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Financial Integration and Financial Development: Does Financial Integration Matter?

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Abstract:

The aim of this paper is to investigate the effects of financial development and financial integration on economic growth in 89 developed and countries in transition, from the period of 1996 to 2007. We have focused in modeling threshold effects regarding financial markets depth as measure of economic absorption capacity of the countries. The results show that both financial development and integration have positive effect on economic growth in countries in transition, which is not case for developed countries. However, the effects are highly non-linear. First, the effect of development domestic financial markets on growth is higher in less developed countries. The effect may vanish as financial development reaches the level of the developed economies. Secondly, financial integration may not have a positive effect on growth, as its effects depend on the development of domestic financial markets, macroeconomic stability, and quality of institutions.

Key Words: *Transition Economies, Financial Integration, Financial Development, Economic Growth, GMM Estimation*

JEL Classification : *F33, F36, G15*

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1. Introduction

The effect of financial integration and financial development on economic growth has traditionally involved vast interest from many researchers. However, the investigations of the effect of financial integration and financial development on economic growth have become more pronounced during the global financial crisis, especially for countries in transition. In those countries the benefit of the political and trade integration, which are closely linked have now widely accepted by scientists. However, the criticism is focused in the effect of the financial integration on economic growth.

According to the theoretical point of view the financial integration may take several ways on having positive effect on economic growth, both by direct and indirect channels. The direct channel of financial integration may have positive effect on growth through the facilitation of the efficient international allocation of the capital and, international risk allocation (see more Obstfeld, 1994; Kose at al., 2009; Thalassinos et al., 2012; Thalassinos et al., 2013; Thalassinos et al., 2014a and 2014b; Thalassinos et al., 2015; Thalassinos and Liapis, 2013). The indirect channel of the financial integration may affect positively the economic growth through its effect on development of the domestic financial markets. This appears in two ways. The financial integration may increase the competition from foreign financial intermediation, which in turn leads to decrease of investment cost and efficiency (Levine, 2001). In addition, the financial integration affects the financial development by allowing access to foreign financial markets in term of direct lending by the foreign financial intermeddles.

However, the empirical evidence of the effect of financial integration on economic growth is mixed, inconclusive and remains still debatable (see Kose et al., 2009). Therefore, there is still debate for the effect of the financial integration on economic growth, particularly for countries in transition. The study by Klein and Olivei (2000) and Bekaert at al. (2005) shows that the financial integration has positive effect on economic growth. On the other hand, Edwards (2001) finds that the financial integration has positive effect on economic growth in advanced countries and potentially detrimental for less developed countries. Also Edison at al. (2002) examines the effect of the financial integration using various measures of the financial integration and different econometrics techniques, and they find that the effect of financial integration depends on financial institutional quality and factors of economic development. The empirical papers that tend to disaggregated data show that the financial integration has positive effect on economic growth (see more Kose, Prasad, Rogoff, and Wei, 2009b), for an excellent overview of the empirical evidence). For example, Prasad at al. (2007) using industry-level data find evidence of threshold effects that financial integration have positive effect on economic

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