

Are Small Banks the Answer?

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The Chief Economist of the World Bank, Justin Lin, argues in the July 11, 2009 edition of The Economist that policy makers in developing economies should adopt policies that favor small banks and limit the formation of large banks. This recommendation focuses too much on form over substance and conflicts with considerable empirical evidence.

Justin Lin's core observation – that the structure of financial institutions and markets in many developed economies is inappropriate for many developing economies — is wise, supported by considerable evidence, and frequently ignored by policy advisors. The appropriate form and function of financial institutions differs depending on a country's legal and political systems as well as on the types of economic activities occurring in the country.

Yet, Lin's major recommendation — that low-income countries should make small, local banks the mainstay of their financial systems — focuses too much on form over substance.

The crucial issue is what the financial system does, what services it provides to the rest of the economy, not whether it has big banks or small banks, microfinance companies, or securities markets. The appropriate policy goal is to construct laws, regulations, and institutions that create a healthy environment in which financial institutions compete to provide the most useful credit, risk, and liquidity services to the “real” economy. This will facilitate entrepreneurship, economic growth, and expand economic opportunities.

Although form may affect substance, the evidence does not support tilting the playing field to create a system dominated by small banks ... or large banks.

Consider the states of the United States. For the first three-quarters of the 20th century, they restricted banks from branching in order to create lots of small banks and limit the emergence of large banks. They succeeded. The U.S. had about 30,000 banks. But, this policy created small, localized banking monopolies. Other banks could not easily establish branches to compete with local banks; rather, they had to obtain a new banking license, which was a costly and uncertain endeavor. There were many banks, but little competition. These small banks served the interests of rich local cronies, which in turn supported the continuation of the regulations protecting these small banks.

Copious research identifies the harmful ramifications of making small banks the mainstay of the financial system. In the U.S., these small banks hindered the entry of new firms that would compete with the locally entrenched elites, hurt the poor by keeping credit flowing to local

cronies, slowed economic growth through these inefficient allocations of credit, and even increased instability since the small banks were undiversified.

I am not arguing that large banks are better than small banks. Indeed, considerable evidence validates Lin's concern that national policies frequently favor big banks to the detriment of economy. Rather, I am arguing that Justin Lin's "one size does not fit all" message also applies to his advocacy of small banks.

The connection between the form of the financial system and how it functions is complex. While small, local banks have more information about small, local firms, large banks are typically better diversified with better credit scoring processes, which facilitates lending to risky, new entrepreneurs. While large banks are sometimes too big or complex to supervise, small banks can be too numerous to supervise, as with Russia in the last two decades. While stock markets do not provide much capital to firms, they provide complementary risk diversification services that facilitate the efficient allocation of credit.

Policy should be geared toward enhancing the functioning of the financial system, not toward achieving a particular mix of institutions and markets.