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Banks, financial markets and growth

Luca Deidda [a,b,*], Bassam Fattouh [a]

[a] *Centre for Financial and Management Studies, SOAS, University of London, Thornhaugh Street, London, WC1H 0XG, United Kingdom*

[b] *CRENoS, University of Sassari, Deir, Via Torre Tonda 34, 07100, Sassari, Italy*

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Abstract

We analyze the interaction between bank and market finance in a model where bankers gather information through monitoring and screening. We show that if a market characterized by a disclosure law is established such that entrepreneurs wishing to raise market finance can credibly disclose their sources of financing, this might undermine bankers' incentive to screen, even when screening is efficient. Correspondingly, other things being equal, the change from a bank-based system to one in which market-finance and bank-finance coexist might have an adverse affect on economic growth. Consistent with this result, our empirical findings suggest that both bank and stock market development have a positive effect on growth, but the growth impact of bank development is lower the higher is the level of stock market development.

JEL classification: G10; G20; E44; O40

Keywords: Bank-finance; Market-finance; Economic growth; Monitoring; Screening; Disclosure law

1. Introduction

The large body of literature on finance and growth offers several explanations as to why financial institutions facilitate economic growth.[1] Financial institutions mobilize savings, diversify risk and produce information about investment opportunities. These functions help to improve the productivity of financed investments, which should result in higher growth rates provided that

* Corresponding author.
E-mail address: ld1@soas.ac.uk (L. Deidda).

[1] Seminal contributions include Greenwood and Jovanovic (1990), Saint Paul (1992), Bencivenga and Smith (1991). Pagano (1993) and Levine (1997) survey this literature.

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the returns to accumulable inputs are nondiminishing at an aggregate level. Consistent with this theoretical proposition, several empirical studies find that financial development can be strongly related to the process of economic growth, although the strength and the sign of such a relationship might vary with the level of economic development and other country-specific factors.[2]

An important aspect of the relationship between finance and growth is the way in which the financial structure, proxied by the importance of financial institutions such as banks relative to financial markets, affects the allocation of financial resources. Crucially relevant to this issue is the observation that when the economy is characterized by informational imperfections such that markets are incomplete, financial institutions and capital markets might affect each other in a nontrivial way. For instance, Allen and Gale (1997) demonstrate that while banks can provide more effective intertemporal risk smoothing than financial markets, their effectiveness in performing this role crucially depends on the degree of competition from the markets. Strong competition might result in disintermediation, undermining banks' ability to provide intertemporal risk smoothing.

Boot and Thakor (1997) study the interaction between banks and markets. Their theory of financial system architecture is based on three types of informational asymmetries: imperfect knowledge about the quality of investment projects available to borrowers; possible post-lending moral hazard; uncertainty as to whether an individual borrower would be prone to moral hazard. While the last two types of information asymmetry can be better solved by banks, the first one is more efficiently tackled by financial markets. As a result, they show that the equilibrium financial structure consists of an optimal combination of bank credit and market finance. Interestingly, in their framework, as the financial system develops and borrowers gain reputation, capital markets expand at the expense of banks.

Subrahmanyam and Titman (1999) build a model that explains private versus public financing, based on the costs of acquiring information and the importance of serendipitous information in capital markets. In their model, the value of firms which decide to go public depends positively on the size of the market for public financing. This implies the existence of an externality associated with the decision to go public such that an equilibrium could exist where the number of firms going public is inefficiently low.

In this paper, we study the interaction between financial investors that gather information about investment opportunities and a financial market where information is disclosed, and derive the consequences for the allocation of financial resources. We find that the establishment of a financial market characterized by a disclosure law such that entrepreneurs can credibly disclose their sources of financing may undermine financial institutions' incentives to screen the quality of the investments they finance. This might occur even if screening would have been efficient. Applying this result in the context of a growth model we show that, other things being equal, the change in the financial structure resulting from the introduction of such disclosure law could affect the equilibrium growth rate of the economy in an adverse way.

We construct a simple model of a competitive financial system in which financial investors provide funds to entrepreneurs. Financial investors can monitor (and screen) the entrepreneurs they fund, in which case we call them bankers. Alternatively, they can purchase financial securities, in which case we call them market investors. Entrepreneurs can either rely on bankers

[2] See King and Levine (1993) for an early contribution. Nonlinear studies include Christopoulos and Tsionas (2004), Deidda and Fattouh (2002) and Harris (1997).