

Financial development as an agent of the human development: An economic perspective and prospects of human excellence

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Abstract

The working of Modern economies depends largely on the finance which is the transfer of the resources from the surplus units to the deficit units. This job in an economy is carried out by its financial system. Financial system consists of the financial markets, financial intermediaries and the financial instruments. Understandably, financial system plays an indispensable role in the growth of economies as far as the growth in terms of the wealth or more specifically the growth of GDP is concerned. The shifting of the countries parameter of betterment from simple growth to the overall development has undoubtedly made the role of financial system more important but at the same time has landed more complexities to it. UNDP defined Human development as the "the process of enlarging people's choices", said choices being allowing them to "lead a long and healthy life, to be educated, to enjoy a decent standard of living", as well as "political freedom, other guaranteed human rights and various ingredients of self-respect". Financial development on the other hand is defined as the development in the size, efficiency and stability of and access to the financial system. The paper examines the relationship between the two and the ways of making it complimentary by analysing the various indices of Human development (as developed by the UNDP) and various indices of the financial development in terms of access, depth, efficiency and stability. It is observed from the study that the financial development is essential and has got a good prospect for ensuring the Human Development.

Keywords: financial development, human development, UNDP, human development indices, financial development index

Introduction

Human being, as the most intelligent race, has always strived for excellence depending upon his judgement about it. Any sort of development, be it of sciences or religion has been the result of this quest. In Economics until recently (1970s), growth of the Gross Domestic Product (GDP), of a country, was seen as the end in this regard. Later, this concept changed to the development i.e. the overall social, political and economic well-being. This led to the vast research for finding its determinants and the practical policy implications. One of the major outcomes in the course has been the development of money and subsequently the development of finance. The role of financial system in the process of growth has been little contentious. Whilst Schumpeter (1911) emphasised its importance in the determination of growth, Economists like Charles Kindleberger (1978) found in a study that too much bubbles are formed in the credit expansion which can then result in the financial crisis or Hyman Minsky (1975) who argued that economic stability can lead to financial instability as financiers take more risk. However, most of the working of economies in present times takes place through financial system.

Financing is simply the transfer of resources from the surplus to the deficit units. It takes place through financial sector. Financial sector consists of the financial markets, financial intermediaries and the financial instruments. Financial markets are markets in which funds are moved from people who have an excess of available funds (and lack of investment opportunities) to people who have investment opportunities (and lack of funds). They also have direct effects on personal wealth, and the behaviours of businesses

and consumers. Therefore, they contribute to increase the production and the efficiency in the overall economy. Financial markets (such as bond and stock markets) are markets in which securities are traded. Securities (also called financial instruments) are financial claims on the issuer's future income or assets. They represent financial liabilities for the individual or firm that sells them (borrower or issuer of the financial claim) in return for money and financial assets for the buyer (lender or investor in the financial claim). By definition, therefore, the sum of financial assets in existence will exactly equal the sum of liabilities. Governments and corporations raise funds to finance their activities by issuing debt instruments (bonds) and equity instruments. Bonds are securities that promise to make periodic payments of a sum of money for a specified period of time. Stocks are securities that represent a share of ownership in the firm. Financial intermediaries are economic agents who specialise in the activities of buying and selling (at the same time) financial contracts (loans and deposits) and securities (bonds and stocks). Note that financial securities are easily marketable, while financial contracts cannot be easily sold (marketed). Banks form the largest financial institution in most of the economies. They accept deposits (loans by individuals or firms to banks) and make loans (sums of money lent by banks to individuals or firms): therefore, they borrow deposits from people who have saved and in turn make loans to others. In recent years, other financial intermediaries, such as mutual funds, pension funds, insurance companies and investment banks, have been growing at the expense of banks.

Need of financial system

Financial system performs the essential economic function of channelling funds from units who have saved surplus funds to units who have a shortage of funds. The units who have saved can lend funds: they are known as lender-savers. The units with a shortage of funds must borrow funds to finance their spending: they are the borrower-spenders. The most important lender-savers are usually households; while the typical borrower-spenders are firms and the government.

The channelling of funds from savers to spenders is very important for two reasons:

- First, lender-savers (with excess of available funds) do not frequently have profitable investment opportunities, while borrower-spenders have investment opportunities but lack of funds.
- Second, even for purposes other than investment opportunities in businesses, borrower-spenders may want to invest in excess of their current income or to adjust the composition of their wealth (reconciliation of the preferences for current versus future consumption). In direct finance, borrower-spenders borrow funds directly from lenders in the financial markets by selling them securities. In indirect finance, a financial intermediary stands between the lender-savers and the borrower-spenders: the intermediary helps to transfer funds from one to the other. This suggests that financial markets and intermediaries are alternatives that perform more or less the same function but in different ways (and perhaps with different degrees of success). Note, however, that the process of indirect finance, known as financial intermediation, is the most important way of transferring funds from lenders to borrowers. This contrasts with the attitude of the media to focus mainly on financial markets. Another important function of a financial system is the monetary function. The introduction of money into the economy enables savers and spenders to separate the act of sale from the act of purchase and allows them to overcome the main problem of barter, which is the 'double coincidence of wants' (each of the two parties involved in a transaction has to want simultaneously the good the other party is offering to exchange). The financial system provides a variety of payment mechanisms e.g. cheques, debit cards and credit cards to enable one party to pay another. Financial systems also provide mechanisms for risk to be transferred. For example insurance contracts allow a party such as a firm or household to transfer the risk of loss of wealth due to theft or fire to another party such as an insurance company. The firm or household will pay a fee (insurance premium) for this transfer. The insurance company, by providing a large number of insurance contracts, is better able to manage the risk than an individual firm or household as they can obtain benefits of pooling and diversification. Thus, a more efficient allocation of risk takes place. In short, the main functions of financial systems are to:
 - provide the mechanisms by which funds can be transferred from units in surplus to units with a shortage of funds in order to directly or indirectly facilitate lending and borrowing
 - enable wealth holders to adjust the composition of their portfolios

- provide payment mechanisms
- provide mechanisms for risk transfer

Finance and growth (Role)

Growth of an economy requires the technical progress which being endogenous requires the saving and investment. Financial system facilitates the same. The relationship between the capital and production is strong and positive. Whether it's made available on time, in right quantity and on favourable terms determines the economic development. It enlarges the markets and space over time and improves its efficiency. All this is possible by the role played by the financial system as the mobilisers of savings and the source of investment. There are various theories that explain this. They are the a) The classical Prior voluntary savings theory, b) Forced savings theory c) Credit Creation theory d) Financial repression and e) Financial liberalisation theory which have been explained as under:-

The classical Prior voluntary savings theory

It regards savings as the prerequisite or determinant of investment, and it holds that all savings in the economy can find outlet for the investment. A good financial system helps in the same. The theory is averse to the inflation and believes that all the investment must be financed by the prior savings. The interest rates must be high so that the public saves more and more. The financial system activates the idle savings and puts it to the productive use. The modern economies being characterised by the ever-expanding nature of business organisations, ever increasing scale of production, separation of savers and investors and the difference in the attitude and aptitude of the savers and borrowers requires a system that connects the ultimate savers with the ultimate borrowers. It induces the people to save in banks and in the form of other instruments depending upon the preferences of the savers rather than on the precious metals, consumer durables and currency etc. It encourages investment activity by reducing the cost of finance and risk. This is done by producing the remittance, discounting, insurance services and the hedging opportunities. It also raises the efficiency of investment levels by financing and undertaking the evaluation projects.

Credit creation theory

The financial system doesn't only channel the prior savings but also increases the investment as the savings are expected and the credit is created. This ensures the independence of the investment from the savings. The credit creation instead of raising the inflation level raises the income promptly. This theory is echoes in the opinion of Schumpeter.

Theory of forced savings

The theory was propounded by Keynes and Tobin. According to this theory it is not the savings that determine investment but it is the investment which is autonomous and can be increased with the monetary expansion. Monetary expansion leads to production in following ways. Firstly, if the resources are not fully employed, it leads to increase in output and hence, the savings. Secondly, if resources are fully employed it results in inflation and makes the holding of real balances undesirable and therefore people invest in the physical assets, the phenomenon known as the Tobin or Portfolio shift effect. Thirdly, inflation shifts the income

distribution to the high income people who have the high propensity to save. This is called as the Income distribution effect. Fourthly, inflation imposes tax on real money balances and therefore transfers resources to the government which then uses it for the investment (Inflation tax effect).

Theory of financial regulation

Stiglitz was the chief proponent of this theory. He believed the effective financial system is a public good and needs to be provided by the government through directed credit programmes, low interest rates etc. The social benefits of the financial development cannot be taken care by the market alone.

Financial liberalisation theory

Mc Kinnon and Shaw propounded that the low developed countries suffer from the extra regulation, financial repression and hence the lower volume of saving, investment and growth. Not only the quantity but also the quality of investment suffers in view of the fact that banks concern remains the rules and regulations rather than the return.

Concept and measurement of Human Development

Lately, the concept of betterment has shifted from the mere hoarding of wealth in the form of national income i.e. growth to the overall well-being of human beings in terms of development. In economics, the most acceptable parameter of Human development is the Human Development Index (HDI) as developed by the UNDP. The United Nations Development Programme has defined Human Development as "the process of enlarging people's choices", said choices being allowing them to "lead a long and healthy life, to be educated, to enjoy a decent standard of living", as well as "political freedom, other guaranteed human rights and various ingredients of self-respect". The concept of human developments was first laid out by Mahbub ul Haq and then developed by Amartya Sen. Amartya Sen's concept of Development as Freedom (1999) is highly acclaimed. He argues that human development is about the expansion of citizen's capabilities. In his opinion, "Development consists of the removal of various types of un freedoms that leave people with little choice and little opportunity of exercising their reasoned agency". Sen defines the major factors that limit freedom as 'poverty as well as tyranny, poor economic opportunities as well as systematic social deprivation, neglect of public facilities as well as intolerance or over activity of repressive states'.

Human development is measured by the Human Development Index (HDI). The origins of the HDI are found in the annual Human Development Reports produced by the Human Development Reports Office of the United Nations Development Programme (UNDP). These were devised and launched by Pakistani economist Mahbub ul Haq in 1990, and had the explicit purpose "to shift the focus of development economics from national income accounting to people-centred policies". To produce the Human Development Reports, Mahbub ul Haq formed a group of development economists including Paul Streeten, Frances Stewart, Gustav Ranis, Keith Griffin, Sudhir Anand, and Meghnad Desai. Working alongside Nobel laureate Amartya Sen, they worked on capabilities and functions that provided the underlying conceptual framework.

Haq believed that a simple composite measure of human development was needed to convince the public, academics, and politicians that they can and should evaluate development not only by economic advances but also improvements in human well-being.

HDI from 2010 combines of the following three dimensions:-

1. A long and healthy life: life expectancy at the time of birth
2. Education index: mean years of schooling and expected years of schooling
3. A decent standard of living: GNI per capita

Before 2010, the education index was measured as the adult literacy rate (2/3) and the primary, secondary and tertiary education enrolment ratio (1/3).

Concept of and measurement of financial development:-

Financial development is defined as the development in the size, efficiency and; stability of and access to the financial system. Financial development index is the reflection of all these dimensions. Financial development reports are published by the World Bank and the World Economic Forum. World Bank uses the following indices for the measurement of financial development:

Depth—Financial Institutions

- Private credit by deposit money banks to GDP (%)
- Deposit money banks' assets to GDP (%)
- Nonbank financial institutions' assets to GDP (%)

Depth—Financial Markets

- Stock market capitalization to GDP (%)
- Stock market total value traded to GDP (%)
- Outstanding domestic private debt securities to GDP (%)
- Outstanding domestic public debt securities to GDP (%)
- Outstanding international debt securities to GDP (%)
- Syndicated loan issuance volume to GDP (%)
- Corporate bond issuance volume to GDP (%)
- Syndicated loan average maturity (years)
- Corporate bond average maturity (years)

Access—Financial Institutions

- Bank accounts per 1,000 adults (age 15+)
- Bank branches per 100,000 adults (age 15+)
- Account at a formal financial institution (% , age 15+)
- Saved at a financial institution in the past year (% , age 15+)
- Loan from a financial institution in the past year (% , age 15+)
- Firms with bank loan/line of credit (%)
- Firms using banks to finance investments (%)
- Firms using banks to finance working capital (%)
- Small firms with bank loan/line of credit (%)

Access—Financial Markets

- Value traded excluding top 10 traded companies to tot. val. traded (%)
- Mkt. cap. excluding top 10 companies to tot. mkt. cap. (%)
- Nonfin. corporate bonds to total bonds and notes outstanding (%)

Efficiency—Financial Institutions

- Bank net interest margin (%)
- Bank lending-deposit spread
- Bank overhead costs to total assets (%)

Bank return on assets (% , after tax)
 Bank return on equity (% , after tax)

Efficiency—Financial Markets

Stock market turnover ratio (%)

Stability—Financial Institutions

Bank Z-score
 Bank nonperforming loans to gross loans (%)
 Bank regulatory capital to risk-weighted assets (%)

Stability—Financial Markets

Stock price volatility

Other Indicators—Financial Institutions

Bank concentration (%)
 Boone indicator
 Banking crisis dummy

Other Indicators—Financial Markets

Number of listed firms per 1,000,000 people
 Stock market return (% , year-on-year)
 World Economic Forum uses the following Pillars:

1. Institutional environment
2. Business environment
3. Financial stability
4. Financial intermediation(banks, non-banks and markets)
5. Capital availability and access

Based on them an overall Financial Development Index is calculated.

The study examined the HDI of 2003, 2008 and 2013 and the financial development indices for the same period.

Findings

1. The countries with the high Financial Development Index have the high Human Development index also over the years (Norway, USA, Japan, Switzerland etc).
2. The countries that lag behind in the Financial development are lagging behind in the Human development as well (Niger, Mali, etc).
3. High Income countries have higher financial development.
4. Also, high income countries have the higher Human development as compared low income countries.
5. The top ranking countries in terms of financial development are generally the top ranking in terms of HDI.
6. In many cases low scoring countries on HDI have fairly high score in terms of depth but score badly in terms of efficiency and access.
7. The above trend persists over the years.

Conclusion

The study concludes that the financial development seems to have positive effect on the Human development primarily through growth in income. This is in tandem with the Meta analysis conducted by Petra Valickova, Tomas Havranek and Roman Horvath in 2013, in which the survey of studies showed that most of the studies found the positive relationship between the financial development and economic growth. Also, many studies show that growth helps in the reduction of poverty (Growth, Employment and Poverty by

Azizur Rahman Khan Apart from that the financial development increases the choices of people. They get the route for channelizing their talents. The financial development provides the resources for utilising the talents and aptitudes. A well-developed life, health and general insurance sector, by providing the security against loss, improve the quality of life. Going by the financial regulation theory, government can utilise the sector for providing the loans for skill development and the higher education. Gender specific policies can improve the gender related disparities in developing countries.

The study is just the theoretical perspective on the issue. Many empirical studies do support it; however, more research needs to be done on the causal relationship between the two so as to remove the reverse causality.

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