



# Financial development and economic growth in Latin America: Is Schumpeter right?<sup>☆</sup>

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## Abstract

In this paper we investigate the role of financial development, or more widespread access to finance, in generating economic growth in four Latin American countries between 1980 and 2007. The results, based on panel time-series data and analysis, confirm the Schumpeterian prediction which suggests that finance authorises the entrepreneur to invest in productive activities, and therefore to promote economic growth. Furthermore, given the characteristics of the sample of countries chosen, we highlight not only the importance of a more open, competitive and therefore active financial sector in channelling financial resources to entrepreneurs, but also the relevance of macroeconomic stability (in terms of low inflation rates), and all the institutional framework that it encompasses (central bank independence and fiscal responsibility laws), structural reforms which were implemented in the 1990s, as necessary pre-conditions for financial development, and consequently for sustained growth and prosperity in the region.

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## 1. Introduction and motivation

Latin America has been known for a particular tendency to display erratic growth rates, combined with political transitions and poor macroeconomic performance (in terms of high inflation rates),

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in particular in the 1980s and first half of the 1990s. Some of the countries in the region presenting these, destructive, characteristics include Argentina, Bolivia, Brazil and Peru. Re-democratisation came in the 1980s and macroeconomic reforms and stabilisation in the 1990s (in the spirit of [Alesina & Drazen, 1991](#)), and coincidentally enough, growth rates and financial development became consistently positive some time after these political transitions had passed and economic stabilisation had taken root in the region.

Given this background, we investigate the role of financial development, or wider access to resources which can be channelled to productive activities, in generating growth and prosperity in four Latin American countries which displayed not only political transitions, but also hyperinflationary episodes in the 1980s and early 1990s. More specifically, in the vein of [Sargent, Williams, and Zha \(2009\)](#) we use data from Argentina, Bolivia, Brazil and Peru from 1980 to 2007, and panel time-series analysis to study the role, if any at all, of financial development in promoting economic growth so that our knowledge of the region is furthered.

The results suggest, once we account for all sorts of endogeneity issues, that financial development indeed played an important role in generating growth in the region, even in a time period which includes severe political and macroeconomic conditions. However, the results also indicate that the effect of finance on growth would be even greater if those countries had not experienced the hyperinflationary episodes of the 1980s and early 1990s. Therefore, we not only confirm the early empirical evidence based on large international cross-sectional and panel analysis using a different sample and methodology, but also highlight the role of macroeconomic instability in actually reducing the size of the positive effect of finance on growth, and consequently the welfare costs of poor macroeconomic performance on an important growth determinant.<sup>1</sup>

Essentially, we stress not only the importance of general structural reforms (the import-substitution model came to an end in the 1990s), in particular the financial de-regulation processes that took place in Latin America in the 1990s in helping to create a well-functioning financial sector (open, competitive, less clubby, and therefore more active, in the vein of [Rajan & Zingales, 2003](#)) that tends to provide more financial resources to be invested in all sorts of productive activities and which consequently generates faster growth, but also the importance of the implementation of particular economic institutions like central bank independence and fiscal responsibility laws in Latin America in the second half of the 1990s, which played an important role in bringing macroeconomic stability to the region and therefore in creating the necessary pre-conditions for finance to thrive.<sup>2</sup>

Moreover, given the current debates in developing countries like Argentina and South Africa (the governor of the Argentinean Banco Central has been recently, and somehow hastily, sacked from office; and the policy of inflation targeting conducted by the independent South African Reserve Bank has been under heavy criticism by particular stakeholders), it is always important to understand not only the causes of the hyperinflationary episodes of the past, but also the consequences of periods of economic closeness and poor macroeconomic performance to particular economic variables (financial development in this case) that can affect, in one way or another, economic welfare.

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<sup>1</sup> For instance, [Beck, Demirgüç-Kunt, and Levine \(2007\)](#), and [Bittencourt \(2011a, 2010a\)](#) suggest that financial development also plays an important role in reducing poverty and inequality, which reinforces the prospective role of finance on economic welfare in general.

<sup>2</sup> [Bittencourt \(2011a\)](#) provides an account of the structural changes taking place in Brazil recently and the respective economic outcomes.

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