

The functions of the financial system | economics essay



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Introduction

The objective of this chapter is to provide a theoretical and empirical literature review of the relationship between financial development and economic growth in general and more narrowly at sectoral growth analysis. Therefore, it is important to determine what financial development relates to, how the financial sector and overall economy are related to each other, and the implications of such a relationship for other sectors of the economy.

In the following of this chapter, the study will first review the theory of financial development, whereby explaining the framework of financial system and how they affect growth of the real sector. The next section will focus on those authors who believe that economic growth is a good predictor of financial sector development. Further, effects of financial development on various sectors' growth will be discussed. The next section will review the existing empirical studies examining the relationship of FD and growth.

Theoretical Background

Financial System

A financial system is “ a network of markets and institutions that bring savers and borrowers together” (Hubbard, 1997). Financial systems have become the keystone of most economies around the world. This field is of great interest to economists, who research mainly the causes and impacts of its development. Through years, economists has changed their perceptives about the nature of the relationship between financial systems and economic growth. Bagehot (1873) established the pioneering theory on the relation between financial system and economic growth in his book Lombard

Street: A Description of the Money Market (1873). He found that financial markets facilitate the accumulation of capital and these markets manage the risk from relative investments and business strategies.

Later, Schumpeter (1911) identified that financial intermediaries facilitate technological innovation by gathering savings, evaluating investment projects, monitoring managers and facilitating transactions. The main argument of Schumpeter was that financial development affects economic growth through technological changes and this is done by banking institutions than stock markets. According to the Schumpeterian model, banks create entrepreneurs who carry out new investment projects that lead to economic growth as these rise in investment opportunities are available due to new combinations of providing finance to entrepreneurs.

Following, there were Goldsmith (1969), McKinnon (1973) and Shaw (1973) who emphasised on the role of capital accumulation in economic growth. In the McKinnon-Shaw model, a well developed financial system mobilises savings by channeling small valued savings into profitable large scale investments. According to them, without a proper participation of financial system, these savings might not be available for further investment because a financial institution mobilises savings from various savers in an efficient and effective way by avoiding information asymmetries and lowering transaction costs. Unlike Schumpeter, they did not distinguish between the banking sector and the stock market. For them, both of markets are important in the process of economic growth.

Although Schumpeter (1911), McKinnon (1973), Shaw (1973) and other economists emphasised on the positive role of financial development on economic growth, they failed to explain clearly how channeling of those funds affects growth. Then came Levine (1997, 1999), who has first depicted this link clearly. Levine demonstrated five main functions of the financial markets that affect the economic growth. More specifically, Levine pointed out that financial system

- Facilitate the trading, hedging, diversifying, and pooling of risk,
- Monitor managers and apply corporate control,
- Allocate resources,
- Mobilize savings, and
- Facilitate the exchange of goods and services.

Functions of Financial System

Unlike other economists, Levine (1999) produced a comprehensive way of showing the significant role for financial markets. The impact on economic growth occurs through the following channels according to Levine.

As discussed above, financial markets play a significant role in economic growth through their role of allocation capital, monitoring managers, mobilizing of savings and promoting technological changes among others. Economists had held the view that the development of the financial sector is a crucial element for stimulating economic growth. Financial development can be defined as the ability of a financial sector acquire effectively information, enforce contracts, facilitate transactions and create incentives for the emergence of particular types of financial contracts, markets and

intermediaries, and all should be at a low cost.[1]Financial development occurs when financial instruments, markets and intermediaries ameliorate through the basis of information, enforcement and transaction costs, and therefore better provide financial services. The financial functions or services may influence saving and investment decisions of an economy through capital accumulation and technological innovation and hence economic growth. Capital accumulation can either be modeled through capital externalities or capital goods produced using constant returns to scale but without the use of any reproducible factors to generate steady-state per capita growth.[2]Through capital accumulation, the functions performed by the financial system affect the steady growth rate thereby influencing the rate of capital formation. The financial system affects capital accumulation either by altering the savings rate or by reallocating savings among different capital producing levels. Through technological innovation, the focus is on the invention of new production processes and goods.[3]

As market frictions and laws, regulations and policies differs to a greater extent across economies and over time, the impact of financial development on growth may have different implications for resource allocation and welfare in the economy.

Relationship between Financial Development and Economic Growth

(i) Link of financial development and real sectors of the economy

The theoretical evidence that financial sector development fosters economic growth has been accumulating over many decades. Schumpeter (1911), McKinnon (1973), Shaw (1973) Goldsmith (1969), Levine (1999) and other

proponents came with a clear understanding of the role of financial development on economic growth. However, these theories do not provide a clear explanation of the transmission of financial development to the real sector of the economy that's lead to growth. Recently, some researchers have translated these abstract links between financial development and economic growth into concrete channels, such as household consumption, investment, trade (exports and imports) and government spending. Consequently, any increase from household consumption, investment, trade and government spending will have a positive impact on the real sector of the economy, and on the growth of economies. This link is illustrated below:

$Y_t = C_t + I_t + (X_t - M_t) + G_t$, where

Y_t is the gross domestic product, C_t is household consumption, I_t is domestic investment

X_t is exports, M_t for the imports and G_t is government spending.

Financial development and household expenditure are highly correlated, as discussed in Claessens and Feijen (2006). They argued that despite the causal relationship between financial development and household consumption is less clear than in the case of income, there is evidence that financial development is a leading indicator for increases in household consumption. Apart from increasing the household welfare, financial development also increases investment through the allocation of capital to private sector. The World Business Environment Survey (WBES), recent research concludes that finance is the most important constraint on firm growth. Other studies such as, Rajan and Zingales (1998), Perotti and Volpin <https://assignbuster.com/the-functions-of-the-financial-system-economics-essay/>

(2005) have found that the number of firms in an industry grew faster in countries that have better financial development. Claessens and Feijen (2006) also highlighted that the presence of financial intermediaries with their products such as credit cards, debit cards facilitate domestic and international payment service whereby facilitating trade. The Claessens and Feijen framework hence has demonstrated the link between financial development and economic growth through concrete channels.

(ii) Finance- Growth Nexus

In the traditional development economics, there exist two distinct views of the finance-growth nexus. The first view was first proposed by Schumpeter (1911) who argues that services provided by financial intermediaries are essential drivers of innovation and growth. Thus, well-developed financial systems channel financial resources to their most productive use. The Schumpeter's view was later formalised by Goldsmith (1969); McKinnon (1973); Shaw (1973); King and Levine (1993); Pagano (1993); Fry (1995); Zervos and Levine (1996, 1999); Christopoulos (2004); Manoj and Kamat (2007) and Hasan, Watchel and Zhou (2008) where all believed that financial development is a catalyst for economic growth.

The second view suggests that economic growth is the major driving force behind the development of the financial sector. This idea is very much stressed in the work of Robinson (1952). According to him, as an economy grows, more financial institutions, financial products and services emerge in markets in response to a higher demand for financial services. Further, the Patrick's hypothesis (1966) was introduced with the supply leading and

demand following, which is important to determine the relationship between financial development and economic growth. The demand following view explains the demand for financial services as dependent upon the growth of real output and the modernization of subsistence sectors. Thus, the creation of modern financial institutions, their financial assets and liabilities, related to financial services are a response to the demand for these services by investors and savers in the real economy. Therefore, the more rapid growth of real national income, the greater will be the demand by enterprises for external funds (the savings of others) and therefore financial intermediation. Also, with a given aggregate growth rate, the greater the variance in the growth rates among different sectors or industries, the greater will be the need for financial intermediation to transfer saving from slow-growing industries to fast-growing industries. In this case, an expansion of the financial system is induced because of real economic growth.

The second causal relationship between financial development and economic growth is termed the supply leading by Patrick (1966). Supply leading has two functions. Firstly, is to transfer resources from the traditional low-growth sector to the modern high-growth sector and secondly, to promote and stimulate an entrepreneurial response in these modern sectors.

Thus, the availability of financial services stimulates the demand for these services by the entrepreneurs in the modern, growth-inducing sectors.

However, previous empirical studies have produced mixed and conflicting results on the nature and direction of the causal relationship between finance and economic growth