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WHAT IS HAPPENING TO THE IMPACT OF FINANCIAL DEEPENING ON ECONOMIC GROWTH?

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Abstract

Although the finance-growth relationship is now firmly entrenched in the empirical literature, we show that it is not as strong in more recent data as it was in the original studies with data for the period from 1960 to 1989. We consider several explanations. First, we find that the incidence of financial crises is related to the dampening of the effect of financial deepening on growth. Excessive financial deepening or too rapid a growth of credit may have led to both inflation and weakened banking systems which in turn gave rise to growth-inhibiting financial crises. Excessive financial deepening may also be a result of widespread financial liberalizations in the late 1980s and early 1990s in countries that lacked the legal or regulatory infrastructure to exploit financial development successfully. However, we find little indication that liberalizations played an important direct role in reducing the effect of finance. Similarly, there is little evidence that the growth of equity markets in recent years has substituted for debt financing and led to a reduced role of financial deepening on growth. (*JEL* E44, G10, O40)

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