New study on poor financing in developing countries explains sluggish growth

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Though economists have long suspected that developing countries struggle to emerge from poverty because they lack robust financial sectors, few economists have tried to determine just how this phenomenon occurs – until now.

University of Notre Dame Economics Professor Joseph Kaboski, together with colleagues from UCLA and Washington University in St. Louis, examine this phenomenon in the study "Finance and Development: A Tale of Two Sectors," published recently in the American Economic Review.

Using a computer-based economic model and data from 79 countries to quantify key aspects of the relationship between development and the financial sector, Kaboski and colleagues find that poor financing environments in developing countries inhibit talented individuals from gaining the most from their abilities and result in lop-sided economic landscapes with few large firms and too many small ones. This ultimately slows economic growth.

The researchers show that though lack of financing affects productivity in both large-scale and small-scale industries, it impacts large-scale industry disproportionately. In large-scale industries, such as manufacturing, poor financing opportunities make it harder to start businesses, leading to too few entrepreneurs in the marketplace and even fewer large establishments.

Conversely, in smaller service industries, it is easier for entrepreneurs, such as retail shop owners, to self-finance, so the challenges to starting a business are actually reduced. This is also because the opportunity cost of choosing to start a business—earning a market wage and saving at the market interest rate—decreases. As a result, developing economies often end up with too many entrepreneurs and too many small establishments in the traditional service industries.

Kaboski and colleagues' findings also confirm that weak financial development—such as the lack of financial services—accounts for a substantial part of the difference between poor and rich nations' development; it accounts for poor countries' low per-capita income, their large differences across industrial sectors in prices and productivity, and their low aggregate total factor productivity (TFP), which is an indicator of how effectively an economy produces relative to the resources it uses.

The study also shows that the lack of good credit markets reduces the return to savers in an economy, making it more costly for poor individuals to build up a buffer and protect themselves from the various risks they face.

Provided by University of Notre Dame

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