ECONOMIC GROWTH, FINANCIAL DEVELOPMENT & FINANCIAL DETERMINANTS: A RELATIONSHIP

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ABSTRACT

The association between economic growth and financial development has been a wide-ranging subject of experiential analysis. The sensible proof suggests that there is a big positive relationship between financial development and economic growth. The queries of what determines financial development and the way to develop financial markets remain imperfectly understood. More specifically, economists still have a too little understanding of the subsequent key problems. What brings regarding the emergence and development of financial markets? What are the explanations why totally different financial structures, bank-based or market-based, exist in countries wherever similar levels of economic development have been reached? What accounts for the variations within the levels of financial development in countries. This highlights the importance of the analysis into what is essential to the development of financial markets and what are main aspects to develop carbon markets for endeavor climate change. This paper seeks to research the elemental determinants of the development of financial markets and carbon market. *It additionally shows that cultural or religious forces play an insignificant role in crucial financial development in a multi-cultural and comparatively educated society.*

INTRODUCTION

"Financial development refers to the factors, policies and institutions that lead to an effective financial intermediation and markets, and deep and broad access to capital and financial services" (Financial Development Index, 2008).

Among the profound evolutions in development economics in recent decades has been the revived interest in, and growing contributions on, the role of financial systems in economic development. Whereas it is clear that a positive result exists between financial depth and economic growth, the questions of what determines financial development and the way to develop financial markets remain imperfectly understood. The role of any economical financial system is to channel funds from surplus to deficit units to finance the simplest firms and investment projects. However, in follow this can be not invariably the case because principally large firms tend to urge funds whereas small and medium sized enterprises (SMEs) are left to accept informal sources of finance. The predominant view on financial development is that it will increase the accessibility to financial instruments and institutions that decreases transaction cost thereby channeling funds to efficient economic agents who can use it to invest in each human and physical capital thereby stimulating economic growth.

REVIEW OF LITERATURE

Research on the role of financial development in growth will be derived back a minimum of *Bagehot* (1873) who claims that giant and well-organized capital markets in England enhanced resource allocation towards a lot of productive investment. Different historical antecedents before 1970 include, among others, *Schumpeter* (1911), *Hicks* (1969) and *Goldsmith* (1969). *Schumpeter* (1911) emphasizes the crucial role of a country's banking system for economic development in mobilizing savings and inspiring productive investment. *Hicks* (1969) highlight the importance of financial markets within the process of industrial revolution with an observation that the development of financial systems facilitates the applications of recent technologies and innovations. *Goldsmith* (1969) finds proof of a positive link between financial development and economic growth from a comparative study with information for 35 countries over the period 1860–1963.

Motivated by the *McKinnon-Shaw* model, varieties of studies in this area have been undertaken, like *Kapur* (1976) and *Mathieson* (1980) among others. However, these works generally treat financial intermediation and financial institutions as exogenous. The last two decades have witnessed a resurgence of interest within the relationship between financial development and economic growth which includes the insights of endogenous growth models. These works embrace *Townsend* (1979), *Diamond* 1984), *Gale* and *Hellwig* (1985), *Williamson* (1986, 1987), *Bencivenga* and *Smith* (1991), Greenwood and Jovanovic (1990), Saint-Paul (1992), *King and Levine* (1993) and *Bernanke et al.* (1999) among others.

The explanation to finance technological development is to boost productivity that *Borrus and Stowsky* (1997) identified as one of the three variables to enhance the quality of living of people. When financial development takes place in a bank-based economy, SMEs are the primary to benefit since they need increased access to capital and their ability to undertake investment projects. It ought to be acknowledged that they are the main force in sustaining economic growth and moreover, given that they are usually labour intensive they have an inclination to reduce unemployment.

Thus a surge in SMEs could be a notable feature of a flourishing economy. Equally as a country economy prospers stock markets act as an alternate funding channel on which large firms who shall undertake long-run capital commitments to finance "huge works" (*Hicks*, 1969).

DETERMINANTS OF FINANCIAL MARKET

Policy

Proper policy measures like financial and trade liberalisation have been additionally promulgated as determinants of financial development. Freeing the financial system from government intervention permits a lot of efficient allocation of resources by varied economic agents whereas liberalising trade reduces the facility of interest groups who capture politicians to form policies in their favour that impedes financial development. As such the liberalisation process reduces unskillfulness, improves transparency and fosters a competitive environment that is contributory for the economy as a whole. Some major national macroeconomic policies like maintaining lower inflation and better investment are documented as being contributory to financial development. Several researches have been conducted to indicate the impact of liberal policy on financial development. The majority of them have consent concluded that there is direct relationship between them.

Geography

There is less work directly addressing the potential correlation between geography and financial development as compared thereto for policy and institutions. However, a lot of analysis attention has been paid to the importance of geography for general economic development, emphasizing three aspects specifically. Geography is probably going to work mainly through the demand side of financial development, though it should have an effect on its supply side by influencing the quality of institutions. For example, the production of specific agricultural products or primary product and exploitation of some natural resources might cut back the demand for external finance, relative to other countries at a similar level of GDP per capita.

Economic Growth

Greenwood and *Jovanovic* (2005) and *Saint-Paul* (2007) document that as the economy grows, the costs of financial intermediation decrease attributable to intensive competition, inducing a larger scale of funds accessible for productive investment.

Income Level

The importance of income levels for financial development has been addressed in *Levine* (1997, 2003, 2005). In considering banking sector development in 23 transition economies, *Jaffee and Levonian* (2001) demonstrate that the level of GDP per capita and also the saving rate have positive effects on the banking system structure as measured by bank assets, numbers, branches and employees.

Population Level and spiritual, Language and Ethnic Characteristics

Stulz and Williamson (2003) stress the impact of variations in culture, proxied by variations in religion and language, on the process of financial development. They provide proof that culture predicts cross-country variation in protection and enforcement of investor rights, particularly of creditor rights. The proof additionally shows that the influence of culture on creditor rights protection is satisfied by the introduction of trade openness. *Djankov et al.* (2003) shed light on the role of state possession of the media within the extent of financial development.

Different sets of indicators are utilized in tries to measure the financial development of economies. Beginning in 1999, the World Bank began publishing a database on financial development and structure across countries. The foremost recent World Bank study updates and expands the financial development and structure database. This database contains variety of financial system indicators (around thirty) including:

i. Indicators for the dimensions of the financial system, together with liquid liabilities to GDP, currency outside banking system to base money, financial system deposits to GDP, and then forth;
ii. Banking system indicators for size, structure, and stability;
iii. Indicators for capital markets and also the insurance sector; and
iv. Indicators for financial globalization like international debt to GDP and remittance inflow to GDP.

However, this database does not rank countries on financial development indicators. Other studies by the World Bank offer indicators on regulation and supervision of banks, coverage and structure of deposit insurance schemes, and indicators of barriers to banking access in developing and developed countries.

In another commit to measure financial development, an occasional paper of the European Central Bank constructs, on the idea of an original methodology and database, composite indexes to measure domestic financial development in twenty-six rising economies for 2010, using mature economies as a benchmark. The study uses twenty-two variables, grouped according to three broad dimensions: institutions and regulations, size of and access to financial markets, and market performance. As per to this index, Republic of Korea is ranked sixth among thirty countries, PRC is fourteenth, and India ranks twenty-second. This paper finds that India performed comparatively higher as regards its financial markets and nonbank institutions however needs improvements within the business environment as well as larger and more efficient banks.

Recognizing that there is an absence of consensus on a way to outline and measure financial system development, the WEF discharged its first annual Financial Development Report (FDR), that provides an index and ranking of fifty-two of the world's leading financial systems. The 2009 FDR ranks fifty-five countries based on over 120 variables spanning institutional and business environments, financial stability, and size and depth of capital markets, among others, and is so one amongst the foremost comprehensive databases accessible on financial development.

For the needs of the 2012 FDR and its index, financial development is outlined as "the factors, policies, and institutions that cause effective financial intermediation and markets, and deep and broad access to capital and financial services." In accordance with this definition, the FDR acknowledges varied aspects of development of a financial system, presenting them as the "seven pillars" of the financial development index (FDI). These fall into three broad categories:

i. *Factors, policies, and institutions*: the "inputs" that enable the event of financial intermediaries, markets, instruments, and services. This contains three pillars: institutional environment, business environment, and financial stability.

ii. *Financial intermediation*: the range, size, depth, and potency of the financial intermediaries and markets that offer financial services. This includes three more pillars: banks, nonbank entities, and financial markets.

iii. *Financial access*: the last pillar, associated with access of individuals and businesses to totally different kinds of capital and financial services.

One of the key design principles of the FDI is that the inclusion of an oversized variety of variables relevant to the financial development of each rising and developed economies. Stress is placed on the component parts of the FDI as a framework for analysis, following that a awfully conservative approach has been taken to the weighting of variables. The FDR has typically weighted totally different components of the index equally. Standardization is done to allow aggregation and cross-country comparisons. This can be accomplished by rescaling the variables on a 1–7 scale, 1 being the smallest advantageous to financial development and 7 being the foremost advantageous. In some instances, the interaction among totally different variables is additionally captured as a result of certain variables will be considered a lot of beneficial impact within the presence of others.

The FDI developed by the WEF, like different such indexes on financial development, has several limitations, each conceptual and methodological as well as data related. The FDR acknowledges that limitations additionally exist attributable to the rapidly dynamic environment and also the distinctive circumstances of number of the economies covered. Yet, in its attempt to establish a comprehensive framework and a way for benchmarking, it provides a helpful starting point. The FDR is exclusive within the comprehensiveness of the framework it provides and also the richness of relevant data it brings to bear on financial system development.

The 2009 FDR places most of the developed countries within the high rankings, with the United Kingdom holding the primary rank. Among the rising economies, Malaysia places at the top, ranking twenty-second, followed by Republic of Korea and PRC. India is thirty-eighth in its overall ranking presents India's rankings on varied financial development parameters vis-a-vis different necessary rising markets.

CONCLUSION

It would a good outline to mention that as per these reports, supported on reasonably standard and agreed criteria, India does not rank terribly high in its overall score of financial development. However, it is comparatively well placed in terms of development of nonbanking financial services (seventeenth) and financial markets (twenty-second). Among the financial markets, India fairs well in development of its foreign exchange markets and derivatives markets. A number of the sub indicators during which India ranks well are regulations of securities exchanges (ninth) and currency stability (tenth). However, the country's institutional environment is significantly weaker, ranking forty-eighth, a consequence of its lower levels of financial sector liberalization as well as a low degree of contract enforcement. India's business environment is additionally affected by two specific challenges: an absence of adequate infrastructure and also the high cost of doing business. These areas of problem translate into extremely forced financial access.

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