

Financial Intermediaries and Economic Growth: Evidence from Emerging Markets

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Does the market-oriented “finance leads to economic growth” strategy have any merit in the emerging markets? This paper studies the effect of stock market and banking sector development on economic growth in 10 emerging economies. Using Granger-causality tests, the present study finds little evidence of a causal relationship going from stock market development to economic growth. Findings of the present study show that for most of the emerging markets there are unidirectional and/or bi-directional causality that runs from economic growth to financial sector.

I Introduction

Development economists take it for granted that a well-developed market-based financial system contributes to economic growth. The prevailing paradigm is that competitive private sector capital markets should be able to gather savings at market rates of interest and allocate the capital to the most efficient investable projects. Although the finance and growth relationship is a part of the ‘liberal consensus’ in the modern economics, empirical efforts to describe specific channels of interest have begun to emerge. Studies of the ‘finance-growth’ link with aggregate credit measures are followed by the studies of the separate impact of bank and stock markets on growth. Theory suggests there are systematic differences in the finance-growth relationship among countries with different characteristics. For example, the evidence of finance effects is not as strong among developed countries as it is among less developed countries (Wachtel 2003). The research on the identification of specific institutional characteristics and financial sector channels that contribute to economic growth has produced a plethora of burgeoning literature.

Literature Overview

Within the endogenous growth literature, recent theoretical studies have focused on the links between endogenous growth and financial markets. Bencivenga and Smith (1991) and Levine (1991) propose endogenous growth models to identify the channels through which financial markets affect long-run economic growth. Both the studies emphasized that financial markets help diversify agents’ liquidity and investment risk, attract more savings into productive investment and prevent the premature withdrawal of physical capital invested in the long-

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