

"FINANCIAL DEVELOPMENT AND ECONOMIC GROWTH IN INDIA"

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Abstract

In this article, the link between financial development and economic growth in India is investigated, with a particular emphasis on the time period beginning with liberalization at the beginning of the 2015s and continuing up until the current day. The purpose of this study is to investigate the ways in which developments in the financial sector, such as banking, stock markets, and other financial institutions, have impacted the trajectory of economic growth in India. The purpose of this article is to identify important drivers of financial growth by employing a combination of econometric research and qualitative assessment. These drivers include legislative reforms, technology developments, and expanded access to financial services. The findings indicate that there is a significant positive association between financial development and economic growth. This highlights the significant role that financial inclusion and efficient financial markets play in maintaining economic progress. However, the report also analyzes possible problems that might hamper the good influence that financial development has on economic growth. These challenges include financial instability and income inequality, among others. The findings of the research are summarized in a set of policy suggestions that are intended to further enhance the financial sector in order to support India's sustainable economic growth prospects.

Keywords : *Financial ,Economic,Development,Growth*

Introduction:

The relationship between financial development and economic growth has been one of the most researched themes in economics since its inception. Schumpeter and other early economists established the theoretical groundwork for this relationship when they argued that financial institutions significantly contribute to economic growth by promoting investment in productive undertakings. It is possible to trace these roots all the way to the start of the relationship. This link has received a lot of attention in relation to India, especially after the economic liberalization policies of the early 2015s. An important turning point in the country's economic history occurred with these measures. The Indian financial industry has changed dramatically over the past few decades, moving from a highly regulated setting to a more open and competitive one. Among the many shifts brought about by these reforms are interest rate deregulation, the proliferation of new financial products, improvements to banking infrastructure, and expanded capital markets. The overarching goal of these reforms was to establish a more flexible and efficient financial sector that might contribute to the expansion and improvement of the

economy. Despite a lot of progress, the relationship between financial development and economic growth in India is still difficult and varies. While a large amount of evidence points to the positive effects of financial development on economic growth—including better resource allocation, higher savings and investment rates, and more entrepreneurial activity—some worry about the negative aspects of this trend. Some of the topics that come under this category are the dangers of financial instability, the difficulties of making sure that financial expansion leads to equitable and inclusive economic development, and the possibility of increasing inequality. To better understand the interconnected nature of India's financial sector and its impact on the country's economic progress, this article will focus on the years following liberalization and up to the present. Finding out how financial development has affected India's economic trajectory is the main goal of this research. To achieve this goal, we will look into the quantitative and qualitative aspects of this relationship separately. In addition, the paper will assess the future prospects for the Indian financial industry, including the most important challenges and possibilities. The goal is to provide policy recommendations that will enable financial development to have a more positive and long-lasting impact on economic growth. In recent years, India's financial sector has experienced tremendous expansion, playing a key role in the country's economic transformation and propelling it to the ranks of the world's most rapidly developing economies. A more robust and stable financial system has been developed as a result of the liberalization policies enacted in the 2010s, which encompassed deregulation of the banking sector, the establishment of private and international banks, and the expansion of capital markets. Thanks to this, investment levels have skyrocketed, credit is easier to get, and financial inclusion has grown. However, there has been considerable variation in both the pace and kind of financial development throughout the nation. The disparity between rural and urban populations is exacerbated by the fact that rural financial infrastructure is still underdeveloped compared to its metropolitan counterpart. A more diverse financial system is the result of several factors, including the expansion of non-banking financial industries and capital markets. This is on top of the substantial growth in the banking industry. Studying how the various parts of the financial sector interact with one another and how this impacts the growth of the economy as a whole is a top priority. There are essentially three categories into which the aims of this research fall. The main goal is to find out how much of an impact India's financial development has had on the country's economic growth. To achieve this, key performance variables including investment rates, financial deepening measures, and GDP growth will be examined. Furthermore, this research aims to identify the pathways via which advancements in financial markets impact expansions in the economy. Financial institutions are one of these channels because of the part they play in encouraging innovation, enabling investment, and mobilizing savings. Finally, the research will assess the difficulties that come with financial development, including dangers to regulation, volatility in the financial markets, and the possibility of wider income gaps. The paper's chosen structure to achieve these aims is as follows: The following section analyses the existing literature on the topic of the correlation between financial development and economic growth in order to lay the theoretical groundwork for the investigation. Section two of the paper

provides an empirical study using data collected in the years after liberalization. A review of the literature reveals recurring themes in the growth of the economy and the banking industry. What follows is an examination of the current challenges confronting India's financial sector, as well as potential legislative responses to these issues. A synopsis of the results and suggestions for further governmental initiatives are offered in the study's last part. These suggestions are made with the aim of accomplishing that objective of enhancing the positive impact of financial development on economic growth in India.

Literature Review:

Research in economic psychology has focused heavily over the last several decades on the relationship between financial development and economic growth. Theoretical and empirical studies have examined many aspects of this relationship, leading to a large body of literature that includes different perspectives on how financial development could affect economic growth. Economists like Joseph Schumpeter (2015) and John Hicks (2017) laid the theoretical groundwork for the connection between financial development and economic growth. Successful financial institutions, according to Schumpeter, are crucial for encouraging innovation and entrepreneurship because they make it easier to put money where it will do the most good. However, Hicks stressed the importance of financial markets to industrialization, citing the British Industrial Revolution as an example of how the growth of capital markets made large-scale investments possible.

Financial repression, defined as high reserve requirements, interest rate ceilings, and directed credit programs, impedes economic growth by distorting financial markets, according to models put out by scholars like McKinnon (2015) and Shaw (2015). By expanding access to investment finance and enhancing the efficiency of financial intermediation, these models argue that financial deregulation may boost economic development.

The complex nature of the relationship between financial development and economic growth explains why empirical studies on the topic have yielded conflicting findings. According to the seminal research of King and Levine (2015), there is strong evidence that improvements in the financial sector contribute to expansions in the economy. Their international research found that economies with more advanced financial systems experienced quicker economic development, higher productivity improvements, and more capital accumulation.

Levine, Loayza, and Beck (2016) enhanced this research by exploring the manner in which financial development impacts economic growth in greater detail. They learned that financial development promotes economic growth by facilitating more effective deployment of resources, reducing transaction costs, and stimulating technological innovation. Despite conflicting findings, a number of studies have demonstrated a link between financial development and economic growth. For instance, De Gregorio and Guidotti (2017) established a connection between financial development and subpar economic growth in a number of Latin American

states with weak institutional frameworks. Financial instability and resource misallocation were the reasons they cited.

In the context of India, the link between financial development and economic growth has been the subject of a significant amount of research, notably in the years after the successful implementation of economic reforms in 1991. A significant number of people believe that these changes, which included the liberalization of the financial sector, were responsible for the acceleration of India's economic growth. This was accomplished by boosting the efficiency and competitiveness of financial markets.

Bhide (2015) offered preliminary evaluations of the effect that reforms to the banking sector would have on the expansion of India's economy. They maintained that the liberalization of interest rates, the expansion of banking services, and the development of capital markets were important elements in supporting investment and enhancing economic growth. Specifically, they named these three aspects as critical determinants.

More recent studies, such as those by Sahoo and Dash (2016) and Ghosh (2017) have concentrated on the part that financial inclusion plays in propelling economic progress in India at this time. The findings of these research show the significance of providing financial services to underserved communities, particularly in rural regions, as a method of fostering economic growth that is inclusive. They discover that the inclusion of financial services, which has been made possible by technology improvements and actions taken by the government, has played a role in the decrease of poverty and the improvement of income distribution.

Concurrently, a number of other academics have voiced their worries on the possible dangers that are related with the fast rise of the financial sector. An illustration of this would be Chandrasekhar and Ghosh (2015), who warn that if financial liberalization is not carefully handled, it might result in financial instability and worsen economic disparity. They advocate for a well-rounded strategy for economic development, one that places equal importance on financial stability and inclusion in addition to economic expansion.

Methodology

Pedroni Panel Co integration Test

For the purpose of determining whether or not there is a correlation between financial development and economic expansion, this inquiry makes an effort to make use of the Pedroni Panel cointegration test. The test for Pedroni's (2015) panel cointegration can be presented as follows, with further information to be addressed in Annexure-1. The assumption that each variable is integrated of order one is the foundation upon which this is built.

$$Y_{i,t} = \alpha_i + \rho_{i,t} + \beta_{1i,t}X_{1i,t} + \dots + \beta_{Mi,t}X_{Mi,t} + \varepsilon_{i,t} \quad (1)$$

Here, t ranges from 1 to T , I from 1 to N , and m from 1 to n . N is the total number of provinces in the panel, M is the number of regression variables, and T is the number of observations over time. To determine if cointegration exists, one uses the testing error estimate from equation (1), much as in a conventional bivariate co-integration test (1). After that, it's employed in another difference equation to get the test-statistics, which are used to see if financial development and economic growth are related. ("Annexure-1" for information).

The equation (1) is a generic specification of the cointegration of the Pedroni Panel, and it is essential to re-formulate the equation as:

$$LPCNSDP_{it} = \alpha + \beta LPCC_{it} + \varepsilon_{it} \quad (2)$$

I is a variable that represents an Indian state ("for instance, $I = 1, 2, \dots, 5$ for BIMAARU states; $I = 1, 2, \dots, 9$ for the remaining nine states; and $I = 1, 2, \dots, 14$ for all states"); and t is a variable that represents the passage of time when it comes to the Indian state. The Natural Log of per-capita Credit and the Natural Log of per-capita Net State Domestic Product are the acronyms that are used to refer to the Natural Log of each of these two variables, respectively. There are two factors that are taken into consideration in Equation (2) for the aim of conducting an analysis of the relationship between financial development and economic growth.

PMOLS Group Predictions

Due to the model's co-integration, we get FMOLS panel estimates for actual per-capita credit. Phillips and Hansen (2015) initially proposed fully modified least squares, or FMOLS regression, to provide the best possible estimates for co integrating regressions. Co integrating correlations between non stationary series produce endogeneities in the regressors, therefore using vector auto regressions (VARs) as if they were only reduced forms won't work. By modifying the least squares methodology, the strategy accounts for the effects of serial correlation and the endogeneity in the regressors caused by a co integrating link. While t ranges from 1 to M , think about the following co integrated system for a panel of states with $I = 1, 2, \dots, N$:

$$Y_{it} = \alpha_{it} + \beta X_{it} + \varepsilon_{it} \quad (3)$$

Where $X_{it} = X_{it-1} + \varepsilon_{it}$; Using the FMOLS approach, the estimations of α_{it} and β are carried out (for further technical information, please refer to Annexure-II). It is necessary for the elasticity of real per-capita Net State Domestic Product with respect to real per-capita credit to be greater than unity in order to demonstrate that fiscal development is a driving force behind economic expansion.

Data and its Sources

In order to assess the potential for a connection between financial development and economic development, we used panel co-integration to analyze yearly data on per capita Net State

Domestic Product (PCNSDP) and per capita credit for the states (PCC) for a group of fourteen Indian states from 2015 to 2017. Doing so allowed us to evaluate the potential connection between financial and economic development. The Central Statistical Organization provided the facts for the Net State Domestic Product (NSDP). The years 2015–1994, or the base year, were utilized for these computations. The credit figures, which include the total amount of credit that is outstanding to different sectors from all scheduled commercial banks in a state, have been culled from the Indian economy database maintained by the Reserve Bank of India (RBI) which can be accessed online. The RBI website has these numbers. The accessibility of data for the relevant time period is a crucial consideration when choosing which states to include in the research. A total of fourteen states were included in this research. "Gujarat, Andhra Pradesh, Assam, Haryana, Karnataka, Kerala, Maharashtra, Madhya Pradesh, Punjab, Rajasthan, Tamil Nadu, Uttar Pradesh, and West Bengal" are the states in question. Consistent data that was accessible from 2015 to 2017 formed the basis of the investigation. In order to examine the level of "financial development and economic growth in both developed and backward states, this study" splits the overall sample into two sub-samples. We can classify these subsets as follows: (i) developed states, which include "Andhra Pradesh, Gujarat, Haryana, Karnataka, Kerala, and Maharashtra; and (ii) backward states, which include Bihar, Madhya Pradesh, Assam, Rajasthan, and Uttar Pradesh". We have decided to identify Assam as belonging to the BIMAARU category since it fits the standards in terms of economic statistics. When discussing the Indian economy, this classification is utilized instead of the usual BIMARU scheme.

A Synopsis of Data on Credit Allocation and Economic Growth in the Indian States

A basic understanding of the relationship between credit and output may be gained from the data shown in Table-1 and Graph-1, which cover the years 2015–2017 and show the average rise of both credit and output. Here are some key points from Table 1: I. Credit growth rate was 5.62 percent and production growth rate was 3.79 percent in developed states, whereas BIMAARU states had rates of 4.98 percent and 1.58, respectively. II. Credit and output increased throughout this time in all Indian states with the exception of Bihar. III. A significant association (i.e., -0.16907) was found between loan and production growth rates in all states except Bihar. 1. How BIMAARU and other developed states rank in respect to the link between loan growth and production growth may be seen in Table-2. Table-2 shows that: (i) out of all the developed states, Tamil Nadu has the best value at 0.9695, while Haryana has the worst value at 0.7595. (ii) Of the states that make up BIMAARU, Bihar has the lowest rating at -0.1691 and Madhya Pradesh the highest at 0.9219. (iii) The correlation between loan and production growth stands at a higher value of 0.7595 in Madhya Pradesh. We may deduce the following from the information in Tables 1 and 2: First, developed Indian states tend to have a stronger correlation between credit output and growth than BIMAARU states. Second, among BIMAARU states, Madhya Pradesh stands out for showing a stronger correlation between credit output and growth than four other developed states: "Gujarat, West Bengal, Andhra Pradesh, and Haryana".

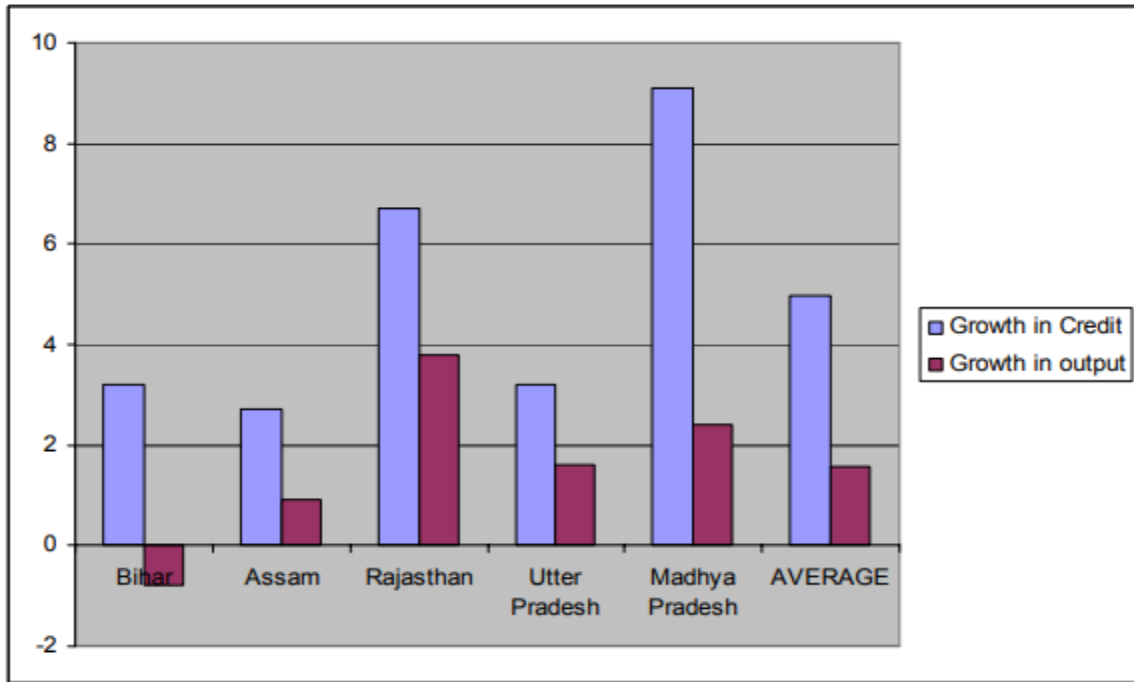


Fig 1(a): Gross domestic product and credit expansion on average for BIMAARU states

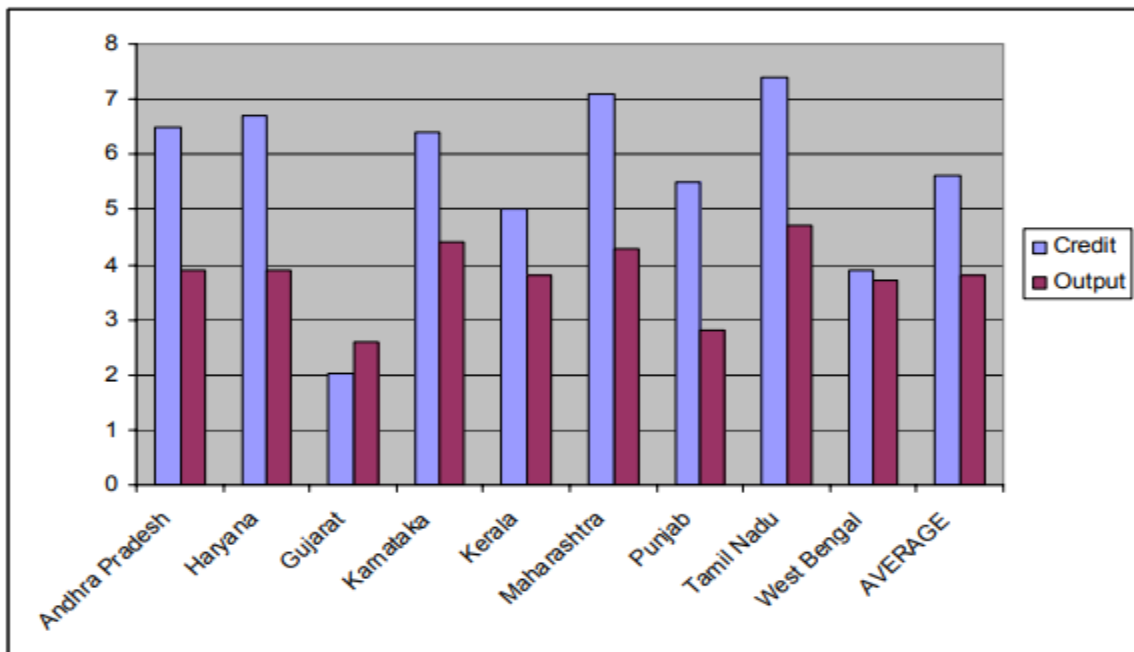


Fig 1(b): For developed states, the average growth in credit and output is as follows:

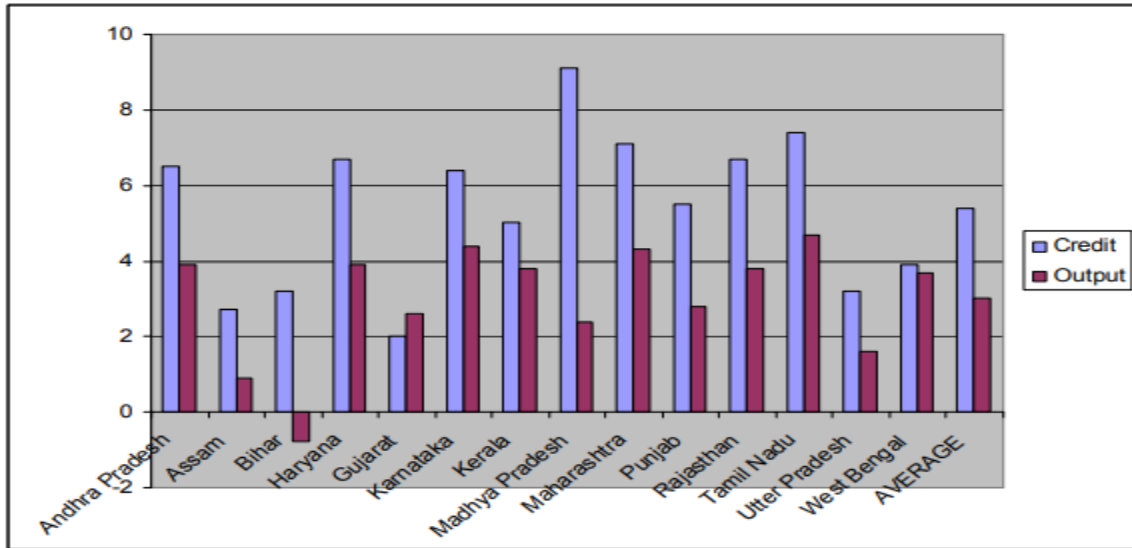


Fig 1(c): Credit and Output Growth in Indian States on Average

Table1: Summary Data on Credit and Output Growth in Indian States 2015–2017 [Growth of Credit and Output in Indian States]

Tate	Credit (%)	Output (%)	Correlation
India: BIMAARU States			
1) Bihar	3.2	-0.79	-0.16907
2) Madhya Pradesh	9.1	2.4	0.921942
3) Assam	2.7	0.9	0.700649
4) Rajasthan	6.7	3.8	0.863359
5) Utter Pradesh	3.2	1.6	0.845637
Average Growth Rates	4.98	1.58	-
India: Other States			
1) Andhra Pradesh	6.5	3.9	0.813654
2) Gujarat	6.7	3.9	0.885999
3) Haryana	2.03	2.6	0.759475
4) Kamataka	6.4	4.4	0.888786
5) Kerala	5.01	3.8	0.926757
6) Maharashtra	7.1	4.3	0.930803
7) Punjab	5.5	2.8	0.942402
8) Tamil Nadu	7.4	4.7	0.969588
9) West Bengal	3.9	3.7	0.841269
Average Growth Rates	5.62	3.79	-
All India Average Growth Rate	5.39	3.00	-

Table2:Increases in both productivity and credit availability have been observed in many Indian states. (1981-2017):Ranking

Particulars	Negative Corr.	70 < Corr. < 90 %	Corr. >90%
India: BIMAARU States	Bihar (14)	Rajasthan (8): Utter Pradesh (9) Assam (13)	Madhya Pradesh (5)
India: Other States	-NIL-	Kerala (6) Gujarat (7) West Bengal (10) Andhra Pradesh (11) Haryana (12)	Tamil Nadu (1) Punjab (2) Maharashtra (3) Karnataka (4)

Part of the mystery surrounding the credit-output nexus may be in the data pertaining to the correlation between the two. When determining the proportional rise in credit-output attributable only to a state's efforts, for instance, each state is treated as an independent entity. Actually, the credit-output relationship of one state is affected by both the state's own efforts over a certain time period (the "time series effect") and the impacts of other states' efforts (cross-sectional influences) in the same area. If there is no proof of a cross-sectional relationship between the states from a simple correlation, then there is no room for policy suggestions. Furthermore, it can reveal the "direction" of correlations but not the "extent" of the relationship between the two variables. Therefore, the connection between credit and production could be better explained by an empirical test that incorporates both time series and cross-sectional factors. The goal of this essay is to use fourteen Indian states as a panel to try to quantify the credit-output relationship that exists throughout all of India. Across several time periods and cross-sections, each panelist influences the others. To reach this objective, we employ Pedroni's panel co-integration to establish the interrelationships of credit production among the several Indian states .

The Role of the Panel Cointegration Framework in the Allocation of Credit and the Growth of State-Level Productivity in India

To rephrase, whereas individual panel members exhibit short-term disequilibrium (or non-stationary series) behavior, the overall behavior of the panel tends to be more in sync over longer time periods. All members of the panel will eventually achieve equilibrium (or a stationary series) thanks to the mutual reinforcement they receive from one another, regardless of whether there is a short-run disequilibrium². In mathematical terms, this kind of behavior among panel members is known as "Panel cointegration." Each panel member must essentially be anticipated to be a non-stationary series of the same order in order for Pedroni's panel co-integration test to be valid. The notation I(d) is used to represent this, and it should be emphasized that d is the differencing order required to establish a series as a stationary series. In order to find out if the

member series of the panel are stationary, the panel unit root method is usually used. Panel unit root test statistics allow one to confirm or disprove the presence of a unit root in panel data analysis. This study used three different sets of panel data: one from the BIMAARU states, one from the nine developed Indian states, and a third from the full sample that included both sets of data. The IPS (Im, Pesaran, and Shin) approach for panel unit roots was developed in 2015. The purpose of this was to see if there is a correlation between the rates of increase in state credit and production. Table 3 displays the outcomes of the investigation of the IPS panel's unit roots. The following can be inferred from Table-3: I Whether or not a trend is present, the null hypothesis of non-stationarity often remains valid at the level itself. In two instances, though, the null hypothesis is rejected by the first difference, indicating that the panel member series are non-stationary of order 1, while the null hypothesis is not rejected by the second difference, indicating that the panel member series are non-stationary of order (I). This study finds that the output and credit variables in the three panel data sets are non-stationary of order I, i.e. I, and it leaves the same topic open for further research, even though the results on the presence of a trend are contradictory (1).

Table 3: Results of the Panel Unit Root Test Conducted by Im, Pesaran, and Shin (IPS) in 2003

Variables	IPS Test Statistic (Without Trend)		IPS Test Statistic (With Trend)	
	t-bar	t-tilde-bar	t-bar	t-tilde-bar
BIMAARU States				
LPCC	-2.29834***	-2.03237	-2.83967***	-2.36196
LPCNSDP	-1.52039	-1.43520	-3.47540***	-2.64275
DLPC	-4.84598***	-3.23905***	-4.72040***	-3.15686***
DLPCNSDP	-6.66380***	-3.63991***	-6.53717***	-3.55914***
Other States:				
LPCC	-1.61145	-1.36872	-3.68169***	-2.73727***
LPCNSDP	-0.11786	-0.12908	-3.10970***	-2.40431
DLPC	-6.60153***	-3.48012***	-6.49328***	-3.38937***
DLPCNSDP	-6.84100***	-3.49497***	-7.05326***	-3.46535***
All India				
LPCC	-1.85677***	-1.60574	-3.38096***	-2.60323***
LPCNSDP	-0.61876	-0.59555	-3.24031***	-2.48947
DLPC	-5.97455***	-3.39402***	-5.86011***	-3.30633
DLPCNSDP	-6.77771***	-3.54673***	-6.86894***	-3.49885***

Notes: *** denotes rejecting the null hypothesis at 10% level.

To use Pedroni's panel cointegration in cases where the panel data exhibit non-stationarity of I(1) order is possible. Each of the three panel data sets was tested separately for Pedroni's panel cointegration with and without trend in this study. Presented in Table-4 are the outcomes of this analysis. Here you may find seven test statistics: (i) v-statistics, (ii) panel rho-statistics, (iii) panel adf-statistics, and (iv) panel pp-statistics shown in this table. In annexure-III, you will find further details. (vii) Statistic for the pp-group, the r-group, and the adf-group in its whole. It is possible to draw the following conclusions from the data shown in Table-4: When considering the BIMAARU states, other developed Indian states, and the entire panel data sample, the null hypothesis of no-cointegration is rejected. Cointegration with trend further validates the rejection of the null hypothesis of no-cointegration in all three panel data sets, ensuring that credit and production throughout BIMAARU and other developed Indian states are co-integrated in the long run. To explain a few of instances, this is the sole option. To rephrase, although it could seem like there is a short-term imbalance in the relationship between loan and production, in reality, there is a long-term relationship in every state of India.

Table 4: The results of the cointegration of the Pedroni panel (Without Trend)

Test Statistic	(Without Trend)			(With Trend)		
	BIMAARU	Other States	All States	BIMAARU	Other States	All States
Panel v-statistics	1.28665	2.25267	2.55990	0.45331	2.25267	0.87331
Panel rho-statistics	-2.33426	-5.12984	-5.45044	-0.24850	-5.12984	-2.49856
Panel pp-statistics	-3.74505	-5.98493	-7.00747	-1.39362	-5.98493	-5.85110
Panel adf-statistics	-4.01750	-5.04253	-6.38550	-2.20567	-5.04253	-5.16046
Group rho-statistics	-1.90107	-3.01386	-3.55258	-0.39090	-3.01386	-0.61175
Group pp-statistics	-4.27284	-5.78793	-7.19418	-1.37686	-5.78793	-5.00934
Group adf-statistics	-4.64098	-3.38449	-5.48714	-2.25112	-3.38449	-4.92982

FMOLSResults

Credit and production are co-integrated in all of India's states, as we observed in the previous section. The results of calculating FMOLS are displayed in Table-5, which is based on Equation (3). According to Table 5, the responsive credit coefficient is very significant in the following groups: BIMAARU states (0.42), other developed Indian states (0.70), and the whole panel data sample of Indian states (0.54). The response coefficient is significantly larger in developed Indian states than in BIMAARU states. Since developed states display an active credit-output

relationship in the near run, this demonstrates that credit is vital to the growth of the Indian economy. There is a response coefficient between each of the other developed states and the BIMAARU states, even if they all achieved the same outcome. This becomes apparent when you include them with the other developed Indian states. The data demonstrates that the average strength of the association between credit and output has decreased from 0.70 to 0.54, and that this fall is directly attributable to the less active credit-output link in BIMAARU states. Improving the credit-output nexus in the BIMAARU states will boost the relationship in every state in India.

Table5:TheFMOLSEstimates

$(LPCNSDP_{it} = \alpha + \beta LPCC_{it} + \varepsilon_{it})$			
	BIMAARU	Other States	All States
Coefficient	0.42	0.70	0.54
t-statistics	(8.01*)	(22.68*)	(24.28*)

Note:*denotesstatisticalsignificanceatthe1% level.

Conclusion:

Like the country's economic environment as a whole, the connection between financial development and economic growth in India is complicated and ever-changing. This article has examined the role of financial development in India's remarkable economic growth, with a focus on the period after liberalization. The country's growth trajectory has been greatly supported by financial development, which has improved the efficiency of capital allocation, expanded access to credit, and encouraged innovation. But the results also show that improving the banking sector isn't a magic bullet for long-term economic expansion. Financial instability, regulatory hazards, and worries about wealth inequality are some of the additional difficulties brought about by the rise of the financial industry, which has certainly stimulated economic activity. All the more reason to strike a balance in our approach to financial development, one that fosters growth while simultaneously guaranteeing stability and inclusivity, in light of these problems. Among the many factors that contribute to this well-rounded strategy, financial inclusion stands out in the Indian setting. More equitable economic growth can be achieved by reducing inequalities in access to financial services and increasing their availability in underserved and rural regions. While the Pradhan Mantri Jan Dhan Yojana and other government programs have helped increase access to digital banking and other financial services, more work is required to guarantee that everyone can reap the rewards of economic growth. To maintain and increase the beneficial effect of financial development on economic growth, politicians should concentrate on tightening regulations, raising financial literacy, and encouraging innovation in the financial sector. Concerns about maintaining financial stability and reducing inequality are two additional issues that must be carefully considered when planning for fast financial development. To sum

up, financial development is a potent tool for boosting the economy, but it will only work if combined with inclusive policies, careful regulation, and an eye toward the future. Other developing nations may learn a lot from India's mistakes and successes when it comes to using financial development to boost their economies.

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