IOSR Journal Of Humanities And Social Science (IOSR-JHSS)
Volume 28, Issue 11, Series 3 (November, 2023) 01-05
e-ISSN: 2279-0837, p-ISSN: 2279-0845.
www.iosrjournals.org

Finance, Growth And Structural Changes: A Theoretical Review

Dr. Remyakrishnan.R
Assistant Professor, Department of Economics, NSS College, Pandalam, Pathanamthitta, Kerala

Abstract
Recognizing the substantial role of access and usage of finance in economic development, development practitioners around the world are focusing on crafting inclusive growth strategies. The underlying forces that bring changes in financial sector will have repercussions in the growth pattern of the economy. The structural shifts that happen because of these changes will determine the long run growth potential of the country. Efficient, well-functioning financial systems are crucial in ensuring productivity of an economy and welfare of its citizens by generating novel opportunities and reducing inequalities. Therefore, committed financial institutions which design strategies targeting the specific needs of the rural and agricultural sector are needed for attaining overall economic development. In the present paper, the researcher tries to explore the theoretical linkages between the macro-economic variables of finance, economic growth and structural changes. A comprehensive review regarding the empirical works reflecting the interconnectedness of access to finance and sustainable development is also presented.
***Keywords**: Economic growth, Financial Capital, Access to Finance, Economic Development, Financial Liberalization, Financial Inclusion*

Date of Submission: 23-10-2023 Date of Acceptance: 03-11-2023

I. Introduction

Financial sector is a complex interconnected system of various institutions offering differentiated financial services like savings mobilization and its allocation, monitoring, credit provision, risk management, provision of payment system etc. Whereas financial development is the process of widening and deepening the financial system with regard to these institutions and instruments. The various indicators of financial development used by international agencies like IMF, World Bank etc. are simply categorized into three viz, size indicators, efficiency indicators and financial sector indicators respectively. The World Economic Forum (WEF) in 2009 devised the seven pillar measurement of financial development, which is comprised of institutional environment, business environment, financial stability, banking financial services, non-banking financial services, financial markets and financial access. Financial access is considered to be a broader concept which is comprised of both people who are using financial services and the involuntarily excluded ones. Involuntary exclusion can happen due to a wide variety of reasons like high risk, poor project quality, lack of credit worthiness of the concerned etc. It is relatively easier to measure use, but not access to financial services and products. Beck (2000) suggested three dimensions of financial access namely availability, eligibility, and affordability of which it is easier to measure availability.

Access to Finance and Sustainability Goals

Being an inevitable part of the development discourse contemporary development theories highlights the strategic significance of access to finance. It makes transactions faster, cheaper, and safer. It is widely acknowledged that the development conduit requires access for households and business units to proper financial products, including savings, credit, insurance, and investment instruments as it enables them to utilize their potentials in a more productive way. Apart from income generation and poverty alleviation, financial sector development can aid economies achieve other Sustainable Development Goals (SDGs) such as improving education, gender equality, and health etc. Higher productivity generated from grabbing new economic opportunities translate not only into more income but also enables parents to send their children to school and provide them with better nutrition and health facilities too. Easy financial access leads to equal opportunities for everybody. It helps women to be more independent economically and assist them in crafting successful socio-economic life. Indeed, financial development can reduce inequality as it broadens opportunities (Claessens, S.,

Honohan, P., & Rojas-Suarez, L. (2009). In short sustained economic growth at both micro and macro-economic levels depends on efficient access to financial products and services.

Theoretical Interlinkages between Finance and Economic Development: The Classical Approach

The deep economic relationship between the twin concepts of financial development and financial access towards the comprehensive processes of economic growth and development of a country is well established in many of the early pieces of economic literature. Among the economists around the globe, Adam Smith, Bagehot, Schumpeter, Gurley, Hicks and Shaw were the prominent economists who had made distinct contributions in explaining the role of financial system in economic development. Adam Smith (1776) focused on the role of money in reducing transaction costs allowing specialization and promoting technological innovations. By citing the reference of England's development to its financial system, later Bagehot (1873) pointed out clearly that allocating the pooled out savings to most optimal use is of much importance than improving the savings rate. The strategic importance of banking system in the economic progress of a nation was also pointed out by Bagehot (1873) by focusing on the dynamic role of banks in incentivizing innovation and channelizing new economic investments.

Schumpeter (1911) emphasizes the critical importance of a well-developed financial system in developing entrepreneurship and fostering technological innovations. He argued that the services provided by financial intermediaries like mobilizing savings, evaluating projects, managing risks, monitoring managers and facilitating transactions are indispensable for technological innovation and economic development. The theoretical argument put forwarded by Schumpeter was empirically proved by King, Levine (1993) later.

Keynesian Approach and Monetary Equilibrium

J.M. Keynes (Monetary Reform, 1923 and A Treatise on money, 1930) assumed much significance to monetary variables like income, consumption, saving, investment etc. while framing the monetary equilibrium theory. He further observed that any rise or fall in monetary outlay will be accompanied with positive or negative changes in output and employment in the economy in the short run itself. Keynesian theories went successful in establishing a sensible grid between changes in money stock and fluctuations in expenditure. Keynesian economics also strongly favour the significance of the banking sector in economic growth. The advocates of Keynesian school of thought suggested bank credit is the pavement along which production travels. The productive powers of the community can be employed at their full capability only with the timely and proper interventions from the banker's side. In the same spirit Robinson (1952) argued that financial development follows growth, and articulated this causality argument by suggesting that "where enterprise leads finance follows".

Other Theoretical Perspectives

In 1950's the Chicago economists leaded by Milton Friedman observed that apart from mere store of value, public value money as an asset which solidifies added services to them. Friedman elucidates about the real yields of holding money as an asset in the form of expediency, safety and improved liquidity apart from the income earned in the form of interest from saving deposits held at financial institutions. Thus, the demand for money is decided not only by price and income levels, but also by the cost of possessing it. From the numerous literatures it is evident that the Chicago economists recognized an intense affirmative correlation between the stock of money and nominal national income and price level. Whereas the modern day economists are of the opinion that money not only determines the price level but also holds a vital role in defining the cyclical pattern of consumption, savings, investment and employment. They consider money as "a link between the present and future". Due to its innate unsteady nature, well- crafted monetary policies are indispensable for meeting certain socio-economic goals and effectual working of the national economy.

Access to financial services can be seen as a public good that is essential to enable participation in the benefits of a modern, market-based economy, in an analogous way as is the access to safe water, basic health services, and primary education (Peachey and Roe, 2004). By improving the access to financial services to the poor, financial sector imposes a positive impact on the process of economic development. Better financial access is very crucial, especially to the poor and vulnerable sections of the society, who otherwise have only very limited self-financing capacity. It helps the households to reduce income inequality, tap their potential and also exploit the opportunities for growth. Financial access or inclusion essentially means that financial services needed to be availed when and where desired; product needs to be tailored for specific needs at affordable prices. (World Bank, 2008). In the opinion of McKinnon and Shaw (1973) also, the financial sector of an economy does matter for its development.

There exist considerable theories in economic literature that upholds a significant relationship between the decisive factors of economic growth and financial sector development. Physical capital accumulation, human capital formation, technological progress constitutes the major factors influential to economic growth. Mobilization

of savings, channelizing productive investments, risk management, payment system, credit provision, etc. forms the primary functions of the financial sector of a country. Capital accumulation and technological applications aimed for stimulating economic growth necessitates lumpsum amount of investment, covering long gestation period which is not possible without proper financial sector development. Gregorio (1999) found evidences of borrowing constraints having negative effects on growth by reducing human capital formation. Resources for education and skill development which are important for facilitating human capital formation can be provided by the financial system. Hicks (1969) put forwarded the theoretical argument that the roots of industrialization can be traced back to the occurrence of financial development. The expansion of the financial markets with a variety of securities that could readily be sold assisted the industrial revolution in the eighteenth century. Financial sector development follows the reduction in transaction costs, and also market expansion that encouraged specialization.

Chick, V, & Dow, S (1988) in their post –Keynesian analysis on examining the relation between banking and regional development underlined the important ways in which finance can influence the economic progress of a region. The willingness and ability of the credit providing institutions like bank is deeply associated with the interest rate regime which in turn is allied with the interplay of demand for and supply of money. A potential vicious cycle is visible in the case of regional development and monetary resources evaluation and distribution in an economy.

Enhancing access to financial services will stimulate the independence and self-sustainability of poor households and small business persons especially in phases of uncertainty. Moreover, gaining access to financial services is a critical step in connecting the poor to an extensive economic life and in building the confidence for them to play a larger role in the nation building process. Estrada (2010) highlighted that "access to finance is the indispensable lubricant for entrepreneurship". Without proper access to financial services, investment and business activities in an economy cannot be flourished which will negatively affect both the corporate sector and poorer households more or less equally. Timely and adequate credit will better the corporate investment climate as well as reinforce the welfare gains of marginalized sections. Therefore, financial inclusion initiatives can meet twin objectives of growth as well as wider social development.

The prior-saving argument portraying saving as an essential element for investment and economic growth is present in many of the early financial liberalization models (Shaw, 1973; McKinnon, 1973). As per these models financial deregulation can boost up internal savings by increasing competition between the financial institutions. Creation of new economic opportunities, risk management options and better exchange of goods and services are the three recognized direct outcomes of increased access to financial resources. Increased investment of households and firms due to easy access of finance will spur the future income levels and thereby hike the rate of economic growth of a specific economy. (Ellis, Alberto and Juan-Pablo (2010).

Finance and Development Nexus: Some Empirical Evidences

The positive correlation between improved access to financial services and socio-economic development agenda has been strongly proven empirically in the economic literature. The existence of the association between financial development and economic growth has been acknowledged in a number of pragmatic studies starting with Cameron (1979), Goldsmith (1969) and McKinnon (1973). A nonlinear relationship between financial development, income inequality, and economic development was observed in the study of Greenwood and Jovanovic (1990). Being an important determinate of capital allocation, access to finance influences every stage of economic development. Using the Gini coefficient technique, it was found that financial development reduces income inequality. The results of the causality tests between financial development and real GDP using time series techniques conducted by Rousseaua and Wachtelb (2011) also testifies the leading role of finance in the process of development.

The positive impact of local finance on economic progress was deeply analyzed in the study conducted by Guiso, Sapienza and Zingales (2002) among the households and firms of Italy. Local financial development makes better use of the hidden and untapped entrepreneurial potential in the domestic areas and promotes economic growth by increasing competition. Clarke, Xu and Zou (2003) examined the relationship between finance and income inequality for 83 countries between 1960 and 1995. The result is somewhat similar to the Kuznets's inverted 'U' hypothesis that in the long run higher the financial development, lesser will be the level of inequality. The theoretical argument put forwarded by Schumpeter propagating the strong correlation between finance and growth was empirically proved by King, Levine (1993) later by presenting cross-country evidence regarding the same using data on 80 countries over the 1960–1989 periods. A strong correspondence was underlined in his study between level of financial sector development and real per capita GDP growth, the rate of physical capital accumulation, efficiency level of its employment etc.

Branch penetration and number of ATMs generally signifies the outreach of the banking institutions in a specific area. Thorsten, Demirguc-Kunt and Peria (2005) argues that with higher branch and ATM penetration loan services usage are reported to be higher and thus minimizing the financing obstacles which forms major constraints to growth. Level of financial development and poverty reduction is strongly correlated and there exists many empirical

studies to prove such a relationship. Significant rise in the income level of the poorest quartile owing to the financial sector development was depicted in the cross –country analysis of Demirgüç-Kunt and Levine (2007). It is interesting to note that countries with higher levels of financial development experienced hastier fall in the percentage of below poverty line section of the population.

Economies around the globe adopt country specific financial inclusion strategies for achieving the goal of inclusive growth. Bank led model of financial inclusion is quite universal in nature and is implemented in many economies under the monitoring of the central bank of the country. Bruhn and Love (2009) examined the effects of access to finance on variables like entrepreneurial activity, employment, and income of poor people with special reference to the activities of the Banco Azteca in Mexico which opened more than 800 branches simultaneously in 2002 as part of their financial inclusion strategy. 7.6 percent hike in the number of informal business units was reported in the study as a result of the increased bank branch penetration. Digitalization and other technological innovations can do wonder in achieving the objectives of financial inclusion. MPESA is one such successful financial inclusion strategy adopted in Kenya. Morawczynski (2009) observed that the income level of the rural mobile money transfer recipients had increased tremendously due to remittances, which ultimately led to higher savings by the households and more rural economic development.

There exist various empirical evidences across countries and time points, employing different measures of financial development and growth, econometric models, in explaining the relationship between financial development and economic growth. Rajan and Zingales (1998) studied whether financial development facilitated economic growth by reducing the cost of external financing, by taking the case of pharmaceutical industry. Using cross sectional instrumental variable estimator and panel technique for the data on 63 countries averaged over the period 1960-’95, Beck (2000) found that financial development exerts a large, positive influence on total factor productivity growth and GDP but has a tenuous relationship with physical capital accumulation and private saving rate. A study on 47 countries for the period 1976-’93 by Levine and Zervos (1998), reveals that stock market liquidity and banking development positively predict growth, capital accumulation and productivity.

Better financial access to finance can be effectively used as a tool for reducing the poverty level and stimulating economic growth rate. Empirical evidences from Indian economy reveal that a 1% increase in the number of rural bank branches led to a drop in poverty of 0.34% and an increase in output of 0.55%, mainly because access to finance made it easier for poor people to diversify out of agriculture (Burgess and Pande, from DFID 2004). Provision to save money at a a financial institution reduces the risk of loss due to theft or fire, in the case of poor people living in vulnerable conditions. It also smoothens their consumption patterns even at times of income fluctuations and equip them to defend unexpected economic or health shocks.

The evidences of the study conducted by Hasan and Zhou (2006) suggest that the development of financial markets institutions and instruments have been robustly associated with economic growth in China. Based on the RBI annual data for the period 1985-’86 to 2005-’06, Bhanumurthy and Singh in 2009 give strong evidences for the link between financial sector development and economic growth rate of different states in India. The major conclusion of the study was that the financial development taken in terms of credit –deposit ratio is important for economic growth. Using a panel data set for over 1000 listed firms in India for the period 1995-2004, the study conducted by Ghosh (2006) indicate the influential role of financial liberalization policy on economic growth.

Concluding Remarks

Without inclusive financial systems, poor people must rely on their own limited savings to invest in their education or become entrepreneurs and small enterprises must rely on their limited earnings to pursue promising growth opportunities. This can contribute to persistent income inequality and low economic development .In the absence of a well-functioning finance system, no direct financial aid can create the right business climate conditions which are essential for long-term economic growth. To achieve sustainable economic growth the focus of the financial sector should be on the whole range of economic activities, including small and medium-sized enterprises (SMEs) and farmers. Access to financial services act as a key strategy for achieving the Sustainable Development Goals in multiple ways.

References

[1]. Bagehot, W. (1873). Lombard Street: A Description Of The Money Market. HS King &Company.
[2]. Beck, T., Levine, R., & Loayza, N. (2000). Finance And The Sources Of Growth. Journal Of Financial Economics, 58(1-2), 261-300.
[3]. Beck, T., Demirguc-Kunt, A., & Peria, M. S. M. (2007). Reaching Out: Access To And Use Of Banking Services Across Countries. Journal Of Financial Economics, 85(1), 234-266.
[4]. Becker, M. C., & Knudsen, T. (2002). Schumpeter 1911: Farsighted Visions On Economic Development. American Journal Of Economics And Sociology, 61(2), 387-403.
[5]. Bhanumurthy, N. R., & Singh, P. (2009). Understanding Economic Growth In Indian States. Delhi: Institute Of Economic Growth.
[6]. Bruhn, M., & Love, I. (2009). The Economic Impact Of Banking The Unbanked: Evidence From Mexico. World Bank Policy Research Working Paper, (4981).

[7]. Cameron, N. (1979). The Stability Of Canadian Demand For Money Functions 1954-75. Canadian Journal Of Economics, 258-281.
[8]. Chick, V., & Dow, S. (1988). A Post-Keynesian Perspective On The Relation Between Banking And Regional Development. Thames Polytechnic.
[9]. Claessens, S., Honohan, P., & Rojas-Suarez, L. (2009). Policy Principles For Expanding Financial Access. Center For Global Development Working Paper.
[10]. Clarke, G. R., Zou, H. F., & Xu, L. C. (2003). Finance And Income Inequality: Test Of Alternative Theories (Vol. 2984). World Bank Publications.
[11]. De Gregorio, J. (1999). Financial Integration, Financial Development And Economic Growth.
[12]. Ellis, K., & Lemma, A. Juan-Pablo Rub. 2010. Investigating The Impact Of Access To Financial Services On Household Investment.
[13]. Estrada, G. B., Park, D., & Ramayandi, A. (2010). Financial Development And Economic Growth In Developing Asia. Asian Development Bank Economics Working Paper, (233).
[14]. Greenwood, J., & Jovanovic, B. (1990). Financial Development, Growth, And The Distribution Of Income. Journal Of Political Economy, 98(5, Part 1), 1076-1107.
[15]. Guiso, Luigi, Paola Sapienza, And Luigi Zingales (2001), The Role Of Social Capital In Financial Development, Mimeo.
[16]. Hasan, I., & Zhou, M. (2006). Financial Sector Development And Growth.
[17]. Hicks, R. E. (1969, January). Programmed Bibliography In Public Finance. In Proceedings Of The Annual Conference On Taxation Under The Auspices Of The National Tax Association (Vol. 62, Pp. 593-602). National Tax Association.
[18]. Keynes, J. M. (1923). A Tract On Monetary Reform. Cosimo Classics.
[19]. Keynes, J. M. (1930). A Treatise On Money. (No Title).
[20]. King, R. G., & Levine, R. (1993). Finance, Entrepreneurship And Growth. Journal Of Monetary Economics, 32(3), 513-542.
[21]. Levine, R., & Zervos, S. (1998). Stock Markets, Banks, And Economic Growth. American Economic Review, 537-558.
[22]. Mckinnon RL (1973) Money And Capital In Economic Development. The Brookings Institution, Washington, D.C.
[23]. Morawczynski, O. (2009). Exploring The Usage And Impact Of "Transformational" Mobile Financial Services: The Case Of M-PESA In Kenya. Journal Of Eastern African Studies, 3(3), 509-525.
[24]. Peachey, S., & Roe, A. (2004). Access To Finance. A Study For The World Savings Banks Institute.
[25]. Rajan, R. G., & Zingales, L. (1998). Power In A Theory Of The Firm. The Quarterly Journal Of Economics, 113(2), 387-432.
[26]. Robinson , J . 1952 . " The Generalization Of The General Theory " . In The Rate Of Interest And Other Essays , London : Macmillan .
[27]. Rousseau, P. L., & Wachtel, P. (2011). What Is Happening To The Impact Of Financial Deepening On Economic Growth?. Economic Inquiry, 49(1), 276-288.
[28]. Shaw ES (1973) Financial Deepening In Economic Development. Oxford University Press, New York.
[29]. Smith, A. (1776). An Inquiry Into The Nature And Causes Of The Wealth Of Nations: Volume One. London: Printed For W. Strahan; And T. Cadell, 1776.
[30]. Team, D. F. S. (2004). The Importance Of Financial Sector Development For Growth And Poverty Reduction. Policy Division Working Paper. London: Policy Division, Department For International Development.