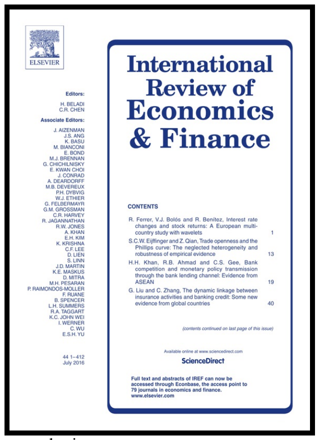

The impact of Financial Development on Income Convergence: An Application of Two Exogenous Growth Models

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The impact of Financial Development on Income Convergence: An Application of Two Exogenous Growth Models

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Abstract

The literature has established that financial institutions and financial markets have a significant impact on economic growth. The present paper seeks to determine whether they increase the speed of convergence towards the steady-state income. If so, then financial development is a convergence factor in addition to being a growth factor. To carry out our study, we employ the growth model of Ramsey-Cass-Koopman as well as that of Diamond. The RCK model predicts financial development positively affects the speed of convergence while the Diamond model predicts only a level effect. Our empirical analysis supports the prediction of the RCK model.

JEL Classification: O4, F4

Key Words: Financial Development; Economic Growth; Income Convergence

1. Introduction

Financial institutions (such as banks and insurance companies) as well as financial markets (such as stock and bond) play an indispensable role in economic growth. Effectively-functioning financial systems can apply remedies that ameliorate the severity of problems such as uncertainty, moral hazard, and adverse selection generally arising from asymmetric distribution of information in the capital market. In any economy, the prevalence of such problems and the inability to