

Chapter Two

The Role of the Financial System in Economic Growth

Summary

There has long been a debate among development economists on the role of the financial system in economic development. Early this century Joseph Schumpeter argued that a well-functioning banking sector had a role to play in spurring economic growth by assisting the identification and implementation of innovations in products and in production processes. Others have claimed, however, that financial sector development responds only passively to real sector development¹. Taking a middle view, Lucas has stressed the importance of the finance-growth relationship².

There are three approaches to the relationship between finance and economic growth: the institutional, functional and instrumental approaches³. The institutional approach concentrates on the role of banking and stock market developments in economic growth. The functional approach concerns the relationship between financial structure and the provision of financial services. The instrumental approach is concerned more specifically with the role of money in economic growth.

This chapter discusses the functional and institutional approaches to the role of the financial system in economic growth. The 1990's developments in international capital movements are discussed, along with the policy responses to those flows.

¹ Robinson, J., (1952, p.86) declared, "Where enterprise leads finance follows".

² Lucas, R., (1988, p.6) wrote: "In general, I believe that the importance of financial matters is very badly over-stressed in popular and even in much professional discussion".

³ See: Levine, R., (1997, pp. 688-726)