Does Finance Accelerate or Retard Growth? Theory and Evidence

Franklin Allen, Elena Carletti, Jun "QJ" Qian, and Patricio Valenzuela

Finance can be beneficial for growth. But it can also contribute to financial crises, which are often very damaging for growth. An extensive review of the literature suggests that financial development has a positive impact on economic growth at adequate levels of financial depth but that the effect vanishes, or even becomes negative, when finance becomes excessive. Excessive finance incubates economic booms and asset prices bubbles that end in financial crises, with low rates of economic growth for sustained periods. Too little finance is not desirable—but too much is not desirable either.

The policy implications of this literature can be summarized as follows:

- The global financial crises of 2007–09 and the current debt crisis in Europe highlight the fact that excessive finance may have undesirable effects on economic growth. A growing literature finds not only a vanishing effect on the positive impact of financial development on economic growth but also a negative effect of excessive finance on growth.
- Long-run economic growth is positively correlated with bank credit to the private sector as a percentage of GDP. In high-income economies, however, this effect is relatively small, and it vanishes in some periods, possibly because these economies may have

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Franklin Allen is the Nippon Life Professor of Finance at the University of Pennsylvania Wharton School. Elena Carletti is a professor of economics at the European University Institute, in Florence; a fellow at the Wharton Financial Institutions Center (WFIC); and a research associate at the Centre for Economic Policy Research (CEPR), in London. Jun "QJ" Qian is an associate professor of finance at Boston College's Carroll School of Management. Patricio Valenzuela is an assistant professor of industrial engineering at the University of Chile and a fellow at the WFIC. The authors are grateful to Stijn Claessens for his very helpful and constructive comments as a discussant. They also thank Arvind Subramanian and other participants at the Geneva meeting of the Global Citizen Foundation Project, held December 1, 2012, and the participants of the Philadelphia meeting, held March 1–3, 2013, for helpful comments and suggestions. This summary was prepared for the Towards a Better Global Economy Project funded by the Global Citizen Foundation. The authors alone are responsible for its content. Comments or questions should be directed to allenf@wharton.upenn.edu.

reached the point at which financial development no longer affects the efficiency of investment.

- Economies with small and medium-size financial systems relative to their GDP tend to do better as they put more of their resources into finance, but this effect reverses once the financial sector becomes too large.
- Although the literature traditionally focuses on financial depth, financial structure is also important. Recent contributions focus on the optimal financial structure, which depends on a country's stage of development and endowments. Early on, for example, small banks may be appropriate for providing finance to small firms.
- Although theory predicts a number of benefits from financial openness—access to cheaper capital, portfolio diversification, consumption smoothing, emulation of foreign banks and institutions, and macro policy discipline among others—results from empirical studies report evidence in favor of and against capital account liberalization.

The literature these conclusions are drawn from is based on the experiences of a wide range of countries. From the perspective of the average global citizen, it might be better to base policy advice on success stories. The experience of Taiwan (China), the Republic of Korea, and China suggests that countries can grow quickly for many years. Within 50–60 years, per capita income can rise from African levels to Western European and possibly U.S. levels. Hong Kong (China) and Singapore, which achieved this kind of improvement are small city-states, but Taiwan and Korea have substantial populations. The problem from the global citizen's perspective is to understand how these countries achieved these spectacular growth paths and to implement their policies in other countries.

In China, alternative finance and institutions rather than traditional strong institutions and rule of law have allowed this growth. One of the most important policy conclusions is that alternative finance and the enforcement mechanisms associated with it should be encouraged rather than hindered. The conventional wisdom characterizes the economic performance in China as "successful despite the lack of Western-style institutions." We argue that China has done well because of this lack of Western-style institutions: conducting business outside the legal system in fast-growing economies can be superior to using the law as the basis for finance and commerce.

Research on political economy factors suggests that rent-seeking behavior by interest groups can turn the legal system, a monopolist institution, into a barrier to change. The "alternative" view argues that by not using the legal system, alternative finance can minimize the costs associated with legal institutions. In a dynamic environment, characterized by frequent fundamental changes in the economy, alternative institutions can adapt and change much more quickly than formal institutions.

There is also a dark side to finance, excessive levels of which can lead to asset price bubbles and financial crises. Other systemic risks that can lead to financial crises include panics (banking crises as a result of multiple equilibria), banking crises as a result of asset price falls, contagion, and foreign exchange mismatches in the banking system. Macroprudential policies are designed to counter these systemic risks. The most important of these policies include the following:

- Deposit insurance and government debt guarantees can prevent banking panics. However, they create moral hazard and can be extremely costly if in fact the systemic risk is not from a panic but is from the collapse of an asset price bubble or some other source.
- On some occasions it may be possible to use interest rates to burst real estate bubbles. However, in large diverse economies such as China, the Eurozone or the United States, doing so will not usually be possible, because bubbles tend to be regional and higher interest rates may cause slowdowns in regions without bubbles. When interest rates cannot be used, policy makers can limit loan-to-value ratios, which could be lowered as property prices increase at a faster pace; impose property transfer taxes that rise with the rate of property price increases; or restrict real estate lending in certain regions.
- If limits to arbitrage and other market failures lead to a serious malfunctioning of markets, it may be necessary to suspend mark-to-market accounting for financial institutions.
- One of the most significant systemic risks is the raising of interest rates by central banks and markets as normalcy returns. These increases will cause asset values to fall and pose a significant risk to the stability banking system. The return to normalcy needs to be carefully planned and carried out over time to minimize systemic risk.

- Contagion is one of the most serious and least understood forms of systemic risk. Several macroprudential policies and regulations may be needed to address the different channels and types of contagion. Perhaps the most important is capital regulation.
- Implementing permanent swap facilities for foreign exchange between central banks is an important policy to prevent currency mismatches in the banking system and reduce the need for large foreign exchange reserves.

The global imbalance in foreign exchange reserves was a significant contributor to the financial crisis, because these funds helped fuel the real estate bubbles that triggered the crisis. Going forward, it is important to reform the governance structure of the International Monetary Fund and the other international economic organizations so that Asian countries are properly represented. This reform would help ensure that they receive equal treatment when they need financial help. It would also reduce their need to accumulate reserves as a self-insurance mechanism. Self-insurance is very wasteful from an economic point of view.

A more likely medium-term scenario is that the yuan becomes fully convertible and joins the U.S. dollar and the euro as the third major reserve currency. With three reserve currencies, there would be more scope for diversification of risks by central banks holding reserves and China itself would have little need of reserves.

With regard to financial inclusion, two innovations in Kenya have expanded access to finance to isolated areas and minority groups. Equity Bank is a pioneering commercial bank that devised a banking service strategy targeting low-income clients and traditionally underserved territories. Its branch expansion targeted clients speaking minority languages. A key part of its strategy involved the use of low-cost services that were possible because of the use of computers. M-Pesa is a mobile phone–based service that greatly facilitates money transfers and remittances by the poor. It has been used primarily to transfer money between individuals rather than as a vehicle for saving. Equity Bank and M-Pesa illustrate the possibilities for using new technologies to leapfrog. Both strategies were profitable and thus can be left to the private sector. There is no need for public subsidies. However, it is necessary that regulators permit the use of such strategies.