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# Financial Development and Economic Growth in Underdeveloped Countries

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# FINANCIAL DEVELOPMENT AND ECONOMIC GROWTH IN UNDERDEVELOPED COUNTRIES\*

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An observed characteristic of the process of economic development over time, in a market-oriented economy using the price mechanism to allocate resources, is an increase in the number and variety of financial institutions and a substantial rise in the proportion not only of money but also of the total of all financial assets relative to GNP and to tangible wealth.<sup>1</sup> However, the causal nature of this relationship between financial development and economic growth has not been fully explored either theoretically or empirically.

## Demand-Following and Supply-Leading Phenomena

Typical statements indicate that the financial system somehow accommodates—or, to the extent that it malfunctions, it restricts—growth of real per capita output. For example,

It seems to be the case that where enterprise leads finance follows. The same impulses within an economy which set enterprise on foot make owners of wealth venturesome, and when a strong impulse to invest is fettered by lack of finance, devices are invented to release it...and habits and institutions are developed

Such an approach places emphasis on the demand side for financial services; as the economy grows it generates additional and new demands for these services, which bring about a supply response in the growth of the financial system. In this view, the lack of financial institutions in underdeveloped countries is simply an indication of the lack of demand for their services.

We may term as "demand-following" the phenomenon in which the creation of modern financial institutions, their financial assets and liabilities, and related financial services is in response to the demand for these services by investors and savers in the real economy. In this case, the evolutionary development of the financial system is a continuing consequence of the pervasive, sweeping process of economic development. The emerging financial system is shaped both by changes in objective opportunities—the economic environment, the institu-

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\* This paper has benefitted from comments by Richard Parter, Donald Mead, Lester Chandler, and the participants in the Conference on Banking in the Early States of Industrialization held at Bellagio, August 1964.

1. See, for example, the work of Raymond Goldsmith, particularly his *Financial Intermediaries in the American Economy since 1900* (Princeton: Princeton University Press, 1958); and "Financial Structure and Economic Growth in Advanced Countries," in Moses Abramovitz, ed., *Capital Formation and Economic Growth* (Princeton: Princeton University Press, 1955). For an empirical treatment for Japan see David J. Ott, "The Financial Development of Japan, 1878-1958," *Journal of Political Economy*, LXIX, No. 2 (April 1961).
2. Joan Robinson, "The Generalization of the General Theory," in *The Rate of Interest and Other Essays* (London: MacMillan, 1952), pp. 86-87.



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