# Chapter 18
# Financial Infrastructure and Economic Growth

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## ABSTRACT

*This chapter attempts to explore both a theoretical and empirical relationship between financial infrastructure and real sector of the Indian economy. It first presents an endogenous growth model where economic growth, proxied by the incremental output-capital ratio, depend on the financial infrastructure through three routes, namely, by changing the quantity of investible resources or by affecting the efficiency of utilization of a given quantity of resources or both, of which the former can either be through change in the amount of savings channeled to investment or change in the rate of savings. A time-series econometric analysis shows that the financial sector variables can explain near about 96% of the changes in real economic growth in India, which is an excellent goodness of fit. It concludes that the development of the financial infrastructure helps the Indian real sector grow both in the short-run and in the long-run. Unlike contemporary literature that prescribes diminished role, our study suggests a greater role of the govt. to ensure long-run economic growth.*

## INTRODUCTION

Until the end of 1970s governments of the developing countries have failed to recognize the need to develop the financial infrastructure and set up conditions favorable to financial development. In the past, financial sector was merely an instrument to finance the key industrial sectors referred to as the 'engines of growth' in form of directed cheap credit allocation. High reserve requirement, interest rate controls, inefficient instruments of taxation and other easy short-run revenue earning policies of the governments resulted in persistent budget deficits and severe external debt crisis.

Unlike yesterday, financial markets are now the key movers, with primary roles of (a) increase in the saving growth rate (b) efficient allocation of investment resources and (c) better utilization of existing resources. Exaggerating these roles, contemporary theories put forward the idea that financial development has a causal influence on growth, unlike the traditional theories that vehemently insists on the

passive role of financial system which merely adapts to the financing needs of the economy's real sector and fits in with the autonomous development of the sector. Therefore, during the last three decades, many developing countries undertook programmes of financial liberalization, aimed at removing various policy induced distortions that limited the development of the financial sector.

The interdependence between real sector and the financial sector of an economy has become a prominent research agenda in development economics since the publication of the seminal works of McKinnon (1973) and Shaw (1973). This gained more importance, as far as policy prescriptions are concerned, during the 1980s with the emergence of debt crisis in the Latin American countries as financial inflows made them more vulnerable to external shocks.

World Bank (1989) report stated that "*It became widely acknowledged that economic growth without well-developed domestic financial markets would be detrimental to the longer run growth prospects of developing countries.*" As a reaction, several developing countries designed and carried out economic reform programmes during the 1980s, in which financial market reforms received a prominent role.

## A BRIEF REVIEW OF LITERATURE

Prof. H T Patrick (1966) worked out a useful reference framework for the study of causal influence on growth, by distinguishing between "supply leading approach" & "demand following approach" to financial development. Demand following financial infrastructure development appears as a consequence of development of real sector. This implies a continuous widening of markers and a product differentiation, which makes necessary more efficient risk diversification, as well as better control of transaction cost. This type of financial infrastructure development therefore plays more permissive role in the growth process. On the other hand, supply leading financial development precedes demand for financial services and can have an autonomous positive incidence on growth. Its role is essentially to mobilize the resources blocked in the traditional sector, transfer them to modern sector which is capable of promoting growth, and ensure they are used of finance the most dynamic projects. The hypothesis put forward by Prof. Patrick is that supply leading financial development dominates the early stages of economic development, especially as it makes it possible to finance investments that embody technological innovations more effectively. Once the economic development process has reached maturity, demand following financial infrastructure development takes over. In addition, the wider the gap with developed countries, the more likely it is that developing country will follow the supply leading financial development model.

Professor Patrick's hypothesis is of tremendous interest as it highlights the two-way causality which may exists between financial development and growth. It is however incomplete as it does not account for the complementarily of the two phenomena in consideration. While "supply leading" financial development can in fact speed up economic growth, "demand following" financial development is not just a passive adaptation of the financial system to the development requirements of the real sector, instead real growth enables the financial system to accomplish its own autonomous evolution, since the sustained increase in real income provides the means to set up a costly and increasingly sophisticated financial intermediation.

Gerschencron (1962) stated, on studying a case for Japan, that wider the gap with developed countries, supply-leading approach will be followed. Gupta (1984) tested this hypothesis and had favorable results subjecting it to Granger Causality tests. Jung (1986) tested this hypothesis and had favorable results subjecting it to Sequential Causality tests. However, Patrick did not take into consideration the

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