The Role Of Financial Markets In The Process Of Economic Growth

This essay is aimed at finding out the relationship between financial development and economic growth. This concern about financial deepening and economic growth finds its root in the policy implications that the relationship can bring about, as improved living standards for their citizens as well as increased economic growth rates are the goals sought by many governments. Moreover, countries with better developed financial systems tend to have a faster rate of economic growth compared to developing countries. As a result, financial deepening has emerged as a strategy to enhance economic growth more so in developing nations.

The impact of financial development on economic growth has received considerable investigation in the empirical literature but some cascade that financial development brings positive growth as per King, R. (1996). Empirical studies suggest that financial deepening has different effects on economic growth depending on the financial deepening indicator used, the period of the study and the data sets that vary from panel data across countries, sub-regions to individual countries. For example, In Kenya, a study was conducted by Odhiambo (2008) using time series of the period 1968–2002 and adopting a dynamic causality model investigated the causality between financial development and economic growth in Kenya. The results suggested that causality between financial development and economic growth depends on the proxy used for financial development in Kenya and that causality on the balance runs from economic growth to financial development.

Financial markets assist to link between savings and investment at intervals the economy in ways that facilitate the acquisition of capital and conjointly the assembly of product and services. The combination of instruments of economic markets, institutions, and products suits the needs of borrowers and lenders and therefore the whole economy. It is written that some economists believe that an optimal financial system, together with a well-developed system, ought to incorporate components of each direct, market and indirect, bank-based finance. This way it enables to bring the existence of a well-developed financial system which improve the efficiency of financing decisions, favoring a better allocation of resources and thereby economic growth

When you look at stock markets and financial-based related to banks they have a comparative advantage for example industries that have advanced technology, financing through market stock is optimal for such industries thus managers can view a firm production through the stock market to confirm if it’s a sensible one. However, for other industries, it prefers bank-based finance over the stock market. Financing using financial intermediaries is an effective solution to adverse selection and moral hazard problems that exist between lenders and borrowers. Banks have developed a way to differentiate lenders and borrowers whereby they indicate that economies with a well-developed banking sector and capital markets are more advantageous.

The financial system is important in the reallocation of capital and thus provides a basis of economic restructuring thus supporting its growth. It is written that in countries with a developed financial system it is observed that a great share of investment is allocated to first growing sectors. During the Industrial Revolution one century ago it is seen that England's financial

system played a major role by identifying and funding profitable ventures than other countries in the mid-1800s. This assisted England to enjoy comparative greater economic success. According to the banker and former editor of 'The Economist,' Walter Bagehot expressed this in 1873 as follows.

'In European country, however, ... capital runs as surely and instantly where it is most wanted, and where there is most to be made of it, as water runs to find its level'.

In our current economy, it is written that lack of a well-developed stock market would pose serious challenges to the economy and also equity is key for the emergence and growth of innovative firms. The modern high-technology firms will be the main gears of future structural change essential for maintaining a country's long-term growth potential. The part that financial markets have contributed in this area is a necessity for maintaining the competitiveness of economic growth and this will be supported by increased international competition, advancement in technology and the increased role of innovation for growth performance.

As indicated Financial development is beneficial to economic growth only up to a certain level because it should be accompanied by the proposition 'more finance, more growth' as per the article was written by (Law and Singh, 2014). An experienced financial system provides a platform for economic growth because the efficient financial system provides better financial services, which enables an economy to increase its growth rate as written by Bencivenga et al. (1995), Pradhan et al.(2017). The opposite is also true as per Moshirian and Wu (2012) report that an inadequately supervised financial system may be crisis-prone, with potentially devastating effects.Following the suggestions of Demirgüç-Kunt and Levine (2009), financial development is not only pro-growth, but it is also pro-poor, suggesting that financial development helps poor citizens to catch up with the rest of the economy as it grows.

As per King and Levine's report, there is a strong positive relationship between the three measures of growth and the four measures of financial development. This report also examines the extent to which financial development at the start of the period in 1960 predicts growth in the subsequent thirty years. They conclude, “the initial level of financial development is a good predictor of subsequent rates of economic growth, physical capital accumulation and economic efficiency improvements over the next thirty years” Levine (1997, p. 707).

There have been two studies that have looked at the significance of securities markets as well as bank development on economic growth. Levine and Zervos (1998) report the influence of stock markets as measured by their size (ratio of market capitalization to GDP) and value traded (as a proportion of GDP) as well as bank credit on economic processes across over forty countries over the amount 1976 to 1993.

They find that value traded is positively and significantly related to growth even when market capitalization is included in the equation thus they concluded that the “stock market liquidity and banking development both positively and robustly correlated with contemporaneous and future rates of economic growth ... and since measures of stock market liquidity and banking development both enter the growth regressions significantly, the findings suggest that banks provide different financial services from those provided by stock markets” as highlighted by Levine and Zervos (1998, p. 554).

In conclusion, financial markets play an important role in economic growth by simply opening up

ways through which savings, investment, and market research is done. The expansion of the size of the banking sector measured by its level of monetization significantly helped the economy to grow. Therefore, developed countries have greater economic growth than developing countries because developed countries have vested more in financial markets which attract investment and savings as compared to developing countries.