Chapter 3
Endogenous Growth Theory and Financial Sector

ABSTRACT
This chapter provides an outline of the endogenous growth theory. Endogenous or modern growth theory argues that financial intermediaries and securities markets allow business owners and investors to undertake innovative activities, which affects economic growth. Furthermore, other groups of studies that are concerned with issues like money creation, credit constraints, government interventions, and market failure are discussed in this chapter in parallel with endogenous growth theory. Later in the chapter, releasing the process of finance in different schools of thought including neo-classical, monetarist, Keynesians, and post-Keynesians is addressed. The discussion in the chapter ends with a review of the most commonly used indicators of financial market development, including but not limited to monetisation ratio, domestic credit availability, and stock market capitalisation.

3.1 WHERE IT ALL BEGAN
In the 1990s research on the relationship between financial development and long-run growth received new impulses from the literature on endogenous growth. A branch of this stream started to focus on the question whether financial conditions could explain sustained growth in per capita GDP. The central argument was that finance
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generates an external effect on aggregate investment efficiency, which offsets the decrease in the marginal product of capital. Some studies consider the role of stock markets exclusively (Eschenbach, 2004).

It appears that the work of Romer (1986) was the opening point for endogenous growth theory. The endogenous growth models consecutively presented the prospect of having a theory of the steady-state growth rate itself, instead of handling it as an exogenously given as in neoclassical. The earliest models, believed AK models, simply anticipated constant returns to capital, or to the set of factors of production that can be accumulated, like capital. These models are not very popular because of the assumption of exactly constant returns to capital, which is not very plausible empirically, and has no convincing theoretical foundation either (Solow, 1987).

Greenwood and Jovanovic (1990) developed a model in which financial intermediation and growth were both endogenous. These authors assumed there was a positive two-way causal relationship between financial development and economic growth. On the one hand, they argue that financial institutions always collect and analyse information in order to find the investment prospects with the possible highest return, in that way, increasing the effectiveness of investment and growth. However, they argued that the effect of financial intermediary is two-folded: the return individuals receive is not only greater, but also less risky because the financial system is actually capable of insuring investors against individual risks. On the other hand, economic growth is capable to provide the resources needed to create and implement costly financial structure.

King and Levine (1993b) develop a Schumpeterian model of technological progress similar to Romer (1990) or Grossman and Helpman (1991), with cost-reducing inventions applying to an intermediate product (as quoted in Eschenbach, 2004). Financial intermediaries and securities markets allow certain entrepreneurs to undertake inventive activities, which affects economic growth through productivity improvement. Financial systems also influence commercial activities in four ways according to Eschenbach: They evaluate entrepreneurs, pool resources, diversify risk and value the expected profits from innovative activities. Another group of studies is concerned with issues like government interventions in the credit market or market failure. The respective authors put these old issues into the new framework of endogenous growth. Roubini and Sala-i-Martin (1992), for instance, re-examine financial repression the context of an AK model of endogenous growth with non-decreasing returns to capital. In their model governments might opt for policies of financial repression in order to generate easy inflationary revenues.

A significantly large number of studies have been written about the importance of stock markets for the development process. Atje and Jovanovic (1993) use the approach of Greenwood and Jovanovic (1990) and apply it to stock markets. The
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