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Financial development, political rights, civil liberties and economic growth: Evidence from South Asia

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A B S T R A C T

A number of existing studies have examined the theoretical link between financial development and economic growth. Kose et al. (2010), among others, have argued that financial development can affect the extent of the benefits from foreign direct investment. Other studies, such as Huang (2010) have suggested that the quality of political institutions can also affect the level of financial development. This implies that the extent of the benefits from financial development also depend on the quality of governance. However, few empirical studies have considered these issues. By making use of panel data over the period 1970 to 2009, this paper focuses on the impact of the interaction of (i) financial development and foreign direct investment and (ii) financial development and the quality of governance on economic growth in South Asia. Our empirical analysis, suggests that financial development has contributed to an increase in the benefits of FDI in South Asia. In addition, improvement in political rights and civil liberties has also enhanced the benefits of financial development in South Asia.

1. Introduction

The exiting theoretical literature suggests that financial development not only increases the supply of capital but it also improves the allocation of financial resources. In other words, financial development enhances economic growth through direct as well as indirect channels. The financial sector provides real services and its development can not only help to identify profitable business opportunities but also improve corporate governance (Levine 2005 and Roubini and Sala-i-Martin, 1992).

The role of financial development on economic growth is highlighted in the theories of financial structure. These theories include bank-based, market-based, financial service based and law and finance based theories. The bank-based theory emphasizes the positive role of commercial banks in economic development. It has been suggested that banks can finance economic development in its early stages, especially when the banks are unhampered by regulatory restrictions. Banks can also help to mobilize resources and reduce risk (Beck and Levine, 2004; Levine, 2002, 2005). The market-based theory highlights the advantages of well-functioning markets in promoting successful economic performance. According to this theory, big, liquid and well-functioning markets foster growth and profit incentives. In addition, well functioning markets also enhance corporate governance, risk management and diversification (Levine, 2005). The financial-services theory, which is based on both the bank-based and the market-based views, stresses the importance of the key financial services provided by the financial system. This theory suggests that financial services contribute to industrial expansion and economic growth (Kose et al., 2010; Merton and Bodie, 1995). The law and finance theory suggests that the legal system is critical to firm, industry and national economic success (La-Porta et al., 1998; Levine, 1999).

Financial development through the development of the stock market can also contribute to economic growth. A well developed stock market (a) allows firms to raise funds for investment and (b) improves corporate governance. Hermes and Lensink (2003) have argued that financial development can also enhance the benefits of foreign direct investment (FDI). This view is also supported by, among others, Carkovic and Levine (2005) and Kose et al. (2008).

Since the work of McKinnon (1973) and Shaw (1973), there has developed a growing consensus on the positive link between financial sector development and economic growth, which has subsequently been supported in the work of King and Levine (1993), Levine and Zervos (1998), Beck et al. (1999), Demirguc-Kunt and Maksimovic (1996), among others. The financial system of a country affects saving and investment decisions which are a major determinant of long run economic growth. At the country level, government polices and legislation can help mobilise savings. Government policies and legislation requiring greater information disclosure can help individuals and firms to make informed investment decisions. At the international level, financial globalisation can contribute to a better allocation of financial resources, not only by channelling capital to its most productive uses, but also by allocating financial resources efficiently thereby

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reducing a country's vulnerability to economic, financial and currency crises.[2] Chinn and Ito (2006) argue that countries with a higher degree of legal/institutional development are in a better position to benefit from financial liberalization. Thus, the degree to which financial development affects economic growth also depends to a great degree on the quality of governance.[3]

The objective of this paper is to investigate the relationship between financial development and economic growth in South Asia, a region that has not received much attention in the literature thus far. Specifically, we consider Bangladesh, Bhutan, India, Nepal, Pakistan, India, Sri-Lanka and the Maldives.[4] A series of economic reforms was undertaken under the auspices of the IMF and the World Bank in South Asia; Sri Lanka in the 1970s, Bangladesh and Pakistan in the 1980s, India, Nepal and Bhutan in the 1990s.[5] In the years following financial liberalisation, the growth rates of these countries have accelerated, in particular, that of India. Financial development is one of the key contributory factors to India's rapid growth. Following deregulation, the financial systems of South Asian countries have expanded with the introduction of new financial institutions, instruments and markets. South Asian economies have in recent years also taken several measures to attract FDI. The existing studies suggest that countries with a higher level of financial development derive greater benefits from FDI (see Kose, et al., 2010 and the references therein). Therefore, we also consider the impact of the interaction of FDI and financial development on economic growth.[6]

Huang (2010) has argued that political institutional improvement promotes financial development and the link between government polices and financial development has also been highlighted by Andrianova et al. (2011). Accordingly, we also consider the role of the quality of governance. Specifically, we examine the impact of the interaction of the quality of governance and financial development on economic growth in South Asia. The quality of governance in our work is measured by the Freedom House political rights and civil liberties indices. We also use the Polity IV democracy index as an alternative measure of the quality of governance. Our interest in investigating this question is motivated by the fact that several South Asian countries, notably Bangladesh, Nepal, Pakistan and Sri Lanka, have experienced political turmoil for many years following deregulation. The political conflict experienced by these countries and their growth experience could be partially attributed to the quality of governance. For this reason we consider the impact of the interaction of civil liberties and political rights and financial development on economic growth.

The rest of this paper is structured as follows. Section 2 contains a brief review of the related literature. The empirical model and data are described in Section 3. Section 4 contains a description of the empirical strategy. The empirical results are presented in Section 5 and the last section contains some concluding remarks.

[2] See Levine (2005), Federici and Carioli (2009) and Kose et al. (2010) and the references therein. Also see, Ang (2008a) for an excellent review of the related literature.

[3] The other aspects of the quality of governance include the issue of corruption which is receiving wide coverage in the media, especially in India and Pakistan. The issue of corruption in South Asia's service delivery sector has been considered by Davis (2004).

[4] Ahmad and Ansari (1998) consider the link between financial development and economic growth in India, Pakistan and Sri Lanka. Using annual data from 1973 to 1991, the authors conclude that financial development has led to economic growth in these three countries. The main problem with this study is that the sample size is small and the empirical model does not include any control variables.

[5] Financial reforms included encouraging the entry of new private and foreign banks, the removal of interest rate controls, the establishment of free trade zones to encourage foreign direct investment and the introduction of resident and non-resident foreign currency accounts,

[6] For example see Kose et al. (2010) and references therein.

2. Review of related literature

Following the work of King and Levine (1993), a number of studies have investigated the link between financial development and economic growth. Demetriades and Hussein (1996), using time series data for 16 countries find that finance is a leading contributor to economic development. Similarly, employing time series data for 71 developing countries, Odedokun (1996) shows that financial intermediation contributed to economic growth in approximately 85% of the countries in the sample. Using panel data for the period 1986–1993 and 44 countries, Demirguc-Kunt and Levine (1996) find a positive relationship between economic growth and stock market development. Luntiel et al. (2008), employing a sample of 10 developing economies, conclude that the causality between financial sector development and economic growth is bi-directional. Braun and Raddatz (2007), using a cross-country panel data for 33 countries for the period 1970–2003, find that domestic financial development has a smaller effect on economic growth in countries that are open to trade and capital flows compared to countries that are closed in both dimensions.[7]

Studies examining the relationship between financial sector development and economic growth in Asia include those by Hsu and Lin (2000) for Taiwan; Ang (2009a,b) for India and Malaysia, Liu and Hsu (2006) for Taiwan, Korea and Japan; Perera and Paudal (2009) for Sri Lanka; Jalil and Feridun (2011) for Pakistan and Anwar and Nguyen (2011a) for Vietnam. Hsu and Lin (2000), using Taiwanese data for the period 1964–1996, find that both banking and stock market development are positively related to short-run and long-term economic growth. In addition, financial depth, as measured by the ratio of the broad monetary aggregate (M2) to GDP, has a strong effect on economic growth. Investigating the impact of financial development on economic growth in three Asian countries, namely, Taiwan, Korea, and Japan, Liu and Hsu (2006) find that high investment led to economic growth in Japan. However, it contributed to faster economic growth in Taiwan and Korea only when investment was efficiently allocated. The finance aggregate was found to have a positive effect on the Taiwanese economy, but its effect was negative in Japan and Korea. Perera and Paudal (2009), investigating the link between financial development and economic growth in Sri Lanka using annual data from 1955 to 2005 and cointegration methodology, find a positive relation between financial development and economic growth. Jalil and Feridun (2011), examining the relationship between economic growth and financial development in Pakistan over the 1975–2008 period, conclude that there is a strong link between economic growth and financial development in Pakistan. Exploring the relation between financial development and economic growth in Vietnam using panel data for 61 provinces in Vietnam for the period 1997–2006, Anwar and Nguyen (2011a) find that financial development contributed significantly to economic growth in Vietnam.

The present study attempts to extend the existing literature by examining the impact of financial development on economic growth in 6 South Asian economies: Bangladesh, Bhutan, India, Nepal, Pakistan and Sri Lanka. We also consider the impact of the interaction of (i) FDI and financial development, (ii) civil liberties and financial development and (iii) political rights and financial development on economic growth, which has not been investigated previously for South Asia.

[7] Other related studies include, Abu-Bader and Abu-Qaran (2008), Ang (2008b), Odhiambo (2008), Yang and Yi (2008), Wolde-Rufael (2009), Anwar and Sun (2011b), Cooray (2011) and Kar et al. (2011).