Causal nexus between economic growth, banking sector development, stock market development, and other macroeconomic variables: The case of ASEAN countries

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Abstract

This paper examines the relationship between banking sector development, stock market development, economic growth, and four other macroeconomic variables in ASEAN countries for the period 1961-2012. Using principal component analysis for the construction of the development indices and a panel vector auto-regressive model for testing the Granger causalities, this study finds the presence of both unidirectional and bidirectional causality links between these variables. The study contributes to understanding the importance of the interrelationship between the variables and combines the different strands of the literature. It also contributes to the literature by focusing on a group of countries that have not been studied before. One particular policy recommendation is to make the banking sector more accessible for those country's inhabitants that do not have bank accounts. Another policy recommendation is to nurture stock market development, which will facilitate the increased raising of capital for investment purposes to enhance economic growth.

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1. Introduction

The level of banking sector development and stock market development is among the most important variables identified by the empirical economic growth literature as being correlated with growth performance across countries (Fink, Haiss, & Vuksic, 2009; Beck & Levine, 2004; Garcia & Liu, 1999; Levine & Zervos, 1998; Naceur & Ghazouani, 2007; Yartey, 2008). These development challenges prevent developing countries from taking full advantage of technology transfer, causing some of these countries to diverge from the growth rate of the world production frontier (Aghion, Howit, & Mayer-Foulkes, 2005; Menyah, Nazlioglu, & Wolde-Rufael, 2014). In fact, it is debated that poor countries with a weakened financial system are trapped in a vicious circle, where low levels of financial development, in both the banking sector and the stock market, lead to low economic performance and low economic performance leads to low financial development (Fung, 2009). An inadequately supervised financial system may be crisis-prone, with potentially devastating effects (Mosherian & Wu, 2012; OECD, 1999). On the contrary, an efficient financial system, with a well-developed and integrated banking sector and stock market, provides better financial services, which enables an economy to increase its growth rate (Bencivenga, Smith, & Starr, 1995; Esso, 2010; King & Levine, 1993a).

Hence, finance is not only pro-growth but it is also pro-poor, suggesting that financial development helps the poor catch up with the rest of the economy as it grows (Demirguc-kunt & Levine, 2009). Furthermore, the endogenous growth theory as articulated by Greenwood and Jovanovic (1990) and Bencivenga and Smith (1991) and others stresses that financial development along with advancement is able to facilitate economic growth through multiple channels. These channels include: (i) providing information about possible investments, so as to allocate capital efficiently; (ii) monitoring firms and exerting corporate

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The relationship between financial development and economic growth has been an important area of discussion among researchers and policy makers. Numerous studies have argued for a link between these two variables, with financial development often seen as growth-enhancing. However, the nature and direction of this relationship have been a matter of debate, with some studies suggesting a unidirectional causality from financial development to economic growth, while others propose a feedback hypothesis. The evidence for these relationships is mixed, with some studies finding strong support, while others fail to detect significant causal effects.

This paper aims to review the literature on the connection between financial development and economic growth. It examines the empirical evidence for the role of financial development in promoting growth, considering both banking sector development and stock market development. The paper discusses the methods used in these studies, including econometric techniques such as cross-sectional, time series, panel data, and firm-level analyses.

2. Literature review

Financial development is pivotal to economic growth. According to Levine (1997), this connection has been a focal point of numerous empirical studies. The empirical evidence suggests that financial development can robustly explain differences in economic growth, with a strong positive impact on growth rates.

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