How Savings and Investment Is Effecting the Economic Growth

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Abstract :-

Savings and investments are fundamental components influencing Economic growth, particularly in developing countries.

Higher savings rates encourage more investment, which is essential for boosting economic productivity and expanding production capacities. As savings increase, , so do investments, which subsequently Contribute to higher GDP growth rates. This research paper explores the relationship between savings , investments and economic growth, emphasizing their crucial roles in Sustainable development. Savings serves as fundamental source of capital, enabling investment that drive productivity and innovation. The paper examines how higher savings rates lead to increased domestic investments, which motivate economic expansion and enhance overall GDP growth The research investigates the impact of government policies promoting savings and investments, savings provides vital source of financial capital, which is essential for funding investment in infrastructure , funding investments in innovation, technology . Government can foster economic growth by implementing policies that encourage savings, such as financial Education programs and incentives for Savings. Savings and investment are key determinants of economic growth ,as they influence capital formation ,productivity, and overall development . By analysing various economic models and case studies from different economies, we explore how higher savings rates and investment levels contribute to GDP growth. This finding suggest that while savings provide the capital for investment , it is efficient allocation of these investments that drives sustainable economic development

Key words: Savings, investing, economic expansion, and sustainable development

Introduction:-

The financial services industry is crucial for economic growth, as it creates jobs, offers investment opportunities, and provides services to customers and communities. Economic growth fosters development, supported by capital from the financial services sector. Capital formation through resource mobilization is essential in growth strategies. Banks facilitate fund accessibility by redistributing excess deposits to investors with innovative ideas but lacking resources, generating income for themselves and ensuring profitability. The banking sector plays a significant role in attracting investments in developing nations.

Research has shown a dynamic relationship between a country's financial sector and its economic performance, indicating that a well-developed financial system can lead to high economic growth. Financial institutions, particularly banks, play a critical role in this process by providing resources to the public and lending to organizations, thus contributing to sustainable economic growth. While there is general agreement on the importance of banks in the economy, there is significant debate regarding the extent of their contribution. Most previous studies have examined various measures of

bank size in relation to economic progress, but few have investigated the impact of bank profitability on economic development.

The recent economic growth in India has been characterized by a significant rise in gross domestic investment and savings. Over five years leading to 2006-07, gross domestic investment increased by 13.1 percent of GDP while savings rose by 11.3 percent. The average investment and saving ratios during the Tenth Five Year Plan were both 31.4 percent, surpassing the previous Ninth Plan averages. The economic reforms of the 1990s improved the business environment, enhancing confidence and competitiveness within the corporate sector while revitalizing the manufacturing sector, leading to increased investment rates. Fiscal accountability under the FRBMA boosted the Government's credibility regarding fiscal deficits, improving the economy's perceived macroeconomic stability. Additionally, moderate tax rates and growing sales bolstered corporate internal accruals, attracting foreign direct investment . Investment rates rose

from 25.2 per balance, it should be considered a positive sign of increased demand.

Literature review :-

- Savings and Investment before Liberalisation :-

Before liberalization, researchers noted that the relationship between savings and investment in the Indian economy is complex, dynamic, and often perplexing. The findings reveal a long-term connection between savings and investment, although the results can be both frustrating and intriguing.

The text discusses the relationship between planned savings and investment in India before and after liberalization. Despite the classical economists' view that planned savings should equal planned investment, evidence shows that investment consistently exceeds savings throughout various periods. The authors argue that this notion is not applicable to the Indian economy in either the pre-liberalization or post-liberalization periods, despite a long-term relationship between savings and investment being observed. They attribute this discrepancy to several factors: rising interest rates before liberalization led to increased savings but hindered corporate investment due to high inventories; significant reliance on foreign aid indicates that increases in savings did not adequately finance investment; and the unorganized agricultural sector, which is prone to crop failures and financial instability, causes a persistent need for money to flow from urban to rural areas.

- Savings and Investment after Liberalisation :-

India began liberalizing its economy in 1980, ahead of the broader reforms implemented in 1991 by various countries. This early shift facilitated an increase in savings and investment within the country.

The oil-price hike of 1979 led advanced industrial countries to raise nominal interest rates, negatively impacting borrowing costs for developing countries. This recession extended to Third World nations, resulting in decreased demand for their exports and worsening trade balances. India's current account deficit grew in the 1980s, forcing it to rely heavily on high-interest loans, which tripled its external debt despite a $2.2 million IMF bailout in 1991. Private savings were insufficient to finance investments, leading to a balance of payments crisis in the 1990s. Consequently, India had to liberalize its economy to attract new loans, resulting in freer capital flow and lower interest rates. However, the classical economic theories were challenged as financial innovations and recurring stock market scams eroded investor confidence. Rising interest rates and issues in the unorganized sector are seen as key factors undermining classical economic principles.

- The Indian Financial System :-

The Indian Financial System consists of an organized sector, which includes banks and financial institutions, and an unorganized sector made up of moneylenders, indigenous banks, and other informal lenders. The organized sector, which holds 65% of total financial assets, has grown since liberalization, allowing more private banks to enter the market. The unorganized sector includes less regulated entities. Following economic liberalization, innovations in the capital markets have emerged, particularly in mutual funds and insurance, driven by private sector involvement. This has created more investment opportunities for both domestic and overseas investors. The development of an efficient financial system is essential for India's growth, as it facilitates the mobilization and optimal allocation of financial resources.

Sustainable economic growth relies on mobilizing domestic resources, promoting self-reliance, and efficiently utilizing investments. Research indicates a two-way causality between investment and economic growth, but evidence shows that investment primarily drives growth. A study by Liang and Reichert found a clear causal link between financial sector growth and economic development, more evident in developing countries. The profitability of banks plays a significant role in influencing GDP by enhancing financial stability, which supports growth. Higher bank profitability allows for better capital acquisition. Additionally, nations with stable fiscal conditions tend to grow faster than those facing frequent financial disturbances, suggesting that while financial freedoms can lead to crises, they can also promote growth. Thus, bank profitability does not necessarily guarantee positive economic growth through financial stability.

The study expanded from correlation to examine the cointegration between savings and investment. Miller (1988) found that in the U.S. (1946-87), both variables were integrated of order 1 and were cointegrated before World War II, but this relationship diminished afterward, potentially due to increased international mobility. Levy (1998) supported the existence of both long-run and cyclical relationships between savings and investment, observing a stronger connection in the postwar period compared to before. Frankel et al. (1986) analysed 64 countries and found a strong correlation and long-run equilibrium in most, except for a few less developed nations. Arginon and Roldan (1994) studied the correlation between domestic saving and investment in E.U. countries from 1960 to 1988, differentiating between private and public sector impacts. Bayoumi (1990) suggested that government targeting of current accounts could explain the high correlation, with both studies indicating a one-way causality from savings to investment.

- Data and Methodology :-

He study utilizes annual data on savings and investment from the Reserve Bank of India for the period of 1970-71 to 2001-2002. The methodology involves two main parts: first, testing for a unit root in each series using the Augmented Dickey-Fuller (ADF) test, and second, determining the number of cointegrating vectors in the system and conducting causality tests if the null hypothesis of a unit root cannot be rejected. The ADF test is performed with and without a deterministic trend.

The study investigates the causal relationship between gross domestic saving, gross domestic investment, and economic growth in India using annual data from 1992 to 2018. It analyses gross domestic saving, gross domestic capital formation from various sectors, and gross domestic product. The analysis employs the Augmented Dickey-Fuller unit root test to determine the integration nature of the time series variables. To assess cointegration, the Johansen cointegration test is utilized. If cointegration is identified, the Granger causality test is conducted using the Vector Error Correction Model. If not, the Vector Auto Regression methodology is used for the Granger causality test. The paper incorporates both VECM and VAR approaches.

The text discusses the need for differences in a time series model to ensure that the error term behaves as white noise. It highlights that if the autoregressive model for Yt has a unit root, the t-ratio for a1 should support the hypothesis that a1 equals zero. However, it notes that the Augmented Dickey-Fuller (ADF) test becomes less effective with larger values of p. As an alternative, it refers to the Phillips-Perron (PP) test, which involves a regression with a serially correlated error term, and mentions that it is used to examine the existence of cointegration.

- Methods of Methodology :-
  1)Unit root test

2) Cointegration root test :-

The cointegration test aims to determine if there is a long-term relationship between savings and investments by identifying significant long-run relationships among variables in the model. If the variables are cointegrated, it suggests a long-run connection exists. Although individual economic series may not be stationary, a linear combination of these variables could demonstrate a dynamic equilibrium over time. The analysis uses the maximum-likelihood test procedures introduced by Johansen and Juselius. The test focuses on determining the rank of matrix G k, which can have three

outcomes: full rank (indicating all variables are stationary), rank zero (indicating no long-run relationship), or an intermediary rank suggesting the presence of cointegration.

Conclusion :-

The study indicates a long-term relationship between bank performance and economic growth, demonstrating that higher bank profitability, as measured by return on assets, positively influences long-term economic growth. While the lending capacity is positively correlated, it is not statistically significant. The findings align with income theory and show that various lending activities in the banking sector contribute to economic growth in less-developed economies. However, the interest margin has a negative yet significant effect on the economy. Despite net interest income being crucial for bank earnings, low net interest margins can indicate a competitive banking environment and reduced funding costs for the private sector. Investments were not found to significantly correlate with India's growth during the study period, but the endogenous growth theory posits that increased bank investments can stimulate economic activities. The study also supports that profitability enhances financial stability and underlines the importance of bank performance for overall economic growth. Policymakers should consider how their policies impact bank performance, given its ongoing influence on the economy.

The stability of the banking sector is essential for a country's economic growth; however, during the study period, banks' investment activities and lending capacity did not significantly influence economic growth. This suggests that banks may have unused funds. The study also found a negative relationship between interest margins and economic growth, prompting the need for further research on monetary policy's effectiveness and the asymmetric relationship between interest rates and financial markets. Additionally, enhancing the return on assets (ROA) is recommended to promote economic growth.Economic output growth relies on capital accumulation, which is limited by the savings rate. Increased savings provide more funds for investment, making it crucial to find ways to boost both savings and investment. Savings are influenced by two main factors: the ability to save, which depends on income levels and government tax benefits, and the willingness to save, shaped by personal motives, family considerations, and the presence of financial institutions, interest rates, and the availability of diverse financial assets.

The paper discusses the essential roles of savings and investment in economic growth, highlighting their effects on capital formation, productivity, and overall development. It analyses the relationship between these factors through theoretical and empirical evidence, demonstrating that higher savings rates and investment levels generally lead to GDP growth. The findings indicate that while savings generate the capital needed for investment, it is the effective deployment of these investments that fosters sustainable growth. The introduction underscores the vital importance of savings and investment in achieving economic growth, noting that savings supply the capital that enables investment to drive economic activities. The theoretical framework includes the Harrod-Domar Growth Model, which emphasizes the connection between savings, investment, and growth, while cautioning against excessive savings without investment opportunities. The Solow-Swan Growth Model highlights the significance of technological progress, stating that while savings and investment promote short-term growth, long-term growth relies on technological advancements. Endogenous growth theory focuses on how investment in human capital, innovation, and infrastructure can significantly boost productivity and long-term growth.

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