

**Emerging Markets Economics and Business.  
Contributions of Young Researchers**

***Proceedings of the 14th International Conference of Doctoral Students  
and Young Researchers***

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# FINANCIAL DEVELOPMENT AND ECONOMIC GROWTH. A LITERATURE SURVEY

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**Abstract:** *The relationship between financial development and economic growth represents a very investigated research topic by a various number of studies, both theoretical and empirical. Nevertheless, research conclusions are ambiguous and it is necessary to clarify them. An amount of studies concluded that financial development exert a positive impact on economic growth. Despite this fact, there are a lot of researches that prove a negative impact when financial development exceeds a certain threshold. More than that, profound negative implications of the recent international crisis and the COVID-19 pandemic crisis on the real economy and the financial system led to a renewal of the interest of researchers to examine this subject. In this context, the main purpose of our study is to clarify the nature of the relationship between financial development and economic growth and to present the main theories on financial intermediation and financial intermediaries.*

**Keywords:** *Financial development; Economic growth; Causality.*

**JEL classification:** *E44; G21; O11; O16; O43.*

## 1. Introduction

It is well known that a higher standard of life can not be reached without economic growth. A lot of empirical and theoretical studies shown that financial development is one of the main determinants of economic growth. Therefore, the institutional framework of the financial system, as well as its performance, can be considered as major stimulus of macroeconomic performance. As a result, the research question of present paper is: What is the role of financial intermediation on economic development?

Despite the fact that the relationship between financial development and economic growth is a topic investigated by a large amount of studies for several decades (at least from the paper published by Goldsmith, in 1969) a consensus have not been reached yet. This is due to the fact that authors use different samples, time periods and methodology. Consequently, the main purpose of our research is to examine, theoretically, the relationship between financial development and economic growth, in special: the presence of the relationship and its impact. Our paper is structured as follows: second section is dedicated to a synthesis of main theories on financial intermediation, the third section axes on a review of main empirical studies on the issue of financial development economic growth nexus, and the last includes some conclusions.

## 2. Main theories on financial intermediation

A lot of studies (Merton, 1995; Allen and Gale, 1997; Allen and Santomero, 2000;

Diamond and Rajan, 2000; Levine, 2005; Andrieş, 2009; Kuhri and Weill, 2010; Méon and Weill, 2010) examine the theoretical framework of the relationship between financial development and economic growth. According to these researches the main theories of financial intermediation is: Asymmetric information theory; Agency theory; and The modern theory of financial intermediation.

According to Andrieş (2009) Theory of financial intermediation is based on Asymmetric information theory and Agency theory. Consequently, the main argument for the existence of financial intermediaries is reflected by the existence of following factors: absence of complete information at the proper time; high transaction costs and lack of complete information in useful time.

*The modern theory of financial intermediation* highlights the primary functions of financial intermediation and its influence on the economy, in general, and, in particular, on economic growth and on the quality of bank regulation and central bank supervision.

Some papers (as: Boyd and Prescott, 1986; Jensen, 1986; Grossman and Hart, 1982; Levine, 2005; Kuhri and Weill, 2010; Méon and Weill, 2010) exposes the main channels through which development of financial intermediation leads to an increase in productivity, hence an increasing economic growth. First channel is represented by the fact that financial intermediaries are able to produce information about possible investments *ex ante*. Due to that banks can reduce the costs of evaluating: investment projects, managers and market conditions, and consequently allowing a better allocation of capital. Second channel is reflecting by the fact that financial system monitors the companies. The supervised managers feel pressured and because of that they increase firm's performance. Third channel is represented by the fact that financial intermediaries pool the savings and, in this way, reduces the costs of gathering money from different economic agents. The last channel is highlighted by the exchange function of financial intermediaries.

In conclusion, all the main theories on financial intermediation exposes only the positive impact of financial development on economic growth.

### 3. Empirical observations on the financial development and economic growth relationship.

Analysing empirical research that deal with the issue of financial development and economic growth nexus, we deduced that the results are controversial. An explanation to that can serve the fact that they use different periods, samples, and methods. To highlight the idea stated previously we present table 1.

**Table 1:** The synthesis of empirical research on the financial development and economic growth nextus subject.

Author s	Period/ Sample	Dependent variable	Independent variables	Research method	Results
King and Levine (1993)	1960-1989/ 80 countries	Real per capita GDP growth rate	1. Ratio of liquid liabilities to GDP; 2. Deposit bank domestic credit divided by deposit money bank plus central bank domestic credit; 3. Ratio of claims on nonfinancial private	Cross-country regressions	There are a strong, statistically significant and positive relationship between financial

			sector to domestic credit; 4. Ratio of claims on the nonfinancial private sector/ GDP.		development and economic growth.
Caporale et al. (2015)	1994–2007/ EU countries (10 new members)	Real GDP per capita	1. Initial income per capita; 2. Investment/ GDP; 3. Trade/GDP; 4. Inflation; 5. Government expenditure/GDP; 6. Secondary school enrollment ratio; 7. Domestic credit to the private sector; 8. Stock market capitalization; 9. Liquid liabilities; 10. Reform index of financial institutional development; 11. Interest rate margin	GMM	There are not a relationship between financial development and economic growth.
Wen et al. (2022)	1997-2017/ 120 countries	Real GDP growth rate	1. Inflation rate; 2. Employment growth rate; 3. M3 % of GDP; 4. M2 % of GDP; 5. Domestic bank credit; 6. Domestic bank private credit; 7. Investment; 8. Government expenditure; 9. Real exchange rate.	GMM	Financial development manifests a negative impact on economic growth.

Source: Own elaboration based on specialized literature.

#### 4. Conclusion

To sum up, our research proves the fact that there is not a consensus in specialized literature on the issue of financial development and economic growth nexus. While theoretical research demonstrate the fact that there is a strong positive relationship between the variables, empirical researches shown that using different methodology results are controversial. This is due to the fact that authors use different samples, time periods and methodology. As future research directions we propose to examine the relationship between financial development and economic growth on the European Union member countries. More than that, we aim to investigate if the relationship is different when targeting euro area countries or when pick up the non-euro area EU countries.

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