Banks, Risk, and Economic Growth:
A Theoretical Analysis

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Abstract

Numerous studies identify a positive correlation between finance and economic growth. The goal of this dissertation is to advance the understanding of the underlying mechanisms in regard to banks' behavior and growth. This is achieved by incorporating liquidity and solvency risk of banks into endogenous growth models.

Chapter two and three layout banking and growth theories required for the literature discussion in chapter four.

The fifth chapter utilizes stochastic deposit transfers to depict banks' liquidity risk. To account for this risk, banks hold reserves as a buffer and demand an interest rate spread. This spread has a negative impact upon bank-financed research and development and growth. Two policy options result. Firstly, interbank clearing by the central bank can foster growth even if it requires mandatory reserves. Secondly, market entry of foreign banks can improve interbank lending and thus enhance growth.

The sixth chapter assumes that banks are risk averse and exposed to solvency risk. Bank capital serves as a buffer against insolvency and enables the bank to offer safe deposits for even more risk averse households. Banking activity coexists with financial markets. Thereby, this model contributes to the bank- versus market-finance literature. Four insights are derived. Firstly, bank-based economies can be explained by heterogeneous risk aversions. Secondly, the growth rate does not depend upon the bank- versus market-finance choice, but rather upon the agents' preferences. Thirdly, banks' risk aversion explains countercyclical movements of the interest rate spread. Fourthly, slow recovery can be explained by the need to accumulate sufficient financial capital to reestablish the ratio of finance to wages.

Keywords: Financial Intermediaries, banks, endogenous growth, Schumpeter, liquidity risk, solvency risk, risk aversion, portfolio choice, stochastic optimization