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The idea that the financial system of a developing economy is a factor that affects the course of development is relevant only for those economies that have decided upon a capitalist route. The financial system of a socialist economy is not a significant determinant of events. If it is a capitalist economy, then the financial system affects the behavior of the economy, depending upon the structure and organization of the financial system, how it is a task of economic policy to structure the financial system so that it facilitates rather than hampers the achievement of economic policy objectives. Thus monetary or financial policy really has two dimensions: the first deals with policy operating within an assumed assumed fixed financial environment, the second with policy operation designed to affect the structure of the financial system.
Capitalism is a financial system. Private, impersonal and marketable ownership and means of production, with the possibility of hypothecating or pledging assets and future income are the essential characteristics. In addition, in modern times, capitalism has been associated with the development of the corporate form. It is through capitalism that a financial system adds the decentralization of investment decisions. This is important.

As a result of its financial system, capitalism is characterized by decentralization of investment decisions. In particular, the financial system presumably facilitates the financing of innovation. Socialist societies have not yet developed such means for financing innovation, taking innovation, and they tend to discourage innovation. In reality, they are incapable of providing the large rewards that a capitalist society provides for truly successful entrepreneur.
Because its financial system, capitalism is characterized by decentralization of investment decisions. In particular, the financial system of capitalism should be judged on whether it facilitates the financing of innovation. Socialist societies have not as yet developed means of financing innovations with highly uncertain outcomes. In addition, their very nature, incompleteness, providing the large rewards that a capitalist economy awards to the truly successful innovator.
The view that policy with respect to financial institution is important depends upon accepting the proposition that the course of economic events depends upon the structure and behavior of the financial system. This is a generalization of the position taken by the "Chicago School," a position embodied in the slogan "money matters." Actually in none of the earlier writings by Chicago economists, particularly in the seminal work of Henry Simons, the monetary system was always examined as part of a broader financial system. The monetary constitution of the social economy encompasses much more than the behavior of the money supply, commercial banks, and the central bank. It is to this broader tradition that this paper is addressed.
Although the Chicago School is considered to be anti-Keynesian, it was Keynes who most explicitly introduced monetary and financial variables into the determination of prices and output. The difference between the two schools is more a question of philosophical outlook than it is of economics of whether the observed flaws in capitalism are considered to be "because of" or "in spite of" some essential fruit of capitalism. The Chicago School seems to hold that it is the imperfections of the monetary and financial systems, due to men's errors or perversity, that impose cyclical instability upon the economy; the Keynesian school seems to hold that cyclical instability would occur regardless of the nature of the monetary system, as long as the financial institutions are compatible with capitalism. Thus Chicago economists are even proposing "philosopher stones," whether it be coin or money or a constant rate of growth in some precisely defined money supply, once the philosopher stones are found and used then a state of perpetual bliss would result. To the Chicago School perfection is inherent in the market system, only uncertainty and honest perversity man makes things work poorly to the 'Keynesian' he humane condition forces one to be 'perversely' unemotional and indifferent.
Both schools agree that the primary flaw in capitalism centers around the generation of serious or deep depressions in business cycles. Although the socially costly phase of the business cycle lies in the recession or depression, and much of economic policy relates to easing these costs, the essential flaw in capitalism centers around the "boom" of prosperity phase. When capitalism does well over a protracted period, expectations about the expected payoff from investment change so that a sharp increase in the value of the existing stock of capital occurs. This increased value of the stock induces a desire to increase the pace of investment. The credit financial system of capitalism enables these increases in the desired pace of investment to be financed. Both capital gains from the revaluation of the stock of capital and higher incomes resulting from an increase in investment expenditure feed back and further raise the value of the capital stock.

This upward spiral results in increasing the ratio of investment to income and simultaneously the closeness with which
Taking place tends to raise interest rates which forces "paper losses" on the holder of fixed-interest long-term fixed interest assets. The close correlation of money expenditure with money receipts plus the fragile paper loans to financial institutions (combined with a very real deterioration of the primary classes of financial intermediaries) can weaken the financial system. A not unusual event can in some circumstances begin as short falls in both the value of real and financial assets. Under circumstances like these, a serious depression can result.
A financial system must not be judged solely—nor even primarily—on how it affects allocative efficiency. Perhaps of greater importance than its impact upon allocative efficiency is its effect upon the "stability" and "growth" characteristics of the economy. It is clear from the history of capitalism that profound and disturbing shocks which had their origins in the financial system have thoroughly disrupted the production of goods and services. Capitalism is a financial system (private, impersonal and a substantial ownership of means of production with the possibilities of high rates of return on investment) plus, in modern times, the corporate form, and...

It is a question of deep theory whether capitalism is inherently flawed in that such disruptive shocks are inevitable, or whether by current legislation or wise administrative discretion a "good financial" society can be constructed so that such disruptive shocks from the financial system will not occur. In the absence of such disruptive shocks, some contend capitalism would exhibit steady full employment growth.
It is quite clear that the focus for studying financial markets is not just allocative efficiency but also financial stability. The focus must shift to the broad economic goals: efficiency, growth, and stability. Thus, there is a base for the construction of a good financial system, which is a view on how economic growth takes place, another base is the view as to what a financial system does and what constraints it imposes upon the real economy.
Historically, the financial system has been capitalism's weakest link. The stresses and strains of investment booms have often led to financial system breakdowns or crises. The credit crunch of 1966 is a recent example. A comprehensive system of investment controls might prevent an investment boom, but such controls can also attenuate the urge to innovate. In an economy with a large government sector, the subjective conditions necessary for an investment boom may be altered by the conscious generation of a recession.
The fiscal drag inherent in a progressive income tax within a framework of big government can be used consciously to generate recessions (the anti-recession and anti-spending bias of the American Congress inadvertently uses these relations to generate recessions from time to time). Given the unequal incidence of recessions upon the population, policy proposals to use fiscal drag to generate recessions seem unacceptable. Thus tendencies to generate financial crises and a recessionary cycle that can lead to deep depression may continue to be a characteristic for investment banking, financial crises and deep depressions will remain characteristics of advanced economies. Thus central banks in an advanced economy must always be ready to come again to act as a lender of last resort.
A developing economy may lack the wide array of competing types of financial institutions that characterize an advanced economy. Thus, the tendency for the financial system to adjust to changes in market demands that is evident in a complex and competitive financial system might be missing in a developing country. Whereas a central banker in an advanced country, such as the United States, with a dynamic financial system must continuously inquire into the effects that evolutionary changes, originating in the financial system, have on financial characteristics of the economy and the efficiency of central bank actions, his counterpart in a less developed country must continually inquire whether the relatively static financial system serves his rapidly changing economy well. It might be that a central banker in an advanced economy sits in judgment on changes due to market evolution more often than he promotes change, whereas the central banker in a less developed economy takes the initiative in promoting change deemed necessary because he sits in judgment on new market-generated developments.
In this section, I discuss the impact of financial investments on the economy. Financial investments can be categorized into two main types: banks and financial institutions. Banks are commercially oriented, meaning they are profit-driven. Financial institutions, on the other hand, are not commercially oriented and provide services like insurance and investment management. The primary goal of financial investments is to increase the flow of money into the economy through loans, investments, and other financial transactions. Banks play a crucial role in circulating money within the economy, as they provide loans and facilitate transactions. Financial institutions, on the other hand, focus on risk management and investment strategies. Overall, financial investments are essential for the growth and stability of the economy.
In these circumstances, a country committed to a capitalist route to development which is at the stage where it is just breaking out of its colonial status must undertake an evaluation of its domestic financial system. The leading question in such an evaluation is the determination whether the banks are a part of a comprehensive system in which a broad spectrum is available both to businesses for the financing of investment and to households and financial intermediaries for portfolio. If the banking system of a country has the approval of the international banking community, then the chances are good that it is not doing enough to make various types of financing available in the economy.
In a newly developing country, the Central Bank may have to promote both a rapid expansion of the financial system and an widening of the institutions and instruments available. This is so because sustained modest economic growth and modernization may require rapid growth in the financing capabilities and spectrum of liabilities that can be sustained in the economy.
This can be made a bit more precise by means of an example. Let us say that initially a country is investing 9% of its real income. The Harrod-Domar formula gives us \( g = \frac{I}{K} \) when \( g \) is the growth rate, \( I \) is the ratio of investment to income, and \( K \) is the capital output ratio. Assuming \( I = 0.3 \) then \( g \) is 3.

9% yields a growth rate of 3.2%. If population is also growing at 3.2% then within this simple numerical exercise no improvement in per capita income takes places.
A rise in the investment ratio to 18% and a decline in population growth to 2.2% could in this country, with these capital output ratios result in a growth rate of 6% (1/3) a year per capita. Let us assume that in this country tries to achieve this transformation in its saving rate over a period of 15 years during which its growth rate rises to 6% per year from its original 3.5% per year. Let us also assume that it doubles its per capita income in this period. Over this period the investment ratio grows from 9% to 18%. But as income has also doubled, investment has grown by a factor of 4. The annual average rate of growth of investment is in excess of 9.6%. The problem of adequacy of the financial institution is related to at least the 9.6% growth rate in investment rather than the economy's rate of 4.8%.
Actually the required rate of growth of the financial system will be greater than indicated above. In the initial state the economy is heavily rural. Then a large portion of the investment put in place will not require organized financing by the organized financial sector. In the final period the growth over the transition period could very well mean that a very large part of investment may require the financial system. This change in the extent to which the economy is monetized and to which organized financial services are needed will in general mean that the rate at which the financial systems must grow. For example if investment financed by an organized sector of the economy grows from 1/4 to 3/4 of total investment, then in the previous example the required rate of growth of the financial systems will be at an annual rate of 12.7% rather than the previously estimated 9.6%.
Thus, the growing capacity of financial institutions to handle financial transactions must grow at a much more rapid rate than the economy during the period in which the proportion of the economy in the monetized sector is growing and in which the proportion of investment to income...
It follows that in a developing economy, the structure of the financial system may need more frequent conscious adjustment than is true in a more developed economy. This is so because even modest overall growth rate can be associated with very rapid sectoral growth. A growth rate of 14% per year in the modern industry sector can be compatible with an economy wide growth rate of 7%. The adjustment needed in the financial system reflects this rapid growth in the modern sector. Given has previously noted the lack of internally generated solutions. In particular, adjustments to ensure that needs met away from the existing primitive financial system, it may be necessary for the Central Bank to become a conscious generator of structural change. The Central Bank rather than market operators may need to be the engines of innovation.