Thresholds in the Finance-Growth Nexus: A Cross-Country Analysis

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Highlights

- How does the finance-growth nexus change with respect to:
  - inflation,
  - government size,
  - trade openness,
  - per capita income?

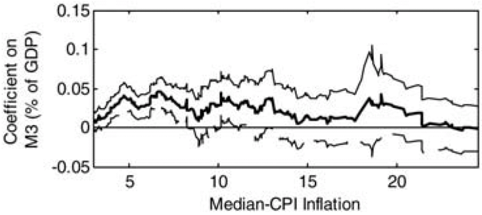
- The results suggest that
  - high inflation crowds out positive effects of financial depth on growth
  - small government sizes hurt low-income countries
  - large government sizes hurt high-income countries
  - low levels of trade openness are sufficient in high-income countries
  - low-income countries need higher levels of trade openness
  - catch-up effects are higher for moderate per capita income levels.

Data and Estimation Methodology

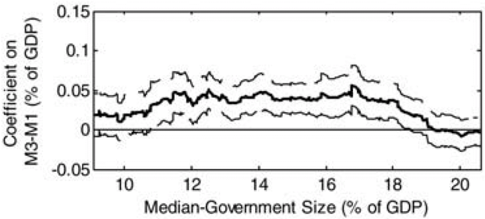
- Data
  - World Development Indicators
  - 5-year data for 84 countries between 1965–2004
  - real per capita GDP growth
  - log initial per capita GDP
  - log initial secondary enrollment rate (SEC)
  - the ratio of liquid liabilities (i.e., M3) to GDP
  - the ratio of M3 less M1 to GDP
  - inflation rate
  - openness
  - government size.
- Estimation Methodology
  - two-stage least squares with initial values as instruments
  - time fixed effects for the 5-year periods
  - rolling-window regressions with a constant window size of 120 after ordering the data according to the threshold variable (e.g., inflation).

Estimation Results

- Inflation and the finance-growth nexus:



- Government size and the finance-growth nexus:



Estimation Results

- We have positive effects of finance on growth when:
  - inflation rate is below 8 percent
  - government size (% GDP) is between 11 and 19 percent
  - trade openness (% GDP) is between 35 and 75 percent
  - per capita income level is above $665
- Financial-depth effects on growth have decreased over time