Determinants of Financial Development

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Abstract

A vast number of studies have found that financial development encourages economic activity and thus helps to recognize key factors for financial development. This study is a literature review on the determinants of financial development for Malaysia (single country), cross-country, regional studies on Mauritius region and global study which covers theoretical and empirical literature. The findings suggest that commercial transparency and liberalization are critical factors in the growth of finances. The increase in the contribution of other sectors to GDP will reduce the dependence of the country on natural resource profits. Further opening of international policy reflects the observed impact on the financial development of trade transparency.

Key Words: Financial Development; Economic Growth; Monetary policy; Inflation

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1. Introduction

More importance has been given in recent years to the significance of financial development and its growth. Different representations exist for verifying financial progress, like the depth of scale, access efficiency and financial system stability. Each of its components can be broken down into the whole industry, such as banks, markets, other financial institutions, and the actual economy. The financial sector would be a great national boon to be productive and competitive, intelligent, wise, and well-managed. It will make it possible for that country to become one of its peers in a prosperous and established society (Wasiak, 2017). Because of their poor performance and the value of financial growth, various countries have tried to improve their financial sectors; however, the results have differed (Hall, 2020). There is, therefore, a critical question that why certain nations have a productive-enhancing financial system when others do not?

Indeed, it is crucial to research the determinants of financial growth across countries in answer to this question. Thus, it is unremarkable that discovering the determinants of financial sector development for nations that seek to attain fast and sustainable economic growth is becoming an increasing priority. However, since the conditions of financial development in countries differ significantly, further analysis of single country is needed (Ledger, 2020). According to (Shahid, 2017; Shahid et al., 2018a; Shahid et al., 2018b) qualitative approach is better while exploring the different domains of a concept under study. So, this paper aims to give a literature review of the determinants of financial development in Malaysia (single country), cross-country, regional studies, and global studies.

2. Literature Review

The overall determinants of financial growth are as follows: liquidity liability (LLY), overhead cost (OVC), stock market capitalization (MCAP), private credit (PRIVO), commercial-central bank (BTOT), and total value traded (TVT) and turnover ratio (TOR) (Huang, 2010). In Malaysia, although numerous studies are explaining financial development, existing literature reveals that empirical finding on the factors to be measured in this study are unquestionably scarce. The studies such as (Beak et al., 2008) and (Carletti, 2013) focuses on the determinant of financial development. The (Beak et al., 2008) study uses

explanatory variables as measures of financial growth, In particular per capita GDP, inflation, population growth, the density of population, exports of fuel and offshore. In addition, (Carletti, 2013) added some additional regressors in a related report, namely natural capital, inflation rate, current account balance to GDP ratio, institutional growth index, manufacturing, and enrolments in secondary or primary school. (Islam et al., 2013) finds that energy consumption in Malaysia during 1971–2009 is influenced by short- and long-term economic growth and financial progress. A report, (Tan, 2012) explores the linkage in Malaysia during 1972–2009 between energy consumption, economic growth, relative price, financial development and FDI. On the other hand, the theoretical literature forecasts that financial development is a positive function of real income and the actual rate of interest. This is based on models of the McKinnon-Shaw style and the literature of endogenous growth. The positive relationship between financial development and output level, in (McKinnon, 1973) model, outcomes from the complementarities of money and capital. According to (Shaw, 1973) model, financial markets facilitate the intermediation of investment by debt, which in turn increases production levels. The positive real interest rates under these models encourage financial growth by increasing the accumulation of financial assets by growing production of capital and productivity (Habibullah, 2009).

The empirical outcomes show that energy usage is a prominent resource for the development of the financial sector, where findings advance indicate that Granger's energy use triggers the growth of the Malaysian financial sector during the time in review (Carletti, 2013). Using the boundary testing method, (Zingales, 2003) indicate that financial openness, trade openness and economic growth in Malaysia are statistically important determinants of the stability of the financial markets and for the stability of the financial markets the efficiency of these markets is also important (Shahid et al., 2018; Shahid et al., 2020). There is still no evidence for it, however, to indicate that both trade and capital accounts must be opened simultaneously to ensure a financial boost. Furthermore, the evidence also shows that trade openness and financial transparency could be far more effective in supporting the growth of the banking sector than an inventory brand. According to (Law, 2008), empirical findings indicate that trade and financial transparency can replace financial growth promotion mechanisms, and it does not complement the findings of (Zingales, 2003). Opening up trading or capital accounts would provide an important catalyst for Malaysia's financial

market growth. The empirical findings also show this free trade gives more space for financial growth than for capital accounts. In addition to transparency, the growth of the financial sector would be facilitated by the strengthening of institutional structures, for example, rule of law and economic growth (Law, 2008).

For cross-country, (King & Levine, 1993) first examine DEPTH in terms of financial development measures, that's just the scale of the financial intermediaries. This is equivalent to liquid debts (currency plus demand, banks and non-bank financial intermediaries' interest-bearing liabilities), divided into GDP. They also establish a BANK that tests the relative extent to which the central bank and the commercial banks distribute the credit. BANK evens the ratio of bank credit divided by bank credit plus domestic assets of the central banks. The intuition underlying that measure is that banks are more likely than central banks to provide the five financial functions. However, with this measure, there are two notable weaknesses. Banks can only offer important financial services and banks can only lend to government or public entities (Levine, 2004). (King & Levine, 1993) is also examining PRIVY, which is the equivalent of credit to GDP-divided private companies. It is the assumption that Financial Systems provide private enterprises with more loans are more engaged in researching companies, corporate control, risk management, mobilization and transaction support than financial systems which merely trickle credit into governmental and state-owned enterprises. While PRIVY and BANK pursue to improve DEPTH by acquiring who is making the allocation and to whom the savings of society flow. The five financial functions underlined in theoretical models of finance and development are still not directly supported by these steps (Levine, 2004). The different metrics of financial growth yield very clear results. (King & Levine, 1993) has evaluated the strength of the empirical relationship between the average level of financial development of each of these indicators around the period of 1960-1989 and three development indicators also averaged throughout 1960-1989. These are the three growth indicators: (1) real average per-capita GDP growth; (2) per-capita average capital stock growth rate; and (3) total productivity growth, described as 'the Solow residual' as real per-capita GDP growth less (0,3) per-capital equity growth rate. Economically, there is a relationship between financial development and growth at the initial level. For instance, these estimates of the coefficients indicate that Bolivia would have

grown by around 0.4% faster annually than it was if Bolivia had increased its financial depth from 10% of the GDP in 1960 to the average value for developing countries in 1960, from 23% in 1960. These case studies do not take into account the consequences of the financial change. They show just how long-term growth could have a huge impact on financial development (Levine, 2004). (La Porta, 2002) use an alternative indicator of financial development. They examine the extent of public ownership by banks throughout the world. This measure provides direct evidence of the connection between economic growth and financial intermediary services, as far as public banks are less efficient to acquire business information, exercise corporate governance, mobilize savings, manage risk and facilitate transactional activities. The authors show that (1) higher public ownership levels associated with lower levels of banking development are 44, and (2) high bank ownership levels related to slower growth. While many of the weaknesses in previous work are addressed, cross-country growth regression does not eliminate them. So, while it shows (King & Levine, 1993) that finance predicts growth, the causality issue is not formally addressed. Although researchers improve past financial development measures, they only focus on one segment of the financial system, banks and their indicators do not directly assess how much information and transaction costs in financial systems are improved (Levine, 2004).

In the Mauritius region, for trade openness, in terms of increased globalization and liberalization, countries are reinforcing to benefit from financial growth, international trade and capital. Nevertheless, the supply side and demand side factors have been established in trade and finance literature to reflect this resistance and remain financially under-developed (Boopen, 2010). The resistant countries have resisted it. In an interest groups' supply-side position, it was pointed out that financial growth does not always work in the political and economic elite's interests (Zingales, 2003). The current industrialists and financial intermediaries enjoy rents when financial markets remain under development.

Because of reputational capital, the 'industrial incumbents' are in a favorable situation to obtain finance and thus benefit from their rents as new firms must team up with them to obtain finance. The 'financial incumbents' appreciate rents because they have the information benefit that is the outcome of the financing

based on relationships and thus, they become monopolistic in providing loans to potential entrants. The liberalization of trade and finance causes rivalry, thus jeopardizing income from incumbents, to protect their advantageous position by organizing interest groups, to catch officials for their benefit in influencing policy and institutions.

The policy measure is primarily concerned with adopting key macroeconomic policies conducive to financial development, including the liberalization of capital account, inflation rates, and monetary policy efficiency measures (Boopen, 2010). Firstly, for capital account liberalization; before the Bretton Wood systems were phased out, most countries had a relatively closed system money account. Liberalization of capital accounts only gained recognition in the mid-1980s as a way to spur financial development. The liberalization of capital accounts refers to the ease of capital constraints flow across national borders and according to (Shaw, 1973), it develops financial systems by curbing financial repression and allowing genuine interest to reach a competitive, balanced market. (Henry, 2000) claimed the removal of capital controls allows us to engage in portfolio diversification with local and foreign investors. (Claessens et al., 1998) stressed that the liberalization process promotes an effective financial system by weakening inefficient financial institutions and heightening the demand to reform financial infrastructure.

Secondly, inflation; (Smith, 1998) was suggesting the relationship between inflation and financial development and (Boyd, 1998) concluded where high economies reduced, fewer effective and inefficient equity markets and banks are prone to inflation rates. (McKinnon, 1973) claimed price stability was key to financial intermediation; inflation rates discourage long-term contracting and exacerbate information asymmetry and moral hazard. (Smith, 1998) argued that knowledge asymmetries created by high inflation rates will have an unfavorable effect on credit market frictions with adverse effects on financial sector results. Lower real return rates decrease the willingness of agents to lend out funds and improve their borrowing rewards, thus decreasing credit accessibility and borrowers' efficiency. Due to market frictions, the decline in borrowers' quality is translated into credit rationing, which will cause fewer loans to be generated by the financial sector and resource allocation is unproductive with adverse effects on capital expenditure (Boopen, 2010). Thirdly, for monetary policy

efficiency measures; although the relationship between monetary policy efficiency and financial development is obvious, surprisingly few efforts have been made to investigate this connection (Boopen, 2010). (Carranza, 2006) identified the role of monetary policy as being to set short-term interest rates to influence prices and output. (Friedman, 1968) stressed that a rise in money supply reduces interest rates through the interest rate or liquidity channel, thereafter, affecting both consumption and investment. (Blinder, 1988, Gilchrist, 1993) stressed on the credit channel that changes in the supply of money not merely influences interest rates but also credit allocation among financial system agents. (Carranza, 2006) argued that if the source of credit and liquidity works through the financial system the degree of financial growth is of utmost importance to clarify the efficacy of monetary policy.

Fourthly, institutional quality; the nexus between institutional quality and financial development is evident without any means to enforce property rights, adequate investor protection is unlikely to impede financial development by giving out loans unequivocally (Boopen, 2010). (Herger, 2008) classified institutional quality as the extent to which man-made procedures foster investor protection and improve access to financial exchange funds for entrepreneurs. Investors rely on the state to enforce contracts and protect, but in nations where corrupt politicians or official abuse their authority for self-enhancement, investors don't want to invest or offer money increased expropriation risks and thus explain why those states remain infinitely underdeveloped.

Lastly, for culture; (Williamson, 2003) has described society as the behaviors and beliefs that influence people's acts within a group. Religion is a major part of the belief systems has a lot more to tell regarding the human rights of creditors and a lesser amount about shareholder rights. (Williamson, 2003) agreed that religions enforce ethical conduct laws on self-upgrading matters; financial problems such as usury or even raising interest rates, which are an integral part of the conduct of financial transactions, are spurned by major religions, suggesting that they put greater importance on debtor rights than on creditors' rights.

Empirical studies have shown that financial development is determined by multiple factors and this would enlighten us on the conclusions reached by the various academics and researchers by revising the different methodologies (Boopen, 2010). Using a dynamic analysis from 1980-2006, (Levine, 2004) established that countries' legal origins tend to explain the differences between the countries. (Ito, 2008) emphasized the ties between financial, legal and institutional liberalization and development through an information panel for 108 countries, which uses 1980-2000 data. Empirical evidence seemed to indicate that lower levels of corruption improve financial liberalization and encourage financial growth in developed economies with a higher level of bureaucratic efficiency, legislation and order (Boopen, 2010). Besides, applying the index "Chinn-Ito" it is stated in the liberalization of the trade liberalization sequence is a necessity for liberalization of the capital account. Using the dynamic panel technique (Ghazouani, 2004) found that inflation had an adverse impact on the country's financial growth in 1979-1999 and evaluated the threshold effect which showed that a rise in inflation rates after a certain level did not affect the banking industry growth. (Huang, 2005) used two prominent tools to address the Bayesian Model Averaging and General model uncertainty relevant methods to analyze the gaps in financial growth around the borders of countries. The result was that numerous variables including institutional efficiency, macroeconomic policies, geography, income levels and culture, were established, trigger financial development. (Huang, 2005) used a group dataset of 90 developed and developing countries from 1960 to 1999 in order to explore the link between political liberalization in encouraging institutional improvement.

Empirical evidence exposed that there was at minimum political liberalization within a short-term, constructive outcome for low-income and French-based countries in financial growth, and also for the most probable increase of the democratic state in financial development (Boopen, 2010). Additionally, evidence suggests that trade and capital flow liberalization is effective in fostering middle-income financial growth, but less effective in low-income countries (Boopen, 2010). (Huang, 2006) tackled the relationship between the private and financial growth trend using panel data technologies for the period 1970-1998 for 43 developing countries. (Rioja, 2006) studies on the short-term stabilization of financial growth by monetary policy-efficiency initiatives for 37 countries. Results showed that established financial markets, regulation of

central bank independence, inflation-focused targeting and EU Monetary Union adherence boost monetary policy implementation (Carranza, 2006) applying data from 175 countries over 1980-2001 suggest that poorly developed countries with a greater lending effect than expansions of monetary contraction policies have a greater impact on credit. (Bittencourt, 2008) investigated the inflation-finance relationship in Brazil from 1995 to 2002 and stated that inflation is impeding financial development. (Boopen, 2010) also explored the relationship between inflation and the development of the banking sector, using a time series analysis over the period 1968-2006. Their results confirmed the threshold effect for the Mauritius case, too. A literature review shows that there was relatively little research in the developing countries and literature was even scarcer in the African sense for the studies (Boopen, 2010).

For global studies, financial development occurs at the most basic, conceptual level where the impacts of incomplete knowledge, minimal compliance and transaction costs are mitigated, but not necessarily eliminated. For instance, credit registers have been developed to enhance knowledge collection and distribution on potential borrowers, increasing the allocation of resources and having a positive impact on economic growth (Boopen, 2010). Another reason is the growth of stock and bond markets in economies with strong regulation and legal structures, which have made it possible for investors to hold more diverse portfolios than they would without a competitive capital market. This increased risk diversification will encourage capital movement to higher return ventures, promote growth and raise standards of living (Boopen, 2010).

However, deciding financial growth to minimize market imperfections is too limited and does not give the economy as a whole much knowledge on the true functions of the financial system (Boopen, 2010), so Levine (1998, 2004) and others have broader definitions of development that focus on what the financial system does. More generally, financial development can be defined as the quality improvement of the five main financial functions such as generating and processing information on potential investments and the assignment of capital based on such assessments; the monitoring and management of individuals and firms following assignment of capital; the facilitation of trade, diversification and risk management; The way they provide these main services differs

considerably between financial institutions and markets worldwide (Boopen, 2010).

3. Conclusion

There is evidence that the key determinants of financial stability are economic development, natural resource reliance, trade openness and inflation. The rate of financial progress has an encouraging effect on economic development and trade openness, while natural resource reliance has a negative impact. However, inflation's consequences are susceptible to the financial creation of choices.

For a stable and diversified economy, a well-established financial sector is a key factor. Liberalization and the elimination of barriers to the growth of the financial sector are important steps in economic progress. Accordingly, our literature reviews of the financial sectors are driven by increased economic growth and free trade.

In addition, the negative effect on the financial growth of natural resource dependency emphasizes the value of economic diversification. Increasing other sectors' contribution to GDP would lower the country's reliance on natural resource income. Finally, there is the desirability of more foreign policy opening than the observed effect of trade openness on financial growth indicates

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