Financial Development and Economic Growth: International Evidence

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I. Introduction

The importance of the relationship between financial development and economic growth has been well recognized and emphasized in the field of economic development.[1] Although recent writings on this subject seem to accept the hypothesis that financial development is crucial for successful economic growth,[2] Patrick asked the critical question, Which sector, financial or real, leads in the dynamic process of economic development?

Patrick identified two possible patterns in the causal relationship between financial development and economic growth. In the first, growth induces an expansion of the financial system.[3] According to this growth induces an expansion of the financial system. According to this view, called "demand-following," the lack of financial growth is a manifestation of the lack of demand for financial services. As the real side of the economy develops, its demands for various new financial services materialize, and these are met rather passively from the financial side. In the second pattern the expansion of the financial system precedes the demand for its services. Channeling scarce resources from (small) savers to (large) investors according to relative rates of return, the financial sector precedes and induces real growth. The deliberate establishment and promotion of financial institutions in many less developed countries (LDCs) might reflect this belief in the "supply-leading" relationship between the two developments. A natural question then concerns the direction of causality between financial development and economic growth. Patrick asserted that the direction of causality changes over the course of development. In his view, financial development is able to induce real innovation-type investment before sustained modern economic growth gets under way, and, "as the process of real growth occurs, the supply-leading impetus gradually becomes less important, and the demand-following financial response

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