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THE RELATIONSHIP BETWEEN FINANCIAL DEVELOPMENT AND ECONOMIC GROWTH IN EMERGING MARKETS

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ABSTRACT

With the negative impacts of the recent global financial crisis, several countries are still experiencing a slow pace in their rate of economic recovery. This trend has been consistent since the first quarter of 2009, taking into consideration that financial systems were the most affected. In addition, economic recovery has been fragile due to several reasons. For instance, there have been increased uncertainties on the performance and sustainability of the U.S. economy. Moreover, different country groups have had divergent economic performance which limit of a consistent economic growth. As the monetary authorities strived to stabilize their financial systems, European economies were exposed to increased risk of sovereign defaults and this worsened the rate of economic recovery. Countries such as Turkey were exposed to a fluctuating and weak global economy. However, Turkish economic recovery in 2010 was boosted by increased business and consumer demand, particularly due to monetary easing measures and fiscal stimulus packages. These policies were instrumental in maintaining positive growth in the last four quarters of 2010. As the financial systems continued to stabilize, Turkey was able to record the fastest recovery among European and OECD nations. Its rate of economic growth was one of the highest across the world. Emerging markets were recipient to capital inflows in 2010 especially because of high global risk appetite. Authorities in several developing economies were able to record strong economic growth due to sound financial systems, strong economic growth, high nominal interest rates and prudent public finance management.

Key Words: *Financial development, Economic growth, Emerging markets.*

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Trakya Üniversitesi Sosyal Bilimler Dergisi
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GELİŞEN PİYASALARDA FİNANSAL GELİŞME VE EKONOMİK BÜYÜME ARASINDAKİ İLİŞKİ

ÖZET

Yakın zamanda yaşanan küresel mali krizin olumsuz etkilerine maruz kalan bazı ülkelerin ekonomik iyileşme hızları halen oldukça düşüktür. Finansal sistemlerin bu durumdan en çok etkilenen bünyeler olduğu dikkate alındığında, bu trendin 2009 yılının ilk çeyreğinden beri aynı şekilde sürdüğü görülmektedir. Buna ek olarak ekonomik iyileşme, birkaç neden yüzünden hassastır. Örneğin ABD ekonomisinin performansı ve sürdürülebilirliği üzerindeki belirsizlikler artmıştır. Bundan başka farklı ülke grupları, tutarlı bir ekonomik büyümeyi sınırlayan birbirinden ayrı ekonomik performanslara sahiptir. Parasal yetkili kurumlar finansal sistemlerini stabilize etmeye çalışmasına karşın, Avrupa ekonomileri devlet borçlarının ödenememesi riskiyle karşı karşıya kalmış ve bu durumda ekonomik iyileşme oranlarını daha da kötüleştirmiştir. Türkiye gibi gelişen ülkeler, kararsız ve zayıf bir küresel ekonomiye maruz kalmıştır. Ancak Türkiye'nin 2010 yılında yaşadığı ekonomik iyileşme, artan iş ve tüketici talepleri ile daha da desteklenmiştir. Bunun sebebi özellikle mali piyasaların rahatlatılması ve güçlü mali teşvik paketleridir. Mali sistemler istikrarlı olmaya devam ettikçe Türkiye, AB ve OECD ülkeleri arasında görülen en hızlı ekonomik iyileşmeye sahip olacaktır. Kamu otoriteleri ekonomilerinde; sağlam finansal sistemler, güçlü ekonomik büyüme, yüksek nominal faiz oranları ve dikkatli mali yönetim sayesinde güçlü bir ekonomik büyüme kaydedebilmiştir.

Anahtar Kelimeler: *Finansal gelişme, Ekonomik büyüme, Gelişmekte olan piyasalar.*

1. INTRODUCTION

The global economy went through one of the worst financial crisis since the Great Depression, and it is not until the first quarter of 2009 that slow recovery was experienced. Rapid economic recovery was weakened by uncertainties on the status of the U.S. economy, economic differences among major country groups and increased risk of sovereign defaults among European countries (Barth & Caprio, 2010). Advanced countries such as the U.S. and Japan experienced moderate growth as the rest of European countries continued to falter. However, emerging countries recorded strong growth probably due to

Trakya Üniversitesi Sosyal Bilimler Dergisi
Aralık 2012 Cilt 14 Sayı 2 (147-156)

implementation of prudent financial and economic policies prior to the global crisis. The Turkish economy began to shrink in the last quarter of 2008 and continued to worsen for four consecutive years. This document critically analyses the relationship between financial development and economic growth in emerging markets, and takes a keen interest in the case of Turkey.

2. GLOBAL ECONOMY

Most of the developed countries experienced severe financial turmoil compared to developing countries. In addition, the rate of recovery was faster in developing countries despite the fact that several nations were at the blink of economic collapse. Rapid recovery in the emerging markets is attributed to keenness in their financial systems as well as appropriate economic policies. These were instrumental in reducing public debt, strengthening their financial positions and accumulating their foreign reserves (Demirguc-Kunt, 2010). On the other hand, accommodative monetary policies were applied by developed countries to support economic activity. Expansionary policies in the developed countries led to increased capital flows to the less developed nations, causing local currency appreciation. Emerging markets began to experience loss in export competitiveness and to avert currency appreciation; monetary authorities had to intervene in the currency market. The currency wars are similar to those policies which several nations applied during the Great depression.

Emerging markets enjoyed increased financial inflow, but as a result of huge fiscal stimulus packages in the developed countries, the global crisis led to severe damage in public budgets. Countries such as the U.S. and other developed economies in Europe saw their public debt to GDP more than triple (Cerra & Saxena, 2008). The sustainability of budget deficits raised huge concerns since the risk of sovereign default was likely to spill over to their short term liabilities. These problems were likely to escalate in countries located in the Eurozone peripheral. Huge fiscal deficits as well as slow economic growth rates means that economic policies implemented by these countries would be less effective.

Trakya Üniversitesi Sosyal Bilimler Dergisi
Aralık 2012 Cilt 14 Sayı 2 (147-156)

3. THE CASE OF TURKEY

Before the global financial crisis, economic growth in Turkey took place for 27 consecutive quarters. However, by the last quarter of 2008, it began to shrink and it continued in the same trend for the next four quarters. To save the economy from total collapse, the government implemented several fiscal and monetary policies. Monetary policy easing measures as well as fiscal stimulus packages led to the rise in the Gross Domestic Product (GDP) in the fourth quarter of 2009 (Edison, Ricci & Slok, 2010). In the first three quarters of 2010, GDP rose by 11.8%, 10.2% and 5.5% consecutively and this was particularly attributed to strong domestic demand. Experts are of the opinion that the financial sector in Turkey is still at its development stage.

However, financial systems have a have a huge potential for further expansion due to solid economic growth and declining inflation and interest rates. Sources from the Turkish Banking Regulation and Supervision Agency (BRSA) showed that the financial sector increased by close to 20% of CAGR between 2002 and 2010 (Invest.gov. 2010). Based on the sizes of assets, banks owned 77% of the assets implying that they are the dominant players in this sector. The insurance sector has also developed at a rapid pace, with CARG increasing by 25 percent during 2002-2010. In addition, the country has experienced new momentum due to the reform in the social security sector and the introduction of the universal health insurance.

When GDP is analyzed in terms of production, it can be seen that all sectors apart from agriculture and financial services, experienced negative growth rates in 2009. Dorrucci, Meyer-Cirkel and Santabarbara (2009) say that contraction of the economy which began in the last quarter of 2008 begun to change by the end of 2009. In the fourth quarter of 2009, the services and industry sector experienced a surge and this contributed to a 6 percent increased in GDP. The high growth trend especially in domestic demand and industrial sector continued in 2010. In four consecutive quarters, Turkey has experienced robust economic performance up to the end of September 2010. Compared to other European and OECD nations, Turkey is ranked as the fastest recovering economy with its growth rate among the highest in the world.

Trakya Üniversitesi Sosyal Bilimler Dergisi
Aralık 2012 Cilt 14 Sayı 2 (147-156)

In the first three quarters of 2010, economic recovery has been significant with a GDP growth of 8.9%. Industry and services sectors were among the major contributors to this phenomenon growth with 3.6% and 3.5% increase respectively. There was a different trend in the financial intermediation services compared to that in the general services sector. Continuous contraction in the services sector began during the global financial crisis and continued until the last quarter of 2009. During the crisis period, financial intermediation services increased consistently unlike the rest of the foreign counterparts (Mello & Dutz, 2011). This is attributed to the prudent reform policies which were implemented previously in the financial sector. By the year 2010, all sectors apart from agriculture experienced growth and contributed positively to the GDP growth.

4. PUBLIC FINANCE

Public finance and economic performance are closely intertwined in the emerging markets (Arestis, 2005). Policies implemented in developed economies have a significant impact in the way fiscal and monetary policies are governed in emerging economies. For instance, in the U.S. and many other developed countries in the Eurozone, authorities implemented huge fiscal stimulus packages. However, the global financial turmoil led to severe damages in public budgets. As the budget deficit continued to raise huge concerns, several countries especially in the Eurozone moved closer to a risk of sovereign default. Current account deficit to GDP ratio has been on the rise but the general indebtness figures in Turkey are robust.

A balanced public finance outcome emerged from increase in tax revenues, recovery in economic activity, control on public expenditure and reduction interest expenses. As the volume of imports continued to increased, the government earned higher tax revenues from imports. In addition, consumption tax revenues rose significantly due to increase in consumption of petroleum and other goods (Stiglitz, 2010). All of the above items are subject to a special consumption tax and as the interest rates continued to decrease, so did the interest expenses. As at the end of 2009, the primary balance was TRY 0.44 billion but this figure rose significantly to TRY 23 billion by the last quarter of 2010. In the first 11 months of 2010, there was a decline in the budget deficit to

TRY 23.5 billion, from the previous figure of TRY 46.4 billion. In the first 3 quarters of 2010, tight fiscal deficit led to a 2.6% government budget deficit, which was down from 5.5% in 2009 (Turkish 2011 Annual Program, 2011).

5. DEVELOPMENTS IN EMERGING MARKETS

Financial growth plays a leading role in influencing economic development in emerging economies. Arestis (2005) says that when monetary authorities are in a position of making funds available at low interest rates, investment and consumption will also increase. As a result of the global financial crisis, global output shrank by 1.1% in the last quarter of 2009. However, substantial fiscal and monetary measures taken to combat the crisis reduced the shrinkage to 0.6%. The recovery process was slow but emerging markets showed a strong growth performance. In the second half of 2009, emerging markets had started recording growth and it continued in 2010 (Turkish 2011 Annual Program, 2011). As the financial markets continued to show a strong performance, growth expectation in emerging markets as well as the world economy was estimated to be 4.8%.

Emerging markets were not as severely affected by the global crisis as the developed countries. In 2009, developed economies shrank by 3.2% while emerging economies recorded a growth rate of 2.5% (Stiglitz, 2010). In addition, experts estimated that developed economies will grow by 2.7 and 2.2 in 2010 and 2011 respectively, while the growth rate in emerging markets will be 7.1% and 6.4 respectively. Since the financial sector in the world economy was the worst affected, financial analysts are of the opinion that the risk is still present. The recovery process has been consistent with several countries having a high level of optimism. Emerging markets implemented monetary policies aimed at shielding their economies from the adverse effects of the global crisis (Caprio, 2008). This was instrumental in enhancing quick recovery as well as ensuring that the growth rate is high compared to developed economies.

When compared to emerging markets, developed economies had their consumption expenditures moderately revitalized during the period of global turmoil as a result of the measures that were implemented. However, the same countries recorded a decline after the measures came to an end (King, 2009). A decline in household revenues as well as low levels of consumer confidence limited the growth of consumption levels. Although the growth rate was positive, it still remained very low. In several countries, the rate of unemployment and government deficit is still high and this has intensified social pressures. A smooth transition to sustainable growth is at risk because of the challenges which limit the implementation of new measures (Barro, 2009). For growth to be stabilized, authorities must come up with measures which enhance employment growth rates and financial recovery.

Emerging markets have seen their employment levels increase due to a positive economic performance. In addition, the financial sector of developing economies was not severely affected by the global crisis (Harwood & Smith, 2009). This ensured that they did not experience a serious problem thus assisting their fiscal policy practices to record growth more easily. In 2009, commodity and oil prices rose considerably before returning to the pre-crisis level in 2010. However, experts estimated that the whole of 2011 will see these prices take a horizontal path due to a slight decline in global demand. Although oil and commodity prices recorded a remarkable decline, contraction in demand led to lower increases in consumer prices compared to the 2009 historical averages. In the emerging markets, there was a 5.2% increase in consumer prices. In developing economies however, this rate remained relatively low at 0.1% and some countries even run the risk of deflation. In 2010, the CPI inflation rose slightly compared to 2009. Graff (2010) says that estimates will be lower than the long-term averages with the rates being 6.2% in developed countries and 1.4% in developing countries.

Financial policies play a significant role when it comes to influencing oil and commodity prices (Hermes & Lensink, 1996). In addition, when prudent measures are implemented to ensure that both factors remain sustainable, there is a high chance of economic growth. Beck and Demirguc-Kunt (2010) say that oil and commodity prices rarely create inflationary pressures therefore there is a progress on demand and increased economic growth. Despite of economic growth, researchers argued that CPI inflation would reduce slightly in 2011 compared to 2010 because of the moderate progress in demand.

Rapid recovery in emerging markets as well as stabilization of the financial systems has been influenced by revitalization of global trade (King, 2009). Moreover, the global economy recovered in 2010 due to increased level of exports and imports. In 2009, global trade volume had declined by 11% but experts estimate that it will rise by 11.4% and 7% in 2010 and 2011 respectively. In 2009, the rate of decline in emerging markets was lesser than in developed economies. The rate of growth in 2010 was also higher in emerging markets. Stability in the financial systems has a major influence on trade volumes which consecutively affects economic development. The positive trend in emerging markets is expected to continue and even achieve higher trade volumes. In 2009, the huge decline in trade prices were moderately recovered in 2010, but Keles (2010) says that it will be very challenging to reach to the pre-crisis level. The prices of finished goods declined by 6.1% in USD terms, but they are expected to rise by 3.1% and 1.4% in 2010 and 2011 respectively. Although they are expected to record a positive growth, the rates will remain low due to the existing surplus capacity.

6. CONCLUSION

It is evident that financial development and economic growth are positively related as it has been revealed in the emerging economies. As different nations emerged from the global financial crisis, most of them recorded negative growth rates. Emerging economies were less severely affected compared to developed economies. Experts attribute this to the keen financial measures taken by monitory authorities. In addition, governments in developing economies implemented monetary and fiscal policies aimed at shielding their economies from the adverse effects the financial crisis. The recovery process in emerging markets was more rapid due to the fact that their financial systems were moderately affected, and that prudent policies had been implemented to safeguard their economic institutions. Turkey is one of the countries which showed a quick recovery in their economic activity. Although the global economy showed a sluggish recovery pace from the financial turmoil, Turkey kept a closely monitored financial system, strengthened their fiscal positions, implemented sound economic policies, accumulated their foreign reserves and reduced their public debt. In the emerging markets, some of the successful

Trakya Üniversitesi Sosyal Bilimler Dergisi
Aralık 2012 Cilt 14 Sayı 2 (147-156)

economic policies had been implemented before the global crisis and they were instrumental in shielding their institutions from total collapse.

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