

Review Article

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Financial Systems and Economic Development

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The focus of the World Development Report 1989 (WDR) is on the role of financial systems in the process of economic growth and development. The relationship between the real sectors and the financial super structure built around them has remained an arresting topic for economists although it has not received their constant attention.

The Great Depression highlighted the links between strained financial system and the downturn in economic activity. While Keynes recognised the importance of financial markets in the context of investment decisions, the Keynesians shifted the focus to money market; money was considered as the most relevant financial variable in the context of economic growth and development. Gurley and Shaw (1955) attempted to bring the focus back to financial system when they stressed importance of financial intermediation. Their argument was that financial intermediaries play an important role in achieving efficient intertemporal trade; a factor which would influence general economic activity. Goldsmith (1969) studied the relationship between economic development and financial sector across time and space. This line of research was however not pursued further because it was effectively argued that in 'real' economic decisions financial variables would not be relevant. Modigliani and Miller (1958) argued that real economic decisions were independent of financial structure. This provided a justification for abstracting from complications arising from financial arguments. This led to eschewing of financial markets

World Development Report, published for The World Bank, Oxford University Press, New York, 1989.