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# A re-examination of financial development, stock markets development and economic growth

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# Abstract

This study provides new evidence on the role of financial development and stock market development in accounting for economic growth across geographic regions and income groups. To derive feasible policy implications, we estimate not only unbalanced panel regressions with period fixed effects, but also variance decompositions of annual Gross Domestic Product (GDP) growth. Our findings suggest that financial development is most important for economic growth in low-income countries, while stock market development is most important for economic growth in high-income countries. Our findings also suggest that financial development is most important for economic growth in emerging markets, while stock market development is most important for economic growth in developed countries. Our findings also suggest that financial development is most important for economic growth in low-income countries, while stock market development is most important for economic growth in high-income countries. Our findings also suggest that financial development is most important for economic growth in emerging markets, while stock market development is most important for economic growth in developed countries.

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## Granger causality tests

## Acknowledgements

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## Notes

Jung-Suk Yu is ‘the first author’ of this article.

<sup>1</sup> Ang ([2008](#)) provides a nice survey of the literature on financial development and economic growth.

<sup>2</sup> Omitting stock market development makes it difficult to assess whether (1) the positive relationship between bank development and growth holds when controlling for stock market development, (2) banks and markets each have an independent impact on economic growth or (3) overall financial development matters for growth but it is difficult to identify the separate impact of stock markets and banks on economic success (Beck and Levine, [2004](#)).

<sup>3</sup> The World Bank only categorizes geographic regions for low- and middle-income countries and high-income countries are not included in classification by geographic regions. Therefore, each geographic region has the homogeneity in the level of financial development, stock market development and economic growth to some degree.

<sup>4</sup> Levine and Zingales (1995) find that the size of the stock market is positively related to economic growth. This finding is consistent with the empirical research of Levine and Zingales (1995).

<sup>5</sup> The panel data is used to analyze the relationship between the size of the stock market and economic growth using a fixed effects model.

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<sup>6</sup> According to 2009 Gross National Income (GNI) per capita, the four income groups are divided into low income (\$995 or less), lower middle income (\$996–3945), upper middle income (\$3946–12 195) and high income (\$12 196 or more) based on World Bank classification.

<sup>7</sup> Despite the well-known shortcomings coming from aggregations, we believe that our approach to construct panel dataset, based on geographic regions and income groups, has several advantages to provide useful policy implications compared to previous literature on cross-sectional studies including many numbers of heterogeneous countries. In addition, if we use 5-year averages, rather than using annual data, to abstract from business cycle, our 29-year sample period (1980 to 2009) only provides six time-series. Therefore, it is very difficult to perform multivariate time-series analysis to examine the causality between finance and growth due to the small degree of freedom.

<sup>8</sup> Some of proxy measures for financial development incorporate information from banks and other financial intermediaries in addition to loan markets. We also take into account stock market capitalization and the value of the trades of domestic shares on domestic exchanges to capture the development of the stock markets and to deal with the differences in the financial systems of the bank-based ('German-Japanese') and market-based ('Anglo-Saxon') countries.

<sup>9</sup> We use the entire panel to run dynamic panel regression in Equation [1](#). More specifically, the panel dataset includes the seven cross-sectional geographic regions and the time periods of proxy measures from 1980 to 2009.

<sup>10</sup> Innovations,  $e(t)$ , are defined as  $e(t) = Y(t) - P Y(t)$  where  $P$  denotes the linear least squares projection of  $Y(t)$  in the space spanned by  $X(t)$ .

<sup>11</sup> To be consistent with the contemporary literature, we follow the j-th order polynomial function to introduce a nonlinear element in the model. This is reasonable because the data are available for the j-th order polynomial function.

<sup>12</sup> Multivariate cross-sectional to the panel data, it is expected that the regression. However, the measures (e.g. DCBS, D

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our panel regression could disentangle explanatory variables successfully although we included several financial and stock market development indicators simultaneously like most of exisiting literature (see King and Levine, [1992](#); Khan and Senhadji, [2000](#); Al-Awad and Harb, [2005](#), among others).

<sup>13</sup> The results of cointegration tests are not shown to conserve the space and are available upon request.

<sup>14</sup> Similarly, GDS shocks explain 14.8585% (12.0161%) of GDPG fluctuations in 10 years (5 years) ahead for VEC model.

<sup>15</sup> Note that the emphasis in Granger causality tests is on short-run relationship because the results of panel regression and cointegration tests strongly imply the presence of long-run linkages between financial development and economic growth.

## Additional information

### Notes on contributors


Jung-Suk Yu  
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