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57. The role of financial intermediation in economic growth

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Introduction: Nineteenth Century Classical Economists ignored financial intermediation as an important element in explaining economic growth until Bagehot. Bagehot, for the first time, gives explicit examples of how money market developments could make capital flow across the country in search of the highest rate of return in England. However, analysis of Bagehot was incomplete. It was Schumpeter, who put the role of financial intermediation at the center stage of economic development. Curiously, renewed interest in economic growth in the post Second World War saw a development in the literature that completely ignored the role of financial intermediation. For example, Solow-Swan model of development and growth has no role of financial intermediation. For all practical purposes, the economies were seen to be well approximated by a one good (corn producing corn) model. It took the international financial crisis of Latin America in the early 1980s to force economists to take the role of financial intermediaries seriously. I examine why financial intermediation is important in the tradition of Schumpeter.

Resources and methods: In the study used the latest scientific achievements of foreign economists. In this study it was used heuristic methods (which are in a creative approach to solution of the given problem and the assumption of the possible options) and statistical methods (which are based on statistical data of public and private organizations). Also, I had made a deep analysis of the latest scientific practical and theoretical research in this regard.

Results: There are important contributions by banks and other financial intermediaries on the economy. This process can be seen when we examine how the economy is affected when there are banking crises. Latin America provides an extremely fertile test-bed. There are important ways financial intermediaries can contribute to growth by examining the models of new growth theory in the tradition of Arrow-Romer. Elements of these models can be found in the writings of Schumpeter. Current debate about the role of financial intermediation in determining the growth rate misses the central point of Schumpeter. I examine why financial intermediation is important in the tradition of Schumpeter. There are important contributions by banks and other financial intermediaries on the economy. If there is perfect competition, all traders are price takers, there is no private information, and hence there is no role of financial intermediation. The Solow-Swan growth model usually assumes away the existence of financial markets. If we introduce market frictions, then we need to introduce the central role of financial intermediaries. There are two important frictions that financial intermediation mitigates.

Financial institutions take in the saving of investors and convert them into stocks and bonds. They money generated from stocks and bonds are finally used by firms to invest in bricks and mortar. Why can't the investors themselves do that? There is informational

asymmetry between the investors and the firms. The financial intermediaries reduce the search, collection and processing cost of investors. This process is sometimes called the screening function of the financial intermediaries.

Financial intermediaries allow individual small savers to access large investment projects through the mechanism of fund pooling. Individual investors are usually too small to access the benefits of indivisible large projects. Pooling done by financial intermediaries allow the small investors to access this avenue. Once again, if there are informational asymmetry between the small investor and the firm, this mechanism becomes essential. Financial intermediaries help diversify risk for small investors. Large projects carry large risks. It is difficult for small investors to invest in large risky investment projects by themselves. Financial intermediaries allow them to pool risks. They can form portfolios of large risky investments. The portfolios themselves would be insulated against high risk if they diversify. It allows the small investors to access this avenue without high risk. Long term projects require long term investment. Most small investors cannot afford to invest in the long term. They want to invest in the short term. This temporal gap is bridged by financial intermediation. This process is called liquidity management. Once again, long-term projects have higher return that ordinary investors cannot access, as they only have short-term investment options. Financial intermediaries make this possible.

Conclusions: Thus, in summary, financial intermediaries help efficient allocation of resources by allowing small-scale investors to get the benefits of large-scale investment projects. They do it through screening, fund pooling, risk-pooling, and financial intermediation. Incentive problems The functions described above assume that there is no conflict of interest between the savers and the firms. Additional problems arise when firms have incentives not to reveal all information. All firms do not have the same risk. Savers typically do not have the means to distinguish between high risk and low risk firms. Financial intermediaries can help them do so. It is also costly to monitor the activities of the firm. Individual investors are too small to carry that out. Financial intermediaries can do it on behalf of small investors. These problems are commonly referred to as problems of adverse selection and moral hazard.

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