Chapter ONE

INTRODUCTION

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Financial aspects of economic development has remained a neglected field in the developed as well as developing countries. In the post war period it caught the attention of empirical investigators & growth economists. They have stressed the crucial role of financial assets, institutions, market & policy instruments. This introduction is an attempt to discuss these aspects.

At a rudimentary financial system where the savers are the users of their own funds, capital formation takes place without generating any financial assets other than money. This has been focussed by many economists who investigated the importance of such relationship between financial development and economic development. Gurley and Shaw (1955, 1960, 1967), Goldsmith Raymond (1969) Patrick (1966) McKinnon (1973), Shaw (1973) and many other eminent economists indulged in this aspect of economic development. Immense financial resources are always required to bring about changes for advancing the economy and promoting growth. The financial growth in all aspects would be necessarily accompanied by economic growth. In course of economic development, process of saving investment takes place by creating either financial liabilities, bonds, equity capital or indirect financial claims through financial institutions which channel the funds of savers to deficit investors. In course of economic development the country's superstructure grows more rapidly than the infrastructure of national product and national wealth.[1] This would

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1. Raymond Goldsmith, "Financial Structure and Economic Development", New Haven, London; Yale University Press, (1969), p.44.

lead to a rapid increase in financial assets. In U.S.A., the level of accumulation of financial assets was about one half of the national wealth in the early 1880s. But later on in the twentieth century, it has grown much faster than the gross national product. In Japan, financial assets rose from 10 percent in 1885 to over 150 percent by 1967. Similar is the case of many other advanced countries. But the case is different for developing economies where a low per capita income is associated with low ratio of financial assets to national wealth.[2]

Economic Growth Models :

Economic development has been generally viewed in terms of wealth, labour force, output and income. In literature of economic growth, as compared to the neglected role of financial aspects[3], this real aspects of development have been a centre of attention. The Marxist ideas about production function were the same as those of the classical school, where growth has been regarded as a function of real productive resources. Hence, capital accumulation given, the labour and capital stock of other resources have been stressed by all classical economists in their models. Schumpeter has emphasized more on the role of technology and entrepreneurs in development. The entrepreneur in Schumpeterian sense is neither a financier nor a technician. He is an innovator who carries out discontinuous technological changes resulting in development.[4] Harrod and Domar

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2. Gurley J.G. and Edward S. Shaw, "Financial Structure and Economic Development", Economic Development and Cultural Change, Vol.15, No.3, (April 1967), p.158.
3. Gurley and Shaw, "Financial Aspects and Economic Development", American Economic Review. Vol.XLV, No.4, (September 1955), p.515-38.
4 Misra and Puri, "Development and Planning : Theory and Practice ", Delhi, Bombay : Himalaya Publishing House, (1991), Page 125.

consider the supply and demand side of investment process. They emphasize on dual character of investment, as it creates income "demand effect" and also generates productive capacity of the economy by increasing its capital stock "supply effect".[5]

Among the New-Classical Economists is Solaw who considers only two factors of production capital and labour. While Meade considers that the output depends on existing stock of capital (machines), amount of labour, amount of land with its natural resources and time.[6] In their models, they have treated technical progress as being completely exogenous. Kaldor in his growth model postulates three functions saving function, investment demand function and technical progress function. Kaldor's growth model is more realistic than the earlier new classical model because it is equally applicable to developed as well as to under developed economies.[7]

These growth models were primarily developed in the context of well advanced economies of western countries with much emphasis and stress on real factors. But it has been strongly felt now that these models are unsuitable for LDCs having real resources constraints and inflexible economic structure. An attempts has been made to incorporate money and finance into growth models, but without much of success. In Keynisian theory, role of money is more elaborated. It has become more than a medium of exchange and much more than a

5. Jhingan M.L. "The Economics of Development and Planning", Konark Publishers Pvt. Ltd., New Delhi, (1992), p.217.
6. Meade J.E. "A Neo-Classical Theory of Economics Growth". UNWIN University Books, London, (1962), p.8-18.
7. Daniel Hamberg, "Model of Economic Growth", Harper and Row Publishers, N.Y., Evanston, London, (1971), p.106-113.

device for mediating transactions in the market. The speculative motive of demand for money was the most important contribution made by Keynes to the theory of demand for money as a function of income and rate of interest. He assumes that perpetual bonds are the only non-money financial assets portfolio of the public. In the classical monetary theory there was demand for real capital assets from businessmen. This constituted demand for savings. Therefore, in classical theory of rate of interest was regarded as real phenomenon. Keynes brought about important changes regarding the rate of interest as a monetary phenomenon which is determined by demand for money and supply of money. Demand for money would means demand for non-interest bearing assets instead of fixed interest bearing assets like bonds and government securities. Thus, with Keynes the whole area of money market with money and bonds as a close substitute came into existence.*

Genesis of The Theory :

In the post war period, i.e., by the end of 1950s, two writers John G Gurley[8] and Edward S. Shaw, broke a new era by introducing their famous classic book "Money in a Theory of Finance" which studies the relationship between financial development and economic development, financial debts, assets, institutions and policies. Their analysis shows that, features of the rudimentary financial system impede financial development and economic growth taking place hand

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* *See*, John M. Keynes, "The General Theory of Employment, Interest and Money, New York : Harcourt Brace and World Inc., (1936).

8. John G. Gurley and Edward S. Shaw, "Money in a Theory of Finance", The Brookings Institutions, Fifth Print, (1968), Washington, D.C., U.S.A.

in hand in the country. In such economy, difficulty of attaining satisfactory rate of growth in real output prevails. The immature financial structure in this economy, places severe financial restraints on the growth of output. Such financial system does not stimulate saving nor enhance investment and in turn impedes economic progress. In this economy, money is the only enticement of saving by the public and to be issued by the government which does not issue non-monetary debt or any other financial assets or allowing explicit rate of interest on money. Lower propensity to save and low growth rate of capital has resulted in this economy, as it does not provide an array of financial assets to stimulate saving which could be allocated to investment through financial intermediaries and markets.[9] In these economies barter system is a dominant one and saving mainly takes place in physical assets. In brief, the economic system lacks of fluidity and organization conducive to strengthening of growth forces.[10] Such economic policies reveal that financial repression[11] is a predominated in these countries.

All these contentions are accepted without much doubt, but with structural changes taking place in LDCs during the last few decades show how these countries could recover from these restraints. Historical experience shows also, that most of the countries accumulate financial assets more rapidly than accumulation of real

9. I bid., p.12-55.

10. Charles wolf Jr., "Institutions and Economic Development" in R. Richardson and B. Okum Edition, "Studies in Economic Development" Holf, Rinehert and Winston, N.Y., (1964), p.358.

11 McKinnon R.I., "Money and Capital in Economic Development" The Brookings Institutions, Washington, D.C.(1973), *See again* Edward S. Shaw, "Financial Deepening in Economic Development" Oxford University Press, N.Y. (1973).

12. Gurley and Shaw, (1967) Op.,Cit. P.158.

wealth.[12] The ratio of financial assets to real wealth varies from country to country. It was 10 to 15 percent in Afghanistan and Ethiopia while in more prosperous countries like Argentina, Brazil, Guatemala, Mexico, Republic of Korea, Venezuela and Yugoslavia, it ranged between 30 and 60 percent. While the ratio was still higher in developed countries like Japan, Switzerland and U.S.A. It ranged between 80 and 100 percent. Trescott[13] investigated the case of Thailand's economy which shows a rapid increase in financial assets from 3 billion baht* in 1946 to 33 billion baht in 1967.

The above discussion makes it clear that financial aspects and economic development remain an undiscovered territory and growth models have failed to integrate finance variables. It also reveals that many LDCs with their rudimentary financial system are not efficient enough to generate adequate stock of financial instruments, promote innovations and accumulate savings much needed to finance investments. Brief survey of developing countries and their experience in the field of financial development shows that these economies have began to affect changes in the financial structure in order to promote economic development. Varieties of new financial instruments have been added and their institutions have been assigned more power to stimulate growth of financial markets.

Present Study:

The present study about the demand for financial assets and economic development in Jordan is undertaken precisely because to the best of

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13. Paul B. Trescott, "Demand for Money and Other Liquid Assets in Thailand 1946-1967" , <u>Economic Development and Cultural Change</u>, Vol.20, No.2, (January 1972), p.260-79.

* Baht is the monetary unit in Thailand.

our knowledge no systemetic and comprehensive study exists except some scattered works in the form of articles and research papers. Not enough empirical evidences exist to review growth prospects of Jordan economy. This study therefore would be a step ahead in the direction of generating empirical evidences so as to view the Jordanian economy in better perspectives.

In the light of the above, the present study intends to investigate the case of Jordan's financial sector, financial claims issued and held by economic units, variables influencing these claims in the context of economic development. We shall use secondary data available to us from standard sources such Central Bank of Jordan and other agencies and also international financial statistics of the I.M.F. A well known technique namely Regression and Correlation Analysis has been used to analyse and identify influence of economic variables besides testing the reliability and stability of the functions. The study covers the span of time from 1970 to 1992. This is a period of recent past during which Jordan experienced a phase of mild inflation and phase of rapid inflation. Again during this period, Jordan economy experienced uneven economic development viz., although some financial institutions collapsed in Jordan the banking sector experienced high growth. It was a period characterized by structural changes in Jordan's economy.

In views of the above scenario the present study aims at examining :

(a) Financial structure of Jordan's economy.

(b) Supply of financial instruments, its mechanisms and factors influencing the supply side.

(c) Fiscal operations in Jordan and its impact on growth of claims on government.

(d) Demand for major financial assets, their determinants.

(e) Financial policies, past and present experiences.

Hypotheses :

(1) Financial development is positively related to the growth of Jordan's economy.

(2) Supply of highly liquid financial assets in Jordan is positively and strongly influenced by government borrowings from the monetary authority, growth of foreign assets & central bank credit to banks & private sectors.

(3) Supply of government financial claims is positively related to government deficit & fiscal operation & debt management.

(4) Demand function of financial assets is expected to be stable and to provide sound basis for further analysis in the context of economic development in Jordan.

(5) On the basis of estimated coefficients of explanatory variables entering in demand and supply functions,an attempt is made to derive policy implications.

In the next chapter, literature review has been presented and the major works that have been carried out in the field of financial development are summarized.

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