

Are Financial Deepening and Development always good for Economic Growth? Evidence From a New Dataset

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Abstract

The theoretical and empirical literature examining the effects of Financial Development on Economic Growth has produced a plethora of mixed results; with papers presenting evidence of the positive effect, negative and even negligible effects. The theoretical arguments of the positive effects can be traced as far back as Bagehot (1873) and Schumpeter (1912) while the ongoing empirical debate appears to be heavily based on the empirical framework outlined in the seminal contributions of King and Levine (1993a, b). This debate has intensified further in light of recent crises. This paper makes a new and distinct contribution to the literature in two main ways. Firstly, it departs from the standard measures of financial development and leverages a new Broad-based Index of Financial Development developed by the International Monetary Fund (Svirydzenka, 2016) which permits the analysis of 77 countries between years 1990 and 2014 inclusive. One advantage of this approach is that it allows us to capture, simultaneously, the interplay between, financial development and its key components i) financial market deepening and 2) institutional quality on economic growth. Moreover, the paper also explores the possible existence of non-linearities in the relationship between Financial Development and growth exploiting recent advances in econometric panel threshold analysis which allow for endogeneity, while controlling for other key explanatory factors. The paper finds stark differences in patterns of financial development between developed and developing countries and finds threshold effects of Financial Development on Growth especially within developing country sample. Of the two major components of Financial Development: Financial Markets and Financial Institutions, Financial markets appear to have a greater impact on growth prospects of developing countries over the sample period. Financial institutions, however, also play a key role and are highly related to institutional quality overall.

Keywords: Financial Development, Economic Growth, Threshold Dynamic Panel

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