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The Impact of Financial Deepening on Economic Growth in India

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ABSTRACT

This study examines the impact of financial deepening on economic growth in India. Financial deepening is defined as a measure of financial inclusion which is measured by the number of accounts and the volume of bank deposits in an economy. Using data for the Indian economy over six years, the study finds that as the volume of bank deposits increases, the economic growth of India improves. Conversely, as the number of accounts increases, the impact on economic growth is negative. The study provides policy implications towards financial inclusion in a developing economy to examine how financial inclusion can drive economic growth and what factors are needed to strengthen this relationship.

Keywords: financial deepening, financial inclusion, India, deposits, accounts

1. INTRODUCTION

Financial deepening refers to the increased provision of financial services with a wider choice for consumers and businesses, leading to a more inclusive and therefore a more efficient financial system. Financial deepening is often considered to be a crucial factor in increasing economic growth, since a well-developed financial sector can efficiently allocate resources, facilitate investment, and support overall economic activity. One conventional measure of financial deepening is the magnitude of household savings that are mobilized into deposits which are further fueled into investments. These investments lead to high economic growth in various economies. In many cases, a strong relationship exists between bank deposits and Gross domestic product (GDP), where higher savings lead to more investments, which ultimately boosts economic growth. While this relationship is widely recognized on a global scale, there are instances where areas with significant financial resources do not experience economic growth. This therefore leads to the question, does the traditional link between bank deposits and GDP growth hold up in all contexts, particularly in a complex, rapidly developing country like India?

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Investigating this question is highly important as it could provide valuable insights for shaping policies that aim to promote financial inclusion and further sustain economic development.

To explore the complex relationship between higher bank deposits and GDP, we focus on India. It is a country with a diverse economic landscape that offers an opportunity to examine this connection at a sub-national level (State). This study will use state-wise data on bank deposits and GDP over a specific period, drawing information primarily from resources like the Reserve Bank of India and other government databases that provide related economic indicators. The main research question in this paper is to examine the relationship between bank deposits and economic growth in the Indian economy.

The relationship between bank deposits and economic growth is crucial in understanding the dynamics of financial deepening and its role in fostering development. The data above, showcasing a consistent rise in bank deposits and accounts over the years, highlights the increasing penetration of banking services in India. This growth reflects an expanding financial ecosystem, where higher deposits may signify greater savings mobilization and investment capacity, which are key drivers of economic activity. At a sub-national level, this pattern becomes even more significant, as states with higher deposit accumulation might exhibit stronger economic performance, indicating a potential link between financial behavior and regional GDP growth. By analyzing state-wise data on bank deposits and GDP, this study seeks to explore how such trends contribute to economic growth, offering insights into the broader interplay between financial inclusion and development in India.

The main results of the study show that while bank deposits improve and enhance economic growth in India, the number of accounts dampens economic growth. High number of accounts could imply high dormant accounts with little or no bank deposits for banks to leverage on. With the introduction of Jan Dhan Yojana in India (financial inclusion plan of the Government of India), and zero balance accounts, number of accounts with low or nil balances increases transaction and operating costs for banks with no multiplier effect on economic growth.

2. LITERATURE REVIEW

The relationship between financial deepening and economic growth has been a subject of extensive research, with numerous studies highlighting its importance while also emphasizing challenges such as regional disparities and structural limitations. This section reviews key studies chronologically to understand the evolution of this discourse.

King and Levine (1993) provided an early foundation for examining financial development and economic growth by testing Schumpeter's hypothesis. Using cross-country data spanning multiple decades, they concluded that financial deepening drives innovation and improves

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resource allocation, thereby promoting long-term economic growth. Their findings underscored the critical role of financial development in fostering economic progress.

Demetriades and Luintel (1996) shifted the focus to India, analyzing the impact of banking sector reforms initiated in the early 1990s. Using time-series data and economic indicators, they demonstrated that while financial liberalization had a positive effect on growth, institutional support was necessary to sustain long-term progress, highlighting the limitations of policy reforms in isolation.

Pradhan (2011) explored the link between financial development and India's economic growth using time-series data over several decades. The study found that financial development, particularly the expansion of banking services, significantly contributed to sustained economic growth. Pradhan emphasized that banking sector growth was a critical driver in supporting India's economic trajectory.

Kar and Mandal (2012) examined financial development in the context of post-reform India. Utilizing time-series data from the post-1991 period, their analysis revealed that financial deepening positively impacted economic growth. However, the study noted substantial regional disparities, with the benefits of financial development being unevenly distributed across states.

Misra and Jena (2014) further investigated the effects of financial sector development on economic growth in India. Their study, which analyzed time-series data, confirmed that financial development significantly contributed to GDP growth. However, they also identified challenges in rural regions where access to financial services was limited, hindering uniform growth.

Kumar (2015) focused on the role of financial deepening in India's post-liberalization economic growth. By analyzing data from the financial sector's evolution, Kumar highlighted that while financial deepening played a crucial role in fostering growth, the presence of regional disparities limited its overall effectiveness.

Goswami (2017) investigated the influence of banking reforms on financial deepening and economic growth in India. Using data from the banking sector post-1990s reforms, the study revealed that these reforms promoted financial development and economic activity. However, the benefits were unevenly distributed, with states having better financial infrastructure gaining more from the reforms.

Bose (2018) analyzed the relationship between bank deposits and GDP growth across Indian states. Using state-wise banking data over several years, the study found a strong positive correlation between bank deposits and economic growth. However, regional disparities persisted, as states with better access to financial services exhibited stronger growth patterns.

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Fukuda (2018) took a broader perspective, investigating the interplay between financial development, income inequality, and globalization in India. Through cointegration and causality analysis, the study highlighted the complexities introduced by inequality and globalization, showing that while finance positively influenced growth, rising inequality and globalization's effects necessitated careful policy consideration.

Verma (2019) examined the relationship between bank deposits and economic growth in India using state-wise data. The study demonstrated that bank deposits significantly contributed to GDP growth, with states having more developed banking infrastructure benefiting more. Verma's findings reinforced the importance of financial accessibility in fostering economic development.

Sharma (2020) analyzed the role of bank deposits in financial deepening and economic growth in India. Using recent data, the study highlighted that while bank deposits were instrumental in driving economic growth, unequal access to banking services, particularly in rural areas, constrained their effectiveness.

The findings from these studies collectively suggest that financial deepening is a critical driver of economic growth. However, they also underscore persistent challenges such as regional disparities, unequal access to financial services, and structural issues within the financial system. Addressing these barriers is essential for ensuring that the benefits of financial development are equitably distributed across regions and population groups.

3. DESCRIPTIVE STATISTICS

This section focuses on the descriptive statistics for the key variables in the study. The three key variables in the study are: state-wise deposits in the banking sector, and GDP per capita. The time period for the study is 2018-19 to 2023-24. Figure 1 illustrates the trend of bank deposits from 2018-19 to 2023-24. The bar graph illustrates the deposits from 2018-19 to 2023-24, show a steady increase over the years. When related to the growth in accounts over the same period, there is a clear positive correlation between the number of accounts and the deposit sums.

As the number of accounts increases (as seen in the first graph), it likely drives the overall deposit growth, suggesting enhanced financial participation and trust in banking systems. This trend reflects the combined impact of increased account penetration, higher financial literacy, or economic growth, encouraging individuals to save more.

The bar graph illustrates the accounts sum from 2018-19 to 2023-24. It shows a consistent upward trend, reflecting a steady increase in the number of accounts over the years. The growth is gradual but consistent, suggesting efforts to expand financial inclusion or a rise in population

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engaging with financial systems. Despite challenges in 2020-21, likely due to disruptions from the COVID-19 pandemic, the growth trajectory remains unaffected, unlike in GDP trends. The increasing accounts sum from 2021-22 onward indicates recovery and a continuation of financial system development. Overall, this reflects sustained progress in the sector, highlighting resilience and expansion.

Figure 1: Total number of bank accounts (2018-19 to 2023-24)

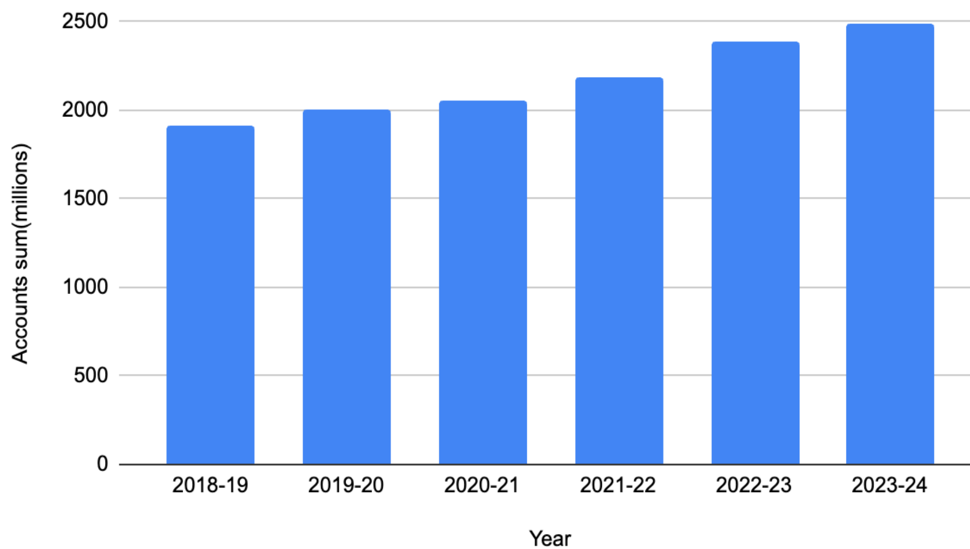
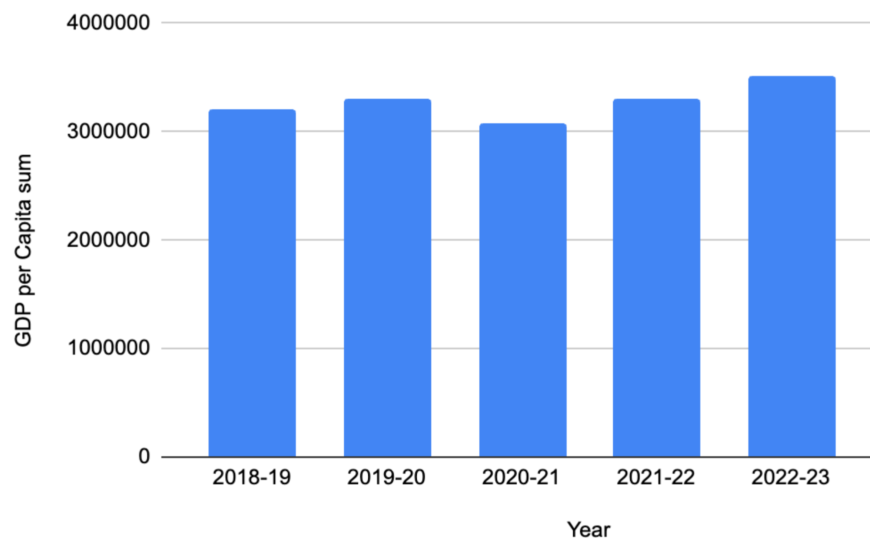


Figure 2: GDP per Capita from 2018-19 to 2022-23



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The bar graph shows GDP per capita sum from 2018-19 to 2022-23. There is a steady growth in GDP per capita over most years, indicating economic expansion. However, in 2020-21, there is a slight decline, likely attributed to the global economic downturn caused by the COVID-19 pandemic. This recession disrupted economic activities, reduced productivity, and constrained consumer spending. The GDP quickly rebounded in 2021-22 and continued growing into 2022-23, reflecting economic recovery measures, increased vaccination rates, and a return to normalcy in economic operations. The overall trend suggests resilience, with temporary setbacks offset by consistent long-term growth.

4. RESULTS AND ANALYSIS

This section presents the results of the regression estimations in the study. The dependent variable in the study is economic growth, as defined as per capita GDP. There are two independent variables, namely, total deposits, and total number of accounts. The research question that the study aims at is to understand if total deposits and total number of accounts (a measure of financial development) leads to higher economic growth. Table 1 illustrates the results of the regression estimates.

The R-squared value of 0.17 denotes that 17 percent of the change in economic growth can be explained by the change in deposits and number of accounts. Furthermore, the association between deposits and economic growth is positive and significant. The association between number of accounts and economic growth is negative and significant. Given that the p-value is less than 0.05 for both the coefficients, it can be inferred that both, number of accounts and total deposits has a significant effect on per capita GSDP in India. The regression estimation takes a double-log form. Thus, in terms of interpretation, a 1% increase in total deposits increases per capita GDP by .74%. On the contrary, a 1% increase in total number of accounts decreases per-capita GDP by 0.73%. One possible explanation that could explain the negative association between number of accounts and per capita GSDP is that with the implementation of Jan Dhan Yojana in India (where a financial inclusion drive), most individuals owned a bank account, however, most of these accounts were dormant, with little or no balance in them. Due to the low balance in deposit accounts, banks are unable to lend this further for investment. Hence, high number of accounts, accompanied with low balance in these accounts could dampen economic growth. On the other hand, the positive association between deposits and GDP per capita depicts the positive effect that bank deposits have on economic growth. Financial deepening through higher bank deposits gets routed through higher investments which have a multiplier effect, thereby increasing economic growth.

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Table 1: Regression results for the effect of bank deposits and accounts on GDP per capita in India

Variables	Coefficients
Constant	9.92*** (0.30)
Deposits	0.74*** (0.07)
Accounts	-0.73*** (0.07)
R-Squared: *0.17*	

*Note: The * denote significant at 0.05 level of significant. The term in parenthesis is the standard error*

5. CONCLUSION, POLICY IMPLICATIONS, AND LIMITATIONS OF THE STUDY

The aim of this study was to examine the relationship between financial development and economic growth. Financial development is defined as the number of accounts and total deposits in the banking sector. The analysis shows that while deposits and number of accounts have been growing over the years from 2018, the evidence of the effect on overall economic growth is mixed. The results indicate that while overall total bank deposits increase economic growth, the number of accounts has a negative effect on economic growth. Thus, opening new bank accounts could be costly to operate for the banks if there are not enough deposits available in those accounts for the banks to mobilize to credit, thereby reducing lending power, and reduction in investment and economic growth. The results also indicate that there is significant state-wise heterogeneity in terms of number of deposits and number of accounts.

The policy implications that emerge from this study are the following. First, financial development as defined by financial inclusion should be meaningful. Having higher number of bank accounts with little or no savings in these accounts has no meaningful effect on economic growth. Hence, it is indispensable that the deposits per account should pass a critical threshold for the banks and financial institutions to mobilize the money into credit for future growth. Second, there should be uniform development across all regions and states in India. The analysis shows that India has a very heterogeneous growth, with certain states performing very well in

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terms of financial development, while other states are lagging behind. Hence, improving the financial development uniformly across all states will need carefully designed policies that reduce the structural barriers to financial development.

The study is not without its limitations. First, this study does not test for causality, it only assesses the association as there could be other factors that lead to economic growth that are not captured in the model. Second, this study is limited to India. A similar study could be done for a group of countries such as the G20 or BRICS nations to understand the effectiveness of financial development on growth across the globe. Lastly, given the availability of comparable data the analysis could be performed only for a few years. The study could be enriched using longer trend data.

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