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Rethinking the impact of GDP on financial development: Evidence from heterogeneous panels

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Abstract

This paper examines the nonlinear impact of real GDP per capita on financial development in a panel of 125 countries. It also determines the moderating effect of inflation on the impact of GDP on financial development. It employs the dynamic panel system generalized method of moments (GMM) and the dynamic common correlated effects (CCE) to do both panel and country-specific analysis, as well as control for cross-sectional dependence, heterogeneity and endogeneity. This study shows that GDP has a positive impact on financial development in the entire panel. However, when we split the panel into different income groups, we find a positive impact in the high- and middle-income groups while the impact is insignificant in the low income group. Although we find no evidence of a nonlinear impact of GDP on financial development in the panel, the country-specific analysis reveals a significant nonlinear relationship between GDP and financial development in 73 countries. We also show that inflation adversely moderates the positive impact of GDP on financial development in middle-income countries. This study implies that the relationship between GDP and financial development depends on the levels of GDP and inflation rate. We recommend some policy options based on the findings.

KEYWORDS

financial development, heterogeneous panels, inflation rate, real GDP per capita

JEL CLASSIFICATION

G15; F10; E31

1 | INTRODUCTION

In the finance-growth nexus, the demand-following hypothesis posits that financial development responds to growth in real GDP per capita (hereafter referred to as GDP) since an increase in GDP causes households and firms to increase their demands for financial products, services, intermediaries and institutions. To meet these increased demands, the financial sector embarks on innovations and technology which facilitate the development of the sector. The empirical literature on demand-following hypothesis suggests that growth in GDP precedes financial development (Baltagi et al., 2009; Law & Habibullah, 2009; Peia & Roszbach, 2015), though Cherif and Dreger (2016) revealed that GDP is not a significant determinant of financial development in emerging market economies. The differences in the empirical outcomes could be attributed to the inability of the studies to account for differences in the level of GDP across the

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