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Revisiting the role of inflation in financial development: unveiling non-linear and moderating effects

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Abstract

Purpose – This paper aims to examine the non-linear impact of inflation on financial development, and the moderating role of GDP in the relationship between inflation and financial development in a panel of 125 countries.

Design/methodology/approach – It employs the dynamic common correlated effects (CCE) that can control for heterogeneity and cross-sectional dependence. This technique enables us to conduct both panel and country-specific analyses.

Findings – Though there is no significant evidence that inflation has a non-linear impact on financial development in the panel, the country-specific estimations reveal that inflation has a non-linear impact on financial development in 66 countries. The results also show that GDP mitigates the detrimental effect of inflation on financial development in 45 countries. An insight into the non-linear relationship between inflation and financial development is crucial for policy decision-making. Besides, knowledge of the moderating role of GDP in the relationship between financial development and inflation is fundamental for policy formulations.

Originality/value – Although the extant literature has shown that the inflation rate plays a negative role in financial development, the literature overlooked the non-linear relationship between the two variables. Besides, the studies have not considered the role of GDP in moderating the impact of the inflation rate on financial development. This study fills these gaps in the existing body of finance literature.

Keywords Financial development, Real GDP per Capita, Inflation rate

Paper type Research paper

1. Introduction

A well-developed and functioning financial system can efficiently facilitate resource mobilization and capital accumulation, which improve productivity and promote economic growth (Levine and Zervos, 1998; Ehigiamusoe and Lean, 2019a, 2020). Fundamentally, Levine (2005) posits that financial development occurs when financial markets and intermediaries eliminate or reduce the effects of information, transaction, and enforcement costs and effectively provide major functions of the financial system. Such functions include mobilizing and pooling savings, easing the exchange of goods and services, facilitating the trading, diversification, and management of risks, monitoring investments and implementing corporate governance, and producing information concerning possible investments. Sahay *et al.* (2015) opine that financial development comprises the depth (market size and liquidity), access (individual's ability to access financial services) and efficiency (institution's ability to offer financial services at minimum cost with sustainable income). Therefore, a consideration of the depth, access and efficiency of the financial system is vital when measuring the level of financial development (Nasreen *et al.*, 2020). Hence, it is believed that factors that enhance or inhibit any

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