definition and Observation of financial Structure

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## □ **Definition of “Financial Structure”:**

- The composition and relative importance of various financial institutional arrangements.
- I will focus on two dimensions of financial structure:
  - the relative importance of banks and financial markets in the financial system;
  - the distribution of banks of different size in the banking sector.

## □ **Empirical observations:**

- The equity markets becomes more active relative to banks as a country become richer
- Small businesses has no access to equity market and generally have less access to large banks' loan facilities.

# Comments on related literature

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- Drawback of the current literature:
  - Supply side approach--Starts from examining the characteristics of various financial arrangements and then discusses the likely effects of different financial systems on economic growth.
  - The financial structure is not relevant
  - The characteristics of the real economy are ignored.
- I propose a demand side approach:
  - Starting from analyzing the characteristics of real economy and the real economy's demand for financial services.
- I argue that the effectiveness of a financial structure is determined by whether the financial structure can best mobilize and allocate financial resources to serve the financial needs of real economy.

# Factor endowments and optimal industrial structure

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- Countries at different stage of development have different endowment structure and comparative advantage.
- The viability of a firm is determined by whether the firm's technology and industry choices are consistent with the economy's comparative advantage.
- Developing countries with relative abundant unskilled workers and scarce capital have comparative advantages in labor-intensive industries. Firms in those industries are in general:
  - Relatively small in terms of capital requirement
  - Using matured technology to produce matured products. Their main risk arises from the entrepreneurial/managerial ability of owner/operators.
- In advanced countries where capital is relatively abundant and labor cost high. Their comparative advantage is in capital-intensive, high-tech industries. Firms in those industries:
  - Rely on R&D to improve technologies and so have to face much technological innovation risk and product innovation risk.
  - Usually demand large amount of capital for investment and operation.

# Optimal industrial structure and optimal financial structure

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- ❑ The efficiency of a financial system in promoting economic growth depends on its ability to allocate financial resources to efficient firms in the most competitive industries in the economy.
- ❑ Firms' size and risk characteristics in the most competitive industries in an economy:
  - *Vary systemically across different levels of development;*
  - *Implication: the optimal financial structure in an economy will be changing according to the change in its optimal industrial structure.*

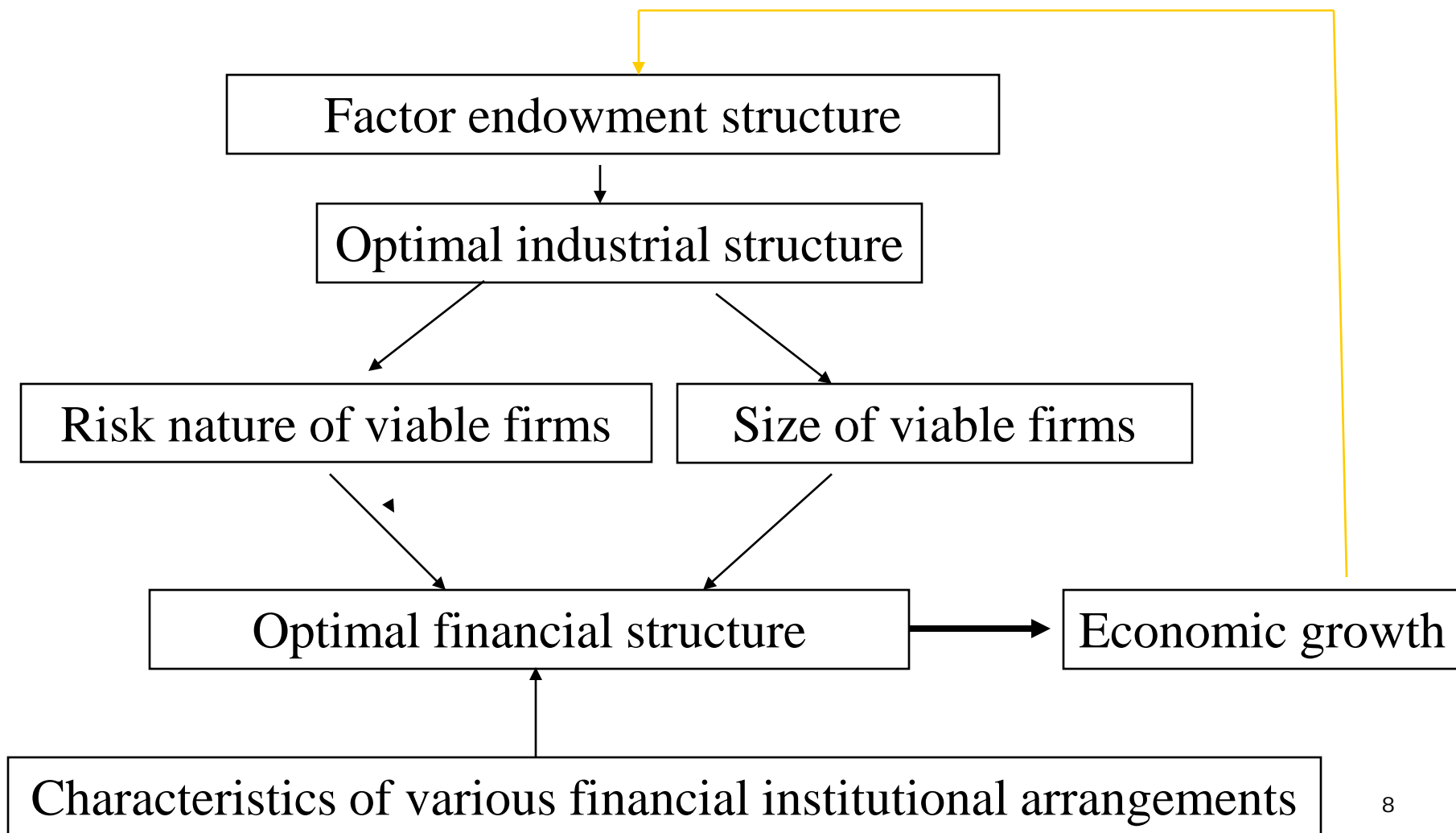
# Optimal structure across the stages of development

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- In developed countries where large capital-intensive firms and high-tech firms dominate the economy:
  - Financial system dominated by capital markets and big banks will be more efficient in allocating financial resources and promoting economic growth.
- In developing countries where small and less risky labor-intensive firms are the main engine for economic growth:
  - The optimal financial structure will be characterized by dominance of banks, especially small local banks.
- The optimal financial structure for any country is changing as the economy develops, endowment structure upgrades, and industrial structure changes.

## A new hypothesis: summarizing the main logic

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# The State and the financial structure

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- ❑ Both the equity market and bank require government regulation and supervision to mitigate the inherent moral hazard problem and reduce the occurrence and severity of financial crisis.
- ❑ While a country's endowment structure and the resulted optimal industrial structure are the most fundamental force shaping its financial structure, the government's policy will also affect the actual evolution of financial system.
- ❑ In addition, the government's development strategy and related policies are among the most important factors that cause the deviation of industrial structure and financial structure to deviate from their optimal structures.
- ❑ If a capital-scarce developing country adopts a comparative-advantage defying strategy in which the development of capital-intensive industries is taken as the priority, financial structure will be distorted from its optimal path so as to channel scarce capital to the government's priority sectors. The "financial repression" in many developing countries was a result of such development strategy.
- ❑ Developing countries need to be vigilant about another type of distortion: to imitate the financial system of developed countries without fully considering the real economy's demand characteristics for financial services.

# Concluding Remarks

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- Proposal: a demand-side hypothesis about the financial structure and its evolution.
  - Endowment structure at a given time in an economy determines the optimal industrial structure of the economy at that time, which in turn determines what the economy's optimal financial structure should be.
  - As the endowment structure and optimal industrial structure in an economy are changing over time, the optimal financial structure in the economy will also change accordingly.
  
- Other factors, such as legal, political, cultural factors, or development strategy will also affect a country's actual financial structure. However, a deviation from its optimal financial structure will have an adverse effect on the real economy and the economic development.

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Thank you!