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Role of Financial Markets on the Financial Development and the National Exchequer: A Review of Literature

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Abstract
The present work is an attempt to examine the financial markets upon the financial development and growth of a country. On one hand, well-functioning financial markets, by lowering costs of conducting transactions, may help direct transmittals to projects that yield the highest returns and therefore enhance growth rates. On the other hand, transmittals can compensate for a bad financial system, by loosening liquidity constraints, potential entrepreneurs could use remittances whenever the financial system does not help them start productive activities due to lack of collateral or because of high lending costs. Entrepreneurs in developing countries confront much less efficient credit markets and available evidence indicates that access to credit is among their biggest concerns. Additionally, the alternatives for financial development can be classified into two broad categories, those relating to the banking sector and those relating to the stock market.

1. INTRODUCTION

The main financial markets are credit (loans) market, the bond market and the stock market. “The main participants in the market are households, non-financial firms, banks, the government and the overseas sector”. The financial markets can be modeled in terms of the supply and demand for funds or supply and demand of bonds or stocks. Lucas (1988), Romer (1989) and Pagano (1993) model of endogenous growth economy shows the effects of financial markets on financial development and Economic growth. “According to it, endogenous growth is partly derived from economic agents in the market for credit (loans), bonds and stock (shares)”.The firm (company) and the government sectors are net demanders of funds and net suppliers of bonds and stocks. “On the other hand, households and overseas sector are net supplier of loanable funds and demanders of bonds or stocks” (Francois, 1999).

The financial markets may induce endogenous economic growth through three mechanisms. The financial markets can raise the proportion of savings channeled to investment. “They may increase the social marginal productivity of Capital, and they may influence the private saving rate”. The first mechanism is particularly important in the process of economic growth and financial development as savings are transformed into investment in such a way that a dollar saved by households generates less than a dollar of investment (Thomas, 2000). “The second mechanism predicts that the financial markets increase the productivity of investment by playing informational role and thus make it possible for economic agents to evaluate alternative investment projects”. In the third mechanism, it is hypothesized that the financial markets can also effect growth by altering the saving rate. “Thus, as the financial markets rise or fall, hence growth can expand or contract which impacts financial development respectively” (Harris & Martin, 2000).

2. FISCAL POLICY IMPACT ON FINANCIAL DEVELOPMENT

The potential impact of fiscal policy on financial development is a neglected issue. Mostly, it has been associated with a positive role of government debt in developing financial sectors. “On the negative side, it is well-known that financial repression and inflation, which are detrimental to financial development and growth, tend to be rooted in governments’ fiscal needs”. Thus, continuously large public sector borrowing from the domestic banking sector can have substantial adverse implications for financial development. “Many developing country governments have reduced their external indebtedness over recent years and increasingly rely on domestic financing which is often seen as preferable over riskier external debt” (Colin, 2000). Recently, it has been found that public sector has a large share of available credit and external debt has been replaced with domestic borrowings. “This large public borrowing could harm financial development through its impact on the structural characteristics of the banking sector”.

Specifically, banks mostly lending to the public sector can be expected to be relatively profitable but inefficient, as banks tend to earn easy profits, engage in little client competition, have special incentives to plan and are often government-owned (Paul & Vassili, 2001). “In long run, these side effects of public sector borrowing could harm financial deepening and thus at least partly offset a positive impact of public sector borrowing on

banking system liquidity". Thus, more lending to the public sector tends to raise the profitability but reduce the efficiency of banks. These negative implications on the depth and quality of financial development add to the costs of fiscal prolificacy in developing countries. "They must be given appropriate consideration when weighing the costs and benefits of fiscal deficit and should also dampen excessive enthusiasm about a shift from external to domestic borrowing" (Nourzad, 2002).

3. POLITICAL INSTITUTION AND FINANCIAL DEVELOPMENT

The political institution view suggests that legal origin has little effect on financial development. Rather, financial development is an outcome of specific law and regulation which are the product of politics ant political institution. "As its core, the political institution view is concerned with the government's inherent conflict of interest: the growth of bank and securities market is not possible without a government that can enforce financial contracts; but the government relies on those same banks and markets to provide it with a source of finance" (Gillman & Harris, 2004).

Unless there are self-enforcing political institutions that limit the government's authority and discretion, it will have strong incentives to govern the financial system so as to facilitate its own political survival, at the expense of the development of the securities markets and banking system that can finance the private economy. "The implication is that the government can decisively influence the development of private banks and securities markets". For example, the government can force the banks to lend it their deposit base by establishing reserve requirement (and then increase reserve requirement) grant corporate charters only to political favored constituents; "refuse to enforce financial contracts when the debtors are from political crucial group; or expropriate the holder of government securities by defaulting on the public debt" (Paola Giuliano & Marta, 2005).

4. FINANCIAL DEVELOPMENT AND POVERTY ALLEVIATION

In the last decade poverty issues in developing and transition countries have received growing attention. "Policy makers of various ideological backgrounds have become increasingly anxious with the failure to significantly reduce the incidence of poverty in their countries". At the same time, the international financial institution have also started to provide more support to efforts aimed at alleviation the poverty of the large number of large number of poor that typify many developing countries. Until recently, few economists explored in any depth the relationship between financial markets and poverty. "The debate essentially ignored poverty issues, rather focusing on the broader association between financial development and economic growth". However economic growth may not be a sufficient condition for poverty alleviation (Arshad, Qayyum & Sheikh, 2005).

5. DISCUSSIONS

In theory at least, if income inequalities increases, it is possible for a country to enjoy positive growth without any benefit to its poorest household, the rich get richer while the income of the poor stagnant or decline. Therefore the relationship between economic growth and income distribution is critical. "More recently, a growing number of studies on the effects of the economic growth on income distribution have challenged, on both theoretical and empirical grounds, the traditional view that the poor fail to gain either relatively or in absolute term" (Stefan & Felix, 2006)..

A series of paper studied the performance of Gini coefficients (one of the most popular representation of income in equality. "It is based on the Lorenz curve, which plots the share of population against the share of income received) over time and across countries and conclude that these coefficients are relatively stable over time within countries but different across countries". For example, David (2006) found that such result using the data set on Gini coefficient covering 112 developed and developing countries for the year 1947-94. "This suggests that inequality is greater determined by factor that change only slowly within countries but are quite different across countries". In addition to in direct macroeconomic links between financial development and poverty reduce, intermediated through economic growth, there are more direct microeconomic links. These links result from the availability of accessible financial instrument, services and institutions for poor household (Badi, Panicos & Siong, 2007).

Until the late 1980, the literature on these microeconomic links had been virtually nonexistent. "In many developing and socialist, the predominant view was founded on the belief that state owned banks, including special development banks, and subsidized lending could massively reduce poverty" (Enrique, Mendoza, Quadrini & Jos, 2008). This view was based on the perception that the private sector was not able or willing to supply to necessary financial services to key economic sector nor did it have any interest in lending to the poor. "However, the state owned financial institution hindered more general financial market development, often

served only to destroy saving, and fail to provide sustainable financial services to the poor" (Stephen, Douglas, North & Barry, 2008). "Many development initiatives which assisted these institutions reached only a small proportion of the poor population and have often favored politically connected large borrowers as a way to promote political advantages and reduce administrative cost" (Cristina, Bai & Zhang, 2009)..

6. CONCLUSION

The related literature regarding the financial markets exposed the variables considered as determinants of financial development are economic growth which comprises income level, population level, religious, language, ethnic characteristics and so on. The literature revealed that as the economy grows, the costs of financial intermediation decrease due to intensive competition, inducing a larger scale of funds available for productive investment. The literature also addresses the importance of income levels for financial development. "In considering the banking sector development in transition economies, it demonstrates that the level of GDP per capita and the saving rate have positive effects on the banking system structure as measured by bank assets, number, branches and employees for transition economies". The related literature also stresses the impact of differences in culture, provide by differences in religion and language, on the process of financial development. "They provide evidence that culture predicts cross-country variation in protection and enforcement of investor rights, especially for creditor rights". The evidence also shows that the influence of culture on creditor rights protection is mitigated by the introduction of trade openness. While it is highly plausible indeed almost tautological that political economy factors have a key influence in shaping policies and institutions that affect the development of financial markets.

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