Endogenous Growth Cycles with Financial Intermediaries and Entrepreneurial Innovation *

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Abstract

This study analyzes how activities of financial intermediaries affects economic fluctuations in a model of endogenous innovation cycles. I consider an economy where entrepreneurs and financial intermediaries engage in their respective innovative activities. Entrepreneurs can invent new products and raise funds for their invention from financial intermediaries. If their invention is successful, they can produce the new products. Only the financial intermediaries can evaluate the entrepreneurial ideas on their new products. Moreover, they can invest their capital to improve information about the entrepreneurial ideas and thus meet successful entrepreneurs with higher probability. I show that when an economy does not accumulate enough capital and the financial sector expands, that is, the level of financial innovation is excessively high, the economy is trapped into no entrepreneurial innovation regime. I also show that the economy at the intermediate stage of financial innovation -neither too high level nor too low level- fluctuates between the following two regimes; one regime is characterized by no entrepreneurial innovation and the other is characterized by entrepreneurial innovation.

Keywords: Economic fluctuation, Endogenous growth cycles, Financial innovation

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