

Financial Innovation and Endogenous Growth

By

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ABSTRACT

We model technological and financial innovation as reflecting the decisions of profit-maximizing agents and explore the implications for economic growth. We start with a Schumpeterian model where entrepreneurs earn profits by inventing better goods and financiers arise to screen entrepreneurs. A novel feature of our model is that financiers also engage in the costly, risky, and potentially profitable process of innovation: Financiers can invent more effective processes for screening entrepreneurs. Every screening process, however, becomes less effective as technology advances, i.e., informational asymmetries evolve endogenously. The model predicts, therefore, that technological innovation and economic growth eventually stop unless financiers innovate to enhance screening. Empirical evidence is consistent with this dynamic, synergistic model of financial and technological innovation and economic growth.