NORTH-HOLLAND

Review of Financial Economics 11 (2002) 131–150

RFE
Review of Financial Economics

Financial development and economic growth
Another look at the evidence from developing countries

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Received 4 January 2001; received in revised form 5 July 2001; accepted 4 February 2002

Abstract

The present paper examines the nature and direction of the relationship between financial development and economic growth using both time-series and panel data from 30 developing countries for the period 1970–1999. The choice of the sample was determined by the availability of data. As such, the exclusion of other developing countries is due to the fact that the data on these countries are missing for some years. The empirical results strongly support the view that financial development and economic growth are mutually causal, that is, causality is bidirectional. There is also some support for the other views presented in the literature (supply-leading, demand-leading, and no relationship) but it is not as strong as that for the bidirectional causality. Moreover, the findings of the present paper accords with the view of the World Bank and other empirical studies that the relationship between financial development and economic growth cannot be generalized across countries because economic policies are country specific and their success depends, among others things, on the efficiency of the institutions implementing them. © 2002 Elsevier Science Inc. All rights reserved.

JEL classification: O16; G18; G28

Keywords: Financial development; Economic growth

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PII: S1058-3300(02)00039-3

1. Introduction

Ever since the pioneering works of Goldsmith (1969) and Shumpeter (1932) and more recently of McKinnon (1973) and Shaw (1973), the relationship between financial development[1] and economic growth has been one important area of discussion among economists. Later studies, both theoretical and empirical, have attempted to deepen our understanding of the different aspects of this relationship by exploring the existence of this relationship, the direction of causality between the two variables, and the channels of transmission between them. A number of recent papers have surveyed this literature (see, for example, Demirguc-Kunt & Levine, 1996; Levine, 1997; Thakor, 1996). Therefore, rather than presenting another review, in the present paper, I will briefly discuss the main streams of thought emanating from this literature on the relationship between financial development and economic growth by way of introduction to the empirical analysis to follow.

The above mentioned literature indicates that economists hold different views on the existence and direction of causality between financial development and economic growth. The first is the ‘‘supply-leading’’ view, which states that financial development has a positive effect on economic growth. According to this view, financial intermediation contributes to economic growth through two main channels: (1) by raising the efficiency of capital accumulation and in turn the marginal productivity of capital (Goldsmith, 1969) and (2) by raising the savings rate and thus the investment rate (McKinnon, 1973; Shaw, 1973). In other words, by increasing the size of savings and improving the efficiency of investment, financial development leads to higher economic growth. This first view has received considerable support from recent empirical studies (see, for example, Bencivenga & Smith, 1991; Greenwood & Jovanovic, 1990; Thakor, 1996).

The second view of the relationship between the two variables was advanced by Robinson (1952) and it states that financial development follows economic growth or ‘‘where enterprise leads finance follows’’ (Robinson, 1952, p. 86). According to this ‘‘demand-following’’ view, as the real side of the economy expands, its demand for financial services increases, leading to the growth of these services. Empirical support for this second view can also be found in some recent studies (Demetrides & Hussein, 1996; Friedman & Schwartz, 1963; Ireland, 1994).

A third view of the relationship between financial development and economic growth postulates that the two variables are mutually causal, that is, they have a bidirectional causality (Demetrides & Hussein, 1996; Greenwood & Smith, 1997).

Finally, a fourth view, which was originally put forward by Lucas (1988), argues that financial development and economic growth are not causally related or in the words of Lucas, ‘‘economists badly overstress the role of financial factors in economic growth.’’

It is obvious from the preceding brief exposition of the different streams of thought on the relationship between financial development and economic growth that the literature is mixed

[1] The terms ‘‘financial development’’ and ‘‘financial intermediation’’ are used interchangeably in the present paper, although the former is broader and includes capital markets in addition to financial intermediaries. However, because of the lack of data on capital markets in the countries studied in this paper, the two terms are used interchangeably.