FINANCIAL DEVELOPMENT AND ECONOMIC GROWTH

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The role of the financial system is to intermediate between lenders and borrowers and provide avenues for saving and help investors find their financing needs. The financial markets impact growth by channeling saving to firms and improving the allocation of capital. Moreover, efficient financial markets and institutions tend to lower search and transactions costs in the economy. As the industrialized nations' economies grew in the eighteenth, nineteenth and twentieth centuries, their financial systems also grew in depth and breadth. In the 19th century, London achieved its status as the world's leading financial centre, because the financial sector had developed rapidly in order to serve the needs of British industry and British exporters. Similar is the case with 20th century New York which played a similar role in relation to the American economy.

The relationship between financial development and economic growth is a subject of debate. Some economists just do not believe that the finance-growth relationship is important. For instance, Robert Lucas asserted in 1988 that economists badly over-stress the role of financial factors in economic growth. Moreover, Joan Robinson declared in 1952 that 'where enterprise leads, finance follows'. According to this view, economic development creates demands for particular types of financial arrangements, and the financial system responds automatically to these demands.

However, it is now increasingly accepted that financial development has a positive effect on growth. Financial intermediation can affect economic growth by acting on the saving rate, on the fraction of saving channeled to investment, or on the social marginal productivity of investment. The studies of McKinnon and Shaw in early seventies propounded that financial repression depresses growth; conversely, financial development should raise growth. A positive correlation between growth and indicators of financial development is well documented. A growing body of evidence suggests that financial institutions (such as banks and insurance companies) and financial markets (including stock markets, bond markets, and derivative markets) exert a powerful influence on economic development, poverty alleviation, and economic stability. This position holds good for India too.

It is imperative that our nation must achieve high economic growth to cater to growing aspirations of its people. To attain such growth large capital and efficient distribution of capital is needed which can only be possible through efficient and developed financial markets.

World Economic Forum has constructed an Index that measures financial development. Measures of financial development are captured across the seven pillars of the Index viz., Institutional environment; Business environment; financial stability; Banking financial services; Non-banking financial services; financial market; and financial access. India is ranked 40^{th} out of 62 countries in the World Financial Development Index in 2012. Characteristics of financial markets development include, size of financial institutions and markets, degree to which individuals can and do use financial institutions and markets, efficiency of financial institutions and markets in providing financial services and stability of financial institutions and markets.

Market development is also dependent on the structure of the market and preference of savers for intermediation. In Asian economies there is a marked preference for bank intermediation. Bank-based finance has a special role to play for many economies in need of capital, and thus helps to ensure a well-balanced growth process. Benefit of bank-based finance relates to the intrinsic nature of the banking business: some projects cannot be financed directly by the market on account of significant information asymmetries between the borrowers and potential lenders. Banks can bridge this gap thanks to their comparative advantages in the assessment and monitoring of investment projects, which contributes to overcoming information asymmetries. Further, the economic literature on 'relationship banking' has demonstrated that banks can contribute to alleviating the impact of sudden economic shocks on their clients. Banks are, however, financial intermediaries that by nature add cost to the allocation of capital.

In Asian economies banking is a marvelous mechanism for channeling into productive investments the huge flow of household savings generated, since those countries including Mainland China, have savings-to-income ratios that are three, four, or even more times than the countries in the West. For all its potential contributions to economic growth, banking remains fragile. The high leverage combined with their 'extreme mismatch' of maturities (funding long-term assets with short-term and, in some cases, foreign currency-denominated liabilities) and reliance on demand deposits, makes them inherently vulnerable – and their economies to severe and recurring credit crunches.

Although banks play an important role in these economies by channeling funds from depositors to companies without access to capital markets, banking itself, says Nobel laureate Merton Miller from University of Chicago, is 'basically a 19th century technology'. Today's emerging Asian economies do not have well-developed capital markets and so remain heavily dependent on their banking systems to finance growth. However, as Miller argues, countries should develop a well fleshed out set of financial markets and associated institutions.

India has the distinction of long history of both banks and capital market. Economic history of India narrates how both have been vibrant in many important cities, though Mumbai has been dominating all others. Slowly and steadily, especially after nationalisation, the banking sector has emerged as the source for investment funding. In India, bank credit has been the significant contributor to the investment. Bank credit increased from Rs. 5 billion as at end March 1951 to Rs. 13 billion by March 1961, Rs. 47 billion by March 1971, Rs. 254 billion by March 1981, Rs. 1,164 billion by March 1991, Rs. 5,114 billion by March 2001, Rs.39,420 billion by March 2011 and Rs. 67,352 billion by March 2014.

Banking is the backbone to the development of trade, investments and business in any country and provides crucial credit and payment infrastructure and services to an economy. Banks are conduits for monetary policy transmission and serve as the backbone for credit creation and payments and settlement systems. Also, banks are highly leveraged institutions and function in fiduciary capacity.

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Published on 17 August 2014