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Investigation of relationship between financial and economic development in the EU countries

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Abstract

The relationship between financial and economic development in the EU countries was investigated in this article. Summarizing the results of this study it can be stated that a positive statistically significant monotonic relationship between economic and financial development in the EU countries exists. However, the analysis results on the relationship between financial and economic development in different clusters of EU countries are mixed and there is no clear consensus on the relation between financial and economic development in different clusters.

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Keywords: **EU countries, economic development, financial development, relationship**

1. Introduction

The relationship between financial and economic development has drawn attention in recent theoretical and empirical literature. Some economists (e.g. Deidda (2006), Greenwood et al. (2013)) are searching for empirical evidence on the relationship between economic and financial development. However, most of scientists (e.g. Eichengreen et al. (2011), Hassan et al. (2011), Zhang et al. (2012), Gimet and Lagoarde-Segot (2012), Mitchener and Wheelock (2013), Hsueh et al. (2013), Sassi and Goaied (2013), Bumann et al. (2013), Narayan and Narayan (2013)) examine the links between financial development and economic growth. Economic theory predicts a positive relationship between financial development and growth but empirical studies on these relationships produce mixed results. Fung (2009) distinguishes two diverse views on the

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causal relationship between financial development and economic growth. The first view, according to Fung (2009), suggests that the increase in the demand for financial services resulting from economic growth is the major driving force behind financial development. Whereas the second view emphasizes a proactive role for financial services in promoting economic growth (Fung (2009)). Proponents of this view argue that differences in the quantity and quality of financial services could partly explain the differences in countries economic growth (Fung (2009)).

Over the last four decades, a wide theoretical debate is concerned with the fundamental relationship between financial development and economic growth, whereas, a number of the empirical studies analyzing the relationship between financial and economic development is scarce. Therefore, it is important to analyze the links between financial and economic development in order to fill this scientific gap. Thus, the main scientific novelty of this paper refers to the comprehensive analysis of the relation between financial and economic development in the European Union (EU) countries in the period of 2000-2011.

The aim of the article is to investigate the relationship between financial and economic development in the EU countries. *The research object:* the links between financial and economic development. *The research methods:* the systemic, logical and comparative analysis of the scientific literature, the analysis of the statistical data, descriptive statistics, hierarchical cluster analysis, correlation analysis (Spearman's correlation coefficient).

2. Literature Review

According to Greenwood et al. (2013), economists have been searching for empirical evidence connecting economic and financial development for a long time. Some academics focus on the links between financial and economic development of countries, while most of scientists investigate the causal relationship between financial development and economic growth.

Greenwood et al. (2013) investigated the impact of financial development on economic development using the cross-country analysis. The results of this study show that financial development explains about 23 percent of cross-country dispersion in output. The analysis suggests that financial intermediation is important for economic development. Deidda (2006) analyzed the interaction between economic and financial development. According to this study, financial development occurs endogenously as the economy reaches a critical threshold of economic development. The results show that when financial development is sustainable, the credit market becomes more competitive and more efficient over time, and this could eventually contribute to economic growth.

Fung (2009) tested for convergence in financial development and economic growth by incorporating the interaction between the real and financial sectors. The results of this study show strong evidence for conditional convergence. According to Fung (2009), middle- and high-income countries conditionally converge to parallel growth in economic and financial development. Fung (2009) also note that the mutually reinforcing relationship between financial development and economic growth is stronger in the early stage of economic development. Demetriades and Hussein (1996) conducted causality tests between financial development and real GDP using time series techniques. The results of this study provide little support to the view that finance is a leading sector in the process of economic development. Demetriades and Hussein (1996) also find considerable evidence of bi-directionality and some evidence of reverse causation. Findings of this study also clearly demonstrate that causality patterns vary across countries. Levine (1997) recognizes that financial institutions might play an important role in economic growth. However, the empirical evidence of this study also suggests that the link between finance and growth is positive and strongly significant only at relatively high levels of economic development. Levine (1997) notes that for relatively less developed economies, the relationship is much weaker, if not insignificant or even negative. Levine et al. (2000) evaluated whether the development level of financial intermediaries exerts a casual influence on the economic growth. Using different statistical techniques, they found that the exogenous components of financial