Chapter 6

Banks, Stock Markets, and Growth Relationships in the EU28 Countries

Andreas G. Georganopoulos
Panteion University of Political and Social Sciences, Greece

Ioannis Filos
Panteion University of Political and Social Science, Greece

Evangelos I. Poutos
Hellenic Open University, Greece

ABSTRACT

This chapter examines the impact of banks and stock markets on economic growth for a panel that includes the 28 EU member states. The originality of this study lies in that it tests these relationships by employing sub-regional panels based on the geographical distribution of EU countries and by clustering EU member states in Eurozone and non-Euro countries. Results support the stock market-led growth hypothesis only for the case of the full sample panel. Furthermore, both the full panel results and Eurozone panel results fail to support the bank credit-led growth hypothesis. These results are inconsistent with other studies, which however employ only full regional panels.

1. INTRODUCTION

The relationships between the financial system (banking sector and financial sector) and economic growth, puzzles academics, scholars and practitioners for more than a century. The literature on this subject provides exhaustive evidence that support the significance of the financial system-growth nexus dating back to the studies of Schumpeter (1911, 1934), who suggests that the financial intermediary sector plays a significant role to the productivity growth and technological advance by the allocation of savings to firms.

The literature evolved with a rapid pace, especially during the last two decades, and can be divided into two groups. The first group of studies deals with the impact of stock market development on economic growth by employing stocks traded, market capitalisation or turnover ratio as proxies. The second group of literature concentrates on the relationships between banking sector developments, as measured by credit and liquid liabilities, and economic growth. Regardless of the proxies and regions/countries employed, both strands of this literature are in consensus that the financial system promotes economic growth, although presenting different characteristics and significance levels across regions/countries. Moreover, this literature further expanded by employing measures of trade, namely, trade openness (the sum of imports and exports) and exports documenting not only the significant impact of trade on economic growth (see Shahbaz, 2012; Georgantopoulos and Tsamis, 2011; Yanikkaya, 2003; Baldwin and Forslid, 1998) but also the linkages between financial development and trade (Bordo and Rousseau, 2012; Taylor and Wilson, 2011; Baltagi et al., 2009; Hur et al., 2006).

This study aims to assess the impact of banking and financial sector developments on economic growth for a full panel of the 28 European Union member countries (EU28) over the period 1996-2016. This paper contributes to the existing pool of literature in three ways. First, this is the only study that focuses on the EU28 (Croatia became the 28th member state of the European Union on 1st of July 2013). Other studies deal with the financial system and growth nexus (see Section 2) either by employing data relating to a single country or by using too many and mixed panel data making it difficult to analyse in depth one particular region that presents similar financial attributes. Moreover, several studies include EU countries in panel data with other non-EU countries. Therefore, this study argues that EU member states, present different financial characteristics than non-EU countries, mainly due to the close economic and political cooperation that EU member states benefit. The European Union operates through a network of independent institutions. Although the EU is not a single country yet, a consolidated economic and political environment has been created for its member states. In this vein, scientific conclusions could be
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