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Why Does Financial Sector Growth Crowd Out Real Economic Growth?

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Abstract

We examine the negative relationship between the rate of growth of the financial sector and the rate of growth of total factor productivity. Using a panel of 20 countries over 30 years, we establish that there is a robust correlation: the faster the financial sector expands, the slower the real economy grows. We then proceed to build a model in which this relationship arises from the fact that investment projects that are easier to pledge as loan collateral have lower productivity. As the financiers improve their ability to recover collateral in default, entrepreneurs expect credit to grow more quickly. As a consequence, they choose to invest in more pledgeable/less productive projects, reducing total factor productivity growth. We take this theoretical prediction to the data and find that financial growth disproportionately harms industries the less tangible their assets or the more R&D intensive they are.

Keywords: asset tangibility, credit booms, financial development, growth, R&D intensity**JEL Classification:** D92, E22, E44, O4[Suggested Citation](#) >[Show Contact Information](#) >CEPR Subscribers Download (<http://cepr.org/active/accounts/login.php>)

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