Chapter 1
Does Financial Development Lead to Employment and Growth? A Frequency Domain Causality Test for G7

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ABSTRACT

Financial systems, which play a major role in the development of the economy, are primarily helping to fund flow and assist in capital increase. In this study, frequency domain causality test, which was developed by Geweke and Hosoya and developed by Breitung and Candelon, was used to analyze the causality relationship by short, medium, and long periods. This test, which provides periodical examination, was investigated to determine the effect of G7 countries on employment and growth of financial institutions and markets index used to calculate financial development index. Among the G7 countries, the development of financial markets and institutions has been affecting employment in Canada (short-medium), Germany (medium-long), Japan (short-medium-long), and the UK (medium-long); in addition, when the effects of economic growth on financial markets and institutions are investigated, Canada (short-medium), France (medium), Italy (medium-long), America (medium-long), Germany (medium-long), Japan (short-medium-long), and UK (short-medium-long) were determined by analysis.

INTRODUCTION

Financial systems, which play a major role in the growth and development of the economy, perform functions such as providing funds flow initially and helping capital increase. Financial systems enable the savings by investors to be maximized from the minimum level, the savings to be used effectively.
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and the companies for investment to be kept under control. They also contribute to recovery by allowing the investments to be made in different areas and the taken risks to be minimized or eliminated. In this context, the financial system is one of the components of the economic system.

Financial development is the existence of all services which support the emergence of markets and intermediary institutions. Economies activated by the decisions taken in financial sector develop various mechanisms to minimize the effects of market imperfections. Governments offer a range of services varying from legal accounting systems to state banks with the purpose of reducing these imperfections and increasing resource allocation. Some economies became more successful in developing financial systems which lower such costs. It was however determined that they became less successful in some countries, which financial markets had great effects in economic development. For that reason, financial development is conceptually defined as the elimination of the effects of wrong information, limited applications and transaction cost of financial instruments, markets and institutions (World Bank, 2018). For example, the economies with effective legal and regulatory systems facilitate the development of equities and bond markets, which enable investors to hold more diversified portfolios without securities markets. Therefore, this may facilitate the capital flow to the investments with higher returns, accelerate the growth and increase the life standard (Demirgüç-Kunt, 2017). Financial institutions and markets in the world differ significantly in how well they provide services on the development of economies.

The aim of this study is to investigate the causal relationship between the level of development of financial institutions and financial markets of G7 countries and unemployment rate and economic growth. For this purpose, the frequency domain causality analysis method, which allows to examine short, medium and long term causality, was used.

Background

Analyzing the relationship between financial development and economic growth was regarded as highly attractive especially within the studies on development. Upon closer look at the literature we can see that many theoretical and empirical studies were carried out in this issue. The guide studies such as Schumpeter (1911), Goldsmith (1969), McKinnon (1973) and Shaw’s (1973) set the theoretical framework of this relationship. Financial markets manage to direct the financial funds to the production by eliminating their unproductiveness and provide the productivity to increase. Therefore, they play an important role in providing economic growth. In this role especially the banking system is an important factor in growth with its success in effective use of savings, promoting innovative approaches and financing the production investments (Durusu-Ciftci, 2017). The support for economy through services such as data collection, analysis, risk spreading and fund-raising provided by financial institutions via Endogenous growth theory indicates that financial institutions have a positive impact on steady growth (Demetriades & Hussein, 1996).

In many studies it was suggested that financial development would provide more output and therefore, more developed financial markets would lead to economic growth. With reference to more output increase it is suggested that financial development would lead to employment increase by grounding upon the law of Okun. That being said, it is thought that companies would tend to capital-intensive technologies with the increase in financial development. There are also some views that this will increase the productivity and contribute to the growth positively but will not affect the employment positively. In this context, it is not certain that the relationship between financial development and economic growth can automatically be established between financial development and employment (Chen, 2016).