Chapter 15

Financial Development and Economic Growth: Panel Data Analysis

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ABSTRACT

The relationship between financial development and economic growth has been the subject of considerable debate in development and growth literature. Therefore this chapter provides evidence on the role of financial development in accounting for economic growth in 23 OECD countries (Italy, Japan, Luxemburg, Holland, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, England, USA, Australia, Austria, Belgium, Canada, Denmark, Finland, Turkey, France, Germany, Greece, Iceland) via panel data analysis using the annual data for the period 1980-2012. The authors find a positive relationship between financial development and economic growth for all countries. Also this result means that financial development leads economic growth in these countries. So the results may help policymakers formulate effective financial sector policies as a tool to promote economic growth.

INTRODUCTION

Together with the rapidly developing globalization which has been ongoing since the 1970s, the neo-liberal policies such as privatization, deregulation, liberalization and global integration which define the economic policies of countries have started to be applied intensively in the form basic elements. The most noteworthy of these policies is financial liberalization, in other words the removal of controls on banking and other financial tools. With the aid of financial liberalization in the 1980s, countries started to achieve conformity and integrity with the globalised world economy.
Thus, with the diversity of a country’s financial market tools, the great increase in the funds in circulation, the development of new financial markets, innovations in technology and the field of communications have provided financial procedures at an international level and much lower transactional costs (Berkman, 2011: 260).

Together with these developments, the increased economic growth created by financial development and the relationship between financial development and economic growth has started to attract great interest from economists and many studies have been conducted on this subject (Dinar, 2012: 111). Parallel to this interest in literature, this study researched the relationship between economic growth and financial development in the period 1980-2012 of 23 OECD countries for panel data analysis. The results obtained from the analysis confirmed a positive relationship between financial development and economic growth.

After presenting the theoretical framework of the relationship between financial development and economic growth in the second part of the study, the third section of the study refers to the importance in literature. After the separation of data and methodology in the fourth part, the final section summarizes the findings and conclusions.

BACKGROUND

Theoretical Framework

The theoretical foundations of the relationship between financial development and economic growth were first defined by Schumpeter (1912) then research was started by economists such as McKinnon (1973), Shaw (1973), Kapur (1976), Galbis (1977), Mathieson (1980) and Pagano (1993)\(^1\). The importance of banks in achieving economic growth was stated first by Schumpeter (1912), emphasizing that entrepreneurs have the opportunity to invest with bank loans, thus increasing production which results in increased economic growth. In this sense, according to Schumpeter (1912), banks contribute to industrial growth with the credit they create (Fowowe, 2010: 72). Whereas according to McKinnon and Shaw (1973) restrictions such as the interest rate ceiling, foreign exchange rates, direct credit allocation policies, high reserve requirements and very heavy taxation of the financial sector imposed on the banking system by the state in developed countries cause pressure on the financial markets (Khan & Senhadji, 2000: 4).

According to these views, these types of policies have the effect of slowing down economic growth. These repressive policies, in shrinking and reducing the depth of the financial system, have a destructive effect on the mobilization of the financial markets and redistribution of financial resource functions. Therefore, McKinnon and Shaw (1973) stated that the problems created by repressive financial policies are resolved with financial development (Fowowe, 2010: 72-75). The studies of McKinnon and Shaw accelerated research into the relationship between financial development and economic growth (Demirgüç-Kunt & Detragiache, 1998: 4) and Galbis (1977) developed the analysis of McKinnon and Shaw (1973) assuming that there are two sectors in the economy, one low activity and the other high activity.

According to the analyses, the sector of high activity is more technologically developed than the other sector and at the same time, has higher income investments. As interest rates are lower for firms in the low activity sector due to financial pressure, it will be more advantageous to invest in this sector. Therefore, investments remaining in the low activity sector cannot go to the high activity sector and productivity and production will reduce. Thus, in this country, together with financial development, rather than the banks investing in the low activity sector, bank deposits will increase and thus by shifting credit to the high activity sector, there will be the effect of increasing economic growth.
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