Chapter 2

Review of Literature

2.1 Introduction

Literature review is very essential part of any research work. Literature finds gaps in current knowledge. Literature increases knowledge in a particular area of research. It helps you to discover research methods which may be applicable to your research work. This chapter deals with the existing literature related to the topic of the study. Many studies related to the financial development and trade has been reviewed in this chapter. The reviewed literature is divided under the following heads:

Bardhan et al. (1987) focuses on an essential function of financial system that consists to mobilize savings and to allocate funds to investors. They assume that in each country, one sector produces an intermediate good while the other produces a final good. Producing the final good requires the use of the intermediate good as an input and committing this resource one period before the output becomes available. The final good sector thus requires external funds to finance working capital. However, due to information asymmetries between firms and funders, external financing entails moral hazard problems. In this context, undeveloped financial system is unable to alleviate information asymmetries and implies rationing. On the other hand, a highly developed financial system makes it possible to reduce frictions and finance working capital more adequately. As the intermediate goods sector does not require outside funding, financial development is only profitable to the final good sector. Finally, the relatively more financially developed country has a comparative advantage in the final good while the relatively less financially developed country specializes in the intermediate good.

C. Rangarajan (1998) highlights the role of financial sector in achieving sustained economic growth. It argues that a competent financial system is very much essential for improving the saving and investment activity and for promoting the overall productivity in the economy. While discussing the rationale and relevance of financial sector reforms the paper specifically discusses the nature and extent of government intervention, interest rate deregulation, prudential norms and directed credit. The study concludes that various measures in India have laid the foundation for an efficient and well-functioning banking system which will support and strengthen a high level of real growth in future.

Z. Xu (2000) analyzed the effects of permanent financial development on domestic investment and output in forty one countries. The data collection was made for a period of 33 years (1960-1993) and variables were included such as real GDP, real domestic investment and financial development index. The financial development index was constructed by taking variables such as total bank deposits in GDP and the geometric mean of this year's bank deposits and last year's bank deposits divided by GDP. To analyze the data VAR model was used. Impulse response analysis was applied to check the effect of financial development on investment and real GDP. The study found strong evidence that for GDP growth financial development is an important component and to achieve financial development, domestic investment is an important channel.

Beck T. (2002) tried to find out the relationship between financial development and trade in manufactures. His study consists of data for 65 countries over the period 1966 to 1995. To estimate the regression, he uses the credit to the private sector by deposit money banks and other financial institution (%of GDP) as a proxy for financial development. After controlling for unobserved heterogeneity and reverse causality, he

finds that countries with a higher level of financial development experience higher shares of manufactured exports in GDP and in total merchandise exports and have a higher trade balance in manufactured goods. The long-run impact of financial development on manufacturing exports appears to be stronger than its short-term impact.

M.Omran (2003) investigated the role of FDI (foreign direct investment) in promotion of economic growth and financial development in Arab countries. 24 years (1975-1999) of data taken and 17 countries were selected for the study. The variables used in this study were domestic credit from commercial banks to the private sector as a ratio of GDP, commercial banks assets as a ratio of commercial banks, foreign direct investment and central bank assets, and total value of shares traded to GDP, turnover ratio. Cross country regression and pair wise granger causality test were used to analyze data. Data was analyzed by dividing it into three groups mainly reform countries, Gulf countries and other countries to find out the causality between financial direct investment and financial development. The result reflected that Arab countries financial system is related with bank.

M. D. B. Rahman (2004) made an attempt to find out whether higher investment and output growth in the long run results in financial development. Study period is from 1976-2005. The variables used in the study were weighted average annual interest rate on lending by banks, domestic credit to the private sector as a percent of GDP, broad money as a percent of GDP, total deposits as a percent of GDP, gross fixed capital formation as a percent of GDP and GDP per capita. To analyze the data VAR model was used. The result show that there is existence of co-movement between financial development on investment and per capita income in the long run.

Huang Y. (2005) in his study used the cross-country and time-series variation in openness to study the relationship between trade and finance. His study period is 1991-2001. To measure overall financial development, he uses principal components analysis. Using OLS or instrumental variable procedures, he finds strong evidence that trade promotes bank-based financial development in higher-income countries, but not in the lower-income group.

Svaleryd et al. (2005) study the effects of financial factors on the pattern of industrial specialization and comparative advantage using data on financial endowment from OECD countries. Their results indicate that countries with well-functioning financial system tend to specialize in industries highly dependent on external financing. Their results also show that differences in financial systems are more important determinants of the pattern of specialization between OECD countries than differences in human capital.

Khan (2006) made an attempt to examine the impact of trade and financial liberalization on economic growth in Pakistan. Researcher has taken annual data over a period from 1961-2005. To analyze the data researcher used ARDL method. The study showed a positive and significant impact of financial sector development index (FSDI) and ratio of discount rate and trade openness on real GDP. However in the short run FSDI shows statistically insignificant negative association with economic growth.

F. X. Rathinam (2007) re-examined the financial development and economic growth puzzle in India, by taking the determinants of financial sector growth such as legal and institutional developments and financial regulation. Variables used in study were M2 over nominal GDP, private credit to make an overall index of financial development by applying PCA. Multivariate VAR frame work, Granger causality test

and Vector Error Correction Model were used to analyze the data. The empirical test showed that legal and institutional developments and financial regulation promotes financial sector growth. The result also reflects that legal, institutional developments positively affect financial sector growth in the long run and financial regulation has a negative impact on financial sector growth.

King R.G (2008) presented cross-country evidence consistent with Schumpeter's view that the financial system can promote economic growth, using data on 80 countries over the 1960-1989 periods. Various measures of the level of financial development are strongly associated with real per capita GDP growth, the rate of physical capital accumulation, and improvements in the efficiency with which economies employ physical capital. Further, the predetermined component of financial development is robustly correlated with future rates of economic growth, physical capital accumulation, and economic efficiency improvements.

Chakraborty I. (2008) examined the impact of the developments in the financial sector on economic growth in India in the post reform period. Her study extends the models of Pagano (1993) and Murinde (1996) to formalize the relationship between financial development and economic growth in the structure of an endogenous growth model. She uses the quarterly data for the period 1993 to 2005 for India. She finds that investment-output ratio has a positive significant effect on real rate of growth of GDP, irrespective of the indicator of stock market development. An increase in market capitalization dampens economic growth but an increase in the money market rate of interest has a positive significant effect. The findings lend little support to the theoretical prediction that the development of stock market would play an important role in enhancing economic growth in India. Instead, the banking system reform appears to have promoted economic growth significantly. These results support the

view that in India stock market is no substitutes for the banking sector, unlike in some emerging economies like Chile and Mexico.

Samba et al. (2009) investigated the relationship between the level of financial development of a country and its comparative advantage in international trade. The relationship between the two notions seems to perform in a two-side direction: firstly it leads to a comparative advantage in the financially intensive goods, alongside capital and human resources. This study aims to check the existence and the sense of the relation between the two variables within East Asian countries. To check long run relationship between financial development and international trade in manufacturing goods a time-series approach using the VAR Model has been used. The main results of the study suggest that for most of the countries considered, international trade in manufactured goods enhances financial development.

J. Dogbey (2010) tried to examine whether financial development is communicable using spatial econometrics analysis. Three measures were used to measure the financial development as a percentage of financial development namely domestic credit to the private sector, private credit by the banking sector and stock market total value traded for the study. Independent variables used in this study include initial GDP per capita, spatial weight matrixes, lagged level of financial development and regional or continent dummies. Fifteen years (1985-2000) of data taken for to analyze the data. This study used spatial econometric methods to examine the spread of financial development; a Spatial Auto Regressive model (SAR) and Spatial Error Model (SEM) were also used. The study found lagged levels of financial development to account significantly and positively for the level of financial development, but negatively for the changes of financial development. Study also found out that bureaucratic quality is important for financial development.

Susanto et al. (2011) posits that countries that are well financially developed should experience larger volumes of international trade. They empirically examine the effects of financial development on trade of both agriculture and manufactured products. Their study results show a positive impact of financial development on bilateral trade flows for the manufacturing sector, which enjoys a greater impact than the agriculture sector. The impacts vary across regions. In most cases, developing countries experience greater impacts of financial development on exports in both agriculture and manufacturing sectors than do advanced countries.

K. Youssouf (2012) in his paper examined the empirical question about the relationship between countries level of manufacturing trade and its financial sector development. It also investigates the role of institutions in this relationship. This study covered pure cross sectional and panel specification on a sample size of 75 countries over the period 1971 to 2010. According to this paper financial development strongly and robustly exerts a positive effect on manufacturing exports. It is found that this effect is stronger in countries with high quality institutions.

Minija k. (2012) attempted to find out the nature of relationship between financial development and economic growth in India and the direction of relationship between financial development and economic growth. He made a financial development index to measure the financial development in India. He divided the study period in to pre and post liberalization period. For identifying the importance of each variable, principal component analysis is applied and appropriate weights for each variable are identified and constructed the index. In order to examine the long run relationship, ARDL co-integration method is used. To know the direction of causality, Pair wise Granger Causality test and VAR block exogenity tests are applied. The results show a structural break in the study period; accordingly the analysis is done for pre and post

liberalization period and found co-integration in the post liberalization period only. It shows the unidirectional causality between financial development and economic growth. Further, in the pre-liberalization period financial development leads economic growth where as in the post liberalization period economic growth leads to financial development.

M. Kalina (2013) in his paper identified the three mechanism through which credit constraint affect trade, these are the selection of heterogeneous firms into production, the selection of domestic manufactures into exporting, and the level of firm exports. Panel data has been used to check the variation in financial development across countries and the variation in financial vulnerability across sectors. According to the study, 20-25% impact of credit constrains on trade is driven by reduction in total output. The result is that financial developed economies export more in financially vulnerable sectors because of their large scale.

Rahman et al. investigates the relationship between financial development, international trade and economic growth in case of Australia over the period of 1965-2010. The ARDL bounds testing approach to co integration is applied to examine the long run relationship among the series, while stationarity properties of the variables are tested by applying two structural break tests. The results show that financial development, international trade and capital are the drivers of economic growth both in short run as well as in long run. Financial development Granger causes economic growth validating supply-side hypothesis in case of Australia.

Sola (2013) examined manufacturing performance for sustainable economic development in Nigeria with some objectives, those are to look at the growth rate and contribution of manufacturing to GDP, to examine trend in both manufacturing and employment, to determine the structure of capacity utilization, to determine

factors influencing manufacturing performance. Panel data analysis was used on secondary data from 1980-2008 that was extracted from CBN Statistical Bulletin. The results indicate positive relationship between manufacturing and each of capacity utilization and import as 1 percent change in capacity utilization and import lead to 43081 and 3.8 percent change in manufacturing respectively. However, there is a negative relationship between manufacturing and each of investment, exchange rate, and export. A 1% change in investment, exchange rate and export lead to 0.04, 12729, 0.3 percent reduction in manufacturing respectively. This showed that investment, capacity utilization and import were major determinants of manufacturing performance for the period. The study concludes that the key to reversing the poor performance of Nigerian manufacturing is to provide incentives for firms to become more export oriented.