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Two to tangle: Financial development, political instability and economic growth in Argentina

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This paper studies the impact of financial liberalization on economic growth. It contributes to this literature by using an innovative econometric methodology and a unique data set of historical series. It presents power ARCH estimates for Argentina for the period from 1896 to 2000. The main results show that the long-run effect of financial liberalization on economic growth is positive while the short-run effect is negative, albeit substantially smaller. Interestingly, we find that financial development affects growth only directly, that is, not through growth volatility.

1. Introduction

Instability and performance are often inversely related. Financial crises are associated with growth decelerations and contractions, while political protest tends to disrupt productive activities, thereby negatively affecting economic growth. Such amplified uncertainties, driven either by economic or political events, have deleterious consequences in terms of economic performance, especially in the short-run. In the long-run, however, financial development and political stability may instead have positive effects on growth. For example, the supply of credit to the private sector and transitions from autocracy to democracy are often considered key determinants of long-run growth across countries. In this light, this paper tries to answer the following questions. What is the relation between financial development on the one hand and economic growth and its volatility on the other? Do the sign and intensity of such effects vary over time and do they vary with respect to short- versus long-run considerations? Is there a dynamic asymmetry in the impact of financial development and political instability (that is, is it negative in the short- and positive in the long-run)?

This paper tries to tackle these questions using an innovative econometric framework and a unique type of data as it employs the power-ARCH (PARCH) framework and annual time series data for Argentina covering the period from 1896 to 2000. The "Argentinian puzzle," according to della Paolera and Taylor (2003), refers to the fact that since the Industrial Revolution, Argentina is the only country in the world that was developed in 1900 and developing in 2000 (see Fig. 1).[1]

As far as the literature on the finance-growth nexus is concerned, the present paper tries to contribute by offering econometric evidence based on historical data. Beck et al. (2000) and Levine (2005) argues that the prevailing consensus favors a positive, lasting and significant effect from financial development to economic

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[1] Authors' calculations using GDP per capita data from Maddison (2007), Western Europe is defined as Austria, Belgium, Denmark, Finland, France, Germany, Italy, Netherlands, Norway, Sweden, Switzerland and United Kingdom. The other group, Western Offshoots, includes Australia, Canada, New Zealand and United States.

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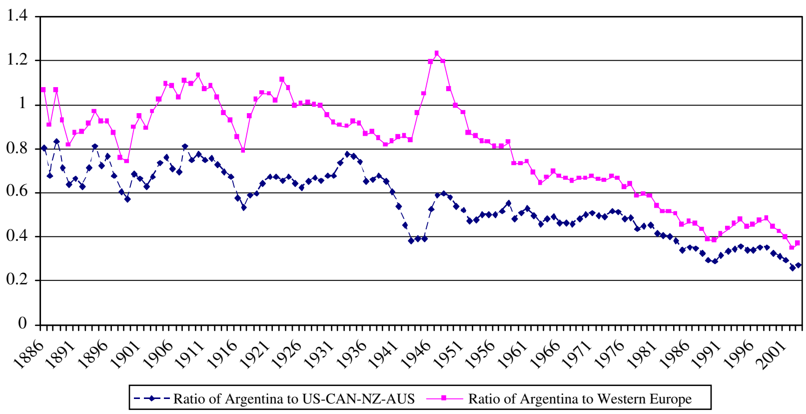

Fig. 1. Ratio of Argentina's GDP per capita to developed countries' GDP per capita, 1885–2003.

growth and that such effects are predictably stronger from measures of financial efficiency (for instance, the share in GDP of credit to the private sector) than from standard measures of financial depth (such as M3 over GDP). By using a range of financial development measures we can throw light on the impacts of these different dimensions over a much longer period of time than that normally considered in the literature. Doing so also allows us to investigate, inter alia, whether the impact of financial development on growth occurs directly or through growth volatility.[2]

An important issue we tackle is that of the contrasting short- versus long-run effects of finance on growth. Seminal papers are those by Kaminsky and Schmukler (2003) and Loayza and Rancière (2006). Despite the development of the financial system being robustly associated with economic growth, it is also often found to be the main predictor of financial crises. That is, while the long-run effect of finance on growth is positive, in the short-run it is negative. However, cross-country heterogeneity and business cycle synchronization issues may play an undesirably large role in generating this result and in particular regarding the relative magnitudes of these two effects. For instance, Loayza and Rancière (2006) report that the size of the effects is similar but the negative short-run effect is often larger than the positive long-run effect. In this paper we use data for a sufficiently long period of time and find supporting evidence for this asymmetric dynamic effect with the positive long-run effect being substantially larger than the negative short-run effect. Moreover, we try to shed light on important puzzles, such as the one regarding the duration of the political instability effects. While the conventional wisdom is that these effects are severe in the long-run, Campos and Nugent (2002)[3] and Murdoch and Sandler (2004) argue that they are stronger in the short- than in the long-run.

One last intended contribution is to try to bridge the literature on the macroeconomics of instability (based on cross-sectional and short-panels) with that on the relationship between growth and its volatility, which is mostly time-series based.[4] The latter tends to downplay the potential dependence between growth and its volatility by assuming a linear relationship, what is usually called the Bollerslev GARCH specification. Another final puzzle we try to address is on the sign of the growth-volatility link: while Grier and Tullock (1989) argue that larger standard deviations of growth rates are associated with larger mean growth rates, Ramey and Ramey (1995) show that output growth rates are adversely affected by their volatility.

Anticipating our main findings, we note the following in relation to the questions raised at the outset. The relationship between, on the one hand, financial development and political instability and economic growth on the other is not as straightforward as one may think at first. We find that it crucially depends on the type of political instability and of financial development, as well as short- versus long-run considerations. The short-run effect on economic growth of both informal instability (e.g., guerilla wars) and financial development is negative and direct and these results are robust to accounting for structural breaks, which are important in light of the long time span we cover in this study. Yet, while the long-run influence of finance is positive, that of informal instability remains negative. We also find that the impact of formal instability (e.g., constitutional changes) is mostly indirect and operates through growth volatility. These results suggest that the "severity" of the political instability effects in a sense "dominates" that of financial development: while the short- and long-run finance effects work in opposite directions, the effects of political instability are both negative and seem to operate through different channels. In this paper, we show that formal political instability is detrimental to growth via the volatility channel and our results suggest that, together with informal instability, it may have played a truly substantial role in the decline of the Argentinian economy during the XXth century.

The paper is organized as follows. Section 2 sets the context by showing how political instability and financial development contributed to the decline of Argentina from a position of a rich or developed country in year 1900 to that of a middle-income or developing country in year 2000. Section 3 describes the data. Section 4 details the econometric methodology. Section 5 discusses the main results. Section 6 concludes and suggests directions for future research.

2. The role of finance and instability in Argentinian growth

Among economic historians, there is little disagreement that the period from 1875 to the eve of World War I is the Belle Époque of Argentinian economic history (Taylor, 1992). There is also little disagreement that Argentina's uniqueness derives from no other country having ever fallen so dramatically down from the selected group of developed countries (Fig. 1). The two major disagreements remain not about whether but when the decline started and why. Some authors argue that it started with the 1930 crisis (e.g., Diaz-Alejandro, 1985). Others argue for an earlier turning

[2] Levine (2005) surveys the finance and growth literature, while Bekaert et al. (2006) and Prasad et al. (2004) survey that on finance and volatility. Recent contributions to this literature include Chang et al. (2010), Gimet and Lagoarde-Segot (2011), Tsoukas (2011), and Umutlu et al. (2010).

[3] They argue that the long-run negative effect of political instability on growth depends on the inclusion of African countries and of institutions.

[4] Durlauf et al. (2005) survey the former, and Grier et al. (2004) and Fountas and Karanasos (2007) review the latter.