Finance-Growth Nexus in open economies with outliers

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Abstract

This paper offers a contribution to the empirical literature on the links between financial and economic development.

In the investigation of the finance-growth nexus for 18 non-OECD countries plus Mexico and Korea, the paper firstly introduces an indicator of restrictions on the establishment of foreign banks. Secondly, it links financial development to the capital–output ratio rather to the level of income per se, implicitly assuming that a sound financial development has to be relatively capital-intensive. A new procedure is systematically applied to take proper consideration of crisis periods through the use of dummies.

The paper finds that in the long run most countries support the capital-output ratio specification for the financial development relationship. Also, "fairly liberal" countries show a negative contribution of financial openness to financial development. The non-linearity between finance and growth seems to be confirmed by the growing elasticity of the capital output ratio in relatively developed countries. Finally, some large countries seem to support the endogenous growth hypotheses while most African countries turn out as "cursed", since neither accumulation nor openness can explain their growth (or, rather, lack thereof).

JEL classification: O16, G15, G28

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3 Previous versions of this paper have been presented to "Economics Policies for the New Millennium" Conference (Coimbra, Portugal), at the RIEF Conference at the Ecole Nationale des Ponts et Chausées (Paris, France) and at the Money, Macro and Finance Research Group 36th Annual Conference (London, UK). Do not quote without written permission by the author
1 Introduction

The empirical literature on the links between financial development and economic development/growth is wide and very differentiated and there is no single way to classify it. Clustering the literature around some common themes one can find among the main researched topics:

- the importance of financial development in the process accumulation and hence in economic development/growth
- the non-linearity of the relationship between financial and economic development
- the relationship between trade- or financial openness and economic development/growth.

A cornerstone of empirical studies is Rousseau - Sylla (2001) who find a robust correlation between financial factors and economic growth that is consistent with a leading role for finance for 17 countries with data from 1850 to 1997. This is further supported by Harrison-Sussman-Zeira (1999) who find a feedback effect between the real and the financial sector that helps to explain international differences in output per capita. Luintel - Khan (1999) using the VAR technique find two cointegrating vectors identified as long-run financial depth and output relationship linking financial and economic development. They also find a negative contemporaneous correlation between the level of financial development (depth) and growth in per capita income in 7 out of 10 countries and a strong positive correlation between the levels of financial depth and per capita output in all sample countries. Beck-Levine-Loayza (2000) in their panel studies for 77 countries from 1960 to 1995 confirm an economically large and statistically significant relationship between financial development and both real per capita GDP growth and total factor productivity growth. In their study the positive link between financial intermediary development and both physical capital accumulation and private savings rates is however ambiguous since it is not robust to alterations in estimation techniques and to measures of financial intermediary development.

A tentative explanation of such puzzle might lie either in differences in long run relationship and short-run dynamics on in the non-linearity of the relationship itself that is therefore not significantly picked up by standard estimation techniques. In fact, Loayza - Ranciere (2002) with a regression on 17 countries find a positive long-run relationship between financial intermediation and output growth coexists with a, mostly, negative short-run relationship. Also, Deidda - Fattouh (2002) with a threshold regression find a positive relationship between the level of financial depth and economic growth for countries with high income per capita but no significant relationship for lower-income countries, which is consistent with the non monotonic relationship implied in the model.
On the relationship between openness and financial development Rousseau - Sylla (2001), using the ratio of trade to GDP as a dependent variable, show that countries with more sophisticated financial systems engage in more trade and appear to be better integrated with other economies. Rappaport (2000), comparing the open-economy and closed economy versions of a calibrated model shows that openness to capital flows causes only a very small increase in the rate of per capita output growth. Alternative calibrations, which instead suggest a large effect of openness on growth, either generate strongly counterfactual closed-economy series or depend on the unrealistic assumption that individuals can borrow against future labour earnings. Also, on the more exquisitely financial side, Clarke-Cull-Martinez Peira (2001) through survey data and a database on bank regulation and supervision find that foreign bank penetration improves firm’s access to credit. It is worthwhile underlining, however, that Buch (2000) using both cointegration and regression analysis finds that liberalising regulation - EU’s single market program and the Basle Capital Accord in particular - have had a positive impact on cross-border banking and the evidence is less convincing for capital account liberalisation as such.

In conclusion, the brief survey of the literature seems to support the view that financial development is linked to economic development/growth even if in non-linear fashion. Furthermore, financial openness might be “good” for the economic development/growth but the different empirical definitions used in the literature are not able to support a robust case in favour of a positive effect of financial openness on economic and financial development.

In this paper the empirical analysis of the finance-growth nexus is attempted within a cointegration framework. The cointegrating relations aim to describe long run relationships between the level of financial and economic development rather than growth, even if the growth dynamics are implicitly considered in the lag structure of the time series model. In line with the empirical literature on financial development and growth credit to private sector as a percentage of GDP will be used as a financial development indicator.

Secondly, as in Clarke-Cull-Martinez Peira (2001) and Loyaza - Ranciere (2002) a composite indicator proxying financial openness will be introduced as an explanatory variable. Thirdly, given the volatility of variables for the sample countries and the consequent need of using dummies a newly developed specific technique has been used. And finally, in accordance with the simple model sketched in section 2, the cointegrating equation describing the long run equilibrium relation between financial development and the ”real economy” will be specified with a role for the capital income ratio rather than income per capita alone.

In what follows section 2 will specify the model, section 3 will briefly describe the data and attempt an interpretation of the stylised facts around the links between finance and growth in open economies. Section 4 will sketch the cointegration methodology and results with a special reference to the outlier detection and estimation procedure. In section 5 the conclusions will be wrapped up.
2 Model Specification

A non-linear relationship between financial and economic development where financial institutions endogenously emerge has a significant tradition in theoretical models. The pillars of such models\(^4\) can be summarised in

- standard 2-period OLG structure where individuals inelastically supply labour during the first period of life and receive a salary which is partly consumed and partly saved and the savings are deposited and receive a real interest rate \(R_t\)
- constant or increasing- return production function of the type
  \[ Y_t = \psi A_t K_t^{\beta_1} l_t^{1-\beta} \text{ or } \ln y_t = \psi + \beta_2 \ln (k_t) \] (2.1)
  where \(k_t = \frac{K_t}{l_t}\) and \(y_t = \frac{Y_t}{l_t}\). \(A_t = k_t^{1-\beta}\) is an externality effect associated with capital accumulation (i.e. \(\beta_2,3 \approx 1\)) and \(\psi\) is the exogenous productivity coefficient. The representative firm’s demand for loans \(b_t\) stems from the equilibrium equation for the yield on loans
  \[ b_t|_{R_t} = \frac{\alpha_{t+1}}{\sigma_{t+1}} = l_{t+1} k_{t+1} = \left( \frac{R_t}{\beta \psi A_{t+1}} \right)^{\frac{1}{\beta-1}} \] (2.2)

- firms have no capital endowment, they operate if and only if they are externally funded,
- banks fund themselves by issuing deposit contracts to households and have a fixed set up cost and non-linear variable costs. The representative bank’s balance sheet can be thought of as

  \[ D_t = \int_0^{z_t} b_t dz + \int_0^{z_t} c(z) b_t dz + E = \int_0^{z_t} [1 + c(z)] b_t dz + E \] (2.3)

  where \(D_t\) are deposits, \(b_t\) is the amount of loans per firm, \(z_t\) is the bank’s market size in the loan market, \(E\) is the fixed amount of physical resources consumed each period \(t\) to set up a bank and \(c(z)\) is the unit capital cost for the bank’s lending activity.

  Solving the model, an equilibrium relationship among the amount of credit outstanding in the system \(b_t\), capital per capita \(k_t\) and the real interest rate \(R_t\) emerges and it is subsequently log-linearised as

  \[ \ln b_t - \ln y_t = \beta_{1.0} - \beta_{1.2} \ln y_t + \beta_{1.3} \ln (k_t) + \beta_{1.5} \ln (R_t) \] (2.4)

  Therefore the credit/GDP ratio \(b_t/y_t\) should have a positive link with the capital/output ratio (i.e. \(\beta_{1.3} = -\beta_{1.2}\) and \(\beta_{1.3}, \beta_{1.2} > 0\)) and also an explicit positive relationship with the real interest rate.

  In what follows for each country the estimation of a cointegration relationship of rank 2 will be carried out for enriched versions of (2.4) and (2.1) to take into account the effect of financial openness. \(\psi\) will be modelled as \(\approx (\beta_{2.0} + \beta_{2.5} \ln (R_t))\).

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3 Data Description

Inasmuch as financially open economies represent the focus of the analysis, the 20 countries for estimation have been selected among those analysed in M. Kono - L. Shuknecht (1998) [KS98 from now] where a long enough time series could be found in either in the May 2003 World Development Indicators [WDI03] or in Heston-Summers-Aten (2001) [PWT6.1]. Ideally the sample for each country includes 41 yearly observations from 1961 to 2001 of real income per capita \( YC \), real capital stock per capita \( KC \), real interest rate \( RR \), credit to private sector as a percentage of GDP \( CR \) as a financial development indicator and the financial openness proxy \( OP \). Details on sources and calculations for each variable in each country are summarised in Appendix A.1.

\( CR \) has been chosen rather than deposits on GDP because of both a better fit with the theoretical reference model and longer time series readily available from WDI03 that would have minimised calculation errors. \( CR \) has been similarly preferred to other frequently used measures of financial development such as M2/GDP since the focus of the estimation is the (hopefully) useful role of money as technology to transfer value and give way to investment rather than money as a facilitator of exchange, which is best represented in M2.

The Restrictions on practices by Foreign Establishments \( (RFE) \) indicator is derived by KS98 from the GATS Schedules\(^5\). GATS commitments are minimum guarantees of market access or national treatment and current policy cannot be reversed to standards below those subscribed in GATS agreements. The value of the \( RFE \) indicator for China and Chinese Taipei has been assessed following KS98 methodology. Restrictions on activities by foreign affiliates on domestic funding, retail operations, equity limits and new licenses for China and Chinese Taipei have been personally assessed in accordance to the respective WTO documents\(^6\). The \( OP \) variable has been built as the \( \log \) of the product of a constant indicator \( (RFE) \) and trade openness in constant prices. \( RFE \) has been rescaled in the construction of \( OP \) so that maximum restrictiveness (i.e. \( RFE = 4 \)) lowers the impact of trade openness while minimum restrictiveness increases it.

It might be argued that in constructing the \( OP \) variable \( RFE \) indicators have been associated with each economy’s trade openness in years well before GATS agreements were actually signed by any of the sample countries and therefore \( OP \) cannot properly act as a dummy for financial openness.

Support for the use of \( OP \) throughout the sample length comes from at least three lines of argument.

First of all, KS98 argue that the nature of GATS commitments may make them more valuable than current policies, especially in emerging markets with a volatile policy.

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\(^5\) The policy commitments are listed in the WTO Members’ Schedules of Specific Commitments made at the end of the Uruguay Round in December 1993 and the updates following the progress of global negotiations.

record, as proxies for financial services trade policy restrictions as perceived by market participants.

Secondly, since the average country has been a member of pro-openness institutions such as the IMF and the WTO for more than half and two thirds respectively of the standard sample period, it is argued that associating \( RFE \) to the whole length of the trade openness series might indeed be considered as a good proxy for the willingness of the country to liberalise the financial sector. Such hypothesis is also consistent with a follow-thy-client strategy by incumbent banks originating from states exporting in each sample country.

And finally Do - Levchenko (2004) analyse the so-called financial comparative advantage, i.e. whether countries endowed with better financial systems produce and export financially-dependent goods. Using panel data for 77 countries they find that trade should be associated with faster financial development although in a non-linear fashion.

As to the quality of all variables, as shown in tables A2-A6, most of them, with the exception of \( RR \), are normally distributed and should grant quality estimates. Problems might be detected for some Latin American and African countries such as Argentina, Chile, Egypt, Ghana, Mexico, Senegal and South Africa (non normal \( KC \) and/or \( CR \)). For Chinese Taipei and Mexico a financially-closed economy specification of the model might give better results than a open economy one, given the detected non-normality in their \( OP \) variable. South African data, in addition to shorter series suffer from non-normality with the exception of \( OP \). Such bad quality does not bode well for the estimation exercise.

Table 1: Some Summary Statistics

Summarising, the sample will be composed by 20 countries, all, with the exception of Korea and Mexico, non-OECD member. All of the countries are member of the WTO though, and apart from Chinese Taipei and Egypt all are subscribers to art. 8 of the IMF statues. More specifically, the average country has been a member of the WTO, or its predecessor, for over 30 years and of the IMF for nearly 20.

As a first assessment of the explanatory power of the main dependent variables within each sample country the main correlations in level and growth rates with \( CR \) are shown in table 2.

Table 2a: CR Correlations and Table 2b: YC Correlations

Legend:
\[
\Delta X = \text{annual growth rate of variable } X \\
\rho(X, Z) = \text{correlation of variables } X \text{ and } Z \text{ over the sample period}
\]

\(^7\) Article 8 sets forth the general obligations of each member with special reference to the avoidance of restrictions on current payments and of discriminatory currency practices and to the convertibility of foreign-held balance.
Table 2a shows that the contemporaneous correlations between the level of real income, or real capital per capita, and financial development are positive with the exception of Costa Rica, Ghana, Mexico, Senegal and South Africa. Correlation with the levels of the capital income ratio is also positive but for Chile, Costa Rica, Ghana, Mexico and South Africa. Correlation with openness is positive with the exception of Costa Rica, Egypt, Mexico, Senegal and Venezuela. Both in the correlation with KY and OP minus signs prevail, although six countries show a positive sign. Correlation between CR and RR is, on average, lower than that with other endogenous variables and positive signs prevail and this support the interpretation of interest rates as a proxy for technical progress and therefore as input in financial development along with capital, income and, possibly, openness.

In the correlation between CR and growth rates (i.e. \( \Delta Y, \Delta K, \Delta OP \) and \( \Delta KY \)), negative signs prevail in the first three cases, while correlation of CR and \( \Delta OP \) shows a split with eight negative signs and ten positive ones. In the end a weak indication in favour of opposite sign relationships between financial development and real variables in the long vs. the short-term seem to emerge, while no precise pattern for the relationship of CR and with OP seems visible at this stage.

Table 2b shows the prevalence of positive signs in level correlation between YC and either KC, KY or OP. Partial exception are the African countries, except Morocco, and Chile and Venezuela. \( \rho(YC, RR) \) is less clear-cut than that between CR and RR since positive and negative signs are equally split. In correlation between YC and growth rates of the variables negative signs prevail with the exception of \( \Delta OP \).

### 3.1 Stylised facts

Considering the World Bank income thresholds in real terms, to carry out intertemporal comparisons, table 1 shows that in 1961:

- 9 countries were considered Low Income (\( YC < \$745 \)): China, Egypt, Ghana, India, Indonesia, Morocco, Philippines, Senegal and Thailand
- 9 countries were considered Lower Middle Income (\( \$746 < YC < \$2975 \)): Brazil, Chile, Chinese Taipei, Costa Rica, Korea, Malaysia, Mexico, Singapore and South Africa
- 2 countries were considered High Middle Income (\( \$2976 < YC < \$9205 \)): Argentina and Venezuela
- No country reached High Income (\( YC > \$9206 \)).
- the KY ratio was not very dissimilar across income group being \( 1.7 < KY < 1.9 \) while financial development was quite heterogeneous being \( 14% < CR < 25% \) with Lower Middle income countries showing the highest CR.

Forty-one years later some miracles and catastrophes have hit the universe of the sample countries. The main miracle is that only three countries, namely Ghana, India and Senegal, are below the US$745 income poverty line in 2001. The same three countries, however, still show a CR similar to that of Lower Middle Income back in 1961!
Also, 6 countries (4 Asian and 2 African) are now in the Lower Middle Income group, 8 in the High Middle Income Group (all of them South American with the exception of Malaysia and South Africa) and the 3 Asian Tigers are in the High Income Group.

Ghana represents the "economic development" catastrophe par excellence given that it is the only country with a negative average annual growth of \( K_Y \) in the whole sample. Senegal and Venezuela show a negative average annual growth of \( Y_C \) but in no country the misfunctioning of the economy seem to have gone so deep as to touch the accumulation process as in Ghana.

Mexico represents the "financial development" catastrophe as it is the only country where financial development is decreasing over the sample period.

End-of-period values of economic and financial development seem to be more closely clustered as \( C_R \) and \( K_Y \) mostly grow with income. \( C_R \) in Low Income countries does not go beyond 30%, while in Lower Middle Income countries it starts at 36% except for Indonesia and in High Income countries where it starts above 100%! High Middle Income countries remain a bit of a problem in so far as their end-of-period \( C_R \) remains low (starting from 11%) and also ends at 69% if it were not for the two non-Latin American countries in the group. Yet another clear evidence of the need of dummy variables for crisis-prone countries such as the Latin American ones.

\( K_Y \) pattern goes along the same lines with Low and Lower Middle Income countries in the \( 2.3 < K_Y < 3 \) area. High Middle Income countries again show some problems since two countries, Chile and Costa Rica, have a lower \( K_Y \) than the best Lower Middle income and again the two non-Latin American countries in the group fare better than their peers.

High Income countries’ \( K_Y \) starts at 2.6. At first sight it seems difficult to reconcile Chinese Taipei’s reputation of (pre-1997) "Asian Tiger" and the lowest \( K_Y \) at the end of the period. The recent difficulties of Taiwanese banks, however, seem to give credit both to the importance of the \( K_Y \) indicator for "sound" financial development and the exceptionally of Taiwan among High Income countries.

### 3.2 The need of proper consideration for dummy variables

With the exception of China, Chinese Taipei, India and Singapore the average country in the sample has experienced more than 10 years of either banking crises and/or some form of default in loans or bonds during the sample period\(^8\). Given that these shocks affects a subset of the variables (mainly \( C_R \) and \( R_R \) usually asymmetrically), and the effect will hardly disappear in the cointegration relation, dummies should be included for nearly all countries.

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\(^8\) In August 2001 the Resolution Trust Commission was set up with a capital of TWD 14bn (euro 4.62 bn) to bail out all insolvent institutions. In May 2003 the government asked the Parliament to increase the fund’s budget allocation to TWD 540 bn (euro 17.5 bn) only to recapitalise insolvent banks. The latest proposal is still undergoing parliamentary debate. Source: Fitch Ratings (2003)

\(^9\) see table 5
The heavy use of such ad hoc dummy variables is also justified by Loayza and Ranciere (2002) who find them essential in order to obtain results for countries subject to the effect of financial crisis longer than the average economic cycle. They observe that “in the case of private credit its correlation with growth is strongly negative prior to the crisis, and it becomes close to neutral in the aftermath”. This effect is at odds with the long run nature of cointegration results and therefore needs proper consideration.

On the other hand, the usual practice to detect outlying observations from the estimated residuals in cointegrated VAR and to include unrestricted (innovational) dummies to whiten residuals, has no sound justification in theory.

More precisely, if there is a fixed number of outliers asymptotic distributions of estimates are unaffected and hence inference in the cointegration model is unchanged. But in finite samples distortionary effects could be relevant especially if outliers are not innovational but are additive instead. This should not be surprising considering that the innovation specification of the estimation model is the fairly standard one:

$$\Delta Y_t = \alpha \beta_0 Y_{t-1} + \sum_{i=1}^{k-1} \Gamma_i \Delta Y_{t-i} + \alpha \beta_1 t + D_t + \mu_0 + \epsilon_t$$

(3.1)

where $Y_t$ is the vector of the endogenous variables in levels, $k$ the lags (of the unrestricted, i.e. level, model), $t$ the (eventual) time trend and $D_t$ the dummy variable(s) while the additive specification of the estimation model is

$$\Delta Y_t = (\beta' : \beta_0' : \beta_1') \left( \begin{array}{c} Y_{t-1} \\ t \\ D_{t-1} \end{array} \right) + \sum_{i=1}^{k-1} \Gamma_i \Delta Y_{t-i} + \theta_1 \Delta D_t + \sum_{i=0}^{k-1} \theta_i \Delta D_{t-i} + \mu_0 + \epsilon_t$$

(3.2)

subject to $$\theta_i = -\Gamma_i \theta$$ for $i = 1, ..., k - 1$

where $\theta$ is the $k$-dimensional vector of parameters for the full lag structure of the dummy variables.

It is important to note that an additive impulse dummy eliminates the contribution from the observation to the likelihood function rather that the contribution from the residual.

In order to prevent a dangerously excessive use or deliberate misuse the objective detection and estimation procedure pioneered by Bohn Nielsen (2004) [BN04 from now] has been used.

4 Cointegration estimation

Before proceeding with the estimation of the cointegrated VAR model\textsuperscript{10} for each coun-

\textsuperscript{10} All calculations have been conducted in EViews\textsuperscript{®}. Codes for estimating the model can be obtained from
try, the stationarity of the series is checked with a (non reported) standard Augmented Dickey fuller test. Hence the following procedure has been followed:

1. Assume an order of cointegration and obtain lag length tests for the proposed VAR with no dummies;
2. Detect and estimate the type and the position of dummy variables with BN04 procedure;
3. Re-assess lag length and order of integration and proceed with identifying restrictions.

The first two steps are particularly crucial: on the one hand the lag, trend and order of cointegration are to be assumed and then held fixed for all the iterations needed for the outlier detection and estimation procedure and on the other hand these parameters - especially the lag length - may differ when the model is estimated with or without the dummies.

4.1 Lag choice

The lag, in no case higher than four in order not to limit degrees of freedom in the estimation of parameters excessively, has been chosen according to a hierarchy of criteria. First of all, as suggested by Johansen-Mosconi-Nielsen (2000), the Hannan-Quinn criterion has been tried, then lags suggested by other information tests, shown in the five columns on the left-hand section of table 3, are considered. If no meaningful result has been obtained this way, the lag showing better normality of residuals, as suggested by the last four columns of table 3, has been used instead. Occasionally, a lag alien to the one suggested by the tests has been chosen on the basis of a more appealing interpretation of resulting coefficients. This has been the case for Indonesia, Singapore and South Africa, countries with serious problems in the data.

[Table 3: Choice of the Lag Length here]

Table 3 shows for each country all the results of the lag length tests. For each country the first row of results represents tests calculated with no dummies and the second row tests calculated at the end of the BN04 procedure, as shown in tables 4.1-4.6. With the exception of Korea and Malaysia the inclusion of dummies always increases the preferred lag. In 5 cases the HQ-after-dummies has been the favoured choice and in 2 cases the HQ-before-dummies. A two-lag model has been the most frequent choice, being estimated for 12 countries. The use of four-lag model, particularly consuming in terms of degrees of freedom, has been limited to two countries and this is just one of the advantages of the BN04 procedure.

the author.
4.2  Outlier Detection & Estimation

The main steps of the iterative procedure can be outlined as follows:

1. Calculate residuals from Vector Error Correction Model (VECM) with lag order and cointegration rank assumed in table 3 with no dummy (VECM₀ from now on) and pick out data where residuals are higher than twice the standard deviation (i.e. outliers)

2. Calculate the VECM₀’s statistic \( t_0 = -\frac{n}{2} \log |\Omega_0| \) where \(|\Omega_0|\) is the determinant of the residuals’ covariance matrix and \(n\) the number of observations

3. For the Innovation Outlier (IO) estimation insert an unrestricted dummy variable at the observed outlier’s date \((\text{year})\) and, using the same cointegration rank and a lag order of VECM₀ calculate \( t_{\text{IO,year}} = -\frac{n}{2} \log |\Omega_{\text{IO}}| \)

4. Obtain the likelihood ratio test \( \tau_{\text{IO,year}} = -2(t_0 - t_{\text{IO,year}}) \)

5. Repeat for all the outlying observations and order the test results in descending order

6. For the Additive Outlier (AO) start assuming \( \theta = 0 \) and follow the iteration algorithm for Maximum Likelihood estimation in par 3.1 of BN04

7. Once convergence, say at \( \theta^* \), is reached, obtain the likelihood estimation of (3.2) and the likelihood ratio test \( \tau_{\text{AO,year}} = -2(t_0 - t_{\text{AO,year}}) \)

8. Repeat for all the outlying dates and sort the test results in descending order

9. Insert a dummy at the observation where \( \max_{\text{year}} \tau_i = AO, IO \) and estimate a VECM model (VECM₉₉)

10. Repeat the routine with VECM₉₉=VECM₀ with the highest test value until no significant test values remain.

The value of the \( \tau_{\text{IO,year}} \) and \( \tau_{\text{AO,year}} \) tests for outliers in the single countries are shown in tables 4.1-4.6.

[TABLE 4.1-4.6: OUTLIER DETECTION & ESTIMATION here]

Iteration 0 is carried out on all observations with a standardised residual higher than 2, subsequent iterations pick the highest-test year (thick-bordered in the table) and insert an innovation or additive dummy in that year. The critical value, below which no further dummy is included in the model, is \( \chi^2_{0.9999}(5) \) and it is calculated focusing on the fact that the highest value statistics is chosen.

[TABLE 5: DUMMY VARIABLES AND CRISIS PATTERNS and GRAPHS 1 & 2 here]
The rationale of the BN04 procedure can be assessed by comparing tables 4.1-4.6 with table 5 and graphs 1 & 2, where parsimoniousness of the dummies used in BN04 vs. the years of crisis reported by the literature is striking. Table 5 and the graphs show that, according to different literature sources, the probability that in a random year in the sample period no country was in a crisis is 34%, that one country was in a crisis 12%. Also the "worst case scenario" would be to be one country in the sample in the years 1988 or 1989: then the probability that a country would be in a crisis is, stunningly, 60%!!!! To name-and-shame Argentina and Indonesia, closely followed by Mexico, make it to the top of crisis-prone countries.

According to the BN04 approach, the might with which such financial quakes have hit the sample panel and the width of their effects come out much curtailed. Along with the results of the iterations, the probability that in a random year in the sample period no country was in a crisis is 22%, that one country was in a crisis 24%. The probability of crisis of 2 or 3 countries together is still double digit but dies down afterwards and abruptly stops at 7. In other words, crisis, as detected by the BN04 procedure, seem to be much less infectious than in the literature-source world. Also the "worst case scenario" would be to be one country in the sample in year 1974: then the probability that a randomly chosen country would be in a crisis is a less shattering 35%. This is not surprising when one considers that in the Seventies 17 countries had average negative real interest rates - a frequently-cited indicator of economic and/or financial difficulties of some sort - comparing with 6 in the Sixties, 5 in the Eighties and 4 in the Nineties. In this new scenario Brazil and Ghana lead the crisis-prone countries hit list.

Please note that two notoriously crisis-prone countries with shorter times series available and a heavy lag structure, namely Indonesia and Mexico, have produced intelligible cointegration results thanks to the parsimonious BN04 procedure. Also the estimation of the CR series for China, specified in Appendix A.2, does not seem to have distorted the panel pattern, given that the outliers identified by the BN04 procedure are 1967-1970 (the Cultural Revolution) and 1993 (the double-digit inflation and the renminbi).

4.3 Cointegration results

Table 6 shows the eigenvalues and the cointegration test with two models with either i) intercepts in the cointegrating equations and no deterministic trends in the level data or ii) intercepts in the cointegrating equations and linear trends in the level data.

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11 The renminbi was massively overvalued in the 1980s and early 1990s, and a parallel currency, foreign-exchange certificates (FECs), circulated until 1994 to enable entities engaged in foreign trade to purchase foreign exchange at a more reasonable rate. The currencies were unified in 1994 and the renminbi pegged at Rmb 8.7:US$1. The average exchange rate in 1993 was Rmb 5.8:US$1.
All countries support at least 2 cointegrating equations - financial depth relationship and output relationship from here on - at least at 1% confidence - according to critical values from J.A. Doornik (1998) - with the exception of Malaysia.

The identification of parameters has proceeded imposing the following restrictions:

1. Normalisation: $CR$ equation represents the link between financial development and economic development and $YC$ equation represent the production function $\Rightarrow \beta_{1,1} = \beta_{2,1} = 1$

2. $CR$ equation is linked to $KY$: $\beta_{1,2} = -\beta_{1,3}$

3. one of the cointegrating equations is not negatively influenced either by $RR$ or by $OP$\textsuperscript{12}

Should the above restrictions yield equations that cannot be meaningfully interpreted, the specification where capital does not enter the financial development equation, i.e. $\beta_{1,2} = 0$, has been estimated instead of nr.2.

The results in table 7 show for each country the specification, among those obtainable with the above restrictions and the identified dummies\textsuperscript{13}, with the highest $\chi^2(1)$ probability associated with the overidentifying restriction test. Chinese Taipei and South Africa, given the (poor) quality of the data already shown in A2-A6 tables, only manage to get significant restrictions at 1% level.

A few common elements seem to emerge. First of all, only in five cases, namely Brazil, China, Chinese Taipei, Costa Rica and Thailand the $\beta_{1,2} = 0$ model of financial intermediation is the preferred identification choice rather than the $KY$ specification ($\beta_{1,2} = -\beta_{1,3}$). With the exception of Chinese Taipei, whose recent banking difficulties have already been mentioned, all these countries are concentrated in Lower or High Middle income group. $|\beta_{1,2}|$ ranges seem roughly to increase with income with $0.1 < |\beta_{1,2}|_{Low} < 0.58$, $0.04 < |\beta_{1,2}|_{LowerMid} < 0.76$, and $0.09 < |\beta_{1,2}|_{HighMid} < 0.98$, at least until the High Middle income level.

Secondly, there are six negative contributions of financial openness to financial development: two among "fairly liberal" countries (i.e. $RFE < 2$), namely Mexico and Morocco and four among "financially closed" countries, namely Brazil, Egypt, India and Venezuela. The two control countries, Costa Rica and Senegal, show a positive sign.

\textsuperscript{12} In practical terms this means testing one of the following restrictions a) $b_{1,4} = 0$, b) $b_{2,4} = 0$; c) interest rates is positively linked either with $CR$ or $YC$ i.e. $(b_{1,5} + b_{2,5}) = (b_{1,5unrestricted} + b_{2,5unrestricted})$ or $b_{1,5} = 0$ or $b_{2,5} = 0$ or $b_{1,5} = 0$ if $b_{i,5unrestricted}$ where $i = 1, 2$ when $i = 2, 1$ is near zero

\textsuperscript{13} Only in the case of Morocco and South Africa fewer dummies than those identified with the BN03 procedure have been used. IO at 1974 and 1986 have been used for Morocco and IO at 1974 and 1988 for South Africa.
No High Income country, all of them with $RFE > 2$, show a negative contribution of openness to financial development and so do Low Income ones with the exception of India, which is however saddled with 5 crisis dummies. History of crisis for Brazil and Venezuela, and special trends in variables in Egypt (the only country in the sample with decreasing $OP$) rather than long-term relationship might be the reasons for $\beta_{1,4} < 0$. If, on the other hands, one considers caveats for the poor quality of estimations for South Africa, there is a weak evidence that "financial openness is bad for growth" especially in the Middle Income group with Morrocco and Mexico supporting the evidence. The evaluation of China’s $RFE$ to 3, i.e. fairly restrictive, seems therefore to be justified, given the resulting positive contribution of financial openness to to financial development. Such assessment is less clear cut for Chinese Taipei, which suffers from already mentioned data and significance problems.

Thirdly, although table A6 unequivocally warns against the good quality of $RR$ data, in terms of statistical properties such as normality, one cannot fail to observe that 12 out of 20 countries show a non negative $\beta_{1,5}$ and three countries show a $\beta_{1,5} < 0 \cap \beta_{2,5} < 0$. The only countries with $\beta_{1,5} > 0 \cap \beta_{2,5} > 0$ are China, Chinese Taipei and Korea, all considered "tigers” in terms of development with Egypt joining the group.

As far as the economic development cointegrating vector is concerned, "big" economies, i.e. Argentina, Brazil, China and India are the nearest one to the endogenous growth condition $\beta_{2,3} \rightarrow 1$. $KC$ always gives a significative and positive contribution with the exceptions of Ghana, Morocco, Senegal and Venezuela. $OP$ is nearly always significant and it is also positive with the exception of Brazil, India, Morocco, Senegal and Venezuela. Brazil and India are among the closest countries in the sample, with a trade/GDP ratio barely above 15%. When considering $\beta_{2,3}$ and $\beta_{2,4}$ together Chile shows a record of $\beta_{2,4} \approx 1$, maybe as a compensation to the low $\beta_{2,3}$ than to a long-term feature itself, and Egypt$^{14}$ stands out as the only African country able to escape the "African curse" whereby neither $KC$ nor $OP$ are able to account for development (or, rather, lack thereof).

Finally, the evidence on the contribution to the economic development equilibrium relationship by $\beta_{2,5}$ is quite inconclusive, with only Argentina, China, Chinese Taipei, Egypt, Korea and Venezuela showing a positive contribution from $RR$.

5 Concluding Remarks

The contribution that this paper aims to offer is a qualification of the link between financial and economic development with reference to restrictions to the role of financial openness.

To this purpose, a link between economic and financial development has been tested for 20 sample countries especially selected from a set of financially open economies

$^{14}$ Together with South Africa, whose bad quality of data and estimation results have already been mentioned
underwriters of the GATS protocol of the WTO. Financial openness has been proxied by the product of trade openness and an inverse function of the restrictiveness of foreign establishment indicator.

For China and Chinese Taipei, the newest WTO members, the foreign restrictiveness indicator has been assessed from their own protocol of admission to the WTO. For China the financial development indicator, i.e. the credit/GDP ratio for years 1961-1976 has also been estimated from data on growth rate of loans to enterprises stated in the relevant five-year plans.

Furthermore, in order to deal with crisis periods in the time series a special detection and estimation procedure has been used to identify dummies. This procedure has identified crises precisely - as shown in table 8 - yet it has allowed for a parsimonious use of dummies with respect to literature.

[Table 8: Detected Outliers Match with References in the Literature here]

The main results of the paper are:

- evidence of a non-linear relationship between \( KC \) v \( KY \) model in financial development since the \( KY \) model is more frequent among Low and High income countries whereas the \( KC \) one is more frequent in the Middle Income countries;
- evidence of a non-linear relationship between financial development and accumulation in line with the literature reviewed, as \( |\beta_{1,2}| \) values seem to increase with income at least until the High Middle Income countries;
- evidence of non-linearity in the relationship between trade, closely linked to the financial openness variable \( OP \), and financial development, in line with Do-Levchenko (2004) given that High and High-Middle income countries present a significant and positive \( \beta_{1,4} \), whereas Lower Middle Income countries mostly show a significant \( \beta_{1,4} < 0 \). Exceptions are represented by relatively poor countries but with above average growth in \( OP \), (China and the Philippines both with \( \beta_{1,4} > 0 \)) or relatively rich but trade-closed countries (Brazil and Mexico both with \( \beta_{1,4} < 0 \));
- weak evidence that financial openness could be bad for financial development as no High Income country, all of which are financially closed (i.e. \( RFE > 2 \)), show a negative contribution of openness to financial development and so do Low Income ones;
- positive effect of real interest rate on financial development for most countries, in line with Arestis-Demetriades-Fattouh-Mouratidis (2002);
- as far as economic development is concerned, there is evidence of endogenous growth for "big" economies, i.e. Argentina, Brazil, China and India showing \( \beta_{2,3} \to 1 \);
• KC and OP nearly always gives a significative and positive contribution to economic development with the exception of Low income countries, Brazil, Morocco and Venezuela;
• Egypt and South Africa, which are hence the only African countries able to escape the "African curse" whereby neither KC nor OP are able to account for development (or, rather, lack thereof).

References


Beijing, People’s Republic of China


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Taiwan, Republic of China


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Appendix A. Data Description

A.1 Data & Sources

<table>
<thead>
<tr>
<th>VARIABLE</th>
<th>DESCRIPTION</th>
<th>SOURCE</th>
</tr>
</thead>
<tbody>
<tr>
<td>CR</td>
<td>Credit to private sector/GDP</td>
<td>WDI03 16</td>
</tr>
<tr>
<td>YC</td>
<td>Real income per capita in 1995 US$</td>
<td>Ratio of real income to population from WDI03 17</td>
</tr>
<tr>
<td>KC</td>
<td>Real capital stock per capita in 1995 US$</td>
<td>Calculated from real investment data from WDI03 18</td>
</tr>
<tr>
<td>OP</td>
<td>Composite financial openness indicator = openness*rescaled RFE</td>
<td>WDI03 19</td>
</tr>
<tr>
<td>RR</td>
<td>Real interest rate = Discount rate - annual inflation</td>
<td>KS98</td>
</tr>
<tr>
<td>KY</td>
<td>Capital-income ratio</td>
<td>KC/YC</td>
</tr>
</tbody>
</table>

15 I would like to thank the Central Bank of China, Nicholas Kwan (HKMA) and Cesar M. Calderon (Central Bank of Chile) for their help in providing data.
19 Taiwan: 1999-2001 Rescaled [Imp(line98c)+exp(90c)]/gdp(99b) from [TW-MonStat]
20 Rescaled RFE = [(1+6-original RFE)/5]; Rescaled RFE =1 if original RFE not ranked; Rescaled RFE =2.2 if original RFE = 0 [minimum restrictions]; Rescaled RFE =1.4 if original RFE = 4 [maximum restriction]
A.2 Domestic Credit on GDP ($CHCR$) for China in 1961-1976

Domestic credit for China in the period 1961-1976 has been calculated applying the average yearly growth rate of loans to enterprises from table 2 page 138 ($gr$) of W. Byrd (1983) to:

1. initial working capital loans in 1957 ($L57$) as estimated on page 125 of K. Hsiao (1971) + Investment in Fixed assets funded by domestic loans ($FX$) of column 3 of table on page 25 of Department of Statistics on Investment in Fixed Assets National Bureau of Statistics of China (2002) and to


So the final formula sums the (forward) smoothed working capital loans from 1957 and the (backward) smoothed bank loans from 1980

\[ CHCR_{year} = \left[ f_{year} + h_{year} \right] / \left( 2 \times \text{no min alGDP}_{year} \right) \]

where

\[ f_{year} = gr \times (L57)_{year} + FX_{year} \]

\[ h_{year} = gr^{-1} \times (L80)_{year} \]

independent variable.  Ghana 1961-64: calculated from a regression of the difference of real and nominal GDP growth rates from WDI03.

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