



DEPARTMENT OF ECONOMICS

**NEW PERSPECTIVES ON
FINANCE AND GROWTH**

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NEW PERSPECTIVES ON FINANCE AND GROWTH*

By

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Abstract

This paper offers a number of new perspectives on the finance and growth literature. It starts by reviewing the empirical evidence on finance and growth, highlighting studies which suggest that financial development may be ineffective in delivering growth in the poorest of countries. The paper proceeds to examine the likely sources of financial (under-)development and argues that: (a) the legal origins view has been largely discredited by lawyers; (b) government ownership of banks is much more of a symptom of weak institutions than a cause of financial under-development. It then argues that political economy explanations of financial development, focussing on the role of incumbents, income and wealth inequality and the evolution of economic institutions, are much more promising hypotheses but remain largely untested. It calls for more work to test and develop further these ideas but warns against over-simplified notions of politics. It ends by reviewing recent work on the political economy origins of financial development and the politics of financial reforms, which suggests that politics plays a greater and more complex role than has so far been recognised by the economics literature on finance and growth.

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1. Finance, Institutions and Economic Development

Banks and other financial intermediaries perform an important function in the growth process, in that they may help to ensure that productive investment opportunities materialise. By screening loan applicants, they address adverse selection in the credit market, helping to channel funds towards productive uses. By monitoring borrowers, they aim to address moral hazard, which helps to ensure that firms stick to their original investment plans. Through long-term bank-borrower relationships, they address both adverse selection and moral hazard, helping to enhance the average productivity of capital.

By and large, the empirical evidence confirms that the development of financial systems and especially banks can have a positive causal effect on economic growth, even though there are important exceptions. King and Levine (1993) provide cross-country evidence on the positive effects of finance on growth, which they interpret as causal. However, Demetriades and Hussein (1996) provide time-series evidence from 16 developing countries which suggests that banking sector development does not always Granger-cause economic growth. If anything, the evidence suggests that the relationship between finance and growth frequently exhibits reverse causality i.e. it is economic growth that causes financial development and often not vice-versa. Further scepticism on causality results obtained using cross-country regressions in the finance-growth context is provided by Arestis and Demetriades (1997) and Arestis *et al* (2001). These studies suggest that time-series approaches are needed in order to establish the direction of causality between financial development and economic growth.² Moreover, they also show that the relationship between stock market development and economic growth is weaker and more fragile than that between banking development and growth.

Further evidence suggesting that ‘one size does not fit all’ in terms of the finance-growth relationship is provided by Rioja and Valev (2004) in their panel study of 74 countries during 1960-1995. These authors find that the relationship between finance and growth varies according to the level of financial development. It is at its strongest

² Some of the limitations of cross-country regressions include equal weighting of countries, sensitivity to the conditioning set, sensitivity to outliers, and clustering. If there are two clusters of countries in the data set, the regression tries to fit a line between them, even though this relationship may not hold at all within each of the two clusters.

among countries that have an intermediate level of financial development (between 25th and 60th percentile), but is statistically insignificant in financially under-developed countries (those below the 25th percentile).³

Arestis and Demetriades (1999) advocate further caution in interpreting the relationship between finance and growth in a causal way, alluding to the role of country specific institutional factors and policies which are likely to affect the nature of this relationship. Among other things, they argue that financial systems operating under conditions of weak governance, manifested, for example, in poorly designed or corruption-prone directed credit programmes, are unlikely to be able to promote growth. Their ideas are taken further in a recent empirical study by Demetriades and Law (2006), who provide evidence which suggests that financial development has greater effects on growth when the financial system is embedded within a sound institutional framework.⁴ Demetriades and Law (2006) also find that the effects of finance on growth are most potent in the case of middle income countries, and rather weak in the case of low-income countries, confirming the earlier findings by Rioja and Valev (2004). Thus, it appears that the relationship between finance and growth is sensitive not only to the level of economic and/or financial development but also to institutional development. Even within similar income groups it varies substantially according to the degree of institutional quality. These studies, therefore, cast further doubt on the view that greater financial development, particularly in low income countries with weak institutions, can deliver substantial benefits in terms of economic growth. As a result, financial development may not offer a quick fix in promoting growth in those parts of the world that are in most need for more growth, such as Sub-Saharan Africa, unless if it is accompanied by strengthening of institutions such as rule of law and property rights.

Financial development itself seems to be at least partially driven by institutional quality. Baltagi *et al* (2007) show that the latter, together with openness, is robustly related to financial development. In the case of countries that are already very open,

³ There are thirteen such countries in their sample during 1991-1995, nine of which are located in Sub-Saharan Africa.

⁴ Their sample includes 72 countries during 1978-2000, and they use annual data and panel cointegration techniques. Their index of institutional quality is the average of five ICRG measures, namely corruption, rule of law, bureaucratic quality, government repudiation of contracts and risk of expropriation.

many of which are located in some of the poorest parts of the world such as sub-Saharan Africa, institutional improvements offer the only viable mechanism for developing financial systems. It is, therefore, essential not to ignore institutions while emphasising the importance of financial development, not least because stronger institutions can enhance the effectiveness of financial development as well as facilitate the process of financial development itself. Having said this, given that institutions may be one of the causal mechanisms that determine financial development, studying the fundamental causes of either financial development or institutions may not require two different studies. Indeed, as we will argue in this paper, political economy factors, broadly defined, could hold the key to understanding both financial (under-) development and (weak) institutions.

2. Promoting Financial Development

If financial development - and the institutions that promote it - is such a good thing in general, why do so many countries remain financially under-developed? In recent literature, four leading hypotheses which help to address this question have emerged. These hypotheses, which are by no means mutually exclusive, are as follows:

- (i) Legal origins, originally put forward by La Porta *et al* (1997)
- (ii) Government ownership of banks, associated with La Porta *et al* (2002).
- (iii) Initial endowments, politics and economic institutions (Acemoglu *et al*, 2001; Acemoglu *et al*, 2004).
- (iv) Incumbents and openness (Rajan and Zingales, 2003).

In this section, we provide a brief outline of each hypothesis and review available empirical evidence on each of them. We conclude that: (a) the first two hypotheses can be readily dismissed on the basis of available evidence; (b) the third and fourth hypotheses, which to a certain extent overlap, can be maintained as plausible working assumptions, even though the evidence supporting them suggests they may require further refinement.

2.1 Legal origins

The legal origins hypothesis (La Porta *et al*, 1997) puts forward the idea that common law based systems, originating from English law, are better suited than civil law based systems, primarily rooted in French law, for the development of capital markets. This is because English law evolved to protect private property from the crown while French law was developed with the aim of addressing corruption of the judiciary and enhancing the powers of the state. Over time this meant that legal systems originating from English law protected small investors a lot better than systems which evolved from French law. Consequently, it is argued that capital markets developed faster in countries with common law systems than in those with civil law systems.

The main difficulty with this hypothesis is that it is static and can, at best, only explain the relative position of countries at some point in the past. Moreover, the view that common-law countries have better shareholder protection than civil law countries has been challenged in an important recent study by academic lawyers at the University of Cambridge.⁵ This study outlines the measurement problems that plague the La Porta *et al* study, which is based on eight proxies for shareholder protection in 49 countries. These include a US bias in the choice of variables, the absence of variables relating to laws about the removal of directors and problems with the definitions of the variables. The same study proposes a more meaningful index of shareholder protection, which involves coding 60 aspects of shareholder protection by lawyers. This is done for five countries (US, UK, France, Germany and India) over a period of thirty years. Their indexes suggest that there have been substantial increases in shareholder protection in all countries and, importantly, that there is no discernible difference between civil law and common law countries in terms of shareholder protection. If anything, France and Germany are shown to have better shareholder protection than the United States since the 1990s. Another important counter-example to the legal origins view is South Korea which succeeded in developing its financial system using legal institutions based on civil law, modelled on Japan. This is not to say that law is not important for financial development. Broad-based property rights protection is critical for investors and, consequently, for financial

⁵ Lele and Siems (2007).

development.⁶ It takes central role in the political economy hypotheses outlined in sections 2.3 and 2.4 below, which, however, place little if any emphasis on the origin of the legal system.

We may therefore conclude that while there is a broad consensus that a properly functioning legal system that provides effective protection for investors' property rights is important for financial development (and growth), the legal origins view is not widely accepted, indeed it has been largely discredited by lawyers.

2.2 Government Ownership of Banks

The “political view” of state-owned banks suggests that government ownership of banks is widespread because it is in the interests of politicians, since it enables them to direct credit and favours, such as employment and subsidies, to political supporters. This, in turn, enables corrupt politicians to attract votes, political contributions and bribes, fuelling a vicious cycle of bad economic decisions and re-election of corrupt politicians. This cycle clearly undermines economic growth, not least because credit is channelled to sectors and firms in accordance to political rather than economic priorities. It is also argued that government-owned banks are less innovative and less efficient – plagued by incompetent and unmotivated employees - than private banks, hence they are typically less able to promote financial development as effectively as private banks.

La Porta *et al* (2002) analyse a cross-country data set of bank ownership in 92 countries and conclude that the evidence supports “political” theories of the effects of government ownership of firms. Specifically, they first show that government ownership is large and pervasive around the world – the world mean of government ownership in 1995 in their data set is 41.6 percent compared to 58.9 percent in 1970. They then provide a correlation analysis that shows, among other things, that government ownership of banks is more prevalent in poor countries, and, conditioning on per capita income in 1960, is less prevalent in countries that are (i) financially developed or (ii) have strong property rights in 1960. In their subsequent analysis, La

⁶ The Northern Rock crisis in the UK in September 2007 has vividly demonstrated that anything less than perfect protection of depositors can trigger a massive flight to quality in circumstances of uncertainty about a bank's future. The UK deposit insurance scheme covers 85% of the value of bank deposits up to £35000.

Porta *et al* (2002) examine the effects of government ownership of banks in 1970 on subsequent (i) financial development and (ii) economic growth, in an attempt to draw causal inferences. In their financial development regressions their dependent variable is the growth in the relevant indicator over approximately a 30 year period. Their conditioning variables comprise the initial level of the dependent variable and per capita income in 1960. Their regressions (Table IV) show that government ownership of banks in 1970 enters with a negative coefficient that is statistically significant in the growth of private credit/GDP and one of two stock market capitalisation/GDP regressions. The variable of interest is not significant in the remaining three regressions (growth of liquid liabilities/GDP, growth of commercial bank assets/total bank assets, growth of stock market capitalisation/GDP).⁷ Even though their results are, at best, weak, they, nevertheless, conclude that "...financial systems of countries with higher initial government ownership of banks grow less fast..." [p. 284].⁸ They also report "simple" growth regressions (Table V) which show that government ownership of banks in 1970 enters with a negative coefficient that is significant at the 1% level. However, when they include the initial level of a financial development indicator alongside the other two conditioning variables, the government ownership variable loses significance: in three out of five reported cases, its level of significance drops to 10% and in the other two to 5%. In their more elaborate growth regressions, which include additional conditioning variables (Table VI) aimed at measuring other forms of government 'distortions', only one out of five specifications provides evidence of a negative and significant coefficient at conventional levels for the government ownership variables. While most commentators would conclude that these results are, at best, fragile, La Porta *et al* (2002) nevertheless play down the lack of statistical significance and proceed to analyse the channels through which government ownership of banks reduces growth! These results (Table VII) suggest that government ownership of banks reduces future productivity growth, but not capital accumulation. However, these results do not include as conditioning variables schooling and initial financial development. When these variables are added to the conditioning set, government ownership of banks is no longer significant at

⁷ No robustness checks are carried out to check the extent to which the two significant results are robust to the inclusion of additional conditioning variables, which other studies have found significant in financial development regressions.

⁸ Similar conclusions are made in relation to measures of bank efficiency.

conventional levels. Specifically, its significance level drops to 10% in two of the three specifications that include these conditioning variables in Table VII and below 10% in the third specification. This does not, however, prevent the authors to conclude the following (highlights are mine):

“The results on productivity growth are striking: GB70 exerts a negative and, in most specifications, statistically significant effect on future productivity growth, even controlling for initial financial development and schooling. The coefficients in specifications with controls are around -0.01, indicating that a 10 percentage point higher measure of government ownership is associated with 0.1 percent per annum lower rate of productivity growth. Productivity appears to be the place where government ownership of banks negatively impacts growth. This evidence is broadly consistent with the political view according to which government ownership leads to misallocation of resources that are detrimental to productivity growth and ultimately economic growth itself.” La Porta et al (2002, p. 288).

Given the fragility of the La Porta *et al* (2002) empirical findings, it is perhaps surprising that the World Bank chose to highlight them in a Policy Research Report (World Bank 2001), which states:

“...the [La Porta et al] fitted regression line suggests that, had the share of government ownership in Bangladesh been at the sample mean (57 percent) instead of at 100 percent, annual average growth would have risen by about 1.4 percent, cumulating to a standard of living more than 50 percent higher than it is today.” (p. 129).

The World Bank does, however, add an important proviso:

“...it needs to be noted that the implied privatization would also have had to be supported by the necessary institutional underpinnings emphasized below, a significant omitted variable in their approach.” (World Bank, p.129-130)

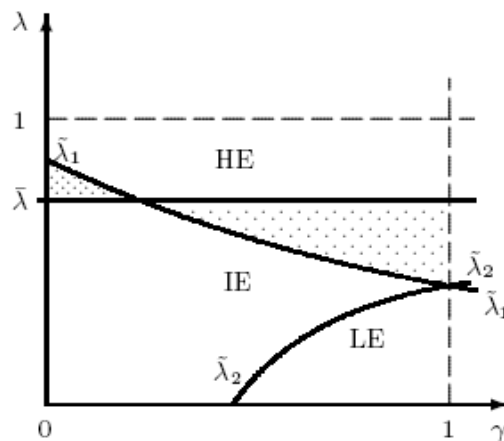
The role of institutions in explaining government ownership of banks is, in fact, the main focus of a paper by Andrianova *et al* (2008), the conclusions of which confirm that the World Bank qualifier is an important one. Andrianova *et al* (2008) provide a theoretical model as well as empirical results which, in fact, suggest that government ownership of banks may be an effective substitute for weak institutions. Furthermore, they also show that privatising government owned banks without strengthening institutions that protect depositors from bank failures is likely to result in a decline in financial development, challenging the La Porta *et al* conclusion.

Andrianova *et al* (2008) put forward a locational (circular city) model of banking with three types of banks in which deposit contract enforcement is imperfect. Besides a government-owned bank, there are two types of private banks: honest and

opportunistic. The latter decide whether to breach their deposit contracts depending on their expected payoff from doing so, which, in turn depends on the quality of contract enforcement. The government bank is assumed to be less efficient than private banks and this is reflected in a lower deposit rate than private banks. In equilibrium, all private banks are indistinguishable and offer the same interest rate to all depositors. The authors derive three types of equilibria:

- (a) A ‘High’ equilibrium in which depositors prefer private banks, and the government bank is, therefore, absent; this prevails when institutional quality is sufficiently high to deter opportunistic behaviour by private banks.
- (b) A ‘Low’ equilibrium in which there are no private banks, because institutional quality is low and the proportion of opportunistic banks is high.
- (c) An intermediate equilibrium, in which the government bank and private banks co-exist, which prevails at intermediate ranges of the parameters.

These are depicted in their Figure 2, which we reproduce below.



In this diagram, λ and γ represent the probability of deposit contract enforcement – the quality of institutions – and the proportion of opportunistic banks, respectively. LE, IE and HE represent the Low Equilibrium, Intermediate Equilibrium and High Equilibrium regions, respectively, which prevail depending on the values of λ and γ .

Andrianova *et al* (2008) show that in the intermediate region the demand for state deposit contracts increases when the enforcement probability is smaller or the proportion of opportunistic banks is larger. They also show that when the economy is in the LE region – i.e. when institutional quality is poor and the proportion of opportunistic banks is high - privatisation of the government bank will lead to financial disintermediation. This is because in this region depositors do not trust private banks, since they know that opportunistic behaviour would be rife and the probability of contract enforcement low. For the same reason honest banks do not enter the banking system, which means that the only banks that will enter are the opportunistic ones. In these circumstances, depositors will either take their money to the state bank which represents the only safe heaven that offers a positive return, or will keep it under the mattress.

Andrianova *et al* (2008) present stylised facts as well as empirical results which accord well with their theoretical predictions. In terms of stylised facts, Russia provides a good example in which the state savings bank - Sberbank - is able to attract the largest proportion of deposits while offering deposit rates that are lower than its private sector competitors. There are similar examples from Romania, China today and Korea in the 1980s. Their empirical findings utilise data from the World Bank survey on banking practices and regulation (Barth *et al*, 2001), which includes data for 108 countries in 1999 and the Kaufmann *et al* (1999) database of governance indicators. This database includes a measure of regulatory quality which the authors utilise as a proxy for institutional quality. The proportion of opportunistic banks is proxied by disclosure requirements, since opportunists are unlikely to be able to enter the banking system when disclosure is high. Andrianova *et al* (2008) report probit regressions that explain the extent of government bank ownership. Their results show that both regulatory quality and disclosure are inversely related to government ownership of banks. Their control variables include legal origin, including a former socialist dummy. The econometric findings also suggest that increased government ownership is positively associated with prior banking crises frequently involving (private) bank failures. They warn, however, against interpreting this in a naive way: the correlation between government ownership of banks and banking crises typically reflects governments taking over failed private banks. Hence, Andrianova *et al* (2008) conclude that privatisation of government owned banks may not be the way

forward in terms of developing banking systems, where institutions are weak. Institutions building should be the top priority.

Additional evidence warning against the political view of state banks is provided by Demetriades *et al* (2007) in their analysis of the finance and growth relationship in China, a country where the banking system is dominated by state banks, yet has enjoyed very high growth rates in the last twenty years or so. These authors employ a large panel dataset of Chinese manufacturing enterprises during 1999-2005, which account for over 90% of China's industrial output; the dataset includes the population of firms with a turnover of 5 million RMB Yuan (US\$620,000). The econometric findings suggest that the Chinese banking system has helped to promote the growth of both firm value added and TFP. Specifically, the authors find that (i) access to bank loans is positively correlated with future value added and TFP growth and (ii) firms with access to bank loans tend to grow faster in regions with greater banking sector development. Interestingly, they also find that while the effects of bank loans on firm growth are more pronounced in the case of purely private-owned and foreign firms, they are positive and statistically significant even in the case of state-owned and collectively-owned firms. These findings challenge the prevalent view in the literature – based on much smaller surveys of firms - that the Chinese banking system had little to do with Chinese economic growth, which could be largely attributed to informal finance.⁹ It also casts further doubt on the view that government ownership of banks is typically associated with poor economic performance.

We conclude that recent empirical studies suggest that the privatisation of government owned banks is unlikely to deliver substantial benefits in terms of either financial development or growth. In cases where institutions are weak, privatisation may be premature in that it may actually end up in financial disintermediation.

2.3 Initial Endowments, Politics and Economic Institutions

These contributions, associated with several papers by Acemoglu and co-authors, acknowledge the importance of strong institutions for economic growth, but do not focus on financial development *per se*. They ascribe institutional quality differences to varying initial endowments and dynamic political economy factors.

⁹ See, for example, Allen *et al* (2002).

The initial endowment hypothesis (Acemoglu *et al*, 2001) suggests that the disease environment encountered by European colonising powers in past centuries – proxied in empirical studies by settler mortality - was a major obstacle for the establishment of institutions that would promote long run prosperity. Thus, it is argued that European colonial powers established extractive institutions that are unsuitable for long-term growth where the environment was unfavourable and institutions that were better suited for growth where they encountered favourable environments. The main problem with this explanation is that it is static and may, at best, explain the relative position of countries a few centuries ago.

The economic institutions hypothesis (Acemoglu *et al* 2004) addresses the main shortcoming of the endowment hypothesis, by proposing a dynamic political economy framework in which differences in economic institutions are the fundamental causes of differences in economic development. Economic institutions, which determine the incentives and constraints of economic agents, are social decisions that are chosen for their consequences. Political institutions and income distribution are the dynamic forces that combine to shape economic institutions and outcomes. It is argued that growth promoting economic institutions emerge when political institutions (a) allocate power to groups with interests in broad based property rights enforcement, (b) create effective constraints on power holders and (c) when there are few rents to be captured by power holders.

While *the economic institutions hypothesis* is highly plausible the jury is still out in so far as the empirical evidence is concerned. It is clearly a hypothesis that warrants a lot more econometric investigation than is available at present.¹⁰ It suggests that policy makers and econometricians should be paying more attention to political institutions as well as income and wealth distribution.

2.4 Incumbents and Openness

The incumbents and openness hypothesis, as formulated by Rajan and Zingales (2003), postulates that interest groups, specifically industrial and financial incumbents, frequently stand to lose from financial development, because it usually

¹⁰ While some of the econometric findings provided in Baltagi *et al* (2007) are consistent with this hypothesis, we are not aware of any attempts to provide direct tests of this hypothesis.

breeds competition, which erodes their rents. They argue that incumbents' opposition will be weaker when an economy is open to both trade and capital flows, hence the opening of *both* the trade and capital accounts holds the key to successful financial development. This is not only because trade and financial openness limit the ability of incumbents to block the development of financial markets but also because the new opportunities created by openness may generate sufficient new profits for them that outweigh the negative effects of increased competition.

This hypothesis has attracted considerable attention in the academic and policy making community but there has been little evidence to suggest it is relevant to developing countries today. Baltagi *et al* (2007) addresses this question utilising four annual panel datasets and dynamic panel data estimation procedures. Its main finding is that trade and financial openness - as well as economic institutions - are statistically important determinants of the variation in financial development across countries and over time since the 1980s. However, there is mixed support for the hypothesis that the simultaneous opening of both trade and capital accounts is necessary to promote financial development in a contemporary setting. Moreover, broadly speaking, the results suggest diminishing returns to openness. There is good news for policy makers in low income countries that are relatively closed, since opening up their trade and/or capital accounts may provide an effective stimulus to financial development (e.g. Bangladesh, Ghana, India and Pakistan). At the other end of the spectrum, however, low income countries that are already very open, such as Malawi, Senegal, Togo and Zambia, need to focus on improving their institutional infrastructure in order to grow their financial systems. The empirical distribution of the marginal effects of openness within the sample suggests that additional openness may be more effective in promoting capital market development than banking system development, while financial openness offers greater scope for advancing financial development than trade openness. This analysis also suggests that additional trade openness is unlikely to deliver any stimulus to banking sector development in any country but may well help to boost the development of capital markets in a few countries, particularly those that do not have very open capital accounts, such as Bangladesh, India, Mexico, Zimbabwe and Pakistan. Additional financial openness is likely to provide a stimulus to banking sector development in a similar small group of

countries but may impact positively on capital market development in a much wider range of countries.

To conclude, trade and financial openness appear to be statistically significant determinants of financial development across countries and over time. However, additional openness offers little, if any, scope for delivering gains in terms of greater financial development in developing countries that are already relatively open.

3. The Politics of Financial Development

The work reviewed in the previous section suggests that political economy explanations of financial development and under-development are, arguably, the most fruitful ones. Financial and industrial incumbents, income and wealth inequality and political institutions appear to be the various players who interact to determine whether financial development in any given country takes off at a particular point in time. This section argues that while none of this is new, politics may actually be playing a more complex role than has been acknowledged so far by contributors to the finance and growth literature.

3.1 Political Economy Origins of Financial Development

The conclusion that political economy factors were instrumental in shaping the emergence of financial markets emanates from a recent paper by Andrianova, Demetriades and Xu (2008) which examines the political economy origins of some of the most successful financial markets in Europe and Asia. It provides historical evidence from London, Amsterdam and Hong Kong that highlights the essential role played by the government in kick-starting financial development. It shows that the emergence of financial systems did not occur through liberalisation approaches and that secure property rights alone were not sufficient for financial development.

In the cases of London and Amsterdam governments created large trade monopolies (with broad based ownership) which were responsible for all the major financial innovations of the time, including the emergence of shares trading. These companies, namely the East India Company and its Dutch equivalent the VOC, were able to issue securities with attractive risk-return characteristics, as a result of their monopoly rents. Importantly, the authors show that the London market emerged well before the strengthening of private property rights that occurred following the Glorious

Revolution of 1688 in England. However, they argue that the property rights of investors vis-à-vis private companies may have already been secure well before 1688, while their rights vis-à-vis the state may have been enhanced, which enhanced the security of public debt.

Andrianova *et al* (2008) argue that the establishment of banking monopolies with close links to government, starting with the Bank of England, was a natural consequence of the success with establishing trading monopolies. The Bank of England model, which was imitated worldwide, facilitated the emergence of banking systems around the world. A good example, which the authors analyse, was Hong Kong where large banking monopolies with close links to the state were created. The paper argues that these three examples were not special cases and that the role of government in the early stages of financial development has been widespread worldwide. To this end, they provide additional examples, which include the emergence of banking in the Italian city states of Genoa and Venice during the 15th and 16th centuries, the emergence of state banking in the United States in the 18th and 19th centuries, and the financial development of Japan, Korea and Taiwan in the 20th century.

Andrianova *et al* (2008) conclude that secure property rights alone may not be sufficient for financial development to take place. In the early stages of financial development, careful government interventions may be needed to ensure that investment returns are sufficiently high in order to mobilise savings.

3.2 The Politics of Financial Reforms

Politics plays a more prominent, albeit complex, role in shaping financial development than is acknowledged by recent contributions to the literature on finance and growth. This conclusion emanates from a recent paper by Burgoon *et al* (2008), which challenges recent findings by Abiad and Mody (2005) who suggest that financial liberalisation has little to do with standard notions of politics. Abiad and Mody's explanation of the timing, pace, and extent of financial reforms and consequent origins of financial liberalisation highlights how increasing-returns become locked-in through learning effects. They see the initial step to liberalization as difficult and typically sparked by economic shocks, but this policy breakthrough yields knowledge and footholds for deepening liberalization over time which are

related to the spatial dynamics of “catching-up” with the most liberalized countries in their region. Many plausible political factors which previous studies found to have played an important role in shaping financial globalization – such as left-right partisanship or democratic institutions – play little role in the Abiad and Mody account and are found to have little influence on the particular measures of financial liberalization in the wide range of countries and time-periods covered by their study.

The main findings of Burgoon *et al* (2008), which are empirically focussed on the Abiad and Mody (2005) dataset, are that political factors which shape the legitimacy of financial reforms are statistically significant determinants of financial liberalisation. Drawing on ideas from political science, the authors distinguish between the “input” and “output” legitimacy of financial liberalisation. Input legitimacy has both a domestic and an international dimension. Its domestic dimension includes the involvement of stakeholders of financial openness in decisions to liberalise and is captured empirically by shifts to left partisanship and the interaction of left partisanship and democracy. Its international dimension comprises support for free-market internationalism versus anti-capitalist closure at the global level. Output legitimacy involves addressing any adverse distributional consequences of financial liberalisation and is captured by the extent of social safety nets and the presence of multilateral and bilateral aid programs.

Burgoon *et al* (2008) find that a shift to left governments increases the likelihood of a reduction of openness by 5.6 percentage points (from a probability of .024 to a probability of .08), and of there being no change by 6.7 percentage points (from probability .795 to .862), and *decreases* the chance of liberalisation (a little or a lot) by 11 percentage points (from a probability of .177 to .067). Additional regressions suggest that the shift to left governments might be mediated by *ex ante* levels of financial openness. In particular, the individual coefficient for first-difference in left government suggests that at levels of full closure of financial markets (a score of 0 on the Abiad and Mody scale), a shift to left government results in a significant reduction of chances of liberalisation, on a scale roughly double for that reported above. But as financial openness becomes greater, this negative effect significantly declines – becoming insignificant once a country reaches a level of financial openness equivalent to .52 liberalization on the rescaled 0 to 1 measure of openness (0 being full closure and 1 being full openness).

Burgoon *et al* (2008) also examine the influence of democracy, which is measured by the Polity IV measure of 10-point autocracy and 10-point democracy, with levels of democracy ranging from complete autarchy (-10) to complete democracy (10). Their findings show that democratisation significantly mutes the tendency of left governments to oppose financial liberalisation. Net of levels of economic development as well as all other controls, low levels of democracy create conditions under which left governments tend to significantly oppose liberalisation. However, as levels of democracy increase, this negative effect becomes weaker, such that at medium to high levels of democracy left parties are no longer associated with less financial liberalization or more closure. They conclude that democratisation – perhaps the most obvious and general measure of input legitimacy – will tend to diminish how much left governments oppose liberalisation.

In terms of output legitimacy, Burgoon *et al* (2008) argue that health spending, which has often provided stronger and more evenly dispersed benefits for workers in both developing and developed countries, might have a more meaningful compensatory effect for workers facing the vagaries of open financial markets. Their findings confirm that such health expenditures significantly increase the chances of financial liberalisation. The substantive effects of such spending, based on the model in column (3), appear to be rather substantial. Moving from the 25th to the 75th percentile in the sample distribution of health spending – the equivalent of moving from a setting where a country spends .7 percent of GDP on health benefits to one where it spends 2.5 percent of GDP on such benefits – decreases the chance that a country will undergo a reversal of financial openness by 3 percentage points (probability of .051 to .022), and also decreases the chance by 8.6 percentage points of there being no change in such openness. Such an increase in health spending predicts an increase of 11.5 percentage points in the chance that a government will liberalise (probability .103 to .218).

Burgoon *et al* (2008) conclude that it is important to consider the complex power-political interaction of a wide range of state and market actors in both formal and private fights on issues of economic governance – well beyond the kinds left-right partisan conditions and simple measures of broad democracy and international voter attitudes.

4. Summary and Concluding Remarks

This paper has offered a number of new perspectives on the finance and growth literature, which can be summarised in terms of the following conclusions:

- (i) While financial development may be able to deliver more growth in middle-income countries, it may be ineffective in doing so in the poorest of countries.
- (ii) Even though property rights are essential in developing financial markets, the distinction between common-law and civil-law made by the legal origins view has little to offer in terms of understanding the process of financial development.
- (iii) Government ownership of banks is much more of a symptom of weak institutions than a cause of financial under-development. Premature privatisation of government owned banks – i.e. before contract enforcement is sufficiently strong – is unlikely to promote financial development or growth.
- (iv) Political economy explanations of financial (under-)development, focussing on the role of incumbents, income and wealth inequality and the evolution of economic institutions, are promising as hypotheses that can be maintained but remain largely untested. More work is needed to test and develop further these ideas.
- (v) Politics plays a greater and more complex role than is recognised by economists in shaping the policies and institutions that underpin financial markets.

The above conclusions highlight several fruitful avenues for future research, which include thorny issues such as how to make financial development more effective in low-income countries, and how to promote financial development in both low and middle income countries. While the recent growth in political economy explanations of financial and institutional development is a move in the right direction, these explanations remain largely untested, leaving considerable scope for empirical work.

Even though some work testing the Rajan and Zingales (2003) thesis exists already (See, for example, Baltagi *et al*, 2007), empirical testing of the Acemoglu et al (2004) thesis appears to be virgin territory. Moreover, the more new datasets emerge, such as new indices of financial liberalisation, banking structures and the like, the more that can be done to increase sample sizes etc. In addition, the advent of new econometric techniques that can handle macro panel data sets better, by allowing for global interdependencies and cross-country heterogeneity, will enable better testing of these hypotheses, improving robustness and enhancing confidence in the results.¹¹

Besides more empirical evidence, we also need satisfactory theoretical models that capture the various political economy mechanisms at play. Given the variation of political systems and institutions and the way in which they interact with interest groups, it may be unreasonable to expect that the same political economy framework can be applicable worldwide. Our conjecture is that the political economy factors that have held back financial development in Latin America are not be the same as the ones that were most prominent in Africa or Asia. In Mexico, for example, banking development was stifled because a succession of authoritarian governments with a tendency to expropriate, frequently in subtle ways, offered privileges to the banking elite, in order to ensure their cooperation and support (See Haber, forthcoming). In India, on the other hand, lack of democracy was clearly not an issue, but the extent to which a banking elite, if it existed, played any role in preventing financial underdevelopment through the ‘repressionist’ policies that were followed is not clear.¹² Conversely, in South Korea successive authoritarian governments did not prevent financial development from taking place, while the same type of policies as were followed in India seemed to have produced the opposite results. In sub-Saharan Africa, the extent to which authoritarian governments and banking elites played a role is also not very clear, but an important feature of these countries has been macroeconomic uncertainty, much of it emanating from political sources. This seems to have undermined confidence in domestic institutions, including banks, fuelling capital flight.¹³ All these examples indicate that a ‘general theory of financial under-

¹¹ See, for example, Pesaran and Smith (2006).

¹² The different role played by financial restraints in India and South Korea is examined by Demetriades and Luintel (1997) and Demetriades and Luintel (2001).

¹³ See, for example, World Bank (2007).

development' may not be the best way forward. 'One size fits all' may prove to be as problematic in theory as it has in empirical work.

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