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Post-independence India: a case of finance-led industrialization?

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Abstract

This paper examines whether financial intermediaries have played a leading role in influencing India's economic performance. After describing the evolution and functions of the financial sector, we construct a set of vector autoregressive (VAR) and vector error correction models (VECM) to evaluate the strength and direction of the links between measures of formal intermediation and various economic aggregates. The results suggest that (i) the financial sector was instrumental in promoting aggregate investment and output, but also in the steady shift toward industry that has characterized India's development; (ii) the operative channel was one of debt accumulation rather than improvements in total factor productivity; and (iii) its contributions went beyond the passive support of fiscal policy. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

The thesis that financial development can influence economic growth and structural change has received strong theoretical underpinnings from general equilibrium analyses

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that identify two distinct, yet complementary channels.[1] The first, sometimes called the "total factor productivity" (TFP) channel, emphasizes the role of innovative financial technologies in ameliorating the informational asymmetries that hinder the efficient allocation of funds and the monitoring of the resulting projects (Townsend, 1979; Greenwood and Jovanovic, 1990; King and Levine, 1993b). The other channel, which is based on the "debt accumulation" hypothesis of Gurley and Shaw (1955) and formalized more recently by Bencivenga and Smith (1991) and Rousseau (1998), focuses on the spread of organized finance at the expense of self-finance and the former's ability to overcome indivisibilities through the mobilization of otherwise unproductive resources.

Finding a strong empirical link from the financial sector to growth and investment in any individual country is, however, by no means a foregone conclusion. King and Levine (1993a,b), for example, impose homogeneity restrictions on the effects of finance across observations, and find a robust correlation between initial financial conditions and subsequent output growth for a cross-section of more than 80 countries. As such, they do not address differences in these effects across countries or their evolution over time. Cross-country regressions are, moreover, beset by other problems, including sensitivity to the set of conditioning variables and the difficulties of drawing correct inferences when testing for convergence or of interpreting the results when growth paths are not stable.[2] Time series studies of a selection of countries by Jung (1986) and Demetriades and Hussein (1996) yield more qualified conclusions: not only do the patterns of causality differ significantly, but also the evidence of a unidirectional link from finance to output is generally weak. On the latter point, Rousseau and Wachtel (1998), using a richer set of financial variables, present more encouraging evidence for the Anglo–American countries prior to the Great Depression. As a group, these contributions highlight the importance of undertaking studies of individual countries using a diverse set of financial variables for specific periods of history to further our understanding of the finance-growth nexus.

This paper pursues the latter approach in the case of India, exploiting the fact that an extensive set of measures of her economic performance is available for a much longer span than that commonly used in studies of sets of countries. Another salient advantage of focusing exclusively on one country is that the econometric findings can be related to the prevailing institutional structure. With its system of industrial and import licensing, which worked in tandem with the directed lending of resources mobilized by the financial sector, some of India's allocative mechanisms have been far removed from the textbook case. In describing the channels through which innovations and institutional changes in India's intermediating sector may have affected economic performance over the past half-century, our story therefore differs from accounts that emphasize the use and generation of information by financial intermediaries. India's financial sector was

[1] These links were posited in the writings of Joseph Schumpeter (Schumpeter, 1911) and were later refined considerably in seminal contributions by Gurley and Shaw (1955), Goldsmith (1969), McKinnon (1973) and Shaw (1973).

[2] For a succinct discussion of these issues, see Arestis and Demetriades (1997).