Chapter IV

Financial Innovation and Economic Growth: Some Further Evidence from the UK, 1900-2003

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Abstract

In this chapter, we assess the contribution of financial development to saving and economic growth in the UK in the 20th century. Financial development in this century has been by leaps and bounds along with a number of infamous crashes like the ones in the 1920s and in 1987. Using annual time-series data for the whole century, we find that financial growth has helped saving and economic growth in the UK throughout the 20th century. The unprecedented increase in money holding in 1965 and various forms of financial innovation and liberalisation initiated in the 1980s raised both the level and the rate of economic growth. Money-stock elasticity of GDP has been positive and statistically significant. There are long-run and unique co-integrated relations of GDP with productivity of capital and financial depth in the 20th century. The financial crash of Black Monday in 1987 upset equilibrium relations and led to a negative money-stock elasticity of economic growth.
Introduction

Keynes held the view that history of money was the history of civilisation. Schumpeter thought development of financial institutions was an essential ingredient of economic development. Entrepreneurship would be encouraged by existence of monopoly profits, but a well-developed banking system would be needed to support entrepreneurs and investment (Schumpeter, 1933). The view that financial factors influence speed, direction and stability of economic growth is shared among a large group of development economists, although degree of reliance on the all pervasive role of the banking system, varies in this group (Garshenkron, 1962; Cameron, et.al., 1967; Ghatak, 2003). The greater the degree of economic backwardness, the stronger would be the role of financial institutions in initiating, promoting and sustaining economic growth and development; the banking system of a developing country is likely to be much stronger than non-economic institutions but many of these institutions including government, religious institutions, the education system, ethics and aesthetics all influence the operation of the banking system. These issues remain only in the background for our purpose as we are considering a developed country like the UK in the 20th century.

Financial development and the phenomenon called financial innovation are closely related. In the recent decades, however, financial innovation has been more closely related to the role of information technology. The term innovation usually means introduction of a new product into the market or a new way of producing an existing product and financial market does not have to be an exception to this. There has been a massive growth of literature on financial innovation and how it affects economic growth and various other aspects of economic life. Two of the best-known papers full of originality are by Silber (1983) and Tobin (1984). In the later decades of the 20th century, the role played by technology, which makes exchange of information around the financial world much easier and much faster, has been assigned a major role in financial liberalisation. The international payments system was already revolutionised by a high degree of automation made possible by a much-improved telecommunications and computer system. SWIFT, Fedwire, CHIPS, CHAPS1 and the like have contributed significantly to the growth of international banking and finance. Financial markets have been more widely publicised in the 1980s and have assumed a larger role in popular culture than in any previous period, with the possible exception of the late 1920s. In this chapter, we make special reference to the years that have affected finance and money in the UK; for example, the quantity of money holding increased substantially during the period from 1965-1999. Nominal money holdings increased from £17 billion in 1965 to £873 billion in 1999; the price level also increased substantially in the same period; the real money holding, as a result, increased four fold. Real GDP also more than doubled (Begg, Fischer, & Dornbusch, 2000). In the following section, we discuss the theoretical background and our methodology.
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