Chapter 3
Financial Development and Economic Growth

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ABSTRACT

In this chapter, the author examines the relationship between financial development and economic growth. In the first three sections of the chapter, they present the expansionary policies in the developed countries that led to increased capital flows in the last decades. Such an analysis was done through a thorough review of both empirical and other critical studies from distinguished academics. In the final section, a new financial system at the service of society and development with a case study for Greece is illustrated.

INTRODUCTION

Economists’ opinion about how important is the relationship of the financial system and economic growth vary. Some have argued that this relationship is very important, because when banks operate effectively choose to finance, and thus promote the most profitable businesses and ultimately facilitate the development process. However, others have argued that a prerequisite to advance economic growth are businesses to progressing (engage), and funding to follow. Others consider wrongly overemphasized the role of monetary factors in economic development. Finally, it is worth noting that economists involved in economic development often express doubts as to the role of financial system in economic development and this show by being unaware of its existence.

In this paper we presented the theoretical arguments and recent empirical research which conclude that there is a positive relationship between the development of the financial system and economic growth, at least at a first level of analysis. It is argued that the development of financial markets and institutions is an integral part of the development process. The financial system, i.e., it is a mere spectator of the process of industrial and economic growth, but contributes positive and promotes it. Section 2 explains how the operation of the financial system affects economic growth, but how is it affected by it. Section 3 summarizes and discusses recent empirical data demonstrate that the operation of the financial system is closely linked to economic growth. In the last section the financial sector of Greece is examined as a case study and policy proposals are presented for the recovery of the hellenic economy.

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THE FUNCTIONS OF THE FINANCIAL SYSTEM

Introduction

In a market without imperfections which operates smoothly and no cost there is no need for the financial system, given that trade between surplus and deficit units can be processed “on an automatic” without requiring the existence of an intermediary body.

Financial markets have a peculiarity compared with other markets: goods (money) delivered today exchanged with promises to deliver the goods (money plus interest) at some future time. Thus, the information available to traders is critical because a trader has the ability to affect the outcome in the time between conclusions by the end of the agreement. Moreover, the acquisition of information has a cost, it is costly affair.

The financial system, i.e. financial markets and institutions, exist precisely because there are several shortcomings in the economy. These weaknesses consist in the existence information costs and transaction costs. Thus, the cost required collecting information and the information itself, but also the costs for agreements and transaction processing creates the conditions that highlight the necessity of the financial system.

Financial markets and institutions are in place to minimize the problems created by the lack of adequate information and various imperfections that exist when making transactions. That is, the role of the financial system is to reduce the cost of pumping and cost information to conclude transactions. Different combinations of information costs and transactions that are highlighting the creation of different financial contracts regulations, markets and institutions.

In other words, the financial systems perform a basic function: to improve the allocation of resources in space and time, in the uncertain environment we live. This basic function can be divided into four main categories. Thus, the financial system has to perform four functions as follows:

- To promote the diffusion, tackling, avoidance of risk,
- To monitor the management of companies and enterprises to monitor,
- To mobilize savings, and
- To facilitate the exchange of goods and services.

But how specific market imperfections justify the emergence of financial markets and intermediaries who offer these five functions? And how they interpret their impact on economic growth?

We can assume that each of the functions of the financial system can affect growth in two ways: through the accumulation of capital and through technological innovations. In the first case, the functions of the financial system affect the growth of the product influencing the rate of creation of capital (e.g. through positive externalities). In the second case, the functions of the financial system affect the growth of the product by increasing the pace of technological innovation, from the discovery of new methods of production and new product introductions.

The sequence of these effects is shown in Figure overleaf and explained in the subsections that follow.

Management, Dissemination, and Risk Aversion

Given the existence of costs for pumping information and transactions costs, the presence of the financial system facilitates the dissemination, treatment and risk avoidance. There are two categories of risk: liquidity risk and the risk associated with specific projects.

Liquidity (liquidity) is the ease and speed with which enable operators to liquidate their assets at agreed prices. However, the asymmetry of information to economic operators and transaction costs