

DOES FINANCIAL DEEPENING CREATE FINANCIAL CRISES?

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Abstract

In the last century, mostly countries promote the sustainable financial development for enhancing economic growth through lowering the governmental interventions in financial sector. This paper portrays the impact of financial deepening on positive and negative perspectives however it may severely affect developing economies as compared to developed economies. Although financial deepening provides many positive outcomes to economies like enhancing the hiding costs, efficiency of transforming savings into investments, heightening the official governmental policies through deregulating credits, strengthening restraints interest rate, price mechanisms as well as improving market competition; but sometimes excess financial deepening may leads to negative outcomes like restraining the financial markets to be efficient, reducing the profit margin and increased financial fragility of banks and may create financial crises if excessive risks is taken in presence of increased competition. It provides recommendations for eliminating its effects and enhances the sustainable development, in both developed and developing economies.

Keywords: financial deepening, financial crises, economic growth, sustainable development, policy reforms

INTRODUCTION

In the early twentieth century, Schumpeter (1911) proved that financial integration leads to economic growth, which is also confirmed by McKinnon (1973) and Shaw (1973). According to finance-leading view, financial intermediaries play a essential role in channeling funds to economy (Bencivenga and Smith, 1991).

Regarding to “McKinnon-Shaw” hypothesis several economies reforming their financial system for improving the efficiency of financial intermediaries in order to achieve goal of financial deepening and high GDP growth. However, Robinson (1952) and Lucas (1988) argued that impact of financial integration on economic growth is overemphasized which creates the financial sector’s demand and thus financial system automatically reacts to that demand. (Arestis, 2005).

Financial crises may be triggered by numerous factors; however in developing economies, financial crises occur due to happening of either the mismanagement of financial liberalization and globalization, or severe fiscal imbalances. But the most underlying reason for happening of financial crises in Mexico in 1994 and many East Asian countries 1997 is attributable to the mismanagement of financial liberalization and globalization (Web chapter).

RESEARCH QUESTIONS

- 1) Does financial deepening leads to financial crises?
- 2) What are the theories of financial deepening?
- 3) What other possible factors which triggers the financial crises?
- 4) Are financial crises more severe in developing economies as compared to developed economies?
- 5) What are policy reforms for recovering from financial crises for developed and developing economies?

SIGNIFICANCE OF STUDY

Many empirical studies showed that financial crises hit economies were overly liberalized for improving high GDP growth and financial boom. However, economic theory does not provide a clear justification of financial deepening leads to financial crises. These findings prompt us whether financial deepening leads to financial crises. So the specialty of our study is to investigate how financial deepening leads to financial crises. What are key reforms that would be implemented in order to achieve sustainable development in the economy.

CONTRIBUTION TO THE STUDY

We provide a theoretical justification for the above mentioned link. Financial deepening leads to economic growth, however, excess financial deepening may leads to financial crises. This paper provides justification of other factors that triggers the financial crises. Moreover, it provides policy reforms for developed and developing economies, in order to achieve sustainable development

The remainder of the present paper is organized as follows. The literature review is presented in Section 3. The methodology along with theoretical framework is described in Section 4. Discussion is outlined in Section 5, concluding remarks in Section 6 and policy implications are given in Section 7

THEORIES OF FINANCIAL DEEPENING

The impact of financial deepening on economic growth has been studied in financial structure theories including bank-based, market-based, financial service based and law and finance based theories.

• Bank-Based Theory

The bank based theory explain the favorable role of commercial banks in economic development through mobilizing resources and reducing risks (Levine, 2002, 2005; Beck and Levine, 2004)

- **Market-Based Theory**

It explains merits of well functioning markets through fostering growth and profit incentives, corporate governance, diversification and risk management (Levine, 2005).

- **Financial-Services Theory**

It emphasizes on both bank-based and market-based views, through stresses the importance of financial services provided by banks that contributes the industrial expansion and economic growth (Kose et al., 2010)

- **Law and Finance Theory**

It emphasizes that effective legal system is crucible factor in firm, industry and country's economic performance. (La-Porta et al., 1998; Levine, 1999)

LITERATURE REVIEW

Since the last century, mostly countries encourage the financial through lowering the governmental interventions in financial sector (Gries, et al, 2009). This relationship has been examined in both theoretical and empirical contexts whether country specific or globally (Schumpeter, 1911; Goldsmith, 1969 and Shaw, 1973). Schumpeter (1911) demonstrated that financial development plays an important role in promotion economic growth through allocating funds, risk management, evaluating projects and monitoring entrepreneurs. Ultimately, above strategies may increase the direct investment both at domestically and globally (Gries, et al, 2009).

According to Shaw (1973:8), financial deepening involves “*specialization in financial functions and institutions, and organized domestic institution and markets gain relation to foreign markets and the curb (informal). He maintained that an increase in the real size of the monetary system will generate opportunities for the profitable operations of other institutions as well, from bill dealers to industrial banks and insurance companies*”. Moreover, Nnanna and Dogo (1998) defined the financial deepening as “*state of an atomized financial system which is free from which is largely free from financial repression*”

Many researchers worked on the financial deepening ‘effect on economic growth (e.g., Ang, 2008; Beck and Levine, 2004; Bekaert et al, 2005; Edison, et al, 2002; Mavrotas and Son, 2006; Rousseau and Vuthipadadorn, 2005). Perera and Paudal (2009) studied the positive relationship between financial deepening and economic growth in Srilanka by using cointegration methodology. Jalil and Feridun (2011) proved the strong link between financial deepening and economic growth in Pakistan for the period of 1975–2008. Anwar and Nguyen (2011) investigated the above mentioned link in Vietnam.

However, this nexus between financial developments provides two different views in traditional economics. The first view highlights the demand for financial services due to economic growth may be attributable to a chief factor towards the financial development (Robinson, 1952). He pointed out financial development does not lead to economic growth; it responds only due to

demand of financial services for generation the positive effect on savings and investments process (Ang, 2008). Conversely, the other one focuses a proactive role of financial development towards economic growth through difference in quantity and quality of financial services in cross countries. (Schumpeter, 1911 and Shaw, 1973). Patrick (1966) named the former views as demand following approach and latter view as supply-leading approach. The latter approach performs transference of resources from traditional to modern sector and to promote the entrepreneurial response to these modern sectors.

The Financial sector may impact economic growth through accumulative channel. In this approach, it focuses finance-induced effects of physical and human capital accumulation on economic growth (Pagano, 1993). Moreover, financial sector may affect the economic growth through Total Factor Productivity (TFP) channel (Ang, 2008). In this view, it emphasizes finance-induced gains in resource allocation efficiency which translates to growth (King and Levine, 1993). However, economic growth contributes towards the development of financial sector through induction of new financial instruments and an easy access to external finance (Robinson, 1952).

Financial deepening plays positive as well as negative roles which have been presented in ensuing points:

Financial Deepening: A Positive Role

- Financial deepening may enhances the hiding costs through providing better laws, which enables the entrepreneurs to take credit for innovative activities. (Ang, 2008)
- Financial deepening may reduce the monitoring cost and screening cost that eliminate the agency problems and enhancing the rate of innovations. (Aghion and Howitt, 2009)
- Financial deepening eliminate credit constraints through facilitating the espousal of modern technology to increase the development of technology-intensive industries (Ang, 2010)
- Deepening of financial markets enhances efficiency of transforming savings into investments and economic profitability of countries. (Bumann, et al, 2013)
- Financial deepening can reduces the financial and economic crises in national and international contexts. (Bumann, et al, 2013).
- Financial deepening can heighten the official governmental policies through deregulating credits, restrains interest rate, eliminating entry barriers for foreign financial institutions and privatization of banking sector (Bumann, et al, 2013).
- Financial deepening strengths the price mechanisms as well as improving market competition that increases the interest rate on deposits translating the higher saving rate and more resources available for investment purposes (Bumann, et al, 2013)
- Financial deepening and increased competition may reduce the relationship lending, due to which

borrowers have many opportunities for financing their investments (Boot 2000).

- Financial development may channels the economic resources to productive usage (Schumpeter, 1911)
- Financial development not only identify the profitable business opportunities as well as improve corporate governance (Levine, 2005)
- Financial development heightens the merits of foreign direct investment (Carkovic and Levine, 2005; Kose et al. , 2008)
- Financial deepening reduces inequality by raising the real income of the poor more than that of the rich, proportionally. (Hamori and Hashiguchi, 2012).
- Financial deepening assists in poverty reduction in Zambia (Odhiambo,2010)
- Financial deepening facilitates the initial providers of capital through lowering their risk and expand their investments. Ultimately, financial sector may diversify their investments by using intermediary approach. (Hamori and Hashiguchi, 2012).
- Financial deepening reduces the highly liquid, low-return investments in favor of high-return alternatives through pooling of capital from different investors. (Hamori and Hashiguchi, 2012).
- Financial deepening provides professional information through reducing the transaction cost of ordinary investors and welcomes the higher investment returns. (Hamori and Hashiguchi, 2012).
- Financial deepening can encourage the regional capital formation. (Danchen and Juan,2007)
- Financial deepening can enhance the allocation of resources (Danchen and Juan,2007)
- Financial deepening can cause the other resources factors flow and gather (Danchen and Juan,2007)

Financial Deepening: A Negative Role

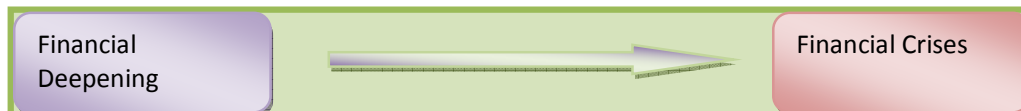
- Financial deepening does not solved the problem of asymmetric information that restrains the financial markets to be efficient, even without governmental interventions (Stiglitz, 2000; Stiglitz and Weiss, 1981).
- Financial deepening and increased competition may reduce the relationship lending that destroys the information capital that increases the asymmetric information (Boot 2000).
- Increased competition in financial markets may reduce the profit margin and increased financial fragility of banks. Reduction in profit margins may encourage banks to economize on monitoring efforts while making loans. Thus, financial deepening may create financial crises if excessive risks is taken in presence of increased competition (Hellmann, Murdock and Stiglitz, 2000; Demirgüç-Kunt and Detragiache, 1998)

High risk taking in financial markets may leads to number of bank failures that triggers bank run and financial instability (Diamond and Dybvig, 1983)

The instability of expectation and asset speculation may lead to severe negative consequences for an economy (Kindleberger, 1978)

METHODOLOGY

The basic aim of our paper is to investigate a link between financial deepening and financial crises. We provide theoretical justification for the above mentioned link. On the basis of above literature, our proposed model has been presenting as follow:



DISCUSSION

Financial integration plays an important role towards economic growth in process of liberalization and globalization. While opening to capital flow and trade flow, encourages financial development through increasing economic growth and external finance demand (Rajan and Zingales, 2003). It has been pointed out that such openness to capital flow leads to financial fragility and financial crises risks enhance volatility in economy which concerned the nexus between economic growth and volatility (Ramey and Ramey, 1995). Moreover, Fukuda and Dahalan (2011) provided that financial deepening is key factor leading to financial crises in India, Indonesia and Mexico. It signifies that an economy is over financialized; and deviation between the real and financial sectors contributed towards financial crises.

Normally, financial systems of developing economies have weak credit culture along with vain screening and monitoring of borrowers and negligence of governmental supervision of banks. Lending booms which accompany

financial liberalization, these countries are typically manifest by risky lending practices. Moreover, financial globalization adds more risky through allowing domestic banks to borrow globally. Domestic banks paid high interest for increasing their lending rapidly. However, government intervene through fixing the value of domestic currency to US dollars , in order to provide comfort to foreign investors.

However, in developed countries like US, the lending booms ends in lending crash. Significant loan losses weakens the balance sheet which prompts to resists lending, severely affect the economic activity. As bank stop lending practice there is no other players which can solve the adverse selection and moral hazard problems Hence, the lending booms and crash may be expected outcomes in developing economies as compared to developed countries. The happening of such events in developing economies may be attributable to institutional weakness which resists the nation from effectively navigating the liberalization and globalization process. If

there is strong prudential regulation and supervision system which resists over risk taking, then these events would not have happened. Here the question arises that why the regulations and supervision system are weak. The best answer is principal-agent problem which resists the financial liberalization process through encouraging national business interests. Politicians and prudential supervisors are agents of principals (voters-taxpayers). The duty of Politicians and prudential supervisors should protect interest of tax payers.

Once financial markets have been liberalized, business interest who own banks will resist supervisor for performing their duty effectively because they are able to motivate the politicians for weakening of regulations through contributing to political campaign, which prevents banks from involving in high risk strategies. Hence, prudential supervisors may not perform in public interest. Moreover, if bank owners earn high growth then they stand to make fortune by expanding their lending practices, otherwise government is likely to bail out in case of trouble. Additionally, business interest can make sure that supervisory authorities may not be able to monitor banking institutions irrespective of presence of tough regulations, may be attributable to lack of resources. Business interest may also prevent supervisors to perform effectively in developed countries like USA; however, they are more powerful in developing economies, transpiring to weak institutional system irrespective of better-educated public and free press monitor politicians who don't perform in welfare of public interest.

Other factors which trigger financial crises are severe fiscal imbalances e.g Argentina in 2001–2002, Russia in 1998, Ecuador in 1999, and Turkey in 2001. When government face large fiscal imbalances can't finance their debt, usually force banks to purchase government debts. Banks exhibit huge decline in their net worth along with balance sheet while holding these debts. With less capital, these banks lack resources due to which their lending practices decline which leads adverse selection and moral hazard problems.

Secondly, rise in interest rate reduces firm cash flows, forcing to search funds from external capital markets where asymmetric problems are greater. When interest rate rises, high risk firms are more willing to pay high interest rate that leads to adverse selection and moral hazard problems

Thirdly, as assets prices decline reduces net worth of firms that may lead to adverse selection and moral hazard problems; however, assets prices don't play a dominant role in triggering financial crises because in developing economies these market are no large. In developed and developing countries, in recession, people are uncertain about rate of investment projects; however one additional factor of uncertainty i.e. instability of political systems may exist in developing countries. As uncertainty increases, it is very hard for lender to screen out and monitor the firm activities to

whom they make loan, also leading to adverse selection and moral hazard problems

CONCLUDING REMARKS

Financial development heightens the economic growth both in domestically and globally. Financial deepening provides efficient legal infrastructures and corporate governance mechanisms. It increases the frequency of innovations through encouraging the entrepreneurs by providing credit expansion. It heightens the foreign direct investment through providing better opportunities in national and international context. It reduces the poverty reduction through discouraging inequality between poor and rich persons. Although financial deepening provides many positive outcomes to economies like enhancing the hiding costs, efficiency of transforming savings into investments, heightening the official governmental policies through deregulating credits, strengthening restrains interest rate, price mechanisms as well as improving market competition; but sometimes excess financial deepening may lead to negative outcomes like restraining the financial markets to be efficient, reducing the profit margin and increased financial fragility of banks and may create financial crises if excessive risks is taken in presence of increased competition. Additionally, financial deepening may lead to negative role in bringing bank failures and financial instability.

Policy Implication for Minimizing Financial Crises: Developing Countries

- Central bank should pursue an explanatory monetary policy through injecting liquidity reserves either from open market operations or banking sector lending, which increase the money supply and price level. Injecting reserves in economy raises the asset prices that will enhance the net worth of company and diminish the moral hazards and adverse selection problem. Other mechanism of using explanatory monetary policy is through stock market intervention and foreign exchange market.
- Debt contract should be denominated in home currency and of long time period which lead in deflation in economy, produces decline in household and firms debt burden, ultimately enhances the net worth, overcomes the adverse selection and moral hazards problem.
- The second measure of recovering from financial crises is to pursue lender of last resort role by central bank that it can ready to facilitate loan facility in financial crises.

Developing Countries

- In developing countries, explanatory monetary policy could not be an effective measure of recovering from financial crises because it will rise the inflation rate dramatically which will depreciate the home currency. As depreciation of home currency deteriorates firm's and bank's balance sheet because much debt is denominated in foreign currency that raises the stack of indebtedness and decline banks net worth.

- Similarly, lender of last resort does not play an effective role in recovering from financial crises because central bank lending create domestic credit expansion might rise the inflation beyond the control. Due to these above factors recovery from financial crises is very complex task in developing countries rather than developed countries. Therefore, restrictive monetary policy should be used in developing countries to bring low inflation and confidence in home currency. Creating and maintaining a regulatory system might be helpful in reducing the excessive risk taking in their financial systems, translating the financial crises recovery. Adequate resources should be available in regulatory system to performance job effectively. Second, accounting and disclosure requisites for financial institutions need to be beefed up significantly. Third there is a need to take corrective action for those institutions that don't have sufficient net worth. Fourth, adopt a financial liberalization strategy that leads to the efficient functioning of financial markets and prolific investment opportunities. Acquiring funds to those with the most prolific investment opportunities is significant to emerging economies because these outlays can have high returns in these nations and kindling speedy economic development. Fifth, the legal and judicial systems should be helpful in recovery from financial crises through providing property rights. If property rights are indistinct to implement, the procedure of financial intermediation can be hindered. Sixth, another important strategy is to provide debt contracts of short horizons both domestically and globally

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