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TESTING THE FINANCE-GROWTH LINK: IS THERE A DIFFERENCE BETWEEN  
DEVELOPED AND DEVELOPING COUNTRIES?

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NON TECHNICAL SUMMARY

How much does financial development spur economic growth? Does financial intermediation affect positively the growth rate of the real GDP? Does the finance-growth link work whatever the level of development of countries? A vast empirical literature aims at providing an answer to these questions. Using cross-section data, the studies generally conclude in favour of a positive correlation between financial intermediation and productivity growth, as well as between financial development and capital accumulation (Leeper and Gordon (1992), Roubini and Sala-I-Martin (1992), King and Levine (1993a, 1993b)). Focusing on the issue of causality, other papers find that developed financial markets induce a strong growth and conclude in favour of bilateral causality (Jung (1986), Rajan and Zingales (1998), Beck *et al.* (2000), Calderon and Liu (2003)). The possibility that financial intermediation may be beneficial to growth is also evidenced in papers using panel data (Levine *et al.* (2000) and Beck and Levine (2003)).

The significant link between finance and economic growth is widely accepted, but the statistical evidence is based on the assumption of a *uniform* finance-growth nexus across countries. This hypothesis may be criticised, since there are several channels through which financial development affects economic growth. Such channels may differ across countries and include liquidity effects, financial depth, the role of financial intermediaries, and the reduced cost of information. Thus, in uncovering the effect of financial intermediation on the real sector, we should consider the possibility that the finance-growth nexus varies across nations. Using dynamic specifications allowing for slope heterogeneity across countries, Favara (2003) finds results that are in contradiction with the vast literature suggesting that finance and growth are positively linked. Not only does financial development have a small effect on growth, but also the impact is negative for some combination of variables and sample periods. These contradictions can be due to several reasons, such as a questionable use of econometric methodologies. What is at stake here is the robustness of the tests and estimators applied when one uses panel data.

In this paper, we revisit the evidence of the existence of a long-run link between financial intermediation and economic growth, as regards these methodological problems. We focus on the issue of cointegration between the growth rate of real GDP, control variables and three series reflecting financial intermediation. To this end, we consider a model with a factor structure that allows us to determine whether the finance-growth link is due to cross countries dependence and/or whether it characterises countries with strong heterogeneities. We employ techniques recently proposed in the panel data literature, such as PANIC analysis and cointegration in common factor models.

Our results put forward differences between developed and developing countries. More specifically, we find that, for the developing countries, cointegration occurs through cross-member dependence exclusively. For the developed countries, to find a significant relationship, we also need to consider the finance-growth links that are specific to each country. On the whole, on the 1980-2006 period, our results show that financial intermediation — mainly through financial depth which is the most important financial variable — is a positive determinant of growth in developed countries, while it acts negatively on the economic growth of developing countries.