# Dual Financial Systems and Inequalities in Economic Development

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## Abstract

This paper analyzes the emergence and the evolution of a modern banking system, in a developing economy where banks coexist with informal credit institutions. Banks have a superior ability in mobilizing savings while informal lenders enjoy a superior information on borrowers. More specifically, banks cannot observe perfectly the behavior of borrowers; therefore the latter need to provide collateral assets in order to obtain bank loans. Physical collateral is not needed to borrow in the informal credit market: informal lenders can rely on social networks to obtain information on borrowers' behavior and invoke social sanctions to enforce repayment. The sustained growth path is associated with the successful development of the banking system that gathers savings on a large scale. However, informal lenders and other traditional credit institutions are necessary in the first stage of development when collateral is scarce. In this economy, the development of modern financial intermediaries is closely associated with the accumulation of collateral assets by entrepreneurs. This implies that the initial level of development as well as the initial distribution of wealth will determine the joint evolution of the real side of the economy and the financial system. Under certain conditions, two long-run steady-state equilibria exist: in the first one the economy stops growing and the banking system never successfully develops; in the second one the economy reaches a sustained growth rate and the informal sector asymptotically vanishes. The impact of the following policies is discussed: financial repression, micro-credit institutions and redistribution of assets.

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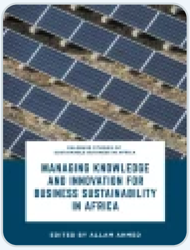


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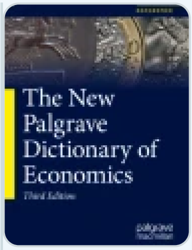


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