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The Role of Financial institutions and the Economic Growth: A Literature Review

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Abstract
The coercion to uplift an economy in a right way to growth is more a mystery than a fact. Every country in the world is determined to be amongst the strong economies of the world. This draws a line of difference between developed and developing economies of the world. Developed countries have strong economies as compared to the developing countries. Economic growth is the major intent of every nation that contributes towards its development but there are certain hurdles such as over population, illiteracy and political instability that hold back their economic growth. Economic growth of every nation is dependent upon the role of financial institutions and the ultimate financial development. Policymakers and economists generally agree that financial development contributes towards financial institutions and markets, such as commercial and investment banks, bond and stock exchanges which in turn lead to economic growth.

1. INTRODUCTION

Financial development is usually defined as a process that marks improvement in quantity, quality, and efficiency of financial intermediary services. “This process involves the interaction of many activities and institutions and possibly is associated with economic growth”. Financial development has very an important role in economy. There are two schools of thought towards this study. First is repressionist and second is structuralism. “The repressionist concludes in their studies that financial development is an outcome of the maintenances of positive real interest rates and it impacts positively on commodity sector growth” (Arshad, Qayyum & Saeed, 2005). These include currency, demand deposits, time deposits (each as a portion of real GDP) and M2/real GDP.

The structuralism view is financial development impacts directly on investment growth and asset competition and it ensures that the relationship between investment and real interest remain negative. In other cases financial sector may be under developed or over developed (Colin, 2000). “If financial sector is underdeveloped it will not provide adequate channels for the mobilization of saving and they may keep it in the form of gold ornaments”. If financial sector is overdeveloped then it may become a medium of transmitting saving from the domestic economy to world capital market. Several studies show that countries such as Japan, Taiwan and China carefully pay attention to “maintaining a balance between real and financial sector development” (Badi, Demitriades & Siong, 2007).

2. ROLE OF FINANCIAL DEVELOPMENT IN ECONOMIC GROWTH

The prevailing view in economics is that financial development contributes to growth in various ways. “For example, financial institutions are better suited than individuals to identify potentially successful projects because these institutions are big enough to pay large fixed costs of collecting information about individual projects and to analyze this information more efficiently” (Cristina, Yan & Zhang, 2009). In addition, once a project has started, they can better monitor its managers to ensure that savers' resources are used productively. “According to Levine (1997) the prevalence of theoretical reasoning and empirical evidence suggests a positive, first-order relationship between financial development and economic growth”.

Financial markets also can enhance growth. First, they help collect resources from many savers necessary to invest in large projects. Second, they facilitate the pooling and hedging of risk inherent in individual projects and industries. “Finally, secondary financial markets also reduce securities holders' liquidity risk by allowing them to sell their securities without affecting firms' access to the funds initially invested” (David, 2006). Thus, well-developed financial markets and institutions can generate growth by increasing the pool of funds and by reducing the risk and enhancing the productivity of fund transfers from savers to investment projects. “Some economists have focused on events that have led to large changes in the size and development of the financial sector in a short period of time to isolate the impact of financial development on growth within a country over time”. These studies are usually called event studies (Erdal, Veli & Tuzel, 2007).

3. DETERMINANTS OF FINANCIAL DEVELOPMENT

Financial Development is closely related to economic growth and economic growth within a country is the

indicator of development in the country. “Economic growth is determined by number of factors which also determine financial development”. Therefore there are numerous factors that determine financial development. Some of them are mentioned below:

3.1 Gross Domestic Product

The gross domestic product (GDP) or gross domestic income (GDI) is a basic measure of a country's overall economic output which is an important factor contributing to financial Development. “It is the market value of all final goods and services made within the borders of a country in a year”. “It is often positively correlated with the standard of living, though its use as a stand-in for measuring the standard of living has come under increasing criticism and many countries are actively exploring alternative measures to GDP for that purpose”. GDP can be determined in three ways, all of which should in principle give the same result. They are the product (or output) approach, the income approach, and the expenditure approach (Claude & Aristomene, 1996).

The most direct of the three is the product approach, which sums the outputs of every class of enterprise to arrive at the total. “The expenditure approach works on the principle that all of the product must be bought by somebody, therefore the value of the total product must be equal to people's total expenditures in buying things”. The income approach works on the principle that the incomes of the productive factors (producers, colloquially) must be equal to the value of their product and determines GDP by finding the sum of all producers' incomes (Francois, 1999).

3.2 M2

In economics, money supply or money stock is the total amount of money available in an economy at a particular point in time. “M2 is an important determinant of financial development”. There are several ways to define "money", but standard measures usually include currency in circulation and demand deposits. “Money supply data are recorded and published, usually by the government or the central bank of the country”. Public and private-sector analysts have long monitored changes in money supply because of its possible effects on the price level, inflation and the business cycle. M2 represents money and "close substitutes" for money. M2 is a broader classification of money than M1. “Economists use M2 when looking to quantify the amount of money in circulation and trying to explain different economic monetary conditions”. M2 is a key economic indicator used to forecast inflation (Harris & Martin, 2000).

3.3 Savings

Saving is the conservation of money. Methods of saving include putting money aside in a bank or pension plan. Saving also includes reducing expenditures, such as recurring costs. In terms of personal finance, saving specifies low-risk preservation of money, as in a deposit account, versus investment, wherein risk is higher. “Savings are an important determinant of financial development because when economy is getting stronger, the earnings of people increases which in turn increases the savings resulting in financial development within the country” (Luca, 2000).

3.4 Advances to deposits ratio

Advances and Deposits are the important determinant of financial development. Advances refer to the amount given by banks or financial institutions to the households or businesses whereas deposits are the amount submitted into banks by people. “When the economy is growing the savings and incomes of people increases that also enhances the deposits in the banks”. As the deposits increase in the banks, the advances by the banks also increase resulting in the circulation of money in the economy (Paul & Vassili, 2001).

3.5 Exports/ Imports

In economics, an export is any good or commodity, transported from one country to another country in a legitimate fashion, typically for use in trade. “Export goods or services are provided to foreign consumers by domestic producers whereas the term "import" is derived from the conceptual meaning as to bring in the goods and services into the port of a country”. The buyer of such goods and services is referred to an "importer" who is based in the country of import whereas the overseas based seller is referred to as an "exporter". Thus an import is any good (e.g. a commodity) or service brought in from one country to another country in a legitimate fashion, typically for use in trade. It is a good that is brought in from another country for sale. “Import goods or services are provided to domestic consumers by foreign producers. An import in the receiving country is an export to the sending country” (Nourzad, 2002).

Imports, along with exports, form the basis of international trade. “Import of goods normally requires involvement of the customs authorities in both the country of import and the country of export and are often subject to import quotas, tariffs and trade agreements”. When the "imports" are the set of goods and services imported, "Imports" also means the economic value of all goods and services that are imported. “The

macroeconomic variable usually stands for the value of these imports over a given period of time, usually one year". When the exports of a country are more than imports than the economy of country is growing indicating financial development (Dawson, 2003).

4. DISCUSSION

The financial development consists of three portions. "First is the relationship between the financial development and the economic development, secondly the relationship between the financial development and socio-economic variables reflecting different level of development and also towards the human capital, thirdly the focus on the measurement through correlation regression which controls all other factors which are associated with financial development" (Nikolaos & Adamopoulos, 2004). Financial system development is an important factor in the growth process of an economy. However, not every process of financial system development is accompanied by high economic growth. "Financial system development also appears to be a difficult process as is indicated by the history of recurrent financial crises and by the fact that even in countries with a well-developed financial system, a large proportion of business investment is financed internally" (Erdal, 2007).

An analysis of the links between financial system development and growth should start with the determination of the extent to which the four indicators of financial development tell us whether the system is performing this central function. "The first two indicators, the level of liquid liabilities in the banking system and the level of lending by the banking system to the private enterprises, measure the extent to which an inter-temporal, inter-personal resource transfer is being affected in an economy" (Bena & Jurajda, 2007). Over the last two decades, two influential economic growth theories were developed. Financial intermediaries reduce the cost of acquiring information, thus helping inputs move to their most efficient uses. "This is especially true in those instances where the acquisition of information concerning the most efficient production process involves substantial fixed costs" (Patricia, 2007).

Equity markets can also provide accurate information at low costs by publishing share prices, thus improving production efficiency. "These markets also promote efficiency through technology. Well-developed financial markets shift capital away from declining industries and toward growing industries" (Indrani, 2008). A wave of financial liberalization in the latter half of the 1980s and early 1990s and a surge of capital inflows too many developing countries, were followed by financial crises in Latin America and East Asia. "These events have fostered a fresh research interest in the role of financial Intermediation in economic development, and a re-examination of the policy options for ensuring that the financial sector's contribution to economic growth and development is fully realized" (Vally, 2008).

5. CONCLUSION

There is a long-lasting tradition in economics with the issue of financial development and economic growth. The connection between the financial superstructure and its real infrastructure accelerates economic growth and improves economic performance to the extent that it facilitates the migration of funds to the best user. These events have fostered a fresh research interest in the role of financial Intermediation in economic development and a re-examination of the policy options for ensuring that the financial sector's contribution to economic growth and development is fully realized. The argument that economic growth is necessary for poverty reduction does not mean that policy-makers can limit their attention to the single target of growth maximization. The extent to which a given rate of economic growth affects poverty levels is influenced by the institutional structure and policy environment that exists in particular countries.

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