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RESEARCH ARTICLE

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What matters for finance-growth nexus? A critical survey of macroeconomic stability, institutions, financial and economic development

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Abstract

This paper analyses the variables that moderate the impact of financial development on economic growth based on theoretical and empirical evidences. We show that financial and economic development, institutions and macroeconomic stability are the fundamental variables that moderate the finance-growth nexus. Specifically, higher levels of financial and economic development, institutional quality and macroeconomic stability promote the impact of financial development on economic growth, while lower levels of these variables could have the opposite effect. We also show that too much finance is deleterious to economic growth, suggesting the existence of a threshold level of financial development beyond which further finance inhibits, rather than enhances growth. The economic implication of this study is that a stable macroeconomic environment, higher level of institutional quality, optimum financial and economic development are necessary conditions for finance to accelerate growth. Hence, countries that want to promote economic growth through the financial sector should give adequate priority to these variables.

KEYWORDS

economic development, economic growth, financial development, institutions, macroeconomic stability

1 | INTRODUCTION

Theoretical literature posits that financial development influences economic growth through two distinct but complementary channels, namely, total factor productivity and capital accumulation. The latter focuses on the ability of the financial system to mobilize savings for the purpose of productive investments, which increase capital accumulation and greater output growth. As the financial sector mobilizes savings, it overcomes the indivisibility problems, and the mobilized resources are channelled to fund investment projects. The factor productivity channel stresses the importance of innovative financial technologies which decrease the problem of information asymmetry that hinders efficient allocation of financial resources and the monitoring of investment projects (King & Levine, 1993a, 1993b). Thus, financial development increases the proportion of savings channelled to investment, raises the social marginal productivity of capital and influences the rate of private savings. Moreover, it allocates financial resources to projects with the highest marginal product of capital, provides information for the evaluation of alternative investment projects and influences risk-sharing by inducing individuals to invest in riskier but more productive technologies. Statistically,[1] the global financial development (proxied by credit to private sector relative to gross domestic product [GDP]), real GDP per capita, growth rate of real GDP

