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Testing Relationship between Private Investment and Financial System's Development: the Case of the EU Countries

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Abstract

In the paper, relationship between private investment and financial system's development was assessed in the case of the EU countries during 2000 – 2011, using cross-sectional data. The research results have shown that financial system is better developed in countries which GDP per capita is higher. Private investment growth rate and private investment to GDP ratio are higher in countries where financial system's development is lower, but in these countries private investment volatility is higher.

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Keywords: **Private investment, financial development, banking sector, financial markets, the EU countries**

1. Introduction

Private investment is an important source of long – term economic growth. In the scientific literature private investment and its determinants have been studied extensively in recent years. Different factors are listed as possible determinants of private investment such as macroeconomic and microeconomic environment, political and institutional environment, private sector's financial conditions, real investment capital costs. Recent financial crisis has highlighted importance of country's financial system as well as its potential to extend credit to finance private investment, because private investment recovery is very important seeking to assess economic growth in post crisis periods.

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The successful functioning of the financial system in each country is an important condition for economic growth. Sinevičienė and Vasiliauskaitė, 2008 highlight importance of bond market for both private and public sectors, because bond markets reduce dependence on the banking sector and increase financial diversification opportunities. Stock market also is very important because in well developed stock market enterprises have higher opportunities to issue new stock emissions. The prevailing view is that well developed financial system has positive impact on private investment, but on the other hand, financial markets might have negative impact on private investment because financial markets are very volatile and create negative signals to real economy. Scientists agree that financial system's development has a positive impact on private investment in the case of developing countries. But there is a lack of empirical studies analyzing relationship between private investment and financial system's development in the case of higher development countries. Thus, the scientific novelty of the paper refers to the analysis of relationship between private investment and financial system's development in the case of the EU countries during 2000 – 2011.

The aim of the paper is to assess relationship between private investment and financial system's development in the case of the EU countries. The research object: relationship between private investment and financial system's development. The research methods: systemic, logical and comparative analysis of the scientific literature, analysis of the statistical data, descriptive statistics, hierarchical cluster analysis, correlation analysis (Spearman's rho correlation).

2. Literature Review

In the scientific literature the prevailing view is that the level of financial system's development (particularly the level of financial intermediation development) has an impact on private investment; and it is the main determinant of financial constraints to the private sector. According to empirical studies (Love and Zicchino, 2006; Misati and Nyamongo, 2011; Huang, 2011; Almeida et al., 2011), the relationship between level of financial system's development and private investment is positive. Well developed financial system provides more opportunities and incentives to invest. According to Zicchino and Love, 2006 the financial system's impact on private investment is much higher in countries where the financial system is less developed. According to Almeida et al., 2011 the costs of external financial resources reduce due to development of the financial system; and this determines not only investment growth, but also the quality of investment. Resource mobilization and allocation is much more efficient in a developed financial system. There is also greater supply of various financial instruments that companies can use to attract financial resources (Mihalca, 2007; Karagöz, 2010; Barna and Mura, 2010). According to Vuranok, 2009 the characteristics of developed financial system are low funds' costs, large variety of instruments and low agency costs. Developed financial system enables more effective diversion of savings into investment.

Well developed financial markets might have a positive impact on private investment, but, according to Caporale et al., 2009 a large financial market can operate inefficiently. High taxes can reduce the incentives of companies to be listed on stock exchanges. According to Misati and Nyamongo, 2011 efficient financial markets, characterized by high stock market turnover ratio, reveals low transaction costs and high liquidity in the stock market. In the case of liquid stock market, small investors tend to invest in equity securities for a longer period, so the companies can attract more financial resources with lower costs; and therefore higher value of this indicator might have a positive impact on private investment.

Misati and Nyamongo, 2011 examined the relationship between financial sector development and private investment in Sub-Saharan Africa. They used panel data covering the period 1991 – 2004 from 18 countries in Africa. It was found that credit to the private sector had significant relationships with private investment. However, the effect of stock market turnover ratio on investment was insignificant due to low stage of stock market development in most of the African economies.