Chapter
TWO

REVIEW OF LITERATURE

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Theory of money and finance is still in a lively debate since fifties. When its significant role has been explored, economic development has been discussed in term of real aspects. However, little attention has been paid to the prominent role played by financial aspects. The real development is accompanied by institutionalisation of savings and investment and diversification of financial assets which would in turn, enhance economic development and promote growth.

The contribution of various economists to this area has focus[1] on (a) explaining the process of financial intermediation and exploring its role in the economic growth of a country (b) interpreting the causal relationship between financial development and economic growth and (c) trying to find out a new empirical evidence in this regard. Since this kind of relationship is still unanswered and yet in a lively debate, we expect more contribution into this field in years to come.

The aim of literature review is to trace out various hypothesis which explaining the relationship between financial structure and economic development. Although there is exhaustive literature available on the subject, this study reviews major works and hypothesis that have been contributed by economists.

1. Niels Hermes, "Financial Development and Economic Growth : A survey of the Literature", International Journal of Development Banking, Vol.12, No.1, (January 1994), pp.3-21.

Financial Structure and Economic Development :

Inspite of vast body of literature on the financial development and its relation to economic growth, the relationship[2] between financial institutions and its variable in real growth, whether a cause or effect, has not been fully explored either theoretically or empirically. The work that has been done so far is not sufficient to provide a solid theoretical foundation to the role of finance in the growth of developing countries.[3] Economists have considered various possible techniques for promoting savings and its mobilisation. Gurley[4] and Shaw, stress on the importance of financial techniques. Fiscal technology and inflationary techniques are also available to promote saving for investment purposes. But due to low income base and poverty, fiscal technology has not been very popular in less developed countries. However, they have been using financial techniques. In what way financial savings can be promoted and what role it plays in economic development has been very well considered by economists. Now we would like to review the works of Gurley, Shaw and others briefly.

Scholars[5] distinguish three schools of thought to the degree of contribution financial institutions make to economic development.

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2. Hugh T. Patrick, "Financial Development and Economic Growth in Underdeveloped Countries", Economic Development and Cultural Change, Vol.XIL, No.2, (January 1966), p.174.
3. Gupta, K.L., "Finance and Economic Growth in Developing Countries", Croom Helm, (1986), p.1.
4. J.G. Gurley and E.S. Shaw, "Money in a Theory of Finance", Washington D.C.: The Brooking Institution, (1968).
5. Khatib, F.M., "Financial Institutions and Economic Growth in Jordan : 1964 - 1984" Un-published Ph.D. thesis, University of Leicester, (1987), U.K. p.39-40.

Gurley (1967) believes that financial institutions are among many other institutional techniques which can promote economic development. Contrary to this, economists like Cameron (1967), Adelman and Morris (1968) are of the opinion that, financial institutions are sufficient for economic growth. In between falls the third group of moderate writers who assign significance of varying degrees to financial institutions in economic development. These different views are elaborated below.

Different Views :

As mentioned earlier, there are different ways in which financial institutions may contribute to economic development. They may be explained by referring to different views expressed by several eminent economists on this subject. The first view among them is the one given by John G. Gurley in his study presented in 1967[6]. According to Goldsmith Raymond, Gurley presents a ***"new approach by regarding finance as one of several alternative means for handling the increase in a country's stock of capital."*** * Gurley's basic view is that besides financial intermediation, there are many other institutional sources available in the country through which real growth can be enhanced. These sources are taxation, foreign aid, self finance by private business firms and profits of state enterprises. Experience shows that many countries, specifically socialist, produces high rate of growth through these techniques, assigning insignificant roles to their financial system as

6. Gurley, John G., "Financial Structure in Developing Economies" In "Fiscal and Monetary Problems in Developing States", edited by David Krivine, New York, Washington, London, Frederick A Praeger (1967), p.99-120. *See also*, J.G. Gurley, "Reviews of Banking in the Early stages of Industrialization", American Economic Review. Vol LVII, No.4, (September 1967), p.950-53.

* *See also* discussion in David Krivine edition "Fiscal and Monetary Problems in Developing States" (1967), P. 119.

an intermediation. While other under developed countries try to shoot ahead through heavy doses of foreign aids. But the fact is that, each country follows a rising path which may differ from country to country depending on the resources allocated, social costs and benefits derived from alternative technique. To put it briefly, it may be said that Gurley does not specify which of these techniques would be best available to one country or a group of countries.

Contrary to this is another view held by a line of economists who consider the contribution of financial institutions as sufficient for economic development. Cameron and Patrick[7] believe that Schumpeter was the first modern economist to relate banking system to economic development. Banks[8] and entrepreneurs are two pillars on which his theoretical scheme rests. He gives important role to money, capital and credit in relation to entrepreneurial activities which in turn would lead to economic development. To him, credit is granted to entrepreneurs through banks either against security mortgage or goods mortgage he ownes.[9] Schumpeter does not study closely the relationship between financial system and economic development, but simply assumes existence of commercial banks with ability to create purchasing power.[10] Schumpeter's study has been supported by recent studies. According to Cameron[11] the relationship between

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7. Rondo Cameron, Olga Crisp, Hugh Patrick and Richard Tilly, "Banking in the Early Stages of Industrialization", London : Oxford University Press, (1967).
8. Joseph Schumpeter, "The Theory of Economic Development", Harvard University Press, (1949).
9. Ibid., p.100-101.
10. Cameron, R. and Others (1957), Op. Cit., p.40.
11. Cameron, R. and Others, "Banking in the Early stages of Industrialization", London: Oxford University Press, (1967), p. 291

banking system and economic development is strong and positive as banks respond to demand for financial services. Financial institutions serve as reservoirs of accumulated liquid savings of the community and therefore, they facilitate its accumulation by stimulating saving and by serving as a vehicles for introduction of capital from abroad as well as by "forcing" society to save money by putting newly created money in the hands of entrepreneurs.[12]

In between the above contradictory views, there appears a moderate opinion on the role of financial structure in economic development. It is introduced by Edward Shaw[13] and by Ronald McKinnon[14] in two different works published in 1973. Their contribution to this area is ***"less rigorous and less elegant but more illuminating and realistic approach to the role of money in economic development."***[15] Both of them view that most of stagnant economies of third world suffer from shallow finance or financial repression characterised by slow growth or even atrophy of financial assets and financial structure.[16] This happens because of inefficient financial policies used by these countries. Which would penalize savings, supress market and encourage lop-sided development.[17] Both McKinnon and Shaw believe in liberalising financial policies which would lead to financial deepening in the

12. Ibid., p.292.
13. Shaw, Edward S., "Financial Deepening in Economic Development" New York : Oxford University Press, (1973).
14. McKinnon, Ronald. I., "Money and Capital in Economic Development" Washington D.C. : The Brookings Industries, (1973).
15. Tushar Shah, "Money Finance and Economic Development : The Case Study of India" Unpublished Ph.D. thesis presented to Indian Institute of Management, Ahmedabad; India : (1978) p.60.
16. JAO, Y.C., "Financial Deepening and Economic Growth : A cross-section Analysis" The Malayan Economic Review, Vol.XXI, No.1, (1976), p.47-58.
17. Ibid., p.47.

country, stimulate savings and induce more investment opportunities, replacing labour intensive by capital and technology intensive. They are in agreement with those economists who believe that real balances should be treated as a factor of production as it enhance efficiency and productivity, especially in less developed countries.[18] McKinnon and Shaw specify South Korea and Taiwan in this category which experience a very successful financial deepening contributing significantly to faster economic development. This is due to realistic rate of interest, exchange rate and curbing inflation policies. Taylor believes that, in these countries the ground was very well cultivated for the seed to germinate. Because of foreign aids, direct contact with American know-how and moreover, they have seen Japans tutees. These countries had inherited long achievement oriented cultural tradition before a rapid spread of capital market took place.[19]

Statistical Evidence :

As discussed above, we find a direct relationship between growth of financial structure and economic development. Although, some economists have investigated this relationship empirically and theoretically to the extent possible the question of causality in this connection is yet not fully answered. In the discussion that follows, we throw light on the empirical works that have been carried out and which I feel, can give an indication of the countries performance.

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18. Ibid., p. 49
19. Lancer Taylor, "Book Review on McKinnon Shaw Theory", Journal of Development Economics, 1, (1974), p.81-84.

While examining empirical works, we find that some economist investigate the experience of developed countries, whereas some other investigate the performance of under developed economies. In between it is found that another group of economists investigate the progress of different continents and experience of both developed and under developed economies. Gupta[20] in his book mentions that Roe investigagte experiences of different continents. He is more comprehensive by investigating experiences of three geographical regions, Asia, Latin America and Africa. He[21] developes four equation models one of them is financial intermediation ratio by measuring M2/ GDP. By using cross-section and time series data for each continent, he finds that neither the actual rate of inflation nor the nominal rate of interest is statistically significant for Asia. On the contrary, it has a small positive effect in Africa while none of the variables carries a significant co-efficient in Latin America. Again Goldsmith[22] investigates the relationship between country's financial structure and economic development by constructing Financial Interrelation Ratio, It is a ratio of country's financial assets at one time divided by the value of country's tangible assets (i.e. national wealth) at the same time. This ratio has been used to investigate financial structure of both developed and developing economies by using cross-section data. It is found that this ratio ranges between 1% and 1.5% in developed economies or mixed economies. While in case of developing economies it varies from 2/3 to 1 in such markets.[23] To find out the

20. Gupta, K.L., (1986) Op.Cit., p.10-11.
21. Ibid., p.10.
22. Raymond Goldsmith, "Financial Structure and Development", New Haven, London : Yale University Press, (1969).
23. Ibid., p.45.

relative importance of various financial institutions operating in a country, Goldsmith uses a ratio of financial assets of every institution to the total financial assets of all institution at the same time. This is somehow similar to the work of Gurley and Shaw as it uses proportion of assets of commercial banks to national financial assets, or to financial assets of all other private financial intermediaries or to national wealth.[24]

I believe that FIR of Goldsmith due to its applicability to both developed and developing economies, can be used as a common measure of comparative financial structures in both the economies. This ratio rises as real economy grows. Many economists applied FIR of Goldsmith to investigate economies of different regions, such as Asia[25], Africa[26] and Latin America[27] using time series data. Their studies reveal the existence of an interrelationship between financial development and economic growth. These works and many others studies support our main contention that there exist an interaction between real and financial sector. This leads us to review statistical evidence on the financial structure and experience of both, developed and developing economies.

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24. Gurley, J.G., and Edward S. Shaw, "Financial Aspects of Economic Development" The American Economic Review, Vo..XLV, No.4, (September 1955), pp.515-38.

25. Gupta, K.L. "Financial and Economic Growth in Developing Countries", (1984). *Again see* Cole, D.C. and Y.C. Park, "Financial Development in Korea 1945-1978", Harvard University Press, (1983).

26. Kwarteng, K., "Banking and Finance in Africa : A Review Article" Savings and Development Vol.6, No.3, (1983), pp. 247-263. *See also* Abebe, A., "Financial Repression and its Impact on Financial Development and Economic Growth in African least Developed Countries", Savings and Development, Vol.14, No.1, (1990), pp.55-85.

27. Basch, A., and M.Kybal, Capital Markets in Latin America : A General Survey and Six Country Studies, New York : Praeger Publishers, (1970). *Again see* Rietti, M., Money and Banking in Latin America, New York : Praeger Publishers, (1979).

In case of developed economies, as studies show the financial system developed very rapidly in the early stages of industrialization[28]. It was the time when some of developed economies of today were not existing. British financial system flourished during 1750-1844, when banks assets were about 20.5 million pound which was about 15.2% of the national income. It increased to 139.0 million pounds making about 24.4% of the British national income in 1844.[29] Another case is Scottland had one banking office possessing 63 thousand pound in 1704. But in course of economic development number of banking offices grew to 694 which owned about 77.22 million pound in 1865. This means that each Scottish citizen owned 24.2 thousand pound in the same year.[30] The case is similar for France which showed high growth in banking system, and as a result, about 64 bank offices were set up and they possessed 102 million franc, which means about 430 thousand citizens were dealing with each branch. The scenario changed when in 1870 the number of bank offices reached to about 469, making average bank dealing to 82 thousand people whereas the resources jumped from 102 to 3.744 million france in the same year.[31] In brief, this reveals the fact that in course of economic development, developed economies experience a high growth rate in banking sector in which density of banks becomes higher leading to lower average of banking dealing. This means that promotion in habit of banking results into increase in total assets of banking system. This case is almost similar to that of many developed countries. For

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28. Cameron R. and Others, Banking in the Early Stages of Industrialization, London: Oxford University Press, (1967).
29. Ibid., p. 35
30. Ibid., p. 66
31. Ibid., p. 111

instance,[32] the assets of the Japanese financial system were about 10% of the national income in 1868 which touched the point of 96% in 1913. The question arises now how far this phenomenon in true is case of developing economies, where growth of financial system is associated with economic development.

Besides some of the basic[33] works, some studies investigate the growth of financial structure using other approaches. Trescott[34] supports the Goldsmith hypothesis that in course of economic development financial assets grows very high and demand for financial assets increases. Investigating Thailand experience, Trescott finds that public holdings of financial assets rise by more than ten folds in twenty years. In 1947 the quantum of financial assets was about 3 billion baht which increased to 33 billion baht* in 1967. It was about 32.0% of the GNP. Deposits with commercial banks during 1947 and 1967 increased by 200 folds while during the same period, the population almost doubled. In fact an other study[35] reveals that assets of Thais commerical banks has grown at a rate of 22.5% annually for the period 1962-1978. These studies indicate that monetization and financial deepening has taken place in Thailand. The case of many developing economies can almost be like this. Bhatia and Khatkhate[36] investigate

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32. Ibid., p.273.
33. Raymond Goldsmith., Financial Structure and Development, New Haven, London : Yale University Press, (1969).
34. Paul Trescott., "Demand for Money and Other Liquid Assets in Thailand, 1946-1967", Economic Development and Cultural change, Vol.20, No.2, (January 1972), pp.260 - 79.
   * Baht is the monetary unit in Thailand.
35. George J. Viksins, Financial Deepening in Asian Countries, Hawai, U.S.A. : Pacific Forum, (1980), p.59-66.
36. Bhatia, R.J. and Khatkhate, D.R., "Financial Intermediation Savings Mobilization and Entrepreneurial Development : The African Experience", I.M.F. Staff Papers, Vol.XXII, No.1, (March 1975), pp.132-58.

a direct relationship between financial deepening and real growth in selected eleven African countries. As an indication of financial growth, they take the ratio of total financial assets to GNP and per capita GNP. The data do not reveal any systematic pattern of financial intermediation in any of the two cases. ***"At one end are countries, such as Ivory Coast, Kenya and Zambia, where the increase in financial intermediation appears to have been coterminus with the growth in per capita GDP. At the other end are countries such as Ghana, Mauritius and Sierra Leone, where despite the growing level of per capita GDP, financial intermediation has not increased perceptibly or has even declined. In between of these two extremities are the remaining countries where financial intermediation is sometimes positively and sometimes negatively correlated with the level of per capita GDP".***[37] The reason behind such a result of lack of positive correlation between financial and real variables is inefficient technology of mobilizing savings which may seep domestic resources out of the country. It would be good to note that this study does not use simple regression analysis to test the joint impact of the two independent variables.[38] Again the conclusion does not shed any light on the relationship between financial deepening and financial repression.

A recent study reveals that during last four decades, the widening and deepening of Indian[39] financial system could enhance growth. Indian banking sector has expanded geographically and functionally

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37. Ibid., p.140.
38. Gupta, K.L. (1986) Op. Cit., p.9.
39. Rangarajan, C. and Narendra Jadav, "Issues in Financial Sector Reform" in Bimal Jalan edition, "The Indian Economy Problems and Prospects", India : Viking Pengauin Books, (1992), pp.141-62.

with time span. There were about 8262 bank offices in 1961 which grew widely to 60190 in 1991. This expansion could mobilize higher savings to meet the needs of deficit sectors. Such developments were very much illustrated by "Supply Leading" pattern in which first financial institutions came into existence and demand for their services followed it. This study further reveals the position of important financial indicators in which, financial ratio leaped to 44% in 1989-1990 from that of 5% in 1951-55 and that of 14% in 1960s. Whereas the Financial Interrelation Ratio (FIR) of 0.63 in 1951-55 jacked up to reach 2.5 in 1989-1990 and Intermediation ratio enhanced to 0.45 in 1989-1990 from that of 0.27 in 1951-55 and that of 0.33 in 1960s. This study assigns an important role to household sector in saving as its gross saving in the form of financial assets was 36% in 1950s which jumped to 43% in 1970-1971 and finally reached the mark of 64% in 1989-1990 of household total saving. Though trends of these financial ratios are impressive and significant, this study concludes that, financial sector has to respond quickly and effectively to the new needs as the real sector becomes more competitive in India.

Leading Works and Related Hypotheses :

What we have discussed earlier is a sketch of important role played by financial structure in economic development and growth. In this respect, there are some important pioneering works which are considered foundation stones in this field. Hence a survey of these prominent hypotheses is called for.

1. Gurley and Shaw Hypothesis "Liquidity Theory" :

The main view of Gurley and Shaw is that as traditional theory of economic development concentrates mainly on real aspects it neglects financial aspects. This does not lead to emergence of modern financial structure.[40] In their works, they stress the important role played by financial institutions in creating a modern financial structure. They believe that real economic development is accompanied by a process of financial innovations in which primary securities become differentiated. In this, process deficit sectors of the economy issue debt and equities of different degress and assurance to lenders. Issuance of each deficit sector differs from the other. Here a wide array of differentiated financial assets can be seen through the increasing role of financial intermediaries. Such new assets promote financial structure and enhance economic growth. Gurley and Shaw mention that financial assets[41] can have dichotomy of two kinds : primary securities and indirect securities. ***"Obligations of financial intermediaries such as currency demand deposits, savings deposits and shares, policy reserves and similar claims are indirect securities.***[42] Whereas the ***"Obligations of non-financial spending units including government securities, corporate bonds and stocks, mortgages and various short-term and intermediate-term debt fall under primary securities.***[43] Financial intermediaries acquire primary securities of borrowers and supply indirect securities to ultimate lenders. That is to say, financial

40. Gurley, J.G. and Shaw E.S., "Financial Aspects of Economic Development", American Economic Review, Vol.XLV, (September 1955). p.515-38.
41. Gurley, J.G. and Shaw, E.S., Money in a Theory of Finance, Washington D.C.: The Brooking Institution, (1960).
42. Ibid., p.363.
43. Ibid., p.364.

intermediation bridges the gap between ultimate lenders, who are usually savers and ultimate borrowers who are investors or in deficit position. Gurley and Shaw theory is characterized by liquidity theory of money or theory of finance. Hence, the important role of money, finance and financial intermediation in economic development has been expanded by Gurley and Shaw. Expansion of Gurley and Shaw views on efficiency of financial system in mobilization of savings and efficient allocation of investment have been explored later on. Among others was contribution of Patrick and Porter.[44]

2. Patricks Hypothesis "Demand Following - Supply Leading":

In the earlier section, we have seen how liquidity theory is important in economic development, in which causal link is not provided. Patrick's phenomenon namely, Demand Following - Supply Leading[45] does care for this issue, yet it does not provide the cause or effect of either of the two patterns. By this phenomenon, what Patrick means is that where enterprise leads finance follows. It lays emphasis on the demand aspect of financial services. He states that ***"The lack of financial institutions in under developed countries is simply an indication of the lack of demand for their services.***[46] This means that evolution of an advance financial system is an essential part of

44. Hugh T. Patrick, "Financial Development and Economic Growth in Under-developed Countries", Economic Development and Cultural Change, Vol.XIV, No.2, (January 1966), p.174-89. *See Again* Porter, R.C., "The Promotion of Banking Habit and Economic Development", Jounal of Development Studies, Vol.2, No.4, (July 1966), pp.346-86.

45. Hugh T. Patrick, "Financial Development and Economic Growth in Under-developed Countries" Economic Development and Cultural Change, Vol.XIL, No.2, (January 1966), p.174-89.

46. Ibid., p.174.

continuing process of economic development. It is the growth which induces expansion of financial system in which higher the growth of national income greater will be the demand for fund from enterprises and also the demand for financial services. This is done only through financial intermediation which transfers saving of slow growing industries and individuals to fast growing industries. This is the way growth contributes to expansion of financial system.

On the other hand "Supply Leading" pattern is inducing to development. Patrick states that supply leading involves ***"The creation of financial institutions and supply of their financial assets, liabilities and related financial services in advance of demand for them, specially the demand of entrepreneurs in the modern growth inducing sectors."***[47] This implies that expansion of financial system must preceed the demand for it. Supply leading has two functions, if transfers resources of traditional sector to modern sector and stimulates entrepreneurial response to advance sector. In brief, in supply leading pattern financial sector preceeds and induces real growth by financial means. The matter of causality changes from demand following to financial leading as development goes ahead. Patrick points out ***"As the process of real growth occurs, the supply leading impetus gradually becomes less important, and the demand following financial response becomes dominent.***[48] Financial growth can induce real innovation type investment earlier to modern process of economic development gets under way. Patrick cites[49] Japan as an example of supply leading-

47. Ibid., p.175.
48. Ibid., p.177.
49. Ibid., p. 177

demand following where banks concentrate their funds on financing agriculture, domestic, commerce and newly important foreign* trade. This is in absence of large scale of industrial demand for fund when, later on in mid 1890s, demand following prevail in financing texile and other consumer goods. By citing case of Hong Kong, Stammer[50] believes that rather than increase in number of branches, development of financial system helped Hong Kong more to become one of the most industrialised countries in the world after world war II. This type of faster growth and rapid industrialization was due to the key role played by commercial banks and merchants houses in transfering savings to proper projects of industry, and much more due to direct finance role played by Chinese family owned businesses. In fact, There has been no sudden proliferation of non-bank financial institutions, no emergence of a complex financial market which other countries experienced, but it was the development of financial system in activities structure and stability which, to some extent was a growth inducing phenomenon in case of Hong Kong rather than an increase in the number and variety of financial institutions which other countries experienced".[51] This is somehow a comment on supply leading phenomenon which Patrick[52] had to reply. In brief, the view presented in this thesis supports the genesis of both Patrick and Stammer.

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* *For further details on* Japanese Case, *see* – Hugh T. Patrick; "Japan" in Rondo Cameron and others edition Banking in the Early Stages of Industrialization; London : Oxford University Press, (1967).

50. Stammer, D.W., "Financial Development and Economic Growth in Under-developed Countries : Comment" Economic Development and Cultural Change, Vol.20, No.2, (January 1972), pp.318-52.

51. Ibid., pp.322-52.

52. Hugh T. Patrick, "Financial Development and Economic Growth in Under-developed Countries; Reply" Economic Development and Cultural Change, Vol.20, No.2, (January 1972), p.326-29.

Empirically the causal relationship between financial growth and economic development has been investigatged by many economists. Gupta[53] uses both tests of causality to analyse cases of fourteen developing countries of Asia and Latin America. His main finding is that economic growth is a result of financial development. This implies in it proposition of Patricks thesis on supply leading pattern. Again, Jung's[54] finding supports Patricks hypothesis. He takes two measures of financial development, currency ratio and monetization variable for 56 countries of which 19 are developed countries. The causal direction of both the tests, unidirectional and simple one shows that financial development causes economic growth which appears more frequently than in reverse direction. This is particularly when currency ratio is measured as an indicator of financial development in LDCs.[55] Again, he finds that in high growth of LDCs, there seems to be supply leading pattern while in low growth of LDCs there appears to be demand following pattern.[56] In general it can be said that less developing countries are characterized by supply leading whereas developing countries have demand following pattern. This hypothesis has been supported more by recent study[57] which has investigaged the data of 56 countries, of which, 37 countries are among less developing economies. Lavine[58] questions causation between financial structure

53. Gupta, K.L., (1986), Op. Cit., pp.35-57.

54. Jung, S.W., "Financial Development and Economic Growth : International Evidence", Economic Development and Cultural Change, Vol.34, No.2, (January 1986), pp.333-46.

55. Ibid., p.341.

56. Ibid., p.342.

57. St. Hill, R.L., "Stages of Banking and Economic Development", Savings and Development, Vol.16, No.1, (1986), pp.5-21.

58. Levine, R., "Financial Structure and Economic Development", Policy Research working papers, No.849, Washington D.C. : The World Bank, (1992).

and economic growth, through setting up an endogenous growth model. One of his focussed propositions is that financial structure permits agents to instigate liquidity and productivity risk, can promote economic growth by raising amount of resources invested in firms and enhancing its efficiency. Hence, financial structure would enhance growth by increasing proportion of resources devoted to human capital augmenting endeavours. These above surveyed works, in general predicate that causality between financial structure and economic development is unsolved issue, but they are strongly related as empirical evidence shows.

3. McKinnon - Shaw Hypothesis "Financial Repression" :

Inspite of inflow of literature in sixties, on the role of financial growth in economic development, convincing theoretical frame work was not enough until works of McKinnon and Shaw were introduced in 1973.[59] In their works McKinnon[60] and Shaw[61] strongly criticise "Lagging Economies" of underdeveloped countries, characterised by "Financial Repression" or "Shallow Finance". They believe, such feature would discourage development of the financial sector and impedes economic growth. This can be seen from policies in which directing banks assets to specific sector in the economy, force banks to buy government debt with control of government over rate of interest. Such policies would distort financial prices and have a low

59. Maxwell, J.Fry, "Models of Financially Repressed Developing Economies", World Development, Vol10, No.9, (1982), pp.731-50.

60. Ronald I. McKinnon, "Money and Capital in Economic Development" Washington D.C. : The Brookings Institutions, (1973).

61. Shaw, E.S., "Financial Deepening in Economics Development" New York : Oxford University Press, (1973).

impact or negative effect on growth of monetary system within the economy. Again in repressed economies stock of financial assets would be smaller as compared to tangible assets accumulation.[62] The essential elements of Mckinnon-Shaw model "Financial Repression" illustrated by Maxwell Fry is presented[63] in the following diagram.

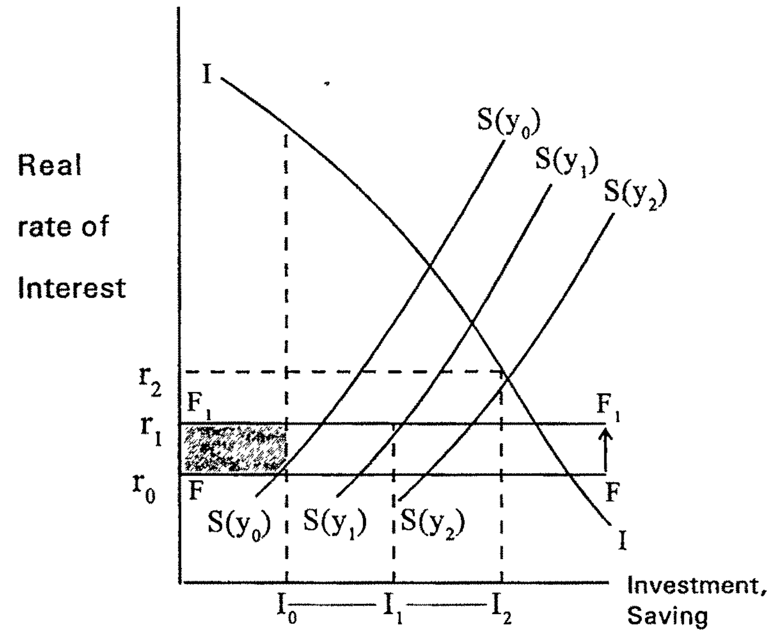

Figure : (2-1) Saving and Investment Under a Financial Constraints

In the diagram, interest rate "r" is measured on vertical axis whereas investment "I" and saving "S" are measured on horizontal axis. Saving is a function of interest rate of different levels of income, "Y0", "Y1", "Y2" while "F" represents the financial constraint, taken here to consist simply of an administratively determined institutional nominal interest rates which hold the real rate "r" below its equilibrium level. It reveals that the amount of saving available for investment is "I_0" at rate of interest "r_0" and savings income function $S(Y_0)$. This level of yield is very low at repression model, which would make banks

62. Feldman, D.H. and Gang I.N., "Financial Development and the Price of Services", Economic Development and Cultural Change, Vol. 38, No.2, (January 1990), pp.341-51.
63. Fry, M.J., "Money and Capital or Financial Deepening in Economic Development?" Journal of Money Credit and Banking, Vol.10, No.4, (November 1978), pp.465-75.

to ration their credit. Suppose now monetary authorities eases financial constraints from "F" to "F_1" by increasing rate of interest from "r_o" to "r_1", This would automatically lead to increase the amount of savings and investment. It also rations out all those low yielding investments shown as "shaded area" distanced from "F" to "F_1". As a result of this, income level will increase to $S(Y_1)$. Suppose now interest rate ceiling is abolished, savings investment would be at maximum, presented by $S(I_2)$ and rate of interest will reach optimum r_2. This is the desired amount of finance for investment. This leads to increase in income level from $S(Y_1)$ to $S(Y_2)$.

This diagram indicates that higher the rate of interest more would be the saving and investment. This eventually leads to greater income. Thus, financial repression in under developed economies may have negative impact on investment and leads to lower growth. The remedy for such economies is to liberalise financial policy as suggested by McKinnon and Shaw. Both maintain that ***"financial liberalization involving the establishment of higher interest rates that equates the demand for and supply of savings, will lead to increased savings."***[64] Besides McKinnon and Shaw, many other economists* advocate this policy and formalize the McKinnon-Shaw view. Financial liberalization means withdrawing the policies responsible for distortion of financial system, directing credit towards productive projects** and increasing rate of interest. It would lead to higher domestic savings. It has positive impact on promotion of banking habits and growth of

64. Bella Ballasa, "Financial Liberalization in Developing Countries" Studies in Comparative International Development, Vol.25, No.4, (Winter, 1990-91), p.56-70.

* *See among them,* Kapur (1976), Galbis (1977), Mathiesen (1980), Fry (1988).

** Liberalization school attributed the existence of credit rationing in LDCs to financial repression policies. In contrast to New-Kynesians ascribed this policy due to presence of imperfect informations in financial market. *For further details see* Jaffee, D.M. and T. Russell, "Imperfect information uncertainty, and credit rationing", Quarterly Journal of Economics, Vol.90, No.4, (November 1976), pp.651-666. *See Again* Stiglitz, J.E. and A. Weiss, "Credit Rationing in Markets with Imperfect information", American Economic Review, Vol.71, No.3, (June 1981), pp.393-410.

financial assets. In turn it leads to faster financial deepening and yield high growth. The objectives of financial reforms are summarised as ***"A general improvement in the functioning and efficiency of the financial system as a whole and the removel of impediments to its long-term development.***[65] Cho and Khatkhate, examine financial liberalization by focussing on the contrast of five Asian countries with Southern Cone countries in Latin America. They find that Korea, Malaysia and Sri Lanka have been successful in financial liberalization, while Philippines has not done well in it. In between stands Indonesia which has shown a mixed record. In contrary to these, financial liberalization experienced in Chile, Argentina and Urugway went awry.[66] It is almost similar to Isreal case which as a result of resenting to all required steps of stabilization, financial liberalization caused macroeconomic disturbances on large scale.[67] While in case of India recommendations of Chakravarty report have been in the main stream and are consistent with reforms.[68]

McKinnon[69] is convinced that self-finance for investment and indivisibilities in investment in less developing countries are due to almost non-existence of financial markets, where money is the only financial asset available to the individuals. This means that in LDCs demand for cash balances or accumulation of money is related to

65. Warren L. Coats, Jr. "Lessons of Financial Liberalization for India, Another View", Economic and Political Weekly, (May 5-12, 1992); pp.1043-46.
66. Yoon, Je Cho and Deena R. Khatkhate, "Lessons of Financial Liberalization in Asia : A Comparative Study", World Bank Discussion Papers, No.50, Washington D.C. : The World Bank (1989).
67. Oren Sussman; "Financial Liberalization : The Israeli Experience", Oxford Economic Papers, Vol. 44, No.3, (July 1992), pp.403-25.
68. Warren L. Coats Jr., (1990), Op. Cit., p.1046.
69. Ronald I. McKinnon, "Money and Capital in Economic Development", Washington: The Brooking Institutions, (1973), pp.57-66.

income, rate of interest and return. That is, when average rate of return increases, demand for capital will rise and when rate of interest increases it leads to hold more cash balances and more self-finance for investment. In turn the increased desirability of holding cash balances reduces the opportunity cost of savings. Again when aggregate demand for money is higher, larger will be the proportion of investment to total expenditure. McKinnon indicates here the indivisibilities of investment. This leads to McKinnon complementary hypothesis. ***"The increased desirability of holding cash balances reduces the opportunity cost of saving internally for the eventual purchase of capital goods from out side the firm house hold".***[70] Cash balances serves as a conduit of capital formation. In such economies, accumulation of physical capital follows accumulation of cash balances.[71]

Edward Shaw[72] lays more emphasis to the role of financial conditions in vanishing financial repression by signifying efficient role of banks in investment and growth process. He stresses that financial liberalization improves financial intermediation and contributes to higher growth. Briefly, he is more concerned about the distinguished role of financial intermediation in economic growth. According to Fry, ***"Shaw maintains that expanded financial intermediation between savers and investors resulting from financial liberalization, i.e. higher real institutional interest rates, increases incentives to save and invest and raises the average efficiency of investment. Financial intermediaries raise real returns to savers and, at the same time, lower real costs to investors by***

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70. Ibid., p.60.
71. Gupta, K.L., "Finance and Economic Growth in Developing Countries" Croom Helm, (1986), p.12.
72. Shaw, E.S., "Financial Deepening in Economic Development", NwYork : Oxford University Press, (1973).

accommodating liquidity preference, reducing risk through diversification, reaping economies of scale in lending, increasing operational efficiency and lowering information costs to both savers and investors through specialization and division of labour." [73]

From the literature surveyed above, we deduce that McKinnon-Shaw approach positively contributes to financial aspect in ending up financial repression which most of lagging economies of less developing countries are facing. Therefore, remedising financial repression through financial liberalization would further lead to higher growth of the economy.

Although many economists follow and advocate financial liberalization school, McKinnon-Shaw approach has been criticised on the basis of following grounds as surveyed by Hermes.[74]

(1) Since there is strong relationship between financial growth and economic development, McKinnon-Shaw approach does not explain how higher rate of interest leads to institutionalization of saving investment process.

(2) Cultural and Political* factors are relevant to financial development in developing economies. McKinnon-Shaw thesis does not consider these aspects.

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73. Fry, M. (1978), Op.cit., p.471.
74. Niels Hermes, (1994), Op. cit., p.9.

* *for further details see,* Wai, U.T., "Financial Intermediation and National Savings", New york : Praeger Publishers, (1972).

In fact economists lay much stress in their literature, on criticising the neglected role of unorganized** money markets, and stabilization policies.

(3) McKinnon-Shaw approach gives less importance to informal credit market. In fact, this market has grown in developing economies where direct contact between surplus and deficit units is possible without regulated rate of interest. The proponents of this thought are known as "New Structuralists"*** economists. Their emphasis that informal credit market is a source of residual finance in working capital. Since informal markets are not subject to reserve requirement they are efficient enough to provide more financial intermediation in developing economies. In such cases, due to higher rate of interest, resources will shift from informal to formal financial market which would lead to less intermediation. That is to say, such a market will substitute more to time deposit rather than having currency substitution to demand deposits.[75] In fact the importance of credit market arises from the volume of loans disbursed by it. Which is highly significant and perhaps several times higher than loans transacted in official market.[76] It constitutes about half of rural credit and a

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** As mentioned by Balassa, 1990-91, *See for further details* the principal critics of McKinnon - Shaw approach. Taylor, Lancer; "Structuralist Macroeconomics : Applicable Models for the Third World", New York : Basic Brooks, (1983). *See Again* Wijnberger, Sweden Van; "Interest Rate Management in LDCs" Journal of Monetary Economics, Vol. 12, No.3, (1983), pp.433-52.

*** In contrast to this the structuralists hypothesis emphasis on the degree of banks contribution in growth is related to the economy backwardness. *See for further details* Gerschenkron, A., "Economic Backwardness in Historical Perspective : A Book of Essays", Cambridge Mass : Harvard University Press, (1962), pp.12-45.

75. Wijnbergen S. Van., "Interest Rate Management in LDCs", Journal of Monetary Economics, Vol.12, No.3, (1983), pp.433-52.

significant part of urban loans. which may equal or even exceed loans quantum of formal sector. Such is the case of Asian developing countries.[77] In Jordan, it is found that 7.2% of borrowers are dealing with unorganized money market. They are borrowing almost from merchants and money lenders in rural areas. Though this ratio is small in Jordan but most of it does not carry a rate of interest.[78] This truth is also consistent with rural market in India.[79]

(4) The policy of stabilization is not given full attention by McKinnon-Shaw approach. Experience of many developing countries[80] shows that a positive financial liberalization is limited due to absence of stabilization policy. To achieve successful liberalization, there must be a considerable degree of macroeconomic stability for which lowering inflation and reducing government deficit are pre-conditions. In Latin American countries, liberalization was undertaken amidist high inflation rate, generally 100 percent or more per annum, resulted to increase the government deficit due to rise in internal borrowing.[81] Therefore, long term investment will be very risky and consequently, real return on financial assets will decrease. Again profitability of

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76. Edward F. Buffie; "Financial Repression, The New Structuralists and Stabilization Policy in Semi Industrialized Economies" Journal of Development Economics, Vol. 14, No.3, (1984), pp.305-22.
77. Ghate, P.B., "Informal Credit Markets in Asian Developing Countries", Asian Development Review, Vol. 6, No.1, (1988), pp.64-88.
78. Khatib, F.M., (1987), Op.Cit., p.62-63.
79. Ghatak, S.B., "Rural Money Market in India", New Delhi : MacMillan of India, (1976).
80. Corbo, V., J. de Melo and Tybout J., "What Went Wrong With the Recent Reforms in Southern Cone", Economic Development and Cultural Change, Vol.34, No.3, (April 1986), pp.607-40.

financial institutions will go weaker. In brief, reformation in one sector without considering another in the economy will be less productive due to absence of macroeconomic stability. Many recent studies* investigate this aspect. This makes McKinnon[82] and others to consider that stabilization should proceed financial liberalization.

2.4 Recent Development on Literature :

In the preceding review, we have noticed that the kernel work of Gurley and Shaw have been expanded by later economists. Recent development in literature on the relationship between financial structure and economic development have incorporated many ideas of the earlier writings to overcome market imperfection. Inspite of this, none of these new studies is capable of answering the unsolved issue of causality between financial growth and economic development. Recent works concentrate chiefly on the role of financial institutions in furnishing informations as it results to better performance and high yield. In addition to this, recent literature tries to explain the relationship of financial institution in real economic activities in context of a formal model. These issues are briefly surveyed below.

81. *For further details see* : Corbo, Vittorio and Jaime de Melo, "Over view and summary" World Development, Special Issue on "Liberalization with stabilization in the Southern Cone of Latin America", Vol. 13, No.8, (1985), pp.863-66. *Again see* Diaz - Alejandro, "Good-bye Financial Repression, Hello Financial Crash", Journal of Development Economics, Vol.19, No.1-2, (Sept.-Oct. 1985), p.1-24 *and look into* Yoon-Je Cho, and Deena Khatkhate; "Lessons of Financial Liberalization in Asia : A Comparative Study" World Bank Discussion Papers, No.50, (1989).

* *See among them* Diaz-Alejandre (1985), Corbo de Melo and Tybout (1986).

82. McKinnon, R.I., "Financial Liberalization in Retrospect : Interest Rate Policies in LDCs "in Gustav, Ranis and T., Paul Schultz edition, "The State of Development Economics : Progress and perspective", Blackwell, Oxford : (1988), pp.386-410.

On the role played by banks in furnishing information in the market, many economists have taken their own stand. Diamond[83] feels that diversification of banks portfolio and monitoring information about borrowers in the market is very important for banks. It is an incentive to financial institutions to allow better contract and have Pareto-Superior allocation of credit in the market. Such information is not easily accessible to clients and is accompanied by high cost. By acting as delegated monitor of borrowers and through diversifying its portfolio heavily, banks would grant depositors assets against risk. That is how, financial intermediaries improve in allocation of credit in competitive exchange market.[84] This is somehow consistent with an earlier study which shows that "banks deposits contract" can provide allocation superior through risk sharing to those of exchange market.[85] Another study sees that as banks go on gathering information about borrowers, the lending by banks to clients will go up.[86] This is so due to the role played by banks credit as a perfect substitute to other securities, like certificate of deposits, bankers acceptance of commercial papers and treasury bills which do not provide an apparent transaction or liquidity services although having almost the same rate of interest for similar maturity.[87] Whereas the model given by Greenwood and Jovanovic[88] emphasize that banks can have multiple output by attracting financial

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83. Diamond Douglas, "Financial Intermediation and Delegated Monitoring" Review of Economic Studies, Vol.51, (July 1984), pp.393-414.
84. Ibid., p.410.
85. Diamond, D. and P. Dybvig, "Bank Runs, Deposit Insurance, and Liquidity" Journal of Political Economy, Vol.91, No.3, (January 1983), pp.410-19.
86. Fama, E., "Whats Different About Banks ?", Journal of Monetary Economics, Vol.15, No.1, (January 1985), pp.29-40.
87. Ibid., p.38.
88. Greenwood, J. and Jovanovic, "Financial Development, Growth, and the Distributioln of Income", Journal of Political Economy, Vol. 98, No.5, (1990), pp.1076-1107.

resources and allocate it into projects with high yield. This is again due to the prominent role played by banks in accessing information, as it would attract the savers and promote economic development.

On the other hand, as a part of recent literature on the relationship between financial structure and economic development, some economists incorporate financial development in a formal growth model by hypothesising the leading works of earlier economists. Their hypothesis begin with the statement that advance financial structure will fetch higher growth through saving investment process. The Diamond Dybvig[89] model incorporates financial development as a factor of economic growth. It emphasises the importance of banks in the provision of liquidity and questions how banks "subject to run" can attract deposits. As a results of panics, public resort to withdrawal of their deposits and banks tend to recall its loans. This, in turn, leads to termination of productive investment and damages economy. They suggest some regulations such as deposit insurance and monitoring solvency would circumvent financial panics and prevent costly liquidity crisis by eliminating depositors incentives to panics.* The need to protect financial institutions exposed to liquidity crisis or risk becomes more eliminating aspect[90] as recent works investigagte the issue. More

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89. Diamond, Douglas W., and Phillip Bybvig "Bank Runs, Deposits Insurance and Liquidity" Journal of Political Economy, Vol. 91, No. 3, (June 1983), pp. 410-19.

* *For further details, following studies touched this issue*, Bryant, J., "A model of Reserves, Bank Runs and Deposits Insurance", Journal of Banking and Finance, 4(1980) pp.335-44. *Again see* Smith, B., "Limited Information, Credit Rationing, and Government Lending Policy" American Economic Review, Vol. 73, (June 1983), pp.305-18.

90. Friedman, Milton and Anna J. Schwartz, "Has Government Any Role in Money?" Journal of Monetary Economics, Vol.17, (January 1986), pp.37-62.

risk becomes more eliminating aspect[90] as recent works investigagte the issue. More recent study[91] empirically stresses that introducing intermediaries in the market will shift up the blocked capital of public's savings to investment projects so that misallocation of invested capital due to liquidity needs in such projects may be averted. In turn capital would bocked up for longer time to produce high yields. On the same line, Levine[92] elaborates the important role played by stock markets in financing investment. Whereas other studies** point out the role played by stock markets in stimulating economic growth as they share risk with entrepreneurs. While other studies[93] go little back to financial repression issue. Through endagenous growth model, these studies shown that government follows financial repression to access resources for financing budget deficit. This study reveals that in Latin American countries financial repression indeed delivers easy inflationary revenue as it induces private agents to carry larger stock of nominal money. In brief these economists reach the old conclusion that financial repression impedes economic growth. Whereas another study[94] discusses the role of financial structure in economic growth

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90. Friedman, Milton and Anna J. Schwartz, "Has Government Any Role in Money?" Journal of Monetary Economics, Vol.17, (January 1986), pp.37-62.
91. Becivenga, V.R. and R.D. Smith, "Financial Intermediation and Endogenous Growth" Review of Economic Studies, Vol.58, (1991), pp.195-209.
92. Levine, R., "Financial Structure and Economic Development" Policy Research Working papers, No.849, Washington D.C. : The World Bank, (1992).

** *See for example* Saint - Paul, G., "Technological Choice, Financial Markets and Economic Development", European Economic Review, Vol. 36, No.4, (1992), pp.763-81.

93. Roubini, N. and X. Sala-i-Martin, "Financial Regression and Economic Growth" Journal of Development Economics, Vol.39, No.1, (1992), pp.5-30.
94. Ghani, E., "How Financial Markets Affect Long Run Growth : A Cross-Country Study" Policy Research Working Papers, No. 843, The World Bank, (1992).

in long run. This study like the earlier one ends up with a definite conclusion that countries having advance financial structure would contribute to better allocation of financial resources and bring higher growth in their economies. Such a conclusion is supported by similar results of other works[95] which investigate data for 100 developed and developing countries.

Thus it seems that, though there exist a strong relationship between financial development and economic growth, the review of literature shows that the direction of causation between financial development and economic growth is inconclusive.

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95. King, R.G. and R. Levine, "Financial Indicators and Growth in a Cross- Section of Countries", Policy Research Working Papers, No. 819, The World Bank, (1992).