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Financial development and economic growth: New evidence from Tunisia

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Abstract

This paper examined an empirical investigation of whether financial development can boost economic growth in Tunisia. We used an Autoregressive Distributed Lag method to assess the finance-growth relation taking private credit, value traded and issuing bank's securities on the financial market as financial development indicators.

The empirical results showed that the domestic credit to private sector has a positive effect on the economic growth suggesting that the financial development is a driver of a long term economic growth, but subject to a financial fragility at the short run. Moreover, this study confirmed the view of bidirectional relationship between credit and economic growth. However, we found that neither the stock market development nor the intervention of banks in the stock market had robust and positive effects on the economic growth. Thus, Tunisia is recommended to accelerate in priority the financial reforms of the Tunisian stock market in order to contribute to mobilize savings and promote long run economic growth.

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1. Introduction

The debate on optimal financial structure that promotes long-run economic growth culminates in four distinct views: the bank-based, the market-based, the financial services, and the law and finance (Dolar & Meh, 2002; Levine, 2005). This debate was initiated by Goldsmith (1969) who compared Germany to the UK, conducting empirical studies to see whether a financial structure matters for an economic growth.[3]

The bank-based view emphasizes the important role of intermediaries to stimulate economic growth. Since Schumpeter (1911), the banking sector has been an engine of the economic growth thanks to its funding of productive investment. Therefore, the economic growth is seen as connected to the indirect finance spread (Gurley & Shaw, 1960). Later, and considering the microeconomic foundations of intermediation, the bank was regarded as the best tool to overcome market frictions; it reduced information cost (Greenwood & Jovanovic, 1990), mobilized savings and provided liquidity (Gorton & Pennacchi, 1990).

In contrast, the market-based proponents insist on the merits of market financing. In fact, markets facilitate the diversification of risk and provide risk management tools. They enhance corporate governance and make it easy to tie managerial compensation to firm performance. They, also, provide managers with valuable information through the feedback effect of prices (Subrahmanyam & Titman, 1999). Then, they are better at funding projects of new technologies subject to diversity of opinions (Boot & Thakor, 1997).

On the other hand, the financial services view, developed by Merton and Bodie (1995), overcame this distinction and minimized the importance of bank-based/market-based debate. According to Levine (1997), the emphasis is put on the stability of financial functions carried out by both banks and markets. We must focus on the capacity of the overall system to offer significant financial services, regardless of the relative importance of its various components, the institutional structure or its evolution. Similarly, according to the legal view developed by La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1997), bank based/market based classification is not a useful way to distinguish financial systems. In fact, the financial development components are determined by the legal codes that impose the respect of the property rights and the efficiency of contracts.

Furthermore, because of recent financial innovations, deregulation and financial globalization occurring since the 80s, the noticed convergence of the different financial systems would occur in terms of complementarity between the banks and the financial market rather than in terms

[3] Several recent empirical works on financial structure and economic growth using the panel and/or pure cross-section frameworks concluded that the financial structure is irrelevant (Luintel, Khan, Arestis, & Theodoridis, 2008). However, Deidda and Fattouh (2008) showed that a change from a bank-dominated system to another in which market-finance and bank-finance coexist might harm economic growth.