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Gobind Kumar Sharma
Research Scholar, Department of Economics, TMB University, Bhagalpur, Bihar, India

Corresponding Author:
Gobind Kumar Sharma
Research Scholar, Department of Economics, TMB University, Bhagalpur, Bihar, India

Role of financial institutions and the economic growth

Gobind Kumar Sharma

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.

Keywords: financial institutions, economic growth, role

Introduction

Financial development

Financial sector is the set of institutions, instruments, markets, as well as the legal and regulatory framework that permit transactions to be made by extending credit. Fundamentally, financial sector development is about overcoming “costs” incurred in the financial system. This process of reducing the costs of acquiring information, enforcing contracts, and making transactions resulted in the emergence of financial contracts, markets, and intermediaries. Different types and combinations of information, enforcement, and transaction costs in conjunction with different legal, regulatory, and tax systems have motivated distinct financial contracts, markets, and intermediaries across countries and throughout history.

The five key functions of a financial system are:

a) Producing information ex ante about possible investments and allocate capital
b) Monitoring investments and exerting corporate governance after providing finance
c) Facilitating the trading, diversification, and management of risk
d) Mobilizing and pooling savings
e) Easing the exchange of goods and services

Financial sector development thus occurs when financial instruments, markets, and intermediaries ease the effects of information, enforcement, and transactions costs and therefore do a correspondingly better job at providing the key functions of the financial sector in the economy.

Importance of financial development

A large body of evidence suggests that financial sector development plays a huge role in economic development. It promotes economic growth through capital accumulation and technological progress by increasing the savings rate, mobilizing and pooling savings, producing information about investment, facilitating and encouraging the inflows of foreign capital, as well as optimizing the allocation of capital.

Countries with better-developed financial systems tend to grow faster over long periods of time, and a large body of evidence suggests that this effect is causal: financial development is not simply an outcome of economic growth; it contributes to this growth.

Additionally, it reduces poverty and inequality by broadening access to finance to the poor and vulnerable groups, facilitating risk management by reducing their vulnerability to shocks, and increasing investment and productivity that result in higher income generation.

Financial sector development can help with the growth of small and medium sized enterprises (SMEs) by providing them with access to finance. SMEs are typically labor intensive and create more jobs than do large firms. They play a major role in economic development particularly in emerging economies.

Financial sector development goes beyond just having financial intermediaries and infrastructures in place. It entails having robust policies for regulation and supervision of all the important entities. The global financial crisis underscored the disastrous consequences of weak financial sector policies. The financial crisis has illustrated the potentially disastrous consequences of weak financial sector policies for financial development and their impact on the economic outcomes. Finance matters for development--both when it functions well and when it malfunctions.

The crisis has challenged conventional thinking in financial sector policies and has led to much debate on how best to achieve sustainable development. Reassessing financial sector policies after the crisis in an important step in informing this process. To help achieve this, publications such as the World Bank's Global Financial Development Report can play a role. Chapter 1 and the Statistical Appendix of the report present data and knowledge on financial development around the world.

Measurement of financial development

A good measurement of financial development is crucial to assess the development of the financial sector and understand the impact of financial development on economic growth and poverty reduction.

In practice, however, it is difficult to measure financial development as it is a vast concept and has several dimensions. Empirical work done so far is usually based on standard quantitative indicators available for a long time series for a broad range of countries. For instance, ratio of financial institutions' assets to GDP, ratio of liquid liabilities to GDP, and ratio of deposits to GDP.

Nevertheless, as the financial sector of a country comprises a variety of financial institutions, markets, and products, these measures are rough estimation and do not capture all aspects of financial development.

The World Bank's Global Financial Development Database developed a comprehensive yet relatively simple conceptual 4x2 framework to measure financial development around the world. This framework identifies four sets of proxy variables characterizing a well-functioning financial system: financial depth, access, efficiency, and stability. These four dimensions are then measured for the two major components in the financial sector, namely the financial institutions and financial markets:

Table 1: Difference of Financial Institution and Financial Markets

	Financial institutions	Financial markets
Depth	Private Sector Credit to GDP Financial Institutions' asset to GDP M2 to GDP Deposits to GDP Gross value added of the financial sector to GDP	Stock market capitalization and outstanding domestic private debt securities to GDP Private Debt securities to GDP Public Debt Securities to GDP International Debt Securities to GDP Stock Market Capitalization to GDP Stocks traded to GDP
Access	Accounts per thousand adults(commercial banks) Branches per 100,000 adults (commercial banks) % of people with a bank account (from user survey) % of firms with line of credit (all firms) % of firms with line of credit (small firms)	Percent of market capitalization outside of top 10 largest companies Percent of value traded outside of top 10 traded companies Government bond yields (3 month and 10 years) Ratio of domestic to total debt securities Ratio of private to total debt securities (domestic) Ratio of new corporate bond issues to GDP
Efficiency	Net interest margin Lending-deposits spread Non-interest income to total income Overhead costs (% of total assets) Profitability (return on assets, return on equity) Boone indicator (or Herfindahl or H-statistics)	Turnover ratio for stock market Price synchronicity (co-movement) Private information trading Price impact Liquidity/transaction costs Quoted bid-ask spread for government bonds Turnover of bonds (private, public) on securities exchange Settlement efficiency
Stability	Z-score Capital adequacy ratios Asset quality ratios Liquidity ratios Others (net foreign exchange position to capital etc.)	Volatility (standard deviation / average) of stock price index, sovereign bond index Skewness of the index (stock price, sovereign bond) Vulnerability to earnings manipulation Price/earnings ratio Duration Ratio of short-term to total bonds (domestic, int'l) Correlation with major bond returns (German, US)

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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