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Financial development, financial structure, and domestic investment: International evidence

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Abstract

Does it matter for domestic investment whether a country's financial system is bank-based or stock-market based? This paper posits that financial intermediation affects domestic investment notably by alleviating financing constraints, allowing firms to increase investment in response to increased demand for output. The key result is that the structure of the financial system has no independent effect on investment, in the sense that it does not enhance the response of investment to changes in output, while financial development makes investment more responsive to output growth. Consequently, rather than promoting a particular type of financial structure, countries should implement policies that reduce transactions costs in financial intermediation and enforce creditor and investor rights. This will facilitate the development of banks and stock markets, which will stimulate domestic investment.

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1. Introduction

For over a century, economists have debated the comparative merits of bank-based systems and stock-market-based systems in mobilizing resources and enhancing economic growth (see Levine, 2002 for a review of this debate).¹ This paper examines whether bank-based or stock-market-based financial systems are better at promoting domestic investment. To investigate this empirical question, the paper posits that financial intermediation affects investment notably by alleviating financing constraints, and that better functioning financial systems allow firms to invest more in response to increased demand for output. It follows that at the aggregate level, developed financial systems are associated with a stronger response of domestic investment to an increase in per capita GDP. This analysis draws from the accelerator theory, which predicts a positive relationship between investment and changes in output.²

The econometric analysis in this paper is based on a sample of 99 countries including developed and developing countries for the period 1965–1997. The effect of financial structure is examined by classifying countries into four categories: financially developed bank-based, financially developed stock-market based, financially underdeveloped bank-based, and financially underdeveloped stock-market-based systems (see Demirgüç-Kunt and Levine, 2001). The analysis uses a dynamic investment equation including lagged investment, an indicator of financial intermediation, an interaction term between the lag of the growth rate of per capita GDP and a dummy for the financial structure category, and other determinants of investment. A significant coefficient on the interaction term implies that financial structure affects domestic investment through the accelerator effect.

The paper tests whether financial structure has an independent effect on domestic investment by controlling for the level of financial development using conventional measures of financial intermediation. Effects of financial development on domestic investment are tested using both cross-section and panel data regressions. To circumvent potential simultaneity problems arising from possible two-way relationships between financial intermediation and investment, lags of the financial intermediation indicators are used as instruments in the panel data regressions. In the cross-section regression analysis the initial level of financial development and the country's legal origin are used alternatively as instruments for financial development. The objective is to establish a connection between the exogenous component of financial development and domestic investment and test whether financial structure exerts any incremental effect on domestic investment given the level of financial development.

The key finding in this paper is that the structure of the financial system has no independent effect on investment, in the sense that it does not enhance the response of domestic investment to changes in per capita GDP in a model that accounts for the level of financial development and other determinants of investment. In contrast, the

¹ Also see Stulz (2001) for a discussion of the links between financial structure and corporate financing.

² See Jorgenson (1971) for a survey of the accelerator investment model and other conventional investment theories.

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