The Relationship between Financial Development and Economic Growth in Emerging Markets

Assoc.Prof.Dr. Ercan Ekmekçioğlu
Turan University
Almaty-Kazakistan

Abstract

In this paper, we investigate the relationship between financial development and economic growth in the emerging economies. We explore the effects of financial liberalization and the impact of financial development on economic growth in the emerging economies. Financial liberalization creates market-based incentives that promote economic growth, (Davies, 2010).

The financial development measures and analyses the factors enabling the growth of financial systems in a number of economies around the globe. It could be intended at providing a comprehensive means to scale their financial systems and establish priorities for improvement. A thoroughly researched the subject in economics is the relationship between financial development and economic growth, (Kohli, 2008).

According to these discussions, the nature of casualty between the two was established. On the other hand, there is a very common view that financial development is significant and provides to economic growth popularly known as supply lending activity. Equally, there is an order following the belief which states that economic growth stimulates the progress of the financial sector.

In addition, researchers state that a pointer association exists between financial development and economic growth. Due to the argument surrounding the link between the two, a group of researchers has subjected the financial growth link to experimental proof. However, despite their efforts, a gap remains in the literature. These results from the fact that very few studies have given attention to the stage development theory, developed by Patrick in nineteen sixty six, where the direction of casualty between the two variables changes over the course of development. The scarcity of experimental studies on Patrick's theory may be due to limitation of information (Kohli, 2008).

1. Introduction

The reason for this study is to extend the literature on finance development links. This is by focusing on testing Patrick's stage of development theory for the South American economies of Jamaica, Trinidad, Tobago and Barbados using forecasting econometrics between 1950's to date, (Kohli, 2008).

Emerging market economies and financial development are a focus that has gathered huge interest for a very long time; the argument being whether the effects of financial development have an impact on the economic prosperity of most emerging economies. This subject was first analysed by Bagehot (1873), Schumpeter (1912) and John Hicks (1969). They pointed out that industrialization in most developing countries was largely due to the availability of financial systems to mobilize productive, financial capital. In this argument, Bagehot and Hicks seem to find a common ground on the input of financial services on economic growth. Levin (1997), in his argument states that, the development of financial markets and institutions play an incredibly critical task in the expansion of different sectors of the economy, (Cline, 2010).

Growth in this case induces an expansion of the financial system. The lack of financial growth is a manifestation of the lack of demand of financial services as the real side of the economy develops. The demand for various new financial services materializes and these could be met rather passively from the financial side, (Davies, 2010).

Economists hold different views on this matter based on both empirical and theoretical framework. Apergis et al, .2007 Sets out four views on the finance-growth relationship. These views are:

i. Supply-leading view
ii. Demand following view
iii. Mutual impact of finance and growth
iv. Null relationship view

The first view supports the fact that growth could be directly related to upward mobility in the financial sector. This view is of the fact that financial development causes economic growth by allocating financial resources to highly productive sectors of the economy. Patrick (1966) explains this view by arguing that the transfer of financial resources from the low to the high growth sectors leads to improved production of commodities which induce a demand for financial services and thus leading to subsequent growth in other sectors of the economy, (Cline, 2010).

The second view is of the agreement that the financial sector responds a lot to changes in the real regions of the country.

The third view is of the fact that growth in the financial services could be followed by an equal response in growth from the economy.

Previous research on this topic does not give consistent results on their findings on this issue. Chistopoulas and Tsional (2004) examine the long run relationship between financial development growth and economic growth for ten developing countries by using panel Co- integration analysis to find a uniform correlation on this issue.

Demetriades and Hussein (1996) find that the availability of funds is relevant to the growth of any sector of the economy.

A majority of these studies come to one conclusion that an upward transgression in the monetary environment leads to economic growth. Most countries in the emerging economies are striving to better on their financial sectors. In the quest, ensure that the low growth economies are financially empowered to come to a level where they can also stimulate economic growth, (Todaro & Smith, 2006).

According to the study on the "Financial Growth and Economic Expansion, time Series facts from Egypt," by Suleiman Abu-Bader and Aamer S. Abu-Quran on their discussion paper No. 05-14, they stress "the significance of financial development for economic expansion as many essential services could be presented by a country's financial structure. These services comprise the gathering and analysis of information regarding possible investment projects and channelling fund to the largely lucrative ones thereby growing the productivity of venture", (Cline, 2010).

This paper seeks to establish whether financial development leads to growth by examining the role of the financial sector and their possible impact on the economy.

Section 2 of this paper explains the various factors considered in financial development in order to determine whether any connection exists between financial progress and economic expansion, (Todaro & Smith, 2006).

2. Financial Liberalization and Economic Growth

Financial liberalization refers to the reduction of any regulation on the financial sector of any given country. It refers to the removal of restrictive barriers that may hinder the smooth performance of this sector. Financial liberalization has been the subject of controversy by many economists. Some argue that this scenario promotes economic growth while others feel that it induces excessive risk-taking, increases macro-economic volatility and leads to more frequent crises, (Ahmed & Islam, 2009).

Economic expansion could be defined as the rise in the amount of goods and services by economy overtime. It could be measured as the percentage pace of increase in actual GDP and could be usually calculated in real terms.

Huw Pill and Mahmood Pradan, (1997) suggest "In most developing nations, the banking industry dominates the financial structure and securities are not well developed." Restrictions on bank behaviour imposed by the government often result in negative real interest rates and an excess demand for credit requiring banks to ration their lending, (Basu, 2002).

By liberalising the market, interest rates, should yield positive real interest rates. This will in the event increase the resources existing to the financial system. Since bank deposits offering a competitive return will attract savings, this will result in more borrowers taking in loans to finance their productive ventures which will in turn generate revenue to them. The revenue generated by these borrowers from their capital investments will enable them repay their loans and make subsequent borrowing expand their investments.
This series leads to growth in the productive sectors which eventually trigger economic growth, (Ahmed & Islam, 2009).

3. Impact of Financial Development on Economic Growth

McKinnon (1973) suggests that liberalization of financial markets allows penetration of financial services among the rural population. This group of people are always on the lower cadre of the social cycle. Therefore, providing them with accessible tools of finance could be considered a very significant step towards achieving economic growth. This is because peasant communities could be mainly left out due to poor infrastructure, insecurity and abject poverty. Providing these people with access to credit gives them the opportunity to expand their business activities to middle class economy, (Loayza & Ranciere, 2004).

King and Levine (1993), Levine and Zervos (1998), Levine (2000), Levine et al. (2000) and Beck and Levine (2001) have developed new approaches to this issue. They identify: "Bank credit to the private sector, stock market activity and description of the legal structure such as the degree of shareholder and creditor defence," as the main reasons for financial differences in between most countries.

Levine (2000) further shows the impact of financial development on growth as through "total feature productivity rather than via capital accretion or saving rates."

Financial development could be calculated by factors, for example, depth, access, effectiveness and strength of the financial structure that includes its market, intermediaries, and range of assets, institutions and regulations.

According to the World Economic Forum's Financial Development Report (2011), greater degree of financial advancement and wider the accessibility of financial services allow for diversification of risk. This increases the long run growth path of a country and eventually improves the interests and affluence of producers and consumers with access to financial services.

This paper looks at the performance of Brazil, Russia, India and China countries by examining the 2010/2011 Financial Performance Index.

Country/Economy	2011 score 1-7	Change in score
Brazil	3.61	+0.09
Russia	3.18	-0.04
India	3.29	+0.05
China	4.12	+0.08

Table 1. *BRIC Countrys* ***Source:*** *World Economic Forum (2011), Financial Development Report.*

From the data available, Brazil's performance could be attributed to its stable currency system; its greatest advantage is in the non-banking financial services which have remained particularly robust. Although Brazil has a relatively low degree of financial sector liberalization, financial access remains one of the greatest strength of this economy.

China's strong economic performance could be attributed to its financial stability and strength in the non-banking financial sector. Despite its weak business environment, China remains remarkably strong in its financial intermediation, (Loayza & Ranciere, 2004).

India's continued economic performance lies in the strength of its non-banking financial services. Although India has a weak financial access, its strong financial intermediation bolstered robust results in its foreign exchange stimulates her growth.

The Russian republic's performance could be based on its currency stability. Russia continues to show strong results in financial intermediation and the non-banking financial sector. Russia's under performance could be under-weighed by considerable instability in its banking system, but this could be countered by superior performance in other financial sectors which contribute heavily to its outstanding performance, (Lee, 2009).

In order to ascertain whether financial development and economic growth have any relationship, this paper takes a look at the economic index of the BRIC countries i.e., Brazil Russia, India and China over the first quarter of 2012. This analysis will prove a clear view on this matter, (Lee, 2009).

Emerging Economies			**Projections**		**Differences from September WEO Projection**		**Q4 Estimates**	**Over Projections**	**Q4**
	2010	**2011**	**2012**	**2013**	**2012**	**2013**	**2011**	**2012**	**2013**
Russia	4.0	4.1	3.3	3.5	-0.8	-0.5	3.5	2.8	4.0
China	10.4	9.2	8.2	8.8	-0.8	-0.7	8.7	8.5	8.4
India	9.9	7.4	7.0	7.3	-0.5	-0.8	6.7	6.9	7.2
Brazil	7.5	2.9	3.0	4.0	-0.6	-0.2	2.1	3.8	4.1

Table 2. *Overview of the World Economic Outlook Projections* ***Source.*** *IMF, (2012) World Economic Forum Outlook Data http://www.imf.org/external/pubs/ft/weo/2012/update/01*

The table above shows a positive trend in the economic outlook. Russia's projection increased by 0.2, China by 0.6, India by 0.3, and Brazil by 1.0 points. By looking at this data, these economies are on an upward trend.

According to HSBC Emerging Markets Index, emerging nations are on the upward trend and project that by 2050, the top 3 economies in the world are likely to be China, U.S and India with Mexico and Brazil emerging among the top10 economies in the world.

4. Conclusion

From the analysis made in this paper, it is evident that financial development is particularly vital in determining economic growth in emerging markets. Various sectors of the economy depend on the financial sector for growth and, therefore, without the input of the financial sector, economic growth seems unrealistic since no economy performs without finances. Caprio and Demirguc-Kunt (1997) suggest that companies grow faster and are more productive when long term finance is available to them. In an economy, a financial system plays a crucial role in transforming and reallocating risk, (Spence, 2011).

From the data and analysis available, this paper, therefore, concludes that a relationship exists between financial development and economic growth, but further research is necessary on this subject, (Cline, 2010).

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