



Relationship between Institutional Quality, Financial Development and Inclusive Growth: Empirical Evidence from SAARC Countries

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Abstract: The current study investigated the influence of financial development and institutional quality on inclusive growth. Financial Development has a bi-directional effect on inclusive growth. When it comes to establishing a solid connection between inclusive growth and financial development, institutional quality acts as a moderator. GDP per capita income is utilized to determine inclusive growth, credit to private sector is utilized to determine financial development, and rule of law and government effectiveness is used to measure institutional quality. The current study selected four SAARC nations Pakistan, India, Bangladesh, and Sri Lanka and data from 2000–2022, to study the connection between inclusive growth, institutional quality, and financial development. The results showed a negative and significant linear relationship between inclusive growth and financial development, but a strong positive association between institutional quality and inclusive growth. The SAARC countries must therefore adhere to the rule of law and maintain effective government in order to utilize financial resources in pursuit of inclusive economic growth.

Key words: Inclusive growth, Institutional quality, Financial development

1. Introduction

Inclusive growth is an emerging economic phrase that has replaced the traditional usage of economic growth, as the difference lies in the conceptual meaning of inclusive growth (Kamal et al., 2021). Following the transition from the Millennium Development Goals (MDGs) to the Sustainable Development Goals (SDGs), the global financial crisis and subsequent spikes in unemployment, economic growth in the face of high poverty levels, and a particular plea for a holistic approach to promote sustainable and inclusive growth in developing countries, the topic of economic growth's inclusivity and participatory tendencies has been front and center in policy discussions (Adeosun et al., 2020).

Researchers have sought to define the concept in various ways, given that the idea of inclusive growth is constantly growing. It is related to continuous growth for all sectors of society. It can cover several aspects of the economy, such as the living standard of an individual, employment level, and financial aspects, such as the cost of capital and availability of resources, geographically and institutionally. Consequently, it can help guide policymaking (Ianchovichina & Lundström, 2009).

FD has been extensively studied and analyzed in several study publications. Financial development (FD) is deemed indispensable by the World Bank in order to achieve seven of the seventeen sustainable development objectives

(Prempeh, 2024). It has been widely held that strong or more finance will lead to greater growth, but if we change this opinion, managing better finance will lead to greater and more inclusive growth (Alfaro et al., 2004). Financial development and economic growth are positively correlated, with high-income and low-income countries adversely affected (Huang & Lin, 2009).

To build a strong relationship between inclusive growth and financial development, institutional quality plays an active role, it enhances the financial development and increasing inclusive growth (Yahyaoui & Al Saggaf, 2019). Institutional quality is a wide term that encompasses several elements, including the efficiency of the government's planning and implementation, business and speech freedom, accountability, the prevention of corruption, and regulatory quality (Nakabashi et al., 2013).

The current study contributes to the current body of research by carrying out an investigation of the influence that financial development has on inclusive growth, with a particular emphasis on the quality of institutions. As opposed to the, this study explicitly takes the SAARC as a case study in order to find the nexus between inclusive growth, financial development and institutional quality.

The main objective of this study is to find out that there is a significant relationship between Institutional quality and financial development in South Asian Regional Countries.

2. Literature Review

Based on the empirical research, a comprehensive investigation into the relationship between FD and economic growth has been carried out. It has already been demonstrated in a great number of empirical investigations that financial development contributes to economic growth. Different researchers defined inclusive growth based on macroeconomic factors (Munir & Fatima, 2020). Inclusive growth does not only involve improving the real income of people but also socially contributing to society.

Numerous research has investigated the correlation between financial advancement and economic growth. The data in the article was collected from 1987 to 2006, employing total market capitalization and credit to the private sector as indicators of financial development and GDP as an indicator of economic growth. They found that there is a bidirectional causality relationship between variables (Demirhan et al., 2011)

The relationship between financial development and economic growth in developing nations such as Kenya was reexamined by Uddin et al. (2013). He applied the Cobb-Douglas production function to determine the relationship, enhanced by financial development and ARDL-bound testing. His research revealed that the financial sector positively influences economic expansion. Since it has a variety of consequences for economic planning, particularly in developing countries, the direction of causality between financial development and economic growth is an important topic for research. The study employed panel data analysis and the system GMM technique to examine the causal relationship between financial development and economic growth in developing nations in Asia. The present analysis validates a substantial correlation between the financial sector and economic growth (Habibullah & Eng, 2006).

To studying the connection between economic growth and institutional quality, a substantial amount of material has been utilized. The study conducted by Qamar et al. (2020) examined the impact of institutional development on economic growth. The Generalized Method of Moments (GMM) approach was employed. The principal component analysis (PCA) method is utilized in the process of developing an institutional quality index. The correlation between the expansion of the economy and the quality of the institutions was favourable but not statistically significant. Khan et al (2019) researched to examine the relationship between institutional quality (IQ) and financial development (FD) in fifteen EAGLE economies. They demonstrated that institutional frameworks are capable of effectively managing ethnic fragmentation (ETHF) and contributed to improve FD. They found that in low developed countries weak institutional framework leads to negative financial development. Similarly, to examine the relationship between financial development and institutional quality, the study examined 40 African countries' economic growth over long and short periods, as well as three income-related subgroup panels between 1980 and 2014. Empirical findings indicated that financial development, institutional quality, and globalization all positively and considerably impact long-term economic growth across the board, including in low-income nations (Berhane, 2018).

Singh Pradhan investigated the impact of institutional quality to determine the economic performance of South Asian countries from 2002 to 2016 using panel data analysis. He used the FMOLS method and analysed with fixed effects. They determined the long run and short run relationship. They found that institutional quality has a long-term beneficial impact on economic performance, but governance variables such as corruption control have a

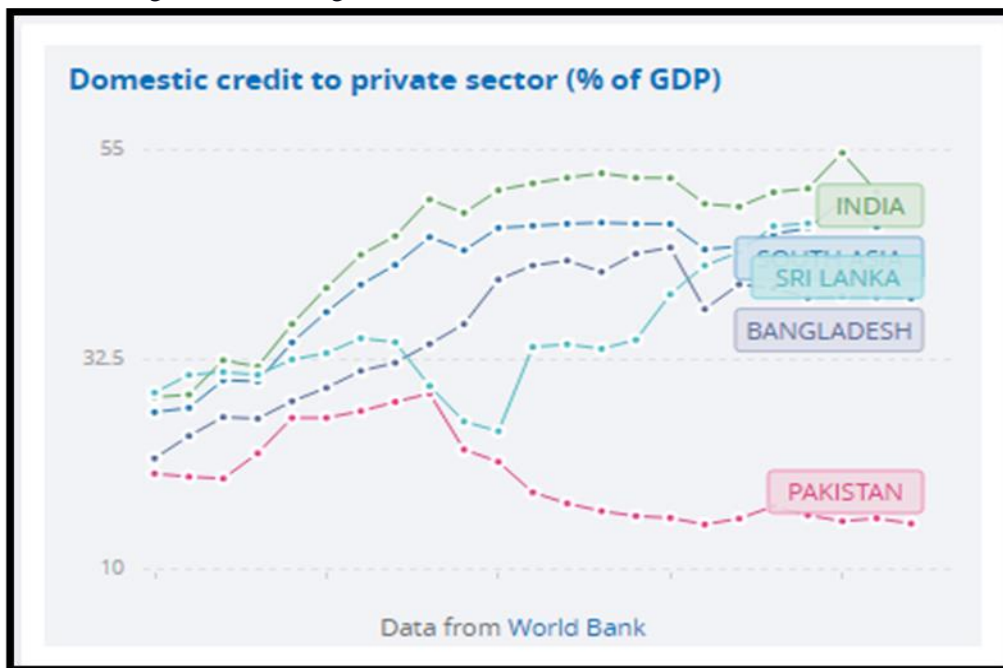
negative impact (Singh & Pradhan, 2020).

3. Data and Variables

This study will use the panel data 2000 to 2021 (22x years) with the annual frequency. The sample of the study is the four Developing Economies of SAARC region which includes Bangladesh, India & Pakistan, Sri Lanka. The selection of these countries was based on their contribution to the overall growth of the region. The data has been taken from world bank indicators and Institution quality data has been taken from World Governance indicators. The variables that measure IG, and FD, are collected from World Bank data and data for INSQ from World Governance indicators. Financial development is typically defined in the literature as an increase in the quality, quantity, and efficiency of financial intermediary services. Many institutions and activities are combined in this process. The financial development variables are credited to the private sector and are expressed as a percentage of the GDP . Institutional Quality acts as the explanatory variable and one of the proxies is Government efficiency, as Governments with ineffective Governance encourage economic agents to operate insecurely, resulting in a lack of enforcement and protection of property rights. As a result, they cannot initiate a continuous growth process (Valeriani & Peluso, 2011). The natural logarithm of GDP measures inclusive growth. It is measured as nominal GDP divided by GDP deflator. (Kling et al., 2020).

4. Result and Discussion

In recent years, credit to the private sector in Pakistan, India, Bangladesh, and Sri Lanka has increased in absolute terms, meaning that more money has been channeled towards the private sector. Using the graph below we can see the increasing and decreasing trends of SAARC countries.



Source World Bank data.

From the graph we can see that, India's credit to the private sector is strong and high in the year 2020-21, which is 50.41. Sri Lanka has improved to 45.01 following the recession. Because there is a lack of allocating economic resources, positive investment in the appropriate direction and balancing with the new technologies in financial development, Pakistan is experiencing a very sluggish pace of economic and financial development. This means that Pakistan is confronting a very slow pace of economic and financial development. (Estrada et al., 2010)

4.1 Inclusive growth (GDP)

Prior to the onset of the COVID-19 epidemic, Sri Lanka's economy had already exhibited indications of fragility. The rate of economic growth and the effectiveness of poverty reduction efforts experienced a deceleration

throughout the course of the previous five-year period. The presence of a trading system that restricts commerce, an unfavourable investment climate, instances of lax monetary policy and a controlled currency exchange rate have all played a role in the development of external imbalances. (Overview, n.d.)

However, Pakistan's economic situation is grave. Large budget deficits, lax monetary policy, and weak consumer spending have contributed to the region's poor economic growth rate. The major problems that Pakistan faces are low investment, huge financial instability, and weak institutional quality that affect Real GDP (Rahman et al., 2020).



Source World Bank data.

From the above graph it is observed that India, which forms most of the region's economy, is projected to maintain steady expansion at a rate of 8.18 percent in FY20/21. Several nations in the region are currently experiencing the lingering effects of recent currency crises. Bangladesh's economic growth is projected to decelerate to 5.72% in the fiscal year FY20/21. Pakistan's projected growth for FY20/21 is a mere 4.55 percent, which falls below the pace of population growth. Sri Lanka is exhibiting indications of recuperation following a profound economic downturn, with the economy projected to expand by 2.40 percent in FY20/21

4.2 Descriptive Analysis

Table 1: Descriptive statistics

	IG	IQ	LFD
Mean	3.781112	-4.55E-09	1.504864
Median	4.402750	0.118751	1.526842
Maximum	8.184368	2.179112	1.736968
Minimum	-6.726292	-2.267838	1.166793
Std. Dev.	2.722521	1.357221	0.161674
Skewness	-1.336968	-0.012427	-0.564656
Kurtosis	5.449912	1.283610	2.332177
Jarque-Bera	48.22399	10.80424	6.311559

Probability	0.000000	0.004507	0.042605
Sum	332.7379	-4.00E-07	132.4280
Sum Sq. Dev.	644.8546	160.2582	2.274040
Observations	88	88	88

The table presents a summary of all the variables GDP, FD and IQ for the period 2000-2020. From the tables it is seen that mean value Inclusive growth (IG) and FD has positive value, but Institutional quality has negative value. Regarding the "IG" variable, the mean is approximately 3.78, indicating the average value. The median, at 4.40, suggests that the data is relatively symmetrically distributed. The maximum value is 8.184, while the minimum value is -6.7262, representing the range of values. The standard deviation is 2.722, indicating that the data points tend to be close to the mean. The negative skewness value (1.336) suggests a slight leftward skew, and the kurtosis value of 5.449 indicates a high peaked distribution. The Jarque-Bera statistic is 48.22, with a probability of 0.00000, which suggests that the data may conform to a normal distribution. The sum of all values is approximately 332.7, and the sum of squared deviations from the mean is 644.8.

For the "IQ" variable, the mean is -4.55, and the median is 0.1185, implying a moderate left skew. The maximum value is 2.1791, while the minimum is (2.267) representing the range of values observed. The standard deviation of 1.357 suggests some variability in the data. The negative skewness value (0.0.124) indicates a leftward skew, and the kurtosis value of 1.283 signifies a moderately peaked distribution. The Jarque-Bera statistic is 10.804, with a probability of 0.0045, indicating to a normal distribution. The sum of all values is approximately -44, and the sum of squared deviations from the mean is 160.25.

For the "LFD" the mean is 1.5048, and the median is 1.526, indicating a relatively symmetric distribution. The maximum value is 1.736, while the minimum value is 1.736. The standard deviation of 1.166 suggests a moderate amount of variability. The negative skewness value -0.564 indicates a leftward skew, and the kurtosis value of 2.332 signifies a peaked distribution. The Jarque-Bera statistic is 6.31, with a probability of 0.042, suggesting a potential adherence to a normal distribution. The sum of all values is approximately 132.4, and the sum of squared deviations from the mean is 2.274.

4.3 Correlation Effect

Table 2: Correlation analysis

	IG	LFD	IQ
IG	1.000		
LFD	-0.284	1.000	
IQ	0.1234	0.5554	1.000

Where IG is inclusive growth, LFD is financial development, IQ is institutional quality.

5. Conclusion

The study seeks to establish the correlation between inclusive growth and financial development, with institutional quality as a mediator. Extensive research has been conducted in the literature regarding the impact of financial development on economic growth. A literature review documents the bidirectional interaction between IG and FD. The function of institutional quality demonstrates how FD and IG are moderated.

Four SAARC nations India, Bangladesh, Pakistan, and Sri Lanka closely bordered by geographic and economic factors have been the subject of research. We employed correlation matrix, and descriptive statistics, analysis. The findings indicate that whereas institutional quality has a positive and significant impact on IG, FD negatively influences IG. Therefore, it is imperative for South Asian nations to enhance the provision of loans to the private sector and regulate the behaviour of participants in the financial market. This can be achieved by establishing strong institutional quality, including ensuring a stable legal framework and improving the effectiveness of government operations. Government efficiency and the rule of law in SAARC nations can be improved by encouraging investment and improving financial institutions through increased openness. Governments must thus

fully appreciate how important IQ is to be sustaining long-term growth. Nations with feeble institutional frameworks witness less financial and economic development. In this situation, authorities should concentrate on developing nations falling behind, presumably due to weak legal systems, ineffective governments and unstable institutions and financial systems. Early phases of development of the financial market have a negative effect on IG. Nevertheless, once a certain degree of progress is made, concerns regarding inclusiveness become significant. There need to be effective institutions like strong rule of law and government effectiveness that will regulate the activities of financial market players in ensuring that they are inclusive in nature. Therefore, it is imperative for South Asian nations to enhance the provision of loans to the private sector and regulate the behavior of participants in the financial market. This can be achieved by establishing strong institutional quality, including ensuring a stable legal rule of law and improving the effectiveness of government operations. Government efficiency and the rule of law in SAARC nations can be improved by encouraging investment and improving financial institutions through increased openness.

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