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The Role of Financial Markets in Economic Growth

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ABSTRACT

This paper aims at scrutinizing how financial markets operate in trying to influence the magnitude and direction of economic growth as they purpose to intermediate funds between surplus spenders and deficit spenders. We examine how direct foreign investments and local investors interlink to optimize on the growth of the economy. We model our problem to incorporate financial markets operations, capital flows from foreign nations and the local market capital structure to show their influence in the level of economic growth.

Our focus is construed towards two view points; that form of growth emanating from foreign direct investment and that which comes from local investments. The various links that are enjoined to from the funders all the way to the injections in the economic structure are also examined. Various past works by renowned scholars serve to provide the empirical evidence that foreign direct investment have superior impact on the growth relative to local investments. From this, we will demonstrate that for any financial market to operate at the point of optimality it needs to adopt mechanisms, policies and infrastructures to attract the FDI.

Economic planners are faced with difficulties of balancing between short term funds availability versus long term. Their levels within the economy serve to guide liquidity conditions as well as prepare economies for long term investment take off influencing policing. The paper formulates ways through which agents can advantage themselves from the policies to either increase their return on investment or to grow, expand their enterprises.

KEYWORDS: Economic Growth, Financial Markets, Foreign Direct Investment

1. Introduction

This paper, tries to scrutinize how financial markets operate in trying to influence the magnitude and direction of economic growth as they purpose to intermediate funds between surplus spenders and deficit spenders. The paper examines how direct foreign investments and local investors interlink to optimize on the growth of the economy.

A financial market is a form of a specialized market that channels financial resources from surplus entities to deficit entities for the sole purpose of carrying out economic activities (Jalloh, 2009; 4). In this regard, financial markets include all financial institutions that propagate financial resources from savers (surplus units) to entities that require financing to undertake financial activities.

The process of transferring financial resources is referred to as financial intermediation; the process of directing financial resources between surplus and deficit entities. In this regard, financial markets constitute an important resource in economic growth (Jalloh, 2009; 13).

On the other hand, Iram and Nishat describe economic growth as the indicator of the health of the economy (Iram & Nishat, 2008). Foreign direct Investment stimulates economic growth of a country while the financial markets play as intermediaries for the flow of investment, be it local or foreign investment from external entities into the local economy. The foreign investment is not only in the form of finances but also knowledge transfer, technological spillovers as well as argumentum human capital.

It is a wide spread belief that foreign direct investment (FDI) leads to positive productivity effects for the host country through various mechanisms including adoption of foreign technology, and direct capital financing (Alfaro et al, 2006). In the recent past, findings have shown that the capacity of a country to utilize externalities occasioned by FDI is limited by local conditions such as the local levels of education and financial markets development (Borensztein et al, 2000). The paper by Alfaro, Chanda, Kalemli-Ozcan and Sayek provides evidence to the fact that FDI only facilitates growth in countries which have well developed financial markets.

2. Analysis

Financial markets are important in enabling economic growth in any economy. They are closely connected to all markets and almost all individuals in an economy (Winkler, 1998). This amplifies the importance of financial markets which lies with the fact that they are linked to all spending decisions in an economy. A flow of funds analysis is certainly the best way of highlighting the close interlinkage between real activity and financial markets.

The funds circulating in a financial market on the other hand are either from locals or from foreign direct investment. On the case of local investments, the gain of an economic agent for example a household or firm results from the loss in another financial agent, i.e. for an agent to incur a financial surplus then an agent in the economy has to incur a financial deficit; the sum of all financial balances in an economy, works out to zero (Winkler, 1998).

Contrary foreign direct investment does not affect two agents in the economy the investment is from external sources, thus it propagates a gaining situation for the local economy. The sum of all financial balances includes the investment from external sources thus does no add up to zero (Winkler, 1998).

Financial markets perform the primary function of intertemporal and interpersonal resource transfer, and are monetary markets (Merton and Bodie, 1995; 12). Although foreign direct investment can be in different forms, it still embodies the fact that it adds financial value to the local economy. FDI induces a number of positive effects to the local economy in the form of technological transfers, managerial skills, introduction of new process and productivity gains (Alfaro et al, 2003).

FDI generally relies on capital from abroad, thus the spillovers for the host country significantly rely on the domestic financial markets development. Consequently, spillovers will not be restricted to the improvements in a local business by taking advantage of the new knowledge, purchases of new machines and equipment and the hiring of skilled labor and management. Local investment is capable of availing the required financial resources but might be constrained in providing the new technological advancements and potential entrepreneurial needs.

Foreign direct investment has the potential to create backward linkages but in the absence of developed financial markets, this is rigorously hampered. FDI through linkages that multinationals create allows existing firms in a host economy to achieve economies of scale and even help in creation of new firms (Hirschman, 1958).

3. Effects of Foreign Direct Investment As Opposed To Local Investment To An Economy

Basically, foreign direct investment influences economic growth by increasing the total factor productivity of the host economy and generally by raising the efficiency of resources in use in the host country (Odenthal, 2001). As mentioned earlier, local investment has little effect on the growth of the economy due to the zero sum game which occurs since any gains by an agent result in a loss by another agent. The points below display a brief comparison between the effects of foreign direct investment as opposed to domestic investment in an economy with a well established financial market:

- Foreign direct investment triggers trade and investment by the integration of the host country's economy into the international economy through imports and exports. Local investment on the other hand has minimal effect on import of new technologically advanced equipment and machinery and export of newer and improved domestically manufactured products.
- Technology transfers whereby new technologies are integrated into the host economy thus leading to better commodities and service delivery. Domestic investment does not impact the need for better and improved equipments and machinery. The industries are contented with the usual machinery and furthermore there is lack of finances to purchase newer equipment.
- Human capital enhancement; this occurs due to better education systems developed by host countries in their bid to attract the foreign investment (Morisset, 2000). If the host country does not realize the importance of foreign direct investment, it will not advance the educational needs of its citizens thus locking out economic development triggered by human capital enhancements.
- Competition by local firms and investors in pursuit of attracting foreign investment; Competition in any case has the potential to create an environment conducive for economic development. Local investment maintains the status quo since the owners of the industries face low competition from new entrants thus they perform at the same level of production and operation.
- Entrepreneurship: Foreign direct investment leads to enterprise development in that local entrepreneurs develop new ideas to attract any form of investment from multinationals and individuals (Morisset, 2000).

4. Conclusion and Recommendations

As depicted in the paper, studies have shown that foreign direct investment in a country with a well developed financial market contributes to economic growth at a higher rate as compared to local investment (Odenthal, 2001). It is however difficult to evaluate the magnitude of foreign direct investment on a host country, since the high growth rate might be as an influence of other unrelated factors. Also the crowding out effect associated with foreign direct investment is yet to be clearly studied.

Foreign direct investment also boosts domestic investment in that it creates an entrepreneurial effect in the local investors who imitate the new technologies advanced by foreign investment.

In less developed economies with low educational, technological and infrastructure development, foreign direct investment has a relatively smaller effect on growth, commonly characterized b threshold externalities which include less developed financial markets (Morisset, 2000).

Governments especially in less developed countries need to enhance and develop robust financial markets in order to realize the full potential of foreign direct investment. Financial markets act as linkages between the foreign financial markets and the economy. With better managed financial markets, the spillovers from direct foreign investment are capable of influencing great economic development in host countries.

For a country to attract foreign direct investment it requires policies and mechanism that make it conducive for the investment. This includes human capital development, streamlining government bureaucracies, development of the financial markets to mirror the international financial markets which are competitive and devoid of corruption. Most developing and third world countries fail to provide these incentives to multinationals and foreign investors.

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