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Chapter 6 - Financial Innovation

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Abstract

Although financial innovation has been an important part of the financial landscape throughout modern economic history, it has received relatively little attention in academia. This essay surveys the existing literature on financial innovation from the disciplines of financial economics, history, law, and industrial organization. I begin by defining financial innovation and discussing problems with creating taxonomies of financial innovations. I then discuss the explanations given for the extensive amount of financial innovation we observe both today and in history, which include: (a) completing inherently incomplete markets; (b) addressing persistent agency concerns and information asymmetries; (c) minimizing transaction, search or marketing costs; (d) responding to tax and regulatory forces; (e) responding to changes in economic conditions, in particular new or newly perceived risks; and (f) capitalizing on technological developments. I review work that studies the identity of innovators, the process of diffusion of innovation, and private benefits of innovation. I illustrate these general trends with a description of a sequence of innovations that show that repeated experimentation and failure characterize the evolutionary process. As difficult as it may

be to measure the private benefits to innovators, it has proven even more problematic to conclusively model or measure the social welfare benefits of financial innovation, although one can point to specific innovations that appear to enhance welfare.

Previous chapter

Next chapter

Keywords

financial innovation; capital markets; security design; financial institutions; *JEL classification*: G2 (G23Â G24), O3 (O31)

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