A Study on how the Determinants of Financial Development affect Economic Growth

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Abstract

Since the past few decades, the nexus around the finance-growth debate has been particularly pivoted onto assessing the determinants of financial development due to the researchers' growing and evolving interests in studying the root causes of financial development which fuels economic growth. The essence of this study intrinsically is to analyse with a wide array of extant literature which provides a plausible explanation to the theoretical and empirical determinants of financial development. The aim of the study is to perform a literature review of related works and thereby assessing the determinants of Financial Development. It has been observed that the determinants like trade openness, capital account liberalisation, Institutional Quality, Political Economy Factors, Macroeconomic Factors among other determinants contribute to the economic growth of a country.

Key words: Financial Development; Economic Growth; Trade Openness; Capital Account Liberalisation

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1. Introduction

One of the most interesting topics in finance that has constantly been receiving the attention of the majority of researchers is financial development. A well-developed financial system correlates with economic growth. Over the years, financial development has proved to be a significant element of the economy of several countries and this has essentially boosted their economic growth. This subject has been underpinned by a wide array of literary reviews. Financial development is essentially depicted as the process of enhancing financial intermediary services by increasing the quality, quantity and efficacity of those services (Choong & Chan, 2011; Lerohim et al, 2014).

The importance of the financial sector has intrinsically advocated the sound and effective development of the financial system and this has been indeed essential for the economic growth of a country. A well-structured and stable financial system increases foreign capital inflows, the availability of financial services by mobilizing savings and facilitating transactions. Moreover, a stronger financial system equally guarantees enhanced resources allocation, poverty reduction, higher levels of investment, easier access to finance, better risk management enforcements, increased transparency, efficient corporate governance practices and improved economic growth. The current study is inductive in nature by presenting an interpretive stance through a review of previous studies as per (Shahid et al., 2018). We conclude based on the findings of previous studies that trade openness, capital account openness, institutional quality, macroeconomic

factors, political economy factors and culture or geography are crucial for a well-established and effective development of the financial system.

2. Literature Review

First and foremost, before delving into the core of this section, it is important to get a glimpse about what is financial development. Financial Development, in essence, refers to the practical enhancement and efficiency of financial intermediary services. In short, being an inextricably fundamental part of economic development, it is indeed an amalgamation of factors, policies and institutions that pave the path towards effective financial intermediation and thus lead to financial access. A growing body of literature acknowledges that high financial development is the elixir to sustained economic growth and the welfare of an economy. Particularly, this study is deeply ingrained into bringing forward what factors have led to financial development and those factors are elaborated in the subsections as follows:

2.1. Trade Openness

The crux around trade openness is that with the advent of increasing globalization, several countries are now embarking on international trade which can fundamentally develop their financial markets, boosting the overall welfare of the countries. The underlying idea behind trade openness is that a well-performing financial sector could potentially boost the import-export sectors of a country. Given this orientation, the savings derived could be re-invested in the private sector, thus fostering economies of scale and this can, in turn, curtail the expenditures leading to lower costs. As such, financial development plays a pivotal role in trade openness.

A plethora of scholars underpin this theory; for instance, Beck et al. (2003) unravel those nations having a well-established financial/judiciary system have more exports to GDP, whilst Huang and Temple (2005), who perform a cross-sectional analysis based on 88 countries, point out that increasing market openness leads to an augmented financial depth, which can be efficiently translated into higher financial intermediation. Further to the above, this can subsequently heighten the monetization of the economy, fueling an effective flow of resources. Likewise, the work of (Levine, 2002) affirms that removing

barriers to foreign flows capital has a positive impact on stock markets' liquidity level.

Rajan and Zingales (2003) further underpin that trade openness plays a huge role in the financial development of a country by addressing the supply side of powerful interest groups, showcasing that financial development does not necessarily side with the bourgeoisie. Due to under developments in financial markets, industrial incumbents and financial intermediaries benefit from rents due to the informational privilege they possess and thus due to their monopolistic nature, there is a threat of potential newcomers exploiting the market. Financial Liberalization indeed fosters competition and thus jeopardizes the rents of those incumbents. Therefore, if a country increases its trade openness to foreign competitors and allows international inflows, then these incentives are debilitated. An open political system, rather than a closed and entrenched one, is more apt in prompting competition and thus, increasing the financial development of the economy (Bzhalava, 2014).

Law and Demetriades (2006) conduct an empirical cross-country analysis using a sample of 43 countries spanning from 1980 to 2000. Employing a dynamic panel data methodology, their study is embedded into investigating whether financial indicators such as banking system, stock market, trade openness and institutional quality are perceived to be the impetus to financial development. The empirical findings underpin that financial openness and institutions are indeed key players in shaping financial development. The evidence also acclaims that trade liberalization as well as capital account liberalization strongly promote and boost the development of the financial sector in middle-income countries.

Moreover, the study of Matadeen and Seetanah (2013) which is based on semi-annual data covering the period 1989 to 2011, seeks to establish whether financial and trade openness steer financial development in Mauritius. Several variables are proxied to capture the essence of financial development and the findings of the study showcase the positive significance of financial openness in Mauritius, which intrinsically boosts financial development, whilst trade openness exhibits a negative influence on the country's financial development.

Furthermore, Seetanah et al. (2011) adopt a time series analysis to determine the factors leading to financial development in Mauritius over the period of 1970 to 2008. Embarking on an Autoregressive Distributed Lag (ARDL) approach, their findings acclaim that both trade openness and financial liberalization are

pivotal tools in inducing financial development. Additionally, there are other significant factors such as per capita, investment rates, or institutional quality which shape the financial development of the country. On the other side, inflation projects an adverse outcome on the financial sector's development.

Using a panel data analysis, Zainudin and Nordin (2017) aim to study the contributing factors to financial development in the ASEAN region, notably four specific economies namely Malaysia, Thailand, Singapore and the Philippines. Based on the Pooled Ordinary Least Square findings, the study evidence that real income and trade openness are found to be the most predominant factors influencing financial development in all four countries. However, applying the second estimation technique that is the Seemingly Unrelated Regression technique, real income has a primordial influence in the financial development of Singapore and Thailand, and on the same line, trade openness is the key factor influencing financial development in Malaysia and the Philippines.

Conducting a dynamic panel study based on data from West African and South African countries covering the period 1980 to 2011, Mahawiya (2015) empirically showcases that the advent of financial and trade openness fosters more financial development for the nations under study.

2.2. Capital Account Liberalization

Capital account openness is intrinsically linked to a particular country's extent of financial development. During the earlier days of the Bretton Woods Systems, the majority of the countries in the world adopts a fairly closed capital account. However, it is only after its elimination that capital account liberalization is globally acknowledged as a stimulator to financial development. Capital account liberalization stresses mitigating capital flow-related curtailments across countries' frontiers. Shaw (1973) affirms that this move has particular curbs financial repression by fostering competition thus, promoting financial development. Capital account liberalization not only encourages portfolio diversification among both local and international investors (Claessens & Laeven., 2001) but also hugely steers the development of a systematic financial system. Furthermore, Arestis (2006) evinces that financial liberalization englobes the following; privatization of state-owned and controlled financial organizations, free entry for new competitors into an otherwise monopolistically competitive market, independence of central bank, abolishing credit ceilings and implementing a loose monetary policy. Against this backdrop, with increasing capital account openness, several benefits are advocated, for instance, it has led

to lower transactional and information asymmetry costs, effective resource allocations, lesser moral hazards due to managerial behavior, higher level of investments, increased economic growth with a better financial system, and finally higher efficiency (Klein & Olivei, 1999).

The work of Chinn and Ito (2006) sheds light on several aspects of the financial sector. By deploying panel data covering a sample of 108 countries over 20 years spanning from 1980-2000, their study is grounded on determining the influence of capital account liberalization and legal and institutional developments on financial development. The empirical findings endorsed that a higher degree of bureaucracy, strong law and order protocols, and low corruption especially in developing countries, eventually improve capital account liberalization thus evoking financial development.

Of equal importance, David et al. (2014) empirically find that trade liberalization and capital account liberalization exhibit no direct relationship on the development of the financial system in countries of sub-Saharan Africa.

Likewise, Arestis et al. (2001) analyze the outcome of trade liberalization on financial development based on a sample of 6 developing economies spanning from 1955 to 1997. Applying the Error Correction Model technique, their results showcase those financial policies varied substantially across different countries and that the process of financial liberalization is indeed intricated and its pronounced impacts on financial development are equivocal.

2.3. Institutional Quality

Institutional quality englobes legal, individual and high-quality governmental aspects all in one frame. It has been defined by Herger et al. (2008) as capturing the degree by which processes devised by man can cater for investor protection and grant investors easy access to capital within the financial exchange medium. The prevalence of institutions and their pivotal effect on economic activities has been highlighted over the years and in most countries, investors are highly dependent on the government for administering contracts and for investors' protection. However, in highly corrupted countries, where state officials misuse their power for enriching themselves, investors become reluctant to invest in such countries prompting them to stay in a state of financial underdevelopment. The endowment theory proposes by Acemoglu et al. (2005) acclaims that these variations in financial establishments embody the foremost determinants of financial development.

Moreover, economic theory indeed carves out a highly efficient institutional environment that addresses information asymmetries and transactional costs. The predominance of legal institutions forms the basis of financial development since it engages in protecting and safeguarding investors' interests. Reform acts that cushion a country's fundamental legal aspects and investors' protection play a huge role in leading to a better financial system and the importance of legal institutions in contributing to effective and sound financial development has been stressed by (Porta et al., 1998). The theory translates into two parts, the first one relates to the legal importance in ensuring investor's protection and enforcement of contracts, whilst the second one relates to the legal differences among countries which are spread globally during the European Colonization, whereby two eminent legal traditions are determined namely civil law (French, German and Scandinavian), countries with which are perceived to have the most unfavorable laws and common law (British), showcasing a better financial development for countries adopting it.

Further to the above, Levine (2002) empirically applies a dynamic cross-country data analysis for the years 1980-2006 and deduces that cross-country disparities in legal institutions cater for disparities in financial development. In the same line, (Demirgüç-Kunt & Detragiache, 2005) use cross-country data for the period 1990 to 1997 by employing several tools to determine the correlation between bank concentration and financial development. Consequently, their empirical findings conclude that bank concentration does not determine financial development.

Yeyati et al. (2005) assess the influence of state-owned banks in spurring financial development utilizing a cross-country data analysis. Their findings evince that state-backed banks generate lower profits as compared to private-owned banks in developing countries. Therefore, their results fail to support the view state-owned banks have a contributing hand in fostering financial development and economic growth, but are also strongly links with slower economic growth thus, spurring slower development of the financial system.

Okeahalam (2005) applies a wide range of tools and variables to evaluate the impact of institutions on the development of the financial system of the MENA countries. His empirical findings upheld that effective and well-organized financial institutions are indeed the bedrock to economic growth and financial development. It has been found that a good institutional quality foster effective allocation of economic rights which are prevalent for the smooth functioning of

markets. Subsequently, the findings also underpin that the extent of openness alongside a sound infrastructural establishment is unequivocally predominant in steering financial development in the MENA region.

Similarly, based on a study of 11 SADC (South African Development Community) countries, Mbulawa (2015) communicates the prominence of institutional quality on financial development placing specific emphasis on low corruption, high law and order, enhanced regulation, lower political violence and higher state accountability.

Last but not least, covering both North and South Mediterranean countries from 1985 to 2009, Ayadi et al. (2015) manifest that a robust legal institution, strong governance and effective financial reforms can be the impetus to efficient financial development in those countries.

2.4. Political Economy Factors

Political Economy Factors are also a significant determinant of financial development and political choices largely influence the development and functioning of a country's financial system (Voghouei, 2011). Beck et al. (2003) acknowledge that free democratic countries with an open political system are in a much better position to achieve greater financial development than those whose financial systems are based on a centralized, authoritative and closed political approach. Political freedom and democracy are intrinsically sought tools in spurring financial development (Halperlin et al., 2004) since those democracies have lesser incentives in maintaining the public ownership of financial institutions (La-Porta et al., 2002). As noted above, economic and financial institutions have a huge say on the incentives and curtailments press on the economy and these indeed can shape the economy (Acemoglu et al., 2005). Moreover, political institutions essentially govern the distribution of power politically in society and factors such as a poorer political system, political instability, corruption, civil unrest have detrimental and adverse impacts on countries (Acemoglu et al., 2005; Mauro, 1995; Detragiache et al., 2005).

Besides, Mauro (1995), from a cross-country data sample, showcases that political factors and specifically corruption have prevalent impacts in lowering investments, thus impeding financial development. Likewise, Ibrahim and Alagidede (2017) find a correlation between legal differences in sub–Saharan Africa (SSA) region and differences in financial development. They essentially point out that the Southern African countries which are grounded onto British

common law generate a higher potential for financial development. Honohan and Beck (2007) particularly attribute the low levels of financial development in African countries to the weak governance, poor institutional quality and a lack of political and economic stability in these countries.

In a panel study of 90 developed and developing countries, Huang and Temple (2005) intends to explore the relationship between political liberalization and institutional development over the period 1960 to 1999. His results empirically evidence that in the short run, political liberalization positively influences financial development especially in low-income countries as well as those which are grounded on Civil law. The results further imply that democracy is the key to speedy financial development. Similarly, Shahid and Sattar (2017) address that democracy through the active functioning of stock markets fosters financial stability.

Furthermore, a study by Voghouei and Law (2013) seek to determine the potential impact of legal institutions on financial development as per the theoretical underpinning of (Beck et al., 2003). Using a panel study of 60 countries during the years 1980-2006, the authors apply a wide range of political variables to determine their likely impact on the legal surroundings and thus on financial development in the countries under study. Empirically, it is evinced that political power could definitely shape the legal surroundings, most specifically in countries that follow the common law, and this could significantly impact financial development. Detragiache et al. (2005) also confirm that the advent of political instability and high levels of corruption in low-income economies particularly could posit unfavorable effects for financial development.

2.5. Macroeconomic Factors

Macroeconomic factors such as inflation, monetary policy and fiscal policy are enormous contributors to a country's sound financial development. A smoothly running and efficient financial system is the key to financial stability and each of the macroeconomic factors affecting financial development will be discussed as follows.

First and foremost, the underpinning theory behind inflation and financial development has been corroborated by a plethora of scholars. Theoretically, Huybens and Smith (1999) point out that the level of inflation negatively impacts financial development. Since, information asymmetries owing to high inflationary levels adversely impact on credit market frictions thus, undermining

financial performance e.g., the higher the inflation level, the lesser becomes the real returns and this in turn fuels lesser credit into the economy, by reducing potential lenders, and simultaneously increasing potential borrowers, thereby fostering market imperfection. This being said, the financial sector can be consequently stimulated to grant fewer loans, exacerbating an uneven and inefficient resource allocation, with unfavorable ramifications for financial development. Moreover, inefficiency and inactivity in banks and stock markets have been advocated in countries with high inflationary pressures (Boyd et al., 2001) and other notable studies find an inextricable connection between high inflation rates and banking crises (Demirgüç-Kunt & Detragiache, 2005; Padachi et al., 2008)

Secondly, fiscal policy has captivated a paramount significance in the realm of financial development and there are notably several underpinned pieces of literature to support this claim. (Caballero and Krishnamurthy, 2004; Christensen, 2005) acknowledge that emerging economies with a poorly developed financial system may experience a financial crowd-out in their investments owing to an uncurbed number of public debts. Given this orientation, the complacency of banks from the returns of public debts might erode their efficiency. Such advances in economies with considerable fiscal deficits trigger the incompetency and inefficiency of financial systems.

Further to the above, the soundness of monetary policy unequivocally complements financial development. Carranza et al., (2006) claim that the extent of financial development highlights the significance of monetary policy efficiency. Krause and Rioja (2006) further depict that the efficacy of monetary policy helps to evaluate the macroeconomic performance of an economy, catering for inflationary levels, output volatility and the aggregate disturbances in the economy.

A large number of cross-country studies provide overwhelming support to empirically enhance the current level of knowledge in the existing literature on financial development. (Huang & Temple 2005) attempts to study the factors influencing cross-country variations in financial development. Employing both the Bayesian Model Averaging tool and the General to specific approach tool, the empirical results unveil those factors such as macro-economic factors, geographical features, income level and culture are the likely factors to affect the extent of financial development.

Bittencourt (2011) studies the potential influence of inflation as a determinant of the financial sector's development in Brazil covering the years 1985 to 2004. Applying a panel time-series approach, the study states that inflation has detrimental and adverse impacts on financial development during the study period. Based on this study, it can be advocated that a low macroeconomic performance can carve toxic impacts on the economy, thus impeding financial development. Therefore, a relatively low and balanced inflation level is a must for better financial development.

Similarly, (Ghazouani, 2004) conducts a dynamic panel data analysis to assess the likely influence of inflation on financial development using 11 countries from the MENA region between 1979 to 1999 and it is unraveled that inflation negatively influenced the development of the financial system. Ben-Naceur et al. (2008) equally base their research on 11 countries from the MENA region and they state that policies that relate to effective resources allocation can complement financial development.

2.6. Other determinants

There are other potential determinants of financial development which researchers have brought forward in their previous works. For instance, Levine (2002) acclaims that the level of income, whilst Pagano and Volpin (2001) reinforce that the distribution of power among different social classes. Huang (2006) argues that a higher extent of private investment is perceived to have a key role in shaping financial development. Moreover, shreds of evidence showcase that culture (Levine, 2002) and geography (Malik & Temple, 2009) are also factors affecting financial development.

Applying a cross-country analysis for the timeframe 1960-1995, Beck et al. (2003) advocate that real per capita GDP growth and total factor productivity growth displayed a statistically significant relationship with financial development. By deploying a GMM technique, they affirm that the presence of smoothly running financial intermediaries revamp resource allocation efficiently and stimulates economic growth in the long term. Rajandran et al. (2021) suggest that liberalization and commercial transparency are basic factors of financial growth.

3. Conclusion

The positive outlook between financial development and economic growth motivates us to deeply analyze the key determinants which affect financial development in several countries. After scrutinizing extant literature in the realm of Financial Development, this paper contributes essentially to theoretically and empirically enhancing the current level of financial knowledge on the determinants of financial development based on an analysis of single countries, cross countries, regional and global studies. Based on empirical evidence, we can conclude that factors such as trade openness, capital account openness, institutional quality, macroeconomic factors, political economy factors, culture, or geography all contribute to some extent to the well-established and effective development of the financial system.

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