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Financial development and economic growth an empirical analysis for Ireland

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Abstract

This study investigated the relationship between financial development and economic growth for Ireland for the period 1965-2007 using a vector error correction model (VECM). Questions were raised whether financial development causes economic growth or reversely taking into account the positive effect of industrial production index. Financial market development is estimated by the effect of credit market development and stock market development on economic growth. The objective of this study was to examine the long-run relationship between these variables applying the Johansen cointegration analysis taking into account the maximum eigenvalues and trace statistics tests. Granger causality tests indicated that economic growth causes credit market development, while there is a bilateral causal relationship between stock market development and economic growth. Therefore, it can be inferred that economic growth has a positive effect on stock market development and credit market development taking into account the positive effect of industrial production growth on economic growth for Ireland.

Keywords: financial development, economic growth, Granger causality

JEL classification: O11, C22

1. Introduction

The relationship between economic growth and financial development has been an extensive subject of empirical research. The question is whether financial development causes economic growth or reversely. The main objective of this study was to investigate the causal relationship between economic growth and financial development taking into account the positive effect of industrial production index.

The recent revival of interest in the link between financial development and growth stems mainly from the insights and techniques of endogenous growth models, which have shown that there can be self-sustaining growth without exogenous technical progress and that the growth rate can be related to preferences, technology, income distribution and institutional arrangements. This provides the theoretical underpinning that early contributors lacked: financial intermediation can be shown to have not only level effects but also growth effects.

The financial repressionists, led by, McKinnon (1973) and Shaw (1973) – often re-

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