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Stock Markets, Banks, and Economic Growth: Does The Relationship Differ Across Income Levels?

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ABSTRACT

Economists have long debated the relationship between financial sector development and economic growth. This paper contributes to the literature by investigating whether the relationship between stock markets, banks and economic growth differs across income levels by using a comprehensive dataset and modern econometric techniques. This paper uses the dynamic panel data methods with a wide and updated range of data from 1989 to 2011 for 120 countries. We divide our sample into three different income groups; a high income, upper-middle income, and low income group countries in order to see what happens to the size of banks and equity markets relative to the size of the overall economy as countries develop economically. More specifically, we examine whether measures of stock market and bank development each have a positive relationship with economic growth across different income levels over the last two decades. Moreover, different from what is done in the literature on the finance-growth nexus, we construct an index measure of both stock market development and bank development instead of using single variables which are widely used in the literature and highly correlated. We employ principal component analysis to construct the index measure.

KEYWORDS Economic growth; Stock markets; Banks

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