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Puzzles in financial development and economic growth.

GIORGIONI, G. and GHIMIRE, B.R.

2008

Puzzles in Financial Development and Economic Growth

by
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Introduction & Motivation

Persisting mixed reactions within the literature



“developments in finance enabled the industrial revolution”

- Walter Bagehot (1873)

“where enterprise leads finance follows”

-Joan Robinson (1952)



Concluding remark of an extensive review of literature on finance & growth (Levine, 2005) shows MIXED REACTION

“Theory and empirical evidence make it difficult to conclude that the financial system merely - and automatically - responds to economic activity, or that financial development is an inconsequential addendum to the process of economic growth”

An increasing number of very recent contributions have found PUZZLES in the relationship

Positive & significant impact of financial development upon economic growth in the long run accompanied by negative and significant impact in the short run

This work is motivated by Beck and Levine (2004), Favara (2003), Loayza & Rancière (2006) that have made empirical investigation into these mixed reactions and the puzzles



Thorsten Beck
Tilburg University



Ross Levine
Brown University

Data & Variables

Improved & most updated dataset

Pure cross sectional data for 121 countries including 28 LDCs for the period 1970-2006 (The largest/ updated within the existing empirical literature on finance & growth involving banks and stock market, and a sub-set of LDCs)

Improves over existing literature over the self selection biasness – We use our knowledge of date of establishment of stock exchanges in the sub set of LDCs and award a zero entry for stock market variables for the years preceding the establishment of stock exchange

Proxies for bank and stock market development

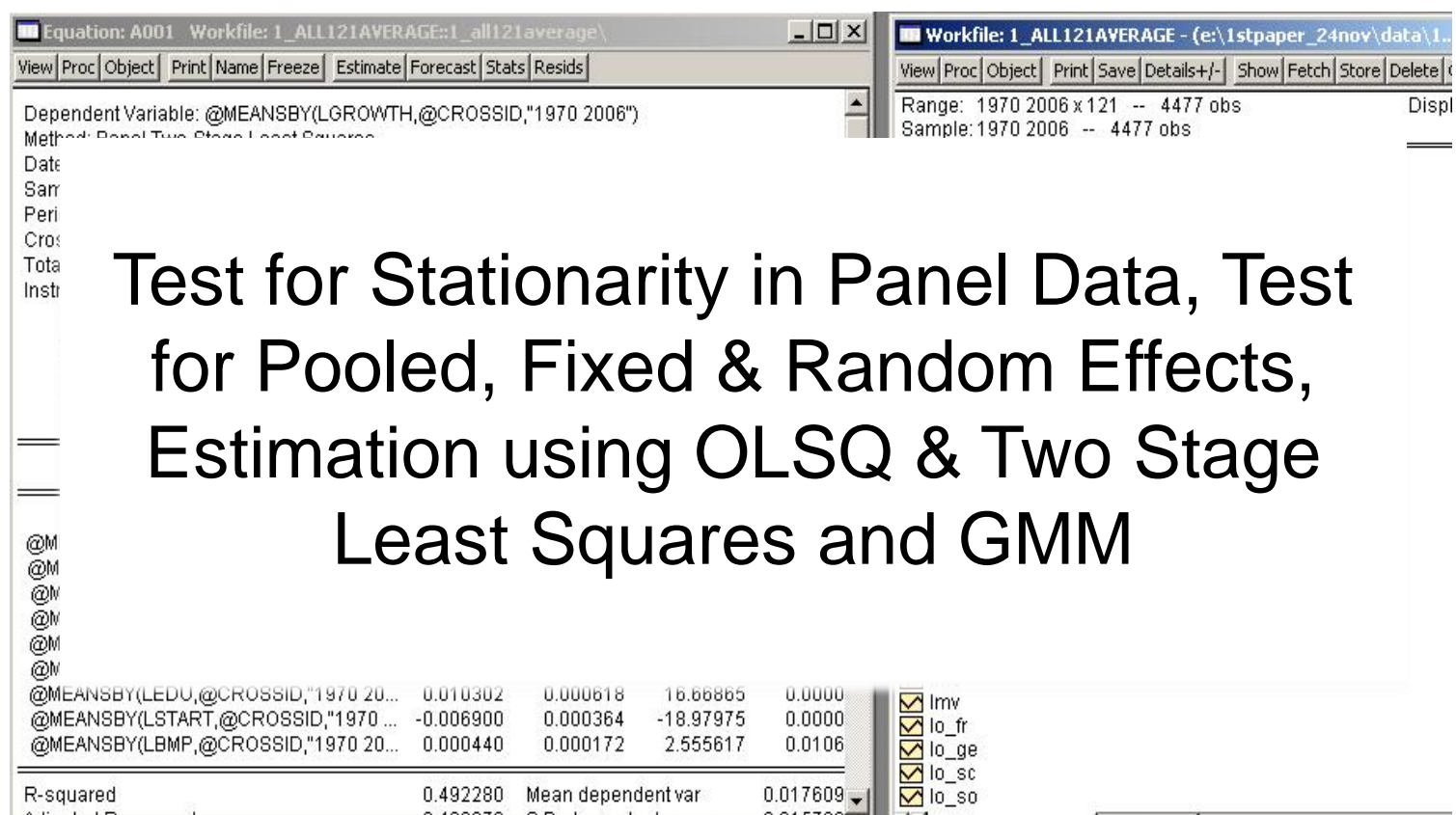
private credit, bank credit, bank credit to all sectors, and liquid liabilities for bank

Stock market capitalisation, stock market value traded and stock market turnover for stock exchange

Control variables

Government consumption, capital formation, trade openness, inflation, education, initial GDP per capita and legal origin variables

Methodology



Test for Stationarity in Panel Data, Test for Pooled, Fixed & Random Effects, Estimation using OLSQ & Two Stage Least Squares and GMM

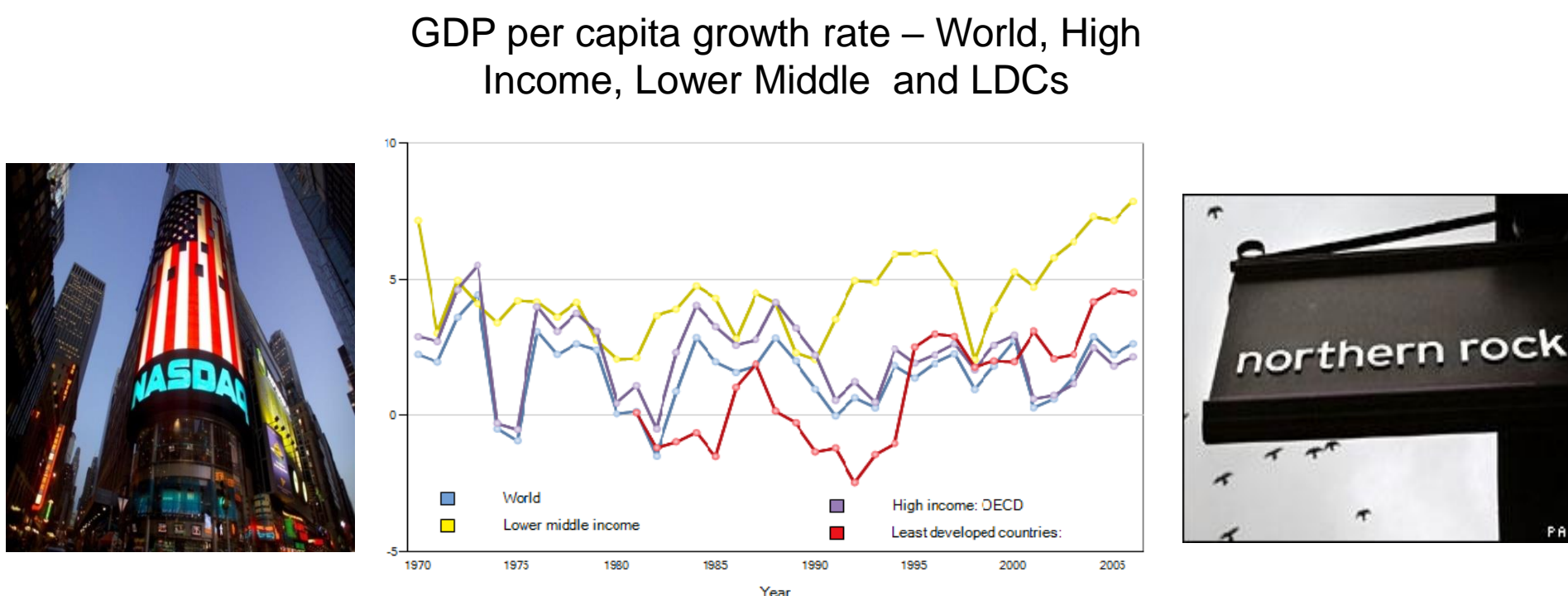
Results & Conclusion

Reinvestigating the puzzles

Evidence to the puzzle

Banks Development and Economic Growth

Negative & significant impact both in short and long run



Stock Market Development and Economic Growth

the sign of the relationship strongly depends on

- the variables chosen
- the method of estimation and
- the possible role of self-selection bias.

Future work

Further research will focus its attention to the determinants of this apparent contradiction by re-assessing the empirical literature and providing further tests on the link between financial liberalisation and banking crises.

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Beck, T., Levine, R., & Loayza, N. (2000). Financial intermediation and growth: causality and causes. *Journal of Monetary Economics*, 46, 31-77.

Favara, G. (2003). An empirical reassessment of the relationship between finance and growth. *International Monetary Fund Working Paper Series*, wp/03/123, 1-46.

Loayza, N., & Rancière, R. (2006). Financial Development, Financial Fragility, and Growth. *Journal of Money Credit and Banking*, 38(4), 1051-1076.