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The Financial Development through the Regional Markets: A Review

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Abstract
The economic globalization has had a particular profound impact upon financial development during the last four decades giving rise to a group of closely intertwined international markets on which banks, corporations, or government agencies trade an increasing amount of assets such as bonds, shares, or currencies. The transaction cost of accessing external funds has shrunk considerably, which facilitates investment and market entry, entails competitive pressures to innovate, mobilizes savings to accumulate capital, and eventually induces further economic growth. Still, in terms of financial development, considerable heterogeneity continues to exist around the world. The importance of understanding the factors behind the time series variation in financial development, alongside those that shape the cross-country variation, cannot be over emphasized. In a world of capital immobility, investments are bound to be solely financed by domestic savings. However, varying degrees of financial development and exchange rate flexibility between countries can both potentially act as frictions to international financial integration.

1. INTRODUCTION

Financial Development varies from country to country depending upon their infrastructure, stock market, GDP, money and Capital markets, saving to expenditure ratio, advances to deposits ratio, balance of trade, balance of Payment and their values, culture and traditions. Following is the comparison of financial Development of different countries.

1.1 Financial development in UK and France

The United Kingdom and France have similar levels of GDP per capita, democratic institutions, and geographic characteristics in terms of latitude, access to the sea and distance from large markets. “Nevertheless they follow different legal traditions, reflected in different legal practices towards the protection of private property rights. In the 1990s the ratio of private credit to GDP in the UK (112%) was much higher than the same ratio in France (89%)”. Stock market capitalization to GDP ratio in the UK was more than three times higher than that in France. “The difference in financial depth between the UK and France is also due to the difference in their legal traditions and practices” (Colin, 2000).

1.2 Financial development in Latin America

The financial development experience in Latin American countries provides an enlightening example of the possible role of macroeconomic policies in financial development given the similarities of geographic conditions, Institutional development and cultural characteristics. After implementing market-oriented policies in the 1970s and establishing prudential regulations in the 1980s. “Chile achieved a remarkable growth in financial intermediary development and stock market capitalization, and has been regarded as the financial leader in Latin America since the mid-1980s”. In the 1990s both the ratio of liquid liabilities to GDP and the ratio of private credit to GDP in Chile were fifty percentage points higher than those of Brazil, the second best country in the region (Paul & Vassili, 2001). “Stock market capitalization as a fraction of GDP in Chile in the 1990s was 78%, at least three times larger than that in any other Latin American country”.

1.3 Financial development in Canada and Mexico

In the 1990s the ratio of credit issued to the private sector to GDP in Canada was 94%, more than four times higher than that in Mexico of 23%. Stock market capitalization as a fraction of GDP in Canada in 1990s was 65%, more than two times higher than in Mexico (31%). “Canada and Mexico share a number of similarities in terms of geographic endowments and institutional development” (Nourzad, 2002). More specially both of them have access to the sea, have a long border with the biggest developed country, have a large land area and a democratic political system, etc. However, among others Canada and Mexico apparently differ in income level and latitude, which is associated with tropical cash crops in Mexico and grain in Canada.

1.4 Financial development in Pakistan

Financial Development of Pakistan examined over period from 1971-2004 showed the empirical relationship between financial development and economic growth. “In the long run, financial depth and real interest exerted positive impact on economic growth”. The share of investment is although positively correlated to real income, but remained insignificant. Furthermore, in the short run economic growth is positively and significantly affected by changes in the share of investment. “Moreover, changes in real interest rate exerted positive (negative) impact on growth. However, the response of real interest rate is very small in the short run” (Dritsakis & Antonios, 2004). The feedback coefficient is negative and significant, suggesting about 0.06 percent disequilibrium in the previous period is corrected in the current year. We find a stable long run relationship between economic growth and financial depth. “Financial Development in Pakistan has taken place somewhat sporadically”. It has risen during 1957-1967 but fell during 1970’s. It rose during 1985-1987 but fell again in 1991. In 1993, it was even below the level of 1967. “There has been particularly marked increase in 2001-02 and 2002-03 due to massive build of foreign assets” (Arshad, Qayyum & Sheikh, 2005).

2. DISCUSSIONS

Patricia (2007) suggested that the endogenous growth theory shows a close association between financial sector development and long-run growth. This association has been well documented since the pioneering statistical work. “The external debt crisis clearly showed the importance of relying on well-functioning financial system to be able to mobilize internal resources in order to finance economic development”. The major contribution of a financial system to growth comes from the setting up of an efficient and adaptable system of payments. “The existence of financial markets and banking intermediaries can lead to a better mobilization of available savings by making the agglomeration of existing financial resources in the economy easier”. Thus, financial intermediaries provide relatively higher yield contributing to rise in capital productivity and speeding up the growth (Indrani, 2008).

Enrique, Mendoza, Vincenzo and Rull (2008) suggested that the services provided by financial intermediaries are essential for economic development. “More recent theoretical reasoning and empirical evidence suggest a positive and significant relationship between financial development and economic growth”. Empirical analyses, including firm-level studies, industry-level studies, individual country studies and broad cross-country comparison, demonstrate a strong positive link between the functioning of the financial system and long-run economic growth. The financial development consist three portions. “First is the relationship between the financial development and the economic development since 30 years ago, secondly the relationship between the financial development and socio-economic variables reflecting different level of development and also towards the human capital, thirdly the focus on the measurement through correlation regression which controls all other factors which are associated with financial development” (The Financial Development Report, 2008).

Financial development system performs several critical functions to enhance the efficiency of intermediation by reducing information transaction and monitoring cost. “A modern financial system promotes investment by identifying and finding good business opportunities mobilizes saving, monitor the performance of managers enable the trading, hedging and diversification of risk and facilitates the exchange of goods and services”. Cristina, Yan & Zhang (2009) suggested that the cross country difference in financial sector development explain an economically meaningful proportion of the cross country difference in long run economic growth rate. A growing body of theoretical and empirical work suggests that bank and stock markets are inextricable part of the growing process. “It shows that the banking system exerts an economically large impact on long run growth after controlling for indigeneity, country specific efforts and a wide array of other growth determinants”.

Most of the contributions stress that financial development enhances lending and equity financing to forms there by improving upon efficiency in the allocation of savings. “Accordingly financial development stimulates long run growth whenever conditions for endogenous growth to occur are satisfied”. This general result is subject to a serious qualification to the extent that financial development has ambiguous consequences on agents’ saving behavior. Lindh (2000) suggested that the financial sector share in the most industrialized economies has more or less doubted in the last few decades. “The expansion is associated with decreasing, rather than increasing, growth rates over most of this period”. Only in the last decade do we see trend towards increased productivity growth (Alan, 2010). This is puzzling, since there is a well-documented positive correlation between financial and economic development. “Growth enhance effects of financial market seems to show up only in the long run while the short run effects is to temporary inhibit growth”. Financial development can influence growth in three distinct ways: by raising the proportion of saving actually invested; by raising marginal productivity in the economy, and by influencing there private saving rate.

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The first mechanism depends on the efficiency of financial intermediation, (i.e., the fraction of saving absorbed to pay for financial intermediation services). “The second mechanism works by improving the allocation of capital through information pooling”. The third mechanism has ambiguous effects on growth since saving may go either way. “If consumers have utility function with a positive third derivative, precautionary saving decreases” (Zahid, 2010). “When, as will be assumed in the model of this paper, the utility function is of the constant relative risk aversion type, the relative risk aversion parameter is then greater than one. Financial markets may also case liquidity constraints by providing consumption credit”. On the other hand, financial development may also increase the rate of return and therefore boost saving.

3. CONCLUSSION

Financial development plays an important role in economy and has a positive impact on economic growth of the country. The financial development consists of three portions. First is the relationship between the financial development and the economic development, secondly the relationship between the financial development and socio-economic variables reflecting different level of development and also towards the human capital, thirdly the focus on the measurement through correlation regression which controls all other factors which are associated with financial development. Financial system development is an important factor in the growth process of an economy. “But these arguments generally abstracted from the fact that financial systems differed substantially across countries, and those differences have remained largely unaltered despite the globalization of capital markets”. In short, financial integration was a global phenomenon, but financial development was not. The countries with different financial markets characteristics choose different compositions of foreign portfolios.

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