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Financial development and economic growth: Convergence or divergence?

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A B S T R A C T

This study tests for convergence in financial development and economic growth by incorporating the interaction between the real and financial sectors into an otherwise traditional test for convergence. The results show strong evidence for conditional convergence. Middle- and high-income countries conditionally converge to parallel growth paths not only in per-capita GDP, but also in financial development. The mutually reinforcing relationship between financial development and economic growth is stronger in the early stage of economic development, and this relationship diminishes as sustained economic growth gets under way. As such, low-income countries with a relatively well-developed financial sector are more likely to catch up to their middle- and high-income counterparts, and those with a relatively under-developed financial sector are more likely to be trapped in poverty. This finding explains the observed "great divergence" between poor and rich countries. Another finding is that, while human capital is more important to growth in the early stage of economic development, economic freedom becomes more important in the later stage.
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1. Introduction

Comparisons of performance across countries are central to answering many of the questions on factors leading to economic growth. Are the low-income countries catching up to the high-income ones and, if so, how quickly and by what means? Economists and policy makers have expressed profound

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interest in the issue of whether best-performing countries can maintain their lead in the future. The standard neo-classical growth models (i.e., Solow, 1956; Ramsey, 1928; Samuelson, 1958; and their descendants) imply that each country should converge on to its own steady-state growth path at a predictable rate.

Based on empirical results from past studies that suggest a positive relationship between financial development and economic growth, a country's level of financial development appears to be a central factor underlying conditional convergence.[1] There are two distinct views of the finance-growth nexus in traditional development economics. The first view suggests that the increase in the demand for financial services resulting from economic growth is the major driving force behind the development of the financial sector. This mechanism is stressed in the work of Robinson (1952, p.86). The second view, proposed by Schumpeter (1911), Goldsmith (1969), McKinnon (1973), and Shaw (1973), emphasizes a proactive role for financial services in promoting economic growth. In this view, differences in the quantity and quality of the services provided by financial institutions could partly explain why countries grew at different rates. Multivariate time-series analysis is a standard approach employed by past studies to examine the causal relationship between financial development and economic growth. However, the results have been largely mixed.[2]

Without ruling out either one of the above two schools of thought, the relationship between financial development and economic growth is considered to be an interactive one in this study. Consequently, the steady-state growth paths of financial development and per-capita GDP are supposed to be simultaneously determined. In this study, therefore, the convergence in financial development and economic growth is examined on a system-of-equation basis. The objective of this study is to test for convergence in financial development and economic growth by incorporating the interaction between the real and financial sectors into an otherwise traditional test for conditional convergence. The results suggest that the mutually reinforcing relationship between financial development and economic growth is stronger in the early stage of economic development, and that this relationship diminishes as sustained economic growth gets under way. As such, poor countries with a relatively well-developed financial sector are more likely to catch up to their middle- and high-income counterparts.

The remainder of this article is organized as follows: In Section 2, the interdependence of financial development and economic growth is formulated. This is followed by Section 3 in which the data is described; and Section 4 in which the results of convergence tests are presented. Conclusions are drawn in Section 5.

2. Empirical formulation

The two schools of thought have sharply differing perspectives on the causal relationship between financial development and economic growth. One suggests that the increase in the demand for financial services resulting from economic growth is the major driving force behind financial development (Robinson, 1952, p. 86).[3] In this study, the following first-order difference equation is designated to capture the causal effect of economic growth on financial development:

[1] For instance, the cross-country growth regressions run by King and Levine (1993a), and Levine and Zervos (1998), show that the level of financial activities and the development of banks and stock markets have a positive effect on growth. A theoretical model proposed by Aghion et al. (2004) predicts that the growth rate of any country with more than some critical level of financial development will converge to the growth rate of the world technology frontier, and that all other countries will have a strictly lower long-run growth rate.

[2] For instance, Jung (1986) found bi-directional causality in most cases. Demetriades and Hussein (1996) found little support to the view that finance is a leading sector in the process of economic development. They found, however, considerable evidence for bi-directional causality and some evidence for reverse causation. Rousseau and Wachtel (1998) found strong uni-directional links from financial development to economic growth. Bell and Rousseau (2001) found that financial intermediaries played an emphatic role in promoting investment.

[3] As Demetriades and Hussein (1996) have pointed out, support for this view can be found in the work of Friedman and Schwartz (1963) on the demand for money.

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