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# Identifying the Relationship among Financial Development, Growth and Inequality: The Study of Bangladesh

**Nelufer Yesmen Milly[1], Md. Moniruzzaman Muzib[2]**

[1]Lecturer, Department of Criminology and Police Science, Mawlana Bhashani Science & Technology University, Tangail, Bangladesh

[2]Assistant Professor, Department of Economics, Mawlana Bhashani Science & Technology University, Tangail, Bangladesh

***Corresponding Author:**
Md. Moniruzzaman Muzib
Email: zamanmuzib@gmail.com

**Abstract:** This paper examines the impact of financial development on the rates of investment in physical and human capital, again with and without accounting for country fixed effects. The development of financial sector through effective utilization of domestic resources is vital for economic growth and poverty reduction. During the first half of the 1990s Bangladesh experienced major financial sector reforms which included the liberalization of interest rates, improvement of monetary policy, abolishing priority sector lending, strengthening central bank supervision, regulating banks, improving debt recovery and broadening capital market development. To the extent that financial development facilitates growth by encouraging factor accumulation; we should observe their impact in these direct specifications.

**Keywords:** Financial Development, Monetary sector reform, Growth and Inequality

## INTRODUCTION

The relationship between financial development and economic growth has become an issue of extensive analysis in recent years. A general proposition states that the development of the financial sector is expected to have a positive impact on economic growth. The theoretical relationship between financial development and economic growth goes back to the study of Schumpeter [1] who focuses on the services provided by financial intermediaries and argues that these are essential for innovation and development. The impact of financial development on the long-run growth is of particular interest: A healthy financial system not only encourages savings, but also improves the allocation of such savings to efficient investment projects; this, in turn, encourages an efficient and high level of capital formation to promote growth. There has been enormous support for the position that even though interest rates might not significantly affect the savings rate, they do influence economic growth through their effect on financial deepening. Levine [2], Jalilian and Kirkpatrick [4] explore that financial development exerts a significant and positive influence on growth contribute to achieving the goal of poverty reduction in developing countries where as Honohan [3] said that Financial depth is not only negatively associated with headcount poverty, income and inequality but depth alone is an insufficient measure of financial development. Quartey [5] If financial sector development causes savings mobilization and savings causes poverty reduction, then by intuition, a developed financial market will promote poverty reduction. Schumpeter [1] argued that financial services are paramount in promoting economic growth. Financial development has contributed to impressive economic growth in a number of developing countries. Bittencourt (2009) showed that the financial development had a significant and robust effect in reducing inequality during the period. Private sector credit has contributed positively on economic growth. That means financial development do not boosts economic growth. But these results may not appear if the financial development is measured by the ratio of the value of credits granted by financial intermediaries.

The development of financial sector through effective utilization of domestic resources is vital for economic growth and poverty reduction. Financial sector reforms began in Bangladesh back in the early 1980s and accelerated the pace in the 1990s. The goal of those reforms was to improve the process of financial intermediation by implementing legal, policy, and institutional restructuring. The changes contributed to the increase in Bangladesh's gross domestic product (GDP), which grew at an average rate of 5.8% per annum from 2000 to 2009, compared to 5.5% from 1995 to 2009. These modifications led to the efficient allocation of financial resources, promoting higher investment and capital formation. During the first half of the 1990s Bangladesh experienced major financial sector reforms which included the liberalization of interest rates, improvement of monetary policy, abolishing priority sector lending, strengthening central bank supervision, regulating banks, improving debt recovery and broadening capital market development. We also directly examine the impact of financial development on the rates of investment in physical and human capital, again with and without accounting for country fixed effects. To the extent that financial development facilitates growth by encouraging factor accumulation, we should observe their impact in these direct specifications. We want to see:

1. The nature of positive relationship between economic growth and financial development
2. The negative relationship between economic growth and inequality in Bangladesh.

**Growth and Inequality**

A high level of inequality may not only increase the poverty but also reducing impact of economic growth. The reason why income distribution is likely to exert an influence on economic efficiency is that productive opportunities might vary along the wealth distribution [6]. Where information is costly and imperfect, equilibrium credit rationing will arise - that is, agents will be able to obtain credit only if they own assets that can be used as collateral. A more unequal distribution of assets would then imply that, for any given level of per capita income, a greater number of people are credit constrained [7]. Higher income inequality can negatively impact on economic growth, and thus, bring about a decrease in the rate of economic growth. Economic growth also may widen disparities between individuals and groups in the economy, and by increasing inequality, reduce the impact of financial development on poverty reduction. This suggests that the relationship between financial development and poverty reduction is complex. It depends on whether financial development increases inequality and this increased inequality is large enough to dwarf the positive effect of financial development. It also depends on whether economic growth and income inequality mutually reinforce each other such that higher inequality leads to lower growth and higher growth leads to higher inequality. The role of financial development in influencing growth stresses its influence on accumulation rates of these primitives, particularly physical and human capital. If financial development influences growth primarily through its impact on factor accumulation, we should not expect indicators of financial development to appear in standard growth accounting exercises that already incorporate rates of factor accumulation as explanatory variables.

The Gross Domestic Product (GDP) in Bangladesh expanded 6.30 percent in 2012 from the previous year. GDP Growth Rate in Bangladesh is reported by the Bangladesh Bank. Historically, from 1994 until 2012, Bangladesh GDP Growth Rate averaged 5.58 Percent reaching an all time high of 6.70 Percent in June of 2011 and a record low of 4.08 Percent in June of 1994. Bangladesh is considered as a developing economy. Yet, almost one-third of Bangladesh's 150m people live in extreme poverty. In the last decade, the country has recorded GDP growth rates above 5 percent due to development of microcredit and garment industry. Although three fifths of Bangladeshis are employed in the agriculture sector, three quarters of exports revenues come from producing ready-made garments. The biggest obstacles to sustainable development in Bangladesh are overpopulation, poor infrastructure, corruption, political instability and a slow implementation of economic reforms. This page includes a chart with historical data for Bangladesh GDP Growth Rate.

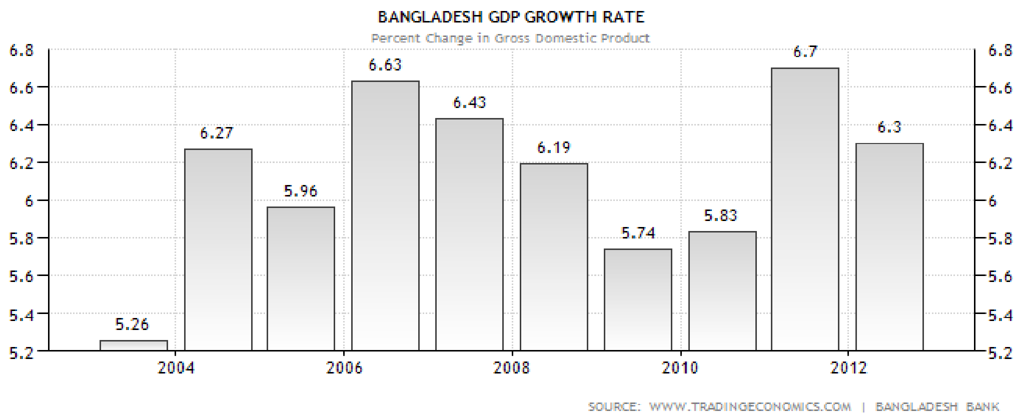


**Fig-1: Bangladesh GDP growth rate**

Table 1 presents the estimation for rural and urban headcount poverty incidence, along with the Gini coefficient of expenditure (a proxy for income), mean consumption expenditure as percent of the poverty line (indicating the changes in income growth) and the rural-urban gap in mean expenditure. The poverty estimates are based on a consistent methodology based on a "cost of basic needs" approach incorporating a minimum level of per capita calorie consumption. The only exception is that the estimates for 1995/96 are based on primary unit-record data (Sen 1998), while those for other years are based on the published grouped data. There are some interesting features of these estimated trends in poverty and income inequality. As regards rural poverty, between 1983/84 and 1991/92, there was little improvement in poverty incidence, which was due to stagnation in rural income(as can be seen from the trends in the mean level of consumption as a ratio of poverty line consumption expenditure) while distribution of income worsened only slightly in the first half of the 1990s.

**Table1: Trends in poverty and income distribution in rural and urban areas, 1983-84 to 1995-96**

| Year | % of population under poverty line | | Gini index(%)of consumption expenditure | | Mean consumption expenditure as% of poverty line | | Urban-rural ratio of mean expenditure |
|---|---|---|---|---|---|---|---|
| | Rural | Urban | Rural | Urban | Rural | Urban | |
| 1983/84 | 53.8 | 40.9 | 24.6 | 29.8 | 106 | 131 | 1.39 |
| 1991/92 | 52.9 | 33.6 | 25.5 | 31.9 | 109 | 153 | 1.60 |
| 1995/96 | 51.1 | 26.3 | 28.8 | 36.7 | 116 | 192 | 2.05 |
| 2000 | 43.6 | 26.4 | 29.7 | 37.9 | 129 | 197 | 1.74 |

Source: Estimated from data reported in Sen (1995), Sen (1998) and Osmani et al.(2003).

Although income increased, its effect on poverty reduction (a decline by 2 percentage points) was compromised by a sharp increasing inequality. In the latter half of the 1990s, income increased even more markedly while income inequality increased only slightly-the result was sharp fall in poverty (by more than 7 % points).

In the first half of the 1990s, agricultural growth stagnated while rural income increased due to income growth in the relatively up-scaled non-farm activities. Evidence from the HES data shows that not only is non-farm income more unequally distributed compared to rural income as a whole, but it also became increasingly so through the 1990s and its share in total rural income also steadily increased [8].

In the second half of the 1990s, a strong agricultural growth seems to have resulted in a further acceleration of growth of rural income with a slowdown in the worsening of income distribution. In the later period, there was also a marked increasing inequality. The rural-urban income differential continually increased up to the mid-1990s, and this trend was reversed only in the latter half of the 1990s, a period of strong agricultural growth. It may be noted that rural income distribution has been less unequal all though compared to urban areas.

**Financial Development, Growth and Income inequality in Bangladesh:**

Financial development can lead to economic growth in the following five ways: i) by facilitating the trading, hedging, diversifying, and pooling of risk, ii) by allocating resources to the most productive uses; iii) by monitoring managers and exerting corporate; iv) by mobilizing savings, and v) by facilitating the exchange of goods and services [9]. The theoretical mechanism by which financial development leads to economic growth is best captured by Figure 2. The figure shows schematically how financial markets and intermediaries can be linked to growth by means of their five main functions. In fulfilling those five functions to overcome market frictions such as information costs and transaction costs, financial markets and intermediaries actually affect saving and allocation decisions in ways that influence growth.

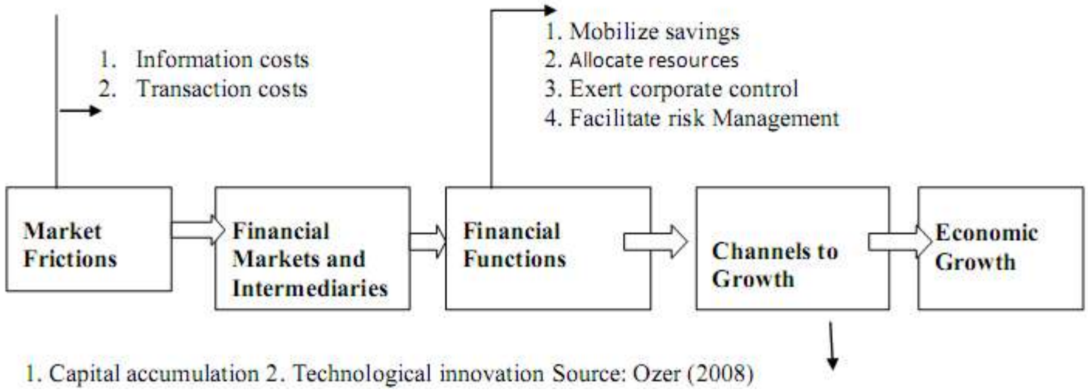


**Fig-2: Understanding the finance-growth nexus**

Levine [9] identifies two channels through which each financial function may affect growth: Capital accumulation and technological innovation [10]. The financial system affects resource allocation either by altering the savings rate or by reallocating savings among different capital producing technologies. With respect to technological innovation, the functions performed by the financial system affect economic growth by altering the rate of technological innovation. Therefore, the degree of financial development can have a positive effect on economic growth both by increasing the volume of investment and its efficiency [8] Financial development can increase the volume of investment by the greater mobilization of investible resources in the economy. There is persuasive empirical evidence both across countries and for individual countries that suggest that countries with better developed financial systems tend to grow faster, controlling for all other determinants of economic growth. However, while financial development can lead to higher economic growth, it is not obvious that it will lead to higher poverty reduction (Holden 2001). This is because of two reasons. Firstly, the effect of financial development on poverty reduction is itself dependent on the level of income or asset inequality in the country. Secondly and more importantly, financial development may itself exacerbate inequality in the country. Thus, as banks and other financial intermediaries grow in size and number, they may choose to lend only to those who have collateral and who can borrow against such collateral. This may be high net worth households and medium and large firms in the country.

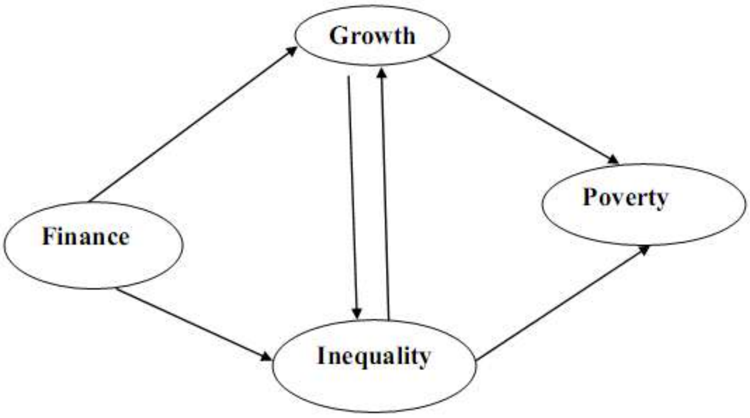


**Fig-3: The inter-relationships between financial developments, Economic growth, income inequality and poverty**

Financial development is the increase in the size of the financial sector relative to economic activity. Higher levels of financial development are brought about by the increase in number of financial intermediaries such as commercial banks and co-operative credit unions along with an increase in the size of these intermediaries. Financial development to have an unambiguous positive effect on poverty reduction, it must lead to both an increase in economic growth and a decrease in income inequality. Such an outcome is most likely if financial development is inclusive.

The strongest effect is the negative relationship between the square of financial deepening and economic growth. Financial deepening can be either positive or negative, while the square is always positive, so the effect is never positive, as shown in Figure 4. The negative effect is much stronger in Bangladesh with large declines in financial deepening or large increases in financial deepening. The marginal effect (Figure 4) is therefore positive when financial deepening declines and negative when financial deepening grows. This suggests that Bangladeshi growth is harmed by both a shrinking and expanding banking system. One can explain the deleterious effect of a shrinking banking system by invoking the theory discussed in the introduction: financial development facilitates economic growth by reducing information costs and transactions costs in product markets. Thus, a shrinking banking system will raise those costs and stifle economic growth. The deleterious effect of an expanding banking system can most likely be attributed to the same sources.

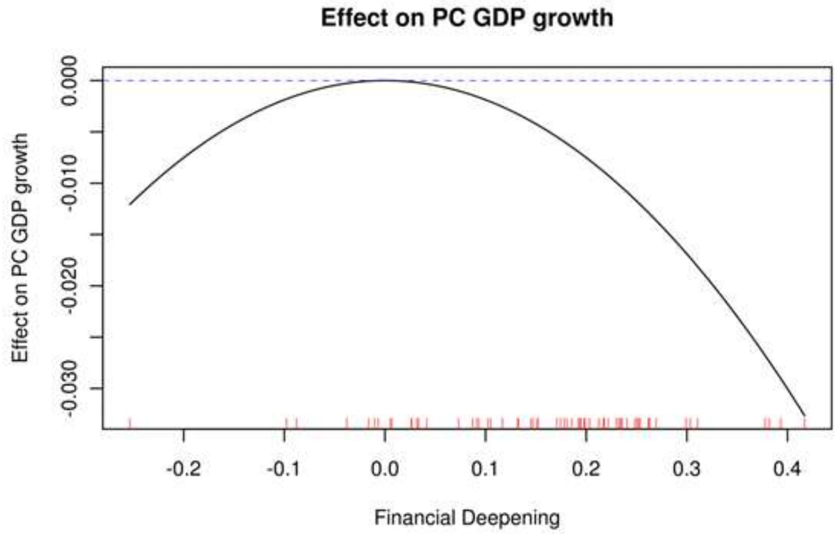


**Fig-4: The effect of the growth of financial deepening on real per capita GDP growth. The curves represent the effects as given in the restricted model, while the red rugplot indicates the values of financial deepening growth found in the data**

## CONCLUSION

This paper examines the nature of positive relationship between economic growth and financial development and the negative relationship between economic growth and inequality in Bangladesh. The degree of financial development has a positive effect on economic growth both by increasing the volume of investment and its efficiency. Financial development can increase the volume of investment by the greater mobilization of investible resources in the economy of Bangladesh. There is persuasive empirical evidence both across countries and for individual countries that suggest that countries with better developed financial systems tend to grow faster, controlling for all other determinants of economic growth.

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