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Causality of Financial Development and Economic Growth

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ABSTRACT

Most of the monetarist are giving an increasing amount of attention has to the connection between financial markets and economic development. The theory of growth and finance establishing aassociationbetween" finance and growth" as well as the results of a large number of empirical studies suggest that financial markets can be regarded as an engine of growth. However, the experiential evidence also shows that crisis-like developments in the financial markets have occurred with increasing frequency in recent years, and that such phenomena at least temporarily limit the scope for economic development. The paper surveys how economic theory has dealt, or is dealing, with the dual impact of financial markets on economic development. Four theories have been selected for consideration - neo-classical and Keynesian theory, the New Development Finance approach and the new theory of finance which is grounded in the economics of information. Each emphasises different aspects of the relationship between financial markets and economic development, but so far it has proved impossible to arrive at a consensus view.

INTRODUCTION

In recent years an increasing amount of attention has been devoted to the connection between financial markets and economic development. New insights in growth theory and the theory of finance establishing a link between" finance and growth" or "finance and development" have spurred interest in this topic, as has the appearance of a large number of empirical studies which have demonstrated a clear positive correlation between indicators providing a quantitative measure of activities of and on financial marketsand quantitative indicators of the level of economic development. However, the positive connotation suggested by this literature represents only one side of the coin. The empirical evidence also shows that crisis-like developments in the financial markets have occurred with increasing frequency in recent years, and that such phenomena at least temporarily limit the scope for economic development.The East Asian financial crisis is the latest and most severe example. How can one explain the fact that a sector which can be regarded as being at least partially responsible for a successful course of economic development is at the same time considered to be responsible at least for triggering crises which slow down economic development, often causing ground to be lost which it takes the economy years to regain?This is a question for economic theory, and it is not the first time it has been asked, given that this dual impact of financial markets characterises the economic development of basically any country. Thus, after creating a uniform basis and standard for comparison using a flow-of-funds analysis (Section 2), the following survey will seek to describe how economic theory has dealt, or is dealing, with the dual impact of financial markets oneconomic development (Sections 3 - 6). Four theories have been selected for consideration - neo-classical and Keynesian theory, the New Development Finance approach and the new theory of finance which is grounded in the economics of information. Each emphasises different aspects of the relationship between financial markets and economic development, but so far it has proved impossible to arrive at a consensus view. Accordingly, the role of financial markets in economic development is still a controversial issue - and with good reason, as is shown by the Asian example of smooth financial development and extraordinary growth (1960 - 1996), followed by a severe financial crisis (1997). This is why, in the concluding section, the question is turned around: Does the Asian example - seen against the background of this theoretical surveys - give an indication of the direction in which theoretical research should move if it wishes to better explain the dual impact of financial markets outlined above? The answer is a clear Yes, pointing to the need for a more detailed analysis of the monetary aspects of the relationship between financial markets and economic development and of financial development itself.

Financial markets and economic development:
The theoreticalobservable correspondence between the development of the financial markets and that of the real economy comes as no surprise. Indeed, in textbooks on macroeconomics and the theory of finance one need look no further than the introductory sections on the topic of financial markets to find explicit mention of the very close connections between economic activities and events in the financial markets." Financial markets are important because they are intimately linked to every other market and every individual in the economy.

The importance of financial markets therefore lies in their linkage with all our spending decisions, both in our personal lives and in the business world." Carrying out a flow-of-funds analysis is perhaps the easiest way of highlighting this close interlinkage of financial and real activity. Such an analysis posits that for each economic agent, i.e., at the level of individual economic units (micro level), the savings accumulated in a given period, in other words the increase in net worth, are equal to the sum of investment, i.e. the increase in real capital, plus the increase in financial assets. This introduces a qualification which must be borne in mind when discussing the potentially positive effects of financial markets on economic development: transactions on financial markets promote economic development if, and only if, mechanisms are employed which mitigate or resolve the incentive- and information-related problems that characterise such transactions. However, unlike Keynes, the proponents of the theory of finance grounded in the economics of information do not derive the rationale for this limitation from the monetary character of financial markets and its macroeconomic implications. Nonetheless, their view is at odds with theneo-classical view that financing relationships, their design and institutionalisation, may be irrelevant, as is implied by the Modigliani-Miller theorem.

Accordingly, research in the framework of the new theory of finance is aimed at identifying the specific forms of finance and/or the specific types of financial institution which can render it possible to overcome information and incentive problems. The starting point in this analytical undertaking is the type of finance in which, by definition, neither moral hazard nor adverse selection problems can occur because lender and borrower are identical: internal financing. Accordingly, any external financing relationship will be characterised by some mechanism which imitates the situation which prevails in the internal financing "relationship". However, the use of these mechanism gives rise to costs. Thus, it comes as no surprise that most corporate investment is internally financed, with external financing playing a comparatively minor role.53 Moreover, the new theory of finance succeeds in explaining the dominance of financial intermediaries, and of banks in particular, over financial markets in the narrow sense, when it comes to shaping external financing relationships. Three different approaches to formal modelling are employed in this endeavour.The first approach focuses exclusively on the notion of intermediation, specifying the advantages of financialintermediaries over financial markets in the narrow sense in terms of their ability to overcome information and incentive problems that arise between lenders (or, as the case may be, depositors) and borrowers (economic units borrowing from banks or, as the case may be, banks). However, it is not claimed that banks render investments possible which are more productive than those facilitated by financial markets in the narrow sense. But this is precisely what is postulated by the second approach, which identifies the ability of financial intermediaries to render possible long-term investments, which are presumably comparatively productive ones, despite the fact that the group of borrowers is heterogeneous (some are "good", others are "bad"), as the decisive advantage of financial intermediaries. Here the focus is not the intermediation function, but rather on the selection and monitoring functions performed by banks. The third approach differs from the other two in so far as attention centres not on financial institutions but on forms of financing. It demonstrates that external equity financing via markets is subject to specific information and incentive problems which make this form of financing rather unattractive.Thus, the new theory of finance succeeds in ordering and analysing the insights yielded by the empirically-oriented work of Gurley, Shaw and Goldsmith, and in accounting for the diversity and complexity of forms of financing, financial institutions and financial markets in the narrow sense in a rigorous theoretical framework.

It leads to the following conclusion: Financial markets foster growth and development by carrying out an intertemporal, interpersonal resource transfer, if they are characterised by institutions and by the use of financial instruments which are able and designed to overcome information- and incentive related problems which are associated with this resource transfer. The little word" if" is crucial here. Indeed, given that various structural weaknesses of financial markets are regularly identified and diagnosed, especially in the aftermath of financial crises, the question of whether financial markets actually overcome these problems must be regarded as moot. This question must be answered before new growth models which focus on the growth-enhancing attributes of financial markets can be used by economic policymakers as the basis for a strategy which assigns to the financial markets an important, active role in the process of economic development.The idea behind this restrictive policy is not only to protect the financial markets from self-inflicted damage by ensuring that an" over-borrowing syndrome" does not set in, but also, at the same time, to increase the chances that the information- and incentive-related problems which are inherent in financial-market transactions can be overcome in the future. By limiting firms' financing options more or less exclusively to internal financing during an initial period, a" thick core of creditworthy borrowers"is created because, over time, the firms which operate successfully in the product markets accumulate a net wealth position which can be used as collateral for future external financing (borrowing), thus making it possible for an effective demand for external finance to arise. On the supply side, it is assumed that within the nonbank capital market new institutions will arise which exhibit a suitable corporate governance structure. Because they grant loans or undertake equity capital participations using own resources, it is highly probable that they will employ the above-mentioned mechanisms to alleviate information and incentive problems. The most successful of them will then accumulate experience and a considerable amount of net wealth which will enable them - after a few years - to apply for a banking licence, thereby endogenously contributing to a more stable financial environment.This is why the net wealth position of (potential) borrowers becomes the focus of efforts in the realm of economic policy. It is seen as the decisive measure of their creditworthiness because it guarantees the identity

of interests between lender and borrower when the financing relationship is initiated and over the life of this relationship.

The same idea forms the basis of the concept of ”financialrestraint, “an approach to financial-sector policy which is presented as an alternative to both financial liberalisation and financial repression: regulation of the financial markets, and especially restrictions on competition effected by regulating entry into the banking market and controlling the deposit rate, should be designed and implemented in such a way as to contribute to an increase in the net wealth of the licensed banks. This is intended to reduce the danger of moral-hazard and adverse-selection behaviour on the part of the banks vis-à-vis their depositors, which also means that, in dealing with their borrowers, the banks for their part will make use of the appropriate mechanisms to overcome information- and incentive-related problems. In contrast to an interventionist financial-sector policy which, for various reasons - and not least because insufficient information is available on the banks and their activities - cannot safeguard the stability of the banking system, the concept of” financial restraint” thus relies on the use of intelligent regulations to create incentives for bank owners and managers to act on their own to create stable financial institutions, and, by extension, to strengthen the financial markets. Moreover, in contrast to a policy of financial repression, an inflationary macro policy is rejected, with the maintenance of interest rates at levels which, while low, are still positive in real terms, being recommended as the appropriate goal for monetary policy.

This highlights the fact that, by taking into account issues raised by the economics of information, the proponents of the New Development Finance approach have modified their policy recommendation in both of the areas in which it relied most heavily on the neoclassical view of financial markets and economic development. For one thing, the idea of financial market regulation is no longer rejected as a matter of principle. Indeed, such regulation is now accepted as beneficial provided it is designed to address the informationand incentive-related problems which are an inherent part of every financing relationship,and especially of that between depositor and bank. For another, the activities on financial markets are again placed in a macroeconomic, monetary context, although, the neo-classical dichotomy of the markets is retained, at least in the formal models.

This is reflected in the recommendation that financial-sector policy be tailored to each country's specific macroeconomic situation and to the particular institutional configuration and ”landscape” found in its financial sector, with attention being focused above all on the role of monetary policy and the central bank. And thus, in what could almost be regarded as a return to the Keynesian tradition, the possibility that interest rates may be determined by monetary policy is implicitly acknowledged, as is the possibility that, in a financial crisis, monetary policy may no longer be able to influence the development of the real economy to any appreciable extent.

The approach to understanding the link between financial markets and economic development which is grounded in the economics of information represents the most recent attempt to describe the complex interplay of factors in the real economy and the financial economy and its significance for the process of economic development. And although the basic concept involved here - namely, that of the problematic nature of transactions under asymmetric information - has in the meantime become part of the standard tool kit of economic theory, this cannot be said of the ”order of liberalisation” which is recommended by McKinnon as a development strategy and whose core element is a policy of financial control, nor it is true of the financial-sector strategy favoured by Hellmann, Stiglitz and Murdock, i.e. financial restraint. Indeed, given the basic tenets of neo-classical theory, these strategies have rather radical implications.

CONCLUSION

In essence, it is fair to say that, in so far as the direction of future theoretical research is concerned, two conclusions may be drawn from an examination of the connection between financial markets and economic development which have been observed in India. First, the links between macroeconomic, monetary factors and the financial markets are even closer than is suggested by an assessment which combines the insights and approaches growth and the new theory of finance. Second, it is apparent that, despite the great strides that have been made in relevant areas of economic theory, it is still very difficult to say with any certainty how and why specific financial markets arise and develop, and whether their development follows some sort of standard sequence.

Thus, it comes as no surprise that we find it even more difficult to determine whether economic policy is able to promote the development of financial markets, and if so, how. Therefore, shedding lights on this crucial area, e.g., through analysis of the historical process by which financial markets in the western industrialised countries developed may be regarded as a second urgent task for macroeconomic theory and the theory of finance which is suggested not only by the results of the theoretical survey presented here but also by recent developments in the East Asian financial markets.

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