

FINANCIAL INTERMEDIATION AND GROWTH: CAUSALITY AND CAUSES

Ross Levine
University of Minnesota

Norman Loayza
The World Bank

Thorsten Beck
The World Bank

Do better functioning financial intermediaries—financial intermediaries that are better at ameliorating information asymmetries and facilitating transactions—exert a causal influence on economic growth? Providing evidence on *causality* has implications for policymakers and economists. For instance, Alexander Hamilton (1781) argued that “banks were the happiest engines that ever were invented” for spurring economic growth. Others, however, question whether finance boosts growth. President John Adams (1819) asserted that banks harm the “morality, tranquility, and even wealth” of nations.¹ Economic theories mirror these divisions. Some models show that economic agents create debt contracts and financial intermediaries to ameliorate the economic consequences of informational asymmetries, with beneficial implications for resource allocation and

This paper was originally published in the *Journal of Monetary Economics*, 46(1): 31-77, 2000. Reprinted with permission. At the time of writing, Ross Levine and Thorsten Beck were affiliated with the University of Virginia.

We thank seminar participants at the University of Illinois, the Federal Reserve Banks of Richmond and Dallas, the University of Texas at Austin, the University of Minnesota, and the Central Bank of Chile as well as Alexander Galetovic, Robert King, Lant Pritchett, Andrei Shleifer, Jonathan Wright, and an anonymous referee for helpful comments. This paper’s findings, interpretations, and conclusions are entirely those of the authors and do not necessarily represent the views of the World Bank, its Executive Directors, or the countries they represent.

1. The quotations from Hamilton and Adams are taken from Hammond (1991, p. 36). For an historical perspective, also see Bagehot (1873) and Schumpeter (1912) on how intermediaries spur economic growth.

Banking, Financial Integration, and International Crises, edited by Leonardo Hernández and Klaus Schmidt-Hebbel, Santiago, Chile. ©2002 Central Bank of Chile.

economic activity.² However, other models note that higher returns from better resource allocation may depress saving rates enough such that overall growth rates actually slow with enhanced financial development (Bencivenga and Smith, 1991; King and Levine, 1993b). Furthermore, Robinson (1952) argues that financial development primarily follows economic growth and the engines of growth must be sought elsewhere.³ In terms of policy, if financial intermediaries exert an economically large impact on growth, then this raises the degree of urgency attached to legal, regulatory, and policy reforms designed to promote financial development.

This paper rigorously examines whether the exogenous component of financial intermediary development influences economic growth. We also present evidence concerning the legal, regulatory, and policy determinants of financial development. While past work shows that the level of financial development is a good predictor of economic growth (King and Levine, 1993a, b; Levine and Zervos, 1998; Neusser and Kugler, 1998; and Rousseau and Wachtel, 1998), these results do not settle the issue of causality. Although this paper does not fully resolve all concerns about causality, it uses new data and new econometric procedures that directly confront the potential biases induced by simultaneity, omitted variables, and unobserved country-specific effects that have plagued previous empirical work on the finance-growth link.⁴

Methodologically, the paper uses two econometric techniques: (1) generalized method of moments (GMM) dynamic panel estimators and (2) a cross-sectional instrumental-variable estimator. Whereas the pure cross-sectional estimator follows directly from traditional growth studies, the panel estimator uses pooled cross-country and

2. Also, see Townsend (1979); Gale and Hellwig (1985); Diamond (1984); Boyd and Prescott (1986); Diamond and Dybvig (1983); and Greenwood and Jovanovic (1990). For reviews of this literature see Gertler (1988) and Levine (1997).

3. For more on how economic activity influences the financial sector, see Patrick (1966) and Greenwood and Jovanovic (1990).

4. This paper complements recent microeconomic efforts aimed at reconciling whether financial development is simply a good predictor of economic growth. Rajan and Zingales (1998) show that, in countries with well-developed financial systems, industries that are naturally heavy users of external finance grow relatively faster than other industries. Demirgüç-Kunt and Maksimovic (1998) show that firms in countries with better-developed financial systems grow faster than they could have grown without this access. Jayaratne and Strahan (1996) show that when individual states of the United States relaxed intrastate branching restrictions the quality of bank loans rose and per capita GDP growth accelerated.

time-series data to exploit the additional information provided by the over-time variation in the growth rate and its determinants. This added information allows us to obtain more precise estimates and, most importantly, correct for biases associated with existing studies of the finance-growth relationship.

Consider first the GMM dynamic panel estimators, which are specifically designed to address the econometric problems induced by unobserved country-specific effects and joint endogeneity of the explanatory variables in lagged-dependent-variable models, such as growth regressions. We assemble a panel dataset of 74 countries, where the data are averaged over each of the seven 5-year intervals composing the period 1960-95. The dependent variable is the growth rate of the real per capita gross domestic product (GDP). The regressors include the level of financial intermediary development, along with a broad set of variables that serve as conditioning information. We employ two GMM panel estimators; both are based on the use of lagged observations of the explanatory variables as instruments (thus labeled "internal" instruments). In the first GMM panel estimator, we (a) difference the regression equation to remove any omitted variable bias created by unobserved country-specific effects, and then (b) instrument the right-hand-side variables (the differenced values of the original regressors) using lagged values of the original regressors to eliminate potential parameter inconsistency arising from simultaneity bias. This *difference* dynamic-panel estimator, developed by Arellano and Bond (1991) and Holtz-Eakin, Newey, and Rosen (1990), has increasingly been used in studies of growth (Caselli, Esquivel, and LeFort, 1996; Easterly, Loayza, and Montiel, 1997). We also use a second GMM dynamic panel estimator that improves upon the *difference* estimator in so far as the quality of the instruments is concerned. Specifically, lagged values of financial development frequently make weak instruments for forecasting *changes* in financial development. This weak instrument problem can induce biases in finite samples and poor precision even asymptotically (Alonso-Borrego and Arellano, 1996). The second GMM panel estimator mitigates this problem by complementing the *difference* specification with the original regression specified in *levels*. This *system* estimator, developed by Arellano and Bover (1995), offers dramatic improvements in both efficiency and consistency in Monte Carlo simulations (Blundell and Bond, 1997). These GMM estimators have not been used before to examine the relationship between financial intermediary development and economic growth.

Our second econometric method to examine the effect of financial intermediary development on economic growth is a cross-sectional estimator. Data for 71 countries are averaged over the period 1960-95, so that there is one observation per country. The countries are listed in appendix table A1. Although the cross-sectional estimator does not deal as rigorously as the panel estimators with the potential problems induced by simultaneity, omitted variables, and unobserved country-specific effects, the cross-sectional results are direct descendants of the cross-country literature on finance and growth (e.g., King and Levine, 1993a; Levine and Zervos, 1998). Also, the cross-sectional estimator serves as a consistency check on the panel findings. Unlike much of the cross-country growth literature, we use instrumental variables to extract the exogenous component of financial intermediary development. For this purpose we use the insight provided by La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1997, 1998; henceforth LLSV). They note that most countries can be divided into countries with predominantly English, French, German, or Scandinavian legal origins and that countries typically obtained their legal systems through occupation or colonization. Moreover, LLSV (1998) show that national legal origin strongly influences the legal and regulatory environment governing financial sector transactions. Since legal origin explains cross-country differences in financial intermediary development and since legal origin is (reasonably) exogenous, we use legal origin as an instrumental variable to control for simultaneity bias.

In conducting this research, we construct a new dataset and focus on three measures of financial intermediation. One measures the overall size of the financial intermediation sector. The second measures whether commercial banking institutions, or the central bank, is conducting the intermediation. The third measures the extent to which financial institutions funnel credit to private sector activities. Our financial development indicators improve on past measures by (i) more accurately deflating nominal measures of intermediary liabilities and assets, (ii) more comprehensively measuring the banking sector, and (iii) more carefully distinguishing who is conducting the intermediation and to where the funds are flowing. While the financial intermediary indicators are still imperfect measures of how well financial intermediaries research firms, monitor managers, mobilize savings, pool risk, and ease transactions, these three measures provide more information about financial intermediary development than past measures and together they provide a

more accurate picture than if we used only a single measure. Moreover, they produce similar conclusions.

The GMM dynamic panel estimators and the pure cross-sectional regressions produce very consistent findings: the exogenous component of financial intermediary development is positively and robustly linked with economic growth. In interpreting the results, note that the findings do not reject the view that economic activity influences financial development. Rather, the results show that the positive link between finance and growth is *not only* due to growth influencing financial development; the strong positive relationship between financial intermediary development and long-run growth is at least partly explained by the effect of the exogenous component of financial development on economic growth. Economically, the impact is large. For example, the estimated coefficients suggest that if Argentina had enjoyed the level of financial intermediary development of the average developing country during the 1960-95 period it would have experienced about one percentage point faster real per capita GDP growth per annum over this period.

The regression results pass a battery of diagnostic and sensitivity tests. The results are robust to modifications in the conditioning information set and alterations in the sample period. Outliers are not producing the results. Specification tests support the appropriateness of the instrumental variables. This gives credence to the conclusion that the estimated positive link between finance and growth is not due to simultaneity bias or insufficient control for other determinants of growth.

The results favor the growth-enhancing view of financial intermediation espoused by Hamilton (1781), Bagehot (1873), and Schumpeter (1912). In turn, the results are less consistent with those that minimize the positive role of financial intermediaries in the growth process (Adams, 1819; Robinson, 1952; Lucas, 1988). Similarly, this paper's findings are consistent with theoretical models that predict that better functioning financial intermediaries accelerate economic growth. Our results do not favor models that emphasize the potentially growth-retarding impact of financial development. Finally, this paper's findings highlight financial reform. If economists can identify legal, regulatory, and policy reforms that promote financial development, this may positively influence economic growth.

Consequently, we also examine whether cross-country differences in particular legal and regulatory system characteristics help

explain cross-country differences in the level of financial intermediary development. The degree to which financial intermediaries can acquire information about firms, write contracts, and have those contracts enforced will fundamentally influence the ability of those intermediaries to identify worthy firms, exert corporate control, manage risk, mobilize savings, and ease exchanges. Thus, as argued by LLSV (1997, 1998), the legal and regulatory system will fundamentally influence the ability of the financial system to provide high-quality financial services. LLSV (1997) examine securities markets. In contrast, we combine their data on the legal and regulatory environment with our data on financial intermediation to study the links between financial intermediary development and cross-country differences in legal and accounting systems.

The results provide useful information to policymakers. The data suggest that countries with legal and regulatory systems that give a high priority to creditors receiving the full present value of their claims on corporations have better functioning financial intermediaries than countries where the legal system provides weaker support to creditors. Moreover, contract enforcement seems to matter even more than the formal legal and regulatory codes. Countries that efficiently impose compliance with laws tend to have better developed financial intermediaries than countries where enforcement is more lax. The paper also shows that information disclosure matters for financial development. Countries where corporations publish relatively comprehensive and accurate financial statements have better developed financial intermediaries than countries where published information on corporations is less reliable. Finally, we confirm these findings when using the legal origin dummy variables (English, French, German, Scandinavian) as instrumental variables to extract the exogenous component of the legal, enforcement, and accounting environment: the legal/regulatory system exerts a powerful influence on financial sector development. While considerable research remains, taken together, this paper's findings provide support for the view that legal and regulatory changes that strengthen creditor rights, contract enforcement, and accounting practices boost financial intermediary development with positive repercussions on economic growth.

The rest of the paper is organized as follows. Section 1 presents the results using purely cross-sectional data, while section 2 discusses and presents the *difference* and *system* dynamic panel results. Section 3 provides information on how the legal and accounting

environment explain cross-country differences in financial development. Section 4 concludes.

1. FINANCE AND GROWTH: CROSS-SECTIONAL ANALYSES

This section examines the relationship between financial intermediation and growth using a pure cross-sectional estimator. We begin with the pure cross-sectional estimator because it more directly follows from the large cross-country growth literature. The next section uses GMM dynamic panel procedures that more comprehensively confront problems induced by country-specific effects, endogeneity, and the routine use of lagged dependent variables in growth regressions.

1.1 Financial Intermediary Development

As discussed above, numerous theoretical models show that economic agents may form financial intermediaries to mitigate the economic consequences of information and transaction costs. More specifically, financial intermediaries emerge to lower the costs of researching potential investments, exerting corporate control, managing risk, mobilizing savings, and conducting exchanges. Theory further suggests that, by providing these services to the economy, financial intermediaries influence savings and allocation decisions in ways that may alter long-run growth rates.⁵ Thus, modern economic theory provides an intellectual framework for understanding how financial intermediaries influence long-run rates of economic growth.

To evaluate the empirical predictions advanced by a variety of theoretical models regarding the relationship between finance and growth, therefore, we would ideally like to construct measures of the ability of different financial systems to research and identify profitable ventures, monitor and control managers, ease risk management and facilitate resource mobilization. It is impossible, however, to construct accurate, comparable measures of these financial services for a broad cross-section of countries over the past 35 years. Consequently, to measure the provision of financial services, this paper constructs three indicators of financial intermediary development.

5. For example, see Greenwood and Jovanovic (1990), Bencivenga and Smith (1991), and King and Levine (1993b).

(We also consider two additional measures in the sensitivity section.) While each has particular strengths and weaknesses, we improve upon past measures of financial intermediary development.⁶

LIQUID LIABILITIES equals liquid liabilities of the financial system (currency plus demand and interest-bearing liabilities of banks and nonbank financial intermediaries) divided by GDP. This is a typical measure of “financial depth” and thus of the overall size of the financial intermediary sector (King and Levine, 1993a). This commonly used measure of financial sector development has shortcomings. It may not accurately gauge the effectiveness of the financial sector in ameliorating informational asymmetries and easing transactions costs. Also, LIQUID LIABILITIES includes deposits by one financial intermediary in another, which may involve “double counting.” Under the assumption that the size of the financial intermediary sector is positively correlated with the provision and quality of financial services, many researchers use this measure of financial depth (Goldsmith, 1969; King and Levine, 1993a; McKinnon, 1973). Thus, we include it as one measure of financial intermediary development.

COMMERCIAL-CENTRAL BANK equals the ratio of commercial bank assets divided by commercial bank plus central bank assets. COMMERCIAL-CENTRAL BANK measures the degree to which commercial banks versus the central bank allocate society’s savings. Again, this measure of financial intermediary development does not directly measure the effectiveness of banks in researching firms, exerting corporate control, mobilizing savings, easing transactions, and providing risk management facilities to clients. Thus, COMMERCIAL-CENTRAL

6. One way this paper improves upon past measures of financial intermediary development is by accurately deflating nominal measures of financial intermediary liabilities and assets. Specifically, while financial intermediary balance sheet items are measured at the end of the year, GDP is measured over the year. Some authors try to correct for this problem by using an average of financial intermediary balance sheet items in year t and $t - 1$ and dividing by GDP measured in year t (King and Levine, 1993a). This however does not fully resolve the distortion, especially in highly inflationary environments. This paper deflates end-of-year financial balance sheet items by end-of-year consumer price indices (CPI) and deflates the GDP series by the annual CPI. Then, we compute the average of the real financial balance sheet item in year t and $t - 1$ and divide this average by real GDP measured in year t . This is described more fully in appendix table A2. Although we have attempted to be as careful as possible in constructing the data, measurement errors undoubtedly remain. We could not identify any reasons to believe, however, that this would systematically influence this paper’s findings since we control for a variety of factors—including the level of economic development—and use instrumental variable procedures.

BANK is not a direct measure of the quality and quantity of financial services provided by financial intermediaries. The intuition underlying this measure is that banks are more likely to identify profitable investments, monitor managers, facilitate risk management, and mobilize savings than central banks. Thus, King and Levine (1993a, b) recommend including COMMERCIAL-CENTRAL BANK as an additional measure of financial intermediary development.

PRIVATE CREDIT equals the value of credits by financial intermediaries to the private sector divided by GDP. This measure of financial development is more than a simple measure of financial sector size. PRIVATE CREDIT isolates credit issued to the private sector, as opposed to credit issued to governments, government agencies, and public enterprises. Furthermore, it excludes credits issued by the central bank and development banks. PRIVATE CREDIT is our preferred indicator because it improves on other measures of financial development used in the literature. For example, King and Levine (1993a,b) use a measure of gross claims on the private sector divided by GDP. But this measure includes credits issued by the monetary authority and government agencies, whereas PRIVATE CREDIT includes only credits issued by banks and other financial intermediaries. Also, Levine and Zervos (1998) and Levine (1998) use a measure of deposit money bank credits to the private sector divided by GDP over the period 1976-93.⁷ That measure, however, does not include credits to the private sector by non-deposit money banks and it only covers the period 1976-93. PRIVATE CREDIT is a broader measure of credit issuing financial intermediation and its time dimension is twice as long, 1960-95. We should also emphasize here that these financial intermediary measures are not simply

7. Levine and Zervos (1998) also examine whether equity markets substitute for credit issuing intermediaries. They find that the answer is no. Measures of banking sector development and stock market development both enter significantly when included together in simple cross-country growth regressions. Evidently, banks provide different financial services from those provided by securities markets. Specifically, theory suggests that securities markets are particularly good at augmenting liquidity and allowing agents to custom design risk management tools. Theory suggests that intermediaries have a comparative advantage in reducing informational asymmetries. This paper is very different from Levine and Zervos (1998) because we are trying to control formally for simultaneity and omitted variable biases, which they do not do. To do this, we rely on the GMM dynamic panel procedures and use the pure cross-sectional estimator to confirm our results. Unfortunately, there do not exist securities market data over a sufficiently long period and across a sufficiently large number of countries to conduct our analyses with securities market data from Levine and Zervos (1998).

picking up the relative importance of state-owned enterprises and the overall level of nationalization. In the analysis below, we control for the role of state-owned enterprises and this does not affect the conclusions. While PRIVATE CREDIT does not directly measure the amelioration of information and transaction costs, we interpret higher levels of PRIVATE CREDIT as indicating higher levels of financial services and therefore greater financial intermediary development.

Table 1 provides summary statistics on the financial intermediary development indicators. The data are listed country-by-country in appendix table A3. (Summary statistics and correlations with other variables used in this paper are provided in tables A4 and A5.) There is considerable variation across countries. For example, PRIVATE CREDIT is less than 10 percent of GDP in Zaire, Sierra Leone, Ghana, Haiti, and Syria. PRIVATE CREDIT, however, is greater than 85 percent of GDP in Switzerland, Japan, the United States, Sweden, and the Netherlands. Real per capita GDP growth also exhibits considerable cross-country variation. For instance, Korea, Malta, Taiwan, and Cyprus all enjoyed growth rates greater than 5 percent per annum over the 35 year period, while Zaire, Niger, Ghana, Venezuela, Haiti, and El Salvador all suffered growth rates of less than *negative* 0.5 percent per year from 1960 to 1995. Thus, the dataset offers rich cross-country variation for exploring the link between growth and financial intermediary development.

The positive relationship between income per capita and financial development is illustrated in figure 1. Figure 1 shows that all three financial intermediary development indicators tend to increase as we move from low- to high-income countries. Since conditional

Table 1. Summary Statistics on Financial Intermediary Development, 1960-95

<i>Statistic</i>	<i>LIQUID LIABILITIES^a</i>	<i>COMMERCIAL- CENTRAL BANK^b</i>	<i>PRIVATE CREDIT^c</i>
Mean	43.44	78.16	38.29
Median	37.48	83.89	27.01
Maximum	143.43	98.99	141.30
Minimum	9.73	23.72	4.08
Standard deviation	25.61	18.26	28.71
No. of observations	71	71	71

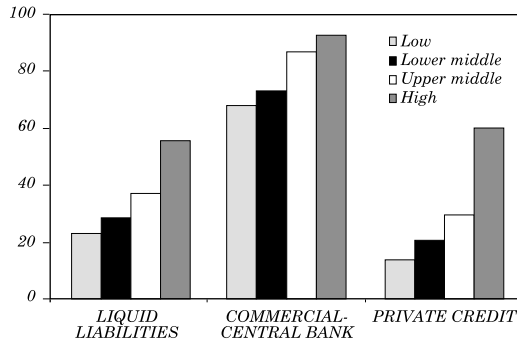
Source: Authors' calculations.

a. Liquid liabilities of the financial system (currency plus demand and interest-bearing liabilities of banks and nonbank financial intermediaries) divided by GDP, times 100.

b. Assets of deposit money banks divided by assets of deposit money banks plus central bank assets, times 100.

c. Credit by deposit money banks and other financial institutions to the private sector divided by GDP, times 100.

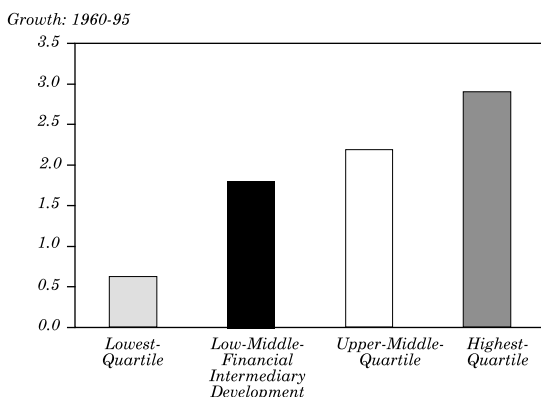
Figure 1. Financial Development across Income Groups, 1960-95



convergence is a feature of cross-country data sets over the post-1960 period (Barro and Sala-i-Martin, 1995), the positive correlation between income per capita and financial development may then suggest a relationship between financial development and economic growth. Indeed, four out of the five countries with the highest level of PRIVATE CREDIT have slower than average growth rates (Japan is the lone exception). In any case, these summary statistics highlight the importance of controlling for the level of real per capita GDP—as well as a host of other economic and political factors—in assessing the independent relationship between financial intermediary development and economic growth.

Figure 2 illustrates that countries with higher levels of PRIVATE CREDIT tend to enjoy faster growth rates over the 1960-95 period than countries with lower levels of financial intermediary development. Indeed, of the ten fastest growing countries over this 35-year period, all of them had larger-than-average values of PRIVATE CREDIT. Many well-known “Asian Miracles,” such as Malaysia, Thailand, Japan, Taiwan, and Korea, were in the top quartile of countries as ranked by financial intermediary development. It is worth noting that four European countries (Greece, Ireland, Portugal, and Cyprus) were also among the ten fastest growing countries during this sample period. Each of these countries also had comparatively well-developed financial systems. Certainly, many factors may account for these economic success stories. At the other end of the spectrum, seven of the ten countries with negative growth rates over the 35-year period were in the lowest quartile of countries as defined by financial intermediary development (Zaire, Niger, Ghana, Haiti, Liberia, Sierra Leone, and Guyana). The banking systems of these

Figure 2. Economic Growth and Financial Intermediary Development, 1960-95



countries have been in disarray for much of the last 35 years (see, for example, Gelbard and Leite 1999, Mehran 1998, Sheng 1996, and Caprio, Atiyas and Hanson 1994 for discussions of the individual countries). Government ownership of banks, massive official intervention in credit allocation, high levels of nonperforming loans, controls on interest rates, and numerous restrictions impede the ability of the financial systems in these countries from mobilizing and allocating capital efficiently.⁸ But these countries suffer many other economic policy and political maladies. Thus, we now turn to regression analyses where we control for an array of factors associated with economic growth (including country-specific factors) and also confront potential biases induced by simultaneity.

1.2 Legal Origin

To confront the issue of simultaneity, we identify instrumental variables for financial intermediary development. Here, we follow LLSV (1998) in looking to legal origin. Comparative legal scholars place countries into four major legal families—English, French, German, or Scandinavian—that descended from Roman law (Reynolds

8. Some countries have effectively improved their financial systems through a range of financial reforms, e.g., Ghana, as documented in Gelbard and Leite (1999). Thus, it is important to exploit the time-series dimension of the data. We do this below.

and Flores, 1996). As described by Glendon, Gordon, and Osakwe (1982), Roman law was compiled under the direction of the Byzantine Emperor Justinian in the sixth century. Over subsequent centuries, the Glossators and Commentators interpreted, adapted, and amended the Law (Berman, 1997). In the 17th and 18th centuries the Scandinavian countries formalized their own legal codes. The Scandinavian legal systems have remained relatively unaffected from the far reaching influences of the German and especially the French Civil Codes.

Napoleon directed the writing of the French Civil Code in 1804. He made it a priority to secure the adoption of the Code in France and all conquered territories, including Italy, Poland, the Low Countries, and the Habsburg Empire. Also, France extended her legal influence to parts of the Near East, Northern and Sub-Saharan Africa, Indochina, Oceania, French Guyana, and the French Caribbean islands during the colonial era. Furthermore, the French Civil Code was a major influence on the Portuguese and Spanish legal systems, which helped spread the French legal tradition to Central and South America.

The German Civil Code (*Bürgerliches Gesetzbuch*) was completed almost a century later in 1896. The German Code exerted a big influence on Austria and Switzerland, as well as China (and hence Taiwan), Czechoslovakia, Greece, Hungary, Italy, and Yugoslavia. Also, the German Civil Code heavily influenced the Japanese Civil Code, which helped spread the German legal tradition to Korea. Unlike these Civil Law countries, the English legal system is common law, where the laws were primarily formed by judges trying to resolve particular cases.

This paper takes national legal origin as an exogenous “endowment” since the English, French, and German systems were spread primarily through conquest and imperialism. It is critical to recognize, however, that exogeneity is not a sufficient condition for economically meaningful instrumental variables. It must also be the case that there are good reasons for believing that legal origin is closely connected to factors that directly affect the behavior of financial intermediaries. LLSV (1998) trace differences in legal origin through to differences in the legal rules covering secured creditors, the efficiency of contract enforcement, and the quality of accounting standards. Thus, legal origin is connected to legal and regulatory characteristics defining financial intermediary activities.

Table 2 presents regressions of the financial intermediary development indicators on the dummy variables for English, French, and German legal origin, relative to Scandinavian origin (which is captured in the constant). We extend the LLSV (1998) data set from 44 countries (with financial intermediary data) to 71 using Reynolds and Flores (1996). The data are listed in appendix table A3. Some of the regressions also control for the level of real per capita GDP. The major message is that countries with a German legal origin have better developed financial intermediaries. While countries with a French legal tradition tend to have less well-developed institutions than other countries on average, this result does not hold when controlling for the overall level of economic development. Also, as indicated by the p values of the F test, the legal origin variables explain a significant fraction of the cross-country variation of the financial intermediary development indicators.

Table 2. Legal Origin and Financial Intermediary Development, 1960-95^a

<i>Legal Origin</i>	<i>LIQUID LIABILITIES^b</i>		<i>COMMERCIAL-CENTRALBANK^c</i>		<i>PRIVATE CREDIT^d</i>	
	(1)	(2)	(3)	(4)	(5)	(6)
Constant	3.829 (0.000)	0.958 (0.081)	4.506 (0.000)	3.063 (0.000)	4.027 (0.000)	-0.674 (0.386)
ENGLISH	-0.134 (0.325)	0.249 (0.038)	-0.170 (0.002)	0.022 (0.716)	-0.717 (0.002)	-0.090 (0.646)
FRENCH	-0.434 (0.001)	-0.052 (0.703)	-0.270 (0.000)	-0.078 (0.152)	-0.894 (0.000)	-0.268 (0.190)
GERMAN	0.477 (0.016)	0.683 (0.000)	0.048 (0.100)	0.152 (0.010)	0.401 (0.076)	0.738 (0.002)
INCOME ^e	...	0.330 (0.000)	...	0.166 (0.000)	...	0.541 (0.000)
<i>Summary statistic</i>						
P value (F statistic)	0.001	0.000	0.040	0.000	0.000	0.000
R^2	0.23	0.44	0.12	0.30	0.26	0.55
No. of observations	71	71	71	71	71	71

Source: Authors' calculations.

a. Scandinavian legal origin is the omitted category. Values for the financial intermediary development indicators are averages over the 1960-95 period. Numbers in parentheses are p values.

b. Liquid liabilities of the financial system (currency plus demand and interest-bearing liabilities of banks and nonbank financial intermediaries) divided by GDP, times 100.

c. Assets of deposit money banks divided by assets of deposit money banks plus central bank assets, times 100.

d. Credit by deposit money banks and other financial institutions to the private sector divided by GDP, times 100.

e. Logarithm of real GDP per capita in 1960.

1.3 Legal Origin and Growth in a Pure Cross-Section of Countries

Cross-sectional estimator. The pure cross-sectional analysis uses data averaged over 1960-95, such that there is one observation per country. The basic regression takes the form:

$$GROWTH_i = \alpha + \beta FINANCE_i + \gamma' (CONDITIONING SET)_i + \varepsilon_i,$$

where the dependent variable, GROWTH, equals real per capita GDP growth, FINANCE equals either LIQUID LIABILITIES, COMMERCIAL-CENTRAL BANK, or PRIVATE CREDIT, and CONDITIONING SET represents a vector of conditioning information that controls for other factors associated with economic growth.⁹

To examine whether cross-country variations in the exogenous component of financial intermediary development explain cross-country variations in the rate of economic growth, the legal origin indicators are used as instrumental variables for FINANCE. Our method of estimation is the generalized method of moments (GMM).¹⁰ In estimation we have only used *linear* moment conditions, which amount to the requirement that the instrumental variables (Z) be uncorrelated with the error term (ε). The economic meaning of these conditions is that the instrumental variables can only affect the dependent variable through the explanatory variables, that is, they cannot have an independent effect on the dependent variable. In the context of the cross-sectional growth regressions, the moment conditions mean that *legal origin* may affect per capita GDP growth only through the financial development indicators *and* the variables in the conditioning information set (that is, the other determinants of growth). We test this condition.

Testing the validity of the moment conditions is crucial to ascertaining the consistency of GMM estimates. The specification test we use is the test of overidentifying restrictions introduced in the context of GMM by Hansen (1982) and further explained in Newey and

9. Due to the potential nonlinear relationship between economic growth and the assortment of economic indicators, we use natural logarithms of the regressors.

10. Two-stage instrumental variable procedures produce the same conclusions.

West (1987).¹¹ If the regression specification “passes” the test, then we can safely draw conclusions taking the moment conditions as given. That is, we cannot reject the statistical and economic significance of the estimated coefficient on financial intermediary development as indicating an effect running from financial development to per capita GDP growth. We can safely discard the possibility that the relationship between financial intermediary development and growth is due to simultaneity bias or to omitted variables linked to *legal origin*.

Conditioning information set. To examine the sensitivity of the results, we experiment with different conditioning information sets. We seek to reduce the chances that the cross-country growth regression either omits an important variable or includes a select group of regressors that yields a favored result. We report the results with three conditioning information sets. The *simple conditioning information set* includes the constant, the logarithm of initial per capita GDP and initial level of educational attainment. The initial income variable is used to capture the convergence effect and school attainment is used to control for the level of human capital. The *policy conditioning information set* includes the simple conditioning information set plus measures of government size, inflation, the black market exchange rate premium, and openness to international trade.¹² The *full conditioning information set* includes the policy conditioning information set plus measures of political stability (the number of revolutions and coups and the number of assassinations per thousand inhabitants; Banks, 1994) and ethnic diversity (Easterly and Levine, 1997). Thus, for each of the three financial

11. Intuitively, the fact that we have more moment conditions (instruments) than parameters to be estimated means that estimation could be done with fewer conditions. We can use this fact to estimate the error term under a set of moment conditions that excludes one instrumental variable at a time; we can then analyze if each estimated error term is uncorrelated with the instrumental variable excluded in the corresponding instrument set. The null hypothesis of Hansen’s test is that the overidentifying restrictions are valid, that is, the instrumental variables are not correlated with the error term. The test statistic is simply the sample size times the value attained for the objective function at the GMM estimate (called the *J statistic*). Hansen’s test statistic is distributed as χ^2 with degrees of freedom equal to the number of moment conditions minus the number of parameters to be estimated. We report this statistic in the tables.

12. The black market exchange rate premium is frequently used as an overall index of trade, exchange rate, and price distortions (Easterly, 1994; Levine and Zervos, 1998). The inflation rate and size of the government serve as indicators of macroeconomic stability (Easterly and Rebelo, 1993; Fischer, 1993).

intermediary development indicators, we present regression results for the (i) simple, (ii) policy, and (iii) full conditioning information sets.

Regression results. The results indicate a very strong connection between the exogenous component of financial intermediary development and long-run economic growth. Table 3 summarizes the purely cross-sectional instrumental variable results for nine regressions, where the instrumental variables are the legal origin variables. For brevity, we report only the coefficients on the financial development indicators. Each of the three financial intermediary development indicators (PRIVATE CREDIT, COMMERCIAL-CENTRAL BANK, LIQUID LIABILITIES) is significantly correlated with economic growth at the 5 percent significance level in the simple, policy, and full conditioning information set regressions. The exogenous component of financial intermediary development is closely tied to long-run rates of per capita GDP growth. Furthermore, the data do not reject the orthogonality conditions at the 10 percent level in any of the nine regressions. The inability to reject the orthogonality conditions plus the result that the instruments are highly correlated with financial intermediary development (table 2)

Table 3. Financial Intermediation and Growth: Cross-Sectional Regressions, 1960-95^a

<i>Explanatory variable</i>	<i>Coefficient</i>	<i>Standard error</i>	<i>t statistic</i>	<i>p value</i>	<i>No. of observations</i>	<i>J statistic</i>	<i>Hansen test^e</i>
<i>Regression set 1: simple conditioning information set^b</i>							
PRIVATE CREDIT	2.515	0.814	3.090	0.003	71	0.001890	0.13
COMMERCIAL-CENTRAL BANK	10.861	3.086	3.520	0.001	71	0.016261	1.15
LIQUID LIABILITIES	1.723	0.844	2.041	0.045	71	0.034906	2.48
<i>Regression set 2: policy conditioning information set^c</i>							
PRIVATE CREDIT	3.222	1.245	2.589	0.012	63	0.007993	0.50
COMMERCIAL-CENTRAL BANK	9.641	4.039	2.387	0.021	63	0.037304	2.35
LIQUID LIABILITIES	2.173	0.908	2.394	0.020	63	0.037989	2.39
<i>Regression set 3: full conditioning information set^d</i>							
PRIVATE CREDIT	3.356	1.150	2.918	0.005	63	0.022386	1.41
COMMERCIAL-CENTRAL BANK	11.289	3.258	3.465	0.001	63	0.003253	0.20
LIQUID LIABILITIES	2.788	0.903	3.089	0.003	63	0.039013	2.46

Source: Authors' calculations.

a. Explanatory variables are defined in the notes to table 2.

b. Logarithm of initial income per capita and schooling.

c. Simple set plus government size, inflation, black market premium, and openness to trade.

d. Policy set, plus indicators of revolutions and coups, political assassinations, and ethnic diversity.

e. Hansen test of overidentifying restrictions; critical values (2 d.f.) are 10 percent, 4.61, and 5 percent, 5.99.

suggest that the instruments are appropriate. These results indicate that the strong link between financial development and growth is not due to simultaneity bias. The estimated coefficient can be interpreted as the effect of the exogenous component of financial intermediary development on growth.

The regression results also indicate an economically large impact of financial development on growth. For example, India's value of PRIVATE CREDIT over the 1960-95 period was 19.5 percent of GDP, while the mean value for developing countries was 25 percent of GDP. The results suggest that an exogenous improvement in PRIVATE CREDIT in India that had pushed it to the sample mean for developing countries would have accelerated real per capita GDP growth by an additional 0.6 of a percentage point per year.¹³ Similarly, if Argentina had moved from its value of PRIVATE CREDIT (16) to the developing country sample mean, it would have grown more than 1 percentage point faster per year. This is large considering that growth only averaged about 1.8 percent per year over this period. These types of conceptual experiments, however, must be treated as illustrative only; they do not account for *how to increase financial intermediary development*.

1.4 Sensitivity Analyses

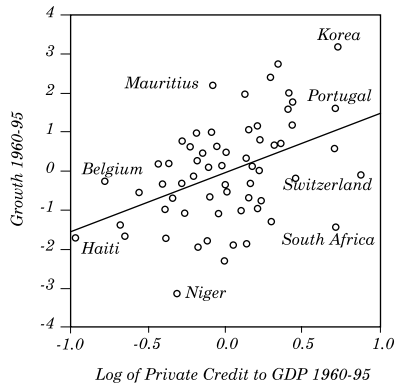
We have conducted a wide array of sensitivity analyses to gauge the robustness of these findings.¹⁴ First, consider the partial scatter plot of the growth regressions involving PRIVATE CREDIT.¹⁵

Figure 3 illustrates the relationship between growth and financial intermediary development after controlling for the full conditioning information set. Since Korea, South Africa, and Niger fall

13. To get this, recall that the regressors are in logs and note that $\ln(25) - \ln(19.5) = 0.25$. Then, use the smallest parameter on PRIVATE CREDIT from table 3, which equals 2.5, so that $2.5 \times (0.25) = 0.63$.

14. These sensitivity results are available on request.

15. The partial scatter plot involves the two-dimensional representation of the relationship between growth and PRIVATE CREDIT controlling for the other regressors. Thus, we regress real per capita GDP growth against the full conditioning information set and collect these growth residuals. Then, we regress PRIVATE CREDIT against the full conditioning information set and collect these PRIVATE CREDIT residuals. The figures in the text plot the growth residuals against the PRIVATE CREDIT residuals along with the regression line. Thus, this regression line is the two-dimensional projection in growth – PRIVATE CREDIT space of the multivariate OLS regression.

Figure 3. Partial Scatter Plot of Growth vs Private Credit

particularly far from the regression line, we removed these countries and redid the estimation. The new GMM results are not substantially different from the table 3 results.¹⁶ To further check for the potential influence of outliers, we examined the residuals from the GMM estimator. We removed all countries with residuals more than three standard deviations away from zero (South Africa and Switzerland) and reran the regressions. This did not alter the results. Then, we removed seven additional countries with residuals more than two standard deviations away from zero (Belgium, El Salvador, Guyana, Jamaica, Mauritius, Niger, and Senegal). This did not change the conclusions either.¹⁷ We followed the same procedures in checking for the effect of outliers for COMMERCIAL-CENTRAL BANK and LIQUID LIABILITIES. In no case did removing outliers

16. Specifically, PRIVATE CREDIT enters with a coefficient of 2.98 and a t statistic of 2.10 and the regression passes all the diagnostic tests discussed above. Furthermore, removing Switzerland, Japan, and Portugal in addition to Niger, South Africa, and Korea did not alter the conclusion either, that is, PRIVATE CREDIT enters with a coefficient of 4.27 and a t statistic of 2.64.

17. Specifically, when we remove South Africa and Switzerland the coefficient on PRIVATE CREDIT rises to 4.72 and the t statistics equals 3.65 while the GMM estimate satisfies the litany of diagnostic tests. Similarly, when the seven additional countries are removed, PRIVATE CREDIT enters with a value of 4.53 and a t statistic of 3.91, while passing the diagnostic tests.

alter the results.¹⁸ The strong positive connection between the exogenous component of financial intermediary development and economic growth does not seem to be driven by outliers.

Second, in assessing the independent link between financial development and economic growth, we considered a broad collection of additional control variables. We included measures of the efficiency of the bureaucracy, the level of corruption, the role of the state owned enterprises in the economy, an index of the strength of property rights, an index of the costs of business regulation, a measure of the risk of expropriation, a measure of the degree to which the country follows the rule of law, and a measure of the accounting standards employed in the country (Knack and Keefer, 1995; Mauro, 1995; LLSV, 1998, 1999). These did not alter our findings.

Third, we considered as instrumental variables measures of the religious composition of each country and the distance of the country from the equator, which have been used in a recent study of the quality of government by LLSV (1999). This did not alter our results. Furthermore, if we use the LLSV (1998) indicators of creditor rights, contract enforcement efficiency, and accounting standards as instrumental variables, we again find that the exogenous component of financial development is positively associated with faster economic growth. These alternative instrumental variable estimations pass the test of the overidentifying restrictions, which implies that these variables, measuring the quality of the legal and accounting environment, affect growth through financial development and the other regressors.¹⁹

18. For the COMMERCIAL-CENTRAL BANK regressions, Haiti's level of financial development is much less than predicted by its country characteristics. Nonetheless, removing Haiti increases the estimated coefficient on COMMERCIAL-CENTRAL BANK to 13.4 (with a t statistic of 3.35). Moreover, when removing other potential outliers such as Korea, Niger, and Peru, the results are unchanged (coefficient estimate of 9.6 on COMMERCIAL-CENTRAL BANK and a t statistic of 2.44). When examining the GMM residuals, Niger, Honduras, Jamaica, Korea, Mauritius, Pakistan, Senegal, and Taiwan are more than two standard deviations from zero. Removing these countries produces an estimated coefficient of 7.71 on COMMERCIAL-CENTRAL BANK, with a t statistic of 2.92, and the regression passes the battery of diagnostic tests discussed in the text. In terms of LIQUID LIABILITIES, the robustness checks produce similar results. The partial scatter plots point to Niger and Korea as potential outliers. Removing these countries does not affect the results (the estimated coefficient becomes 2.24 with a t statistic of 2.71). Similarly, when using the GMM residual criteria, Korea, Jamaica, Switzerland, Taiwan, and Zaire fall more than two standard deviations away from zero. Removing these countries produces a coefficient estimate of 2.63 on LIQUID LIABILITIES, with a t statistic of 4.24, and a regression that passes the various diagnostic tests used in this paper.

19. This result is consistent with the fact that *legal origin* is a proper instrument for financial development in a growth regression, insofar as the judicial and accounting environment depends on *legal origin*.

Fourth, as in King and Levine (1993a), we use the measures of financial intermediary development at the beginning of the period (1960) to forecast growth. We find that financial intermediary development in 1960 significantly predicts economic growth over the next 35 years after controlling for an array of country characteristics.²⁰ We have also restricted the sample to those countries for which LLSV (1998) collect legal data. This did not alter the results. Furthermore, we conduct the estimation over the 1980-95 period. We find the same results: the exogenous component of financial development is positively, significantly, and robustly linked with economic growth.

Fifth, we experimented with two additional measures of financial intermediary development. One measure equals deposit money bank credit to the private sector divided by GDP. This is smaller than PRIVATE CREDIT, which also includes other financial intermediaries. The second additional measure equals the ratio of deposit money bank domestic assets to GDP (and so does not distinguish between credits issued to the private sector and those issued to the public sector). These two additional measures also suggest that the exogenous part of financial intermediary development is positively and robustly associated with economic growth.

2. FINANCE AND GROWTH: PANEL PROCEDURES

2.1 GMM Estimators for Dynamic Panel Models

Motivation. Estimation using panel data, that is pooled cross-section and time-series data, has several advantages over purely cross-sectional estimation. First, besides considering the cross-country relationship between financial development and growth, we also

20. While we make the results on the relationship between growth over the 1960-95 period and financial intermediary development measured in 1960 available to readers, there are econometric reasons for using values of the financial development indicators averaged over the entire sample period as we do in the body of the paper. First, the specification tests support the validity of the instruments. This supports the interpretation of the estimated coefficients as being free from endogeneity bias. Second, the instrumental variables procedures address the issue of endogeneity. Thus, there is no reason to discard the informational gain provided by using observations over the entire sample period. Theory stresses the potential connection between growth and the contemporaneous provision of financial services. Third, by using initial values of the explanatory variables, there is not only an efficiency (informational) loss but also a potential consistency loss. Theory suggests that what matters for current growth is the contemporaneous behavior of the explanatory variables. By using initial values, we run the risk of grossly mismeasuring the “true” explanatory variables, which could bias the coefficient estimates.

would like to take into account how financial development over time within a country may have an effect on the country's growth performance. Working with a panel, we gain degrees of freedom by adding the variability of the time-series dimension. Specifically, the within-country standard deviation of PRIVATE CREDIT in our panel data set is 15 percent, which in the panel estimation is added to the between-country standard deviation of 28 percent. Similarly, the within-country standard deviation for growth is 2.4 percent and the between-country standard deviation is 1.7 percent. Thus, adding the time-series dimension of the data substantially augments the variability of the data.

Second, in a pure cross-sectional regression, any unobserved country-specific effect would be part of the error term, potentially leading to biased coefficient estimates. This problem plagues previous studies of the growth-finance relationship. However, in a panel context, we are able to control for unobserved country-specific effects and thereby reduce biases in the estimated coefficients.

Third, our panel estimator controls for the potential endogeneity of all explanatory variables, while the cross-sectional estimator presented previously only controls for the endogeneity of financial development. The way our panel estimator controls for endogeneity is by using "internal instruments," that is, instruments based on lagged values of the explanatory variables. This method does not allow us to control for full endogeneity but for a weak type of it. To be precise, we assume that the explanatory variables are only "weakly exogenous," which means that they can be affected by current and past realizations of the growth rate but must be uncorrelated with future realizations of the error term. Thus, the weak exogeneity assumption implies that future *innovations* of the growth rate do not affect current financial development. This assumption is not particularly stringent conceptually and we can examine its validity statistically. Weak exogeneity does not mean that economic agents do not take into account expected future growth in their decision to develop the financial system; it just means that future (unanticipated) shocks to growth do not influence current financial development. It is the *innovation* in growth that must not affect financial development. Finally, we statistically assess the validity of the weak exogeneity assumption below.

Methodology. We use the GMM estimators developed for dynamic models of panel data that were introduced by Holtz-Eakin, Newey, and Rosen (1990), Arellano and Bond (1991), and Arellano and Bover (1995). Our panel consists of data for 74 countries over the period

1961-95. We average data over non-overlapping, five-year periods, so that, data permitting, there are seven observations per country (1961-65; 1966-70; 1971-75; etc.). Thus, the subscript “ t ” designates one of these five-year averages. Consider the following regression equation:

$$y_{i,t} - y_{i,t-1} = (\alpha - 1)y_{i,t-1} + \beta' X_{i,t} + \eta_i + \varepsilon_{i,t}, \quad (1)$$

where y is the logarithm of real per capita GDP, X represents the set of explanatory variables (other than lagged per capita GDP), η is an unobserved country-specific effect, ε is the error term, and the subscripts i and t represent country and time period, respectively.²¹ We can rewrite equation (1):

$$y_{i,t} = \alpha y_{i,t-1} + \beta' X_{i,t} + \eta_i + \varepsilon_{i,t}. \quad (2)$$

Now, to eliminate the country-specific effect, take first-differences of equation (2):

$$y_{i,t} - y_{i,t-1} = \alpha (y_{i,t-1} - y_{i,t-2}) + \beta' (X_{i,t} - X_{i,t-1}) + (\varepsilon_{i,t} - \varepsilon_{i,t-1}). \quad (3)$$

The use of instruments is required to deal with (1) the likely endogeneity of the explanatory variables and (2) the problem that by construction the new error term, $\varepsilon_{i,t} - \varepsilon_{i,t-1}$ is correlated with the lagged dependent variable, $y_{i,t-1} - y_{i,t-2}$. Under the assumptions that (a) the error term, ε , is not serially correlated, and (b) the explanatory variables, X , are weakly exogenous (i.e., the explanatory variables are assumed to be uncorrelated with future realizations of the error term), the GMM dynamic panel estimator uses the following moment conditions:

$$E \left[y_{i,t-s} \times (\varepsilon_{i,t} - \varepsilon_{i,t-1}) \right] = 0 \quad \text{for } s \geq 2; \quad t = 3, \dots, T. \quad (4)$$

$$E \left[X_{i,t-s} \times (\varepsilon_{i,t} - \varepsilon_{i,t-1}) \right] = 0 \quad \text{for } s \geq 2; \quad t = 3, \dots, T. \quad (5)$$

We refer to the GMM estimator based on these conditions as the *difference* estimator.

21. We also include time dummies to account for time-specific effects.

There are, however, conceptual and statistical shortcomings with this difference estimator. Conceptually, we would also like to study the cross-country relationship between financial development and per capita GDP growth, which is eliminated in the *difference* estimator. Statistically, Alonso-Borrego and Arellano (1996) and Blundell and Bond (1997) show that when the explanatory variables are persistent over time, lagged levels of these variables are weak instruments for the regression equation in differences. Instrument weakness influences the asymptotic and small-sample performance of the difference estimator. Asymptotically, the variance of the coefficients rises. In small samples, Monte Carlo experiments show that the weakness of the instruments can produce biased coefficients.²²

To reduce the potential biases and imprecision associated with the usual difference estimator, we use a new estimator that combines in a *system* the regression in differences with the regression in levels (Arellano and Bover, 1995; Blundell and Bond, 1997). The instruments for the regression in differences are the same as above. The instruments for the regression in levels are the lagged *differences* of the corresponding variables. These are appropriate instruments under the following additional assumption: although there may be correlation between the levels of the right-hand side variables and the country-specific effect in equation (2), there is no correlation between the *differences* of these variables and the country-specific effect. This assumption results from the following stationarity property,

$$E [y_{i,t+p} \times \eta_i] = E [y_{i,t+q} \times \eta_i] \quad \text{and} \tag{6}$$

$$E [X_{i,t+p} \times \eta_i] = E [X_{i,t+q} \times \eta_i] \quad \text{for all } p \text{ and } q.$$

22. An additional problem with the simple *difference* estimator relates to measurement error: differencing may exacerbate the bias due to errors in variables by decreasing the signal-to-noise ratio (see Griliches and Hausman, 1986).

The additional moment conditions for the second part of the system (the regression in levels) are:²³

$$E \left[(y_{i,t-s} - y_{i,t-s-1}) \times (\eta_i + \varepsilon_{i,t}) \right] = 0 \quad \text{for } s = 1. \quad (7)$$

$$E \left[(X_{i,t-s} - X_{i,t-s-1}) \times (\eta_i + \varepsilon_{i,t}) \right] = 0 \quad \text{for } s = 1. \quad (8)$$

Thus, we use the moment conditions presented in equations (4), (5), (7), and (8) and employ a GMM procedure to generate consistent and efficient parameter estimates.

Consistency of the GMM estimator depends on the validity of the instruments. To address this issue we consider two specification tests suggested by Arellano and Bond (1991), Arellano and Bover (1995), and Blundell and Bond (1997). The first is a Sargan test of over-identifying restrictions, which tests the overall validity of the instruments by analyzing the sample analog of the moment conditions used in the estimation process. The second test examines the hypothesis that the error term $\varepsilon_{i,t}$ is not serially correlated. In both the difference regression and the system difference-level regression we test whether the differenced error term is second-order serially correlated (by construction, the differenced error term is probably first-order serially correlated even if the original error term is not).²⁴

2.2 Results

The dynamic panel estimates suggest that the exogenous component of financial intermediary development exerts a large, positive impact on economic growth. Table 4 presents the results using the *difference* and *system* estimators described above. We also present the results when the panel estimation is performed purely in *levels* for comparative purposes. In table 4, only the results on the financial

23. Given that lagged levels are used as instruments in the differences specification, only the most recent difference is used as instrument in the levels specification. Using other lagged differences would result in redundant moment conditions. (see Arellano and Bover, 1995).

24. In addition, we used the “difference-Sargan test,” presented in Blundell and Bond (1997), to examine the null hypothesis that the lagged differences of the explanatory variables are uncorrelated with the residuals (which are the additional restrictions imposed in the system estimator with respect to the difference estimator). Giving further support to the system estimator, we could not reject this null hypothesis at usual levels of significance.

Table 4. Financial Intermediation and Growth: Summary of Dynamic Panel Regressions^a

Estimator	Conditioning information set ^c	Explanatory variable ^b			No. of observations
		LIQUID LIABILITIES	COMMERCIAL-CENTRAL BANK	PRIVATE CREDIT	
System estimator	Simple	2.163 (0.001) [0.313]	4.642 (0.001) [0.278]	2.185 (0.001) [0.183]	359
	Policy	2.952 (0.001) [0.713]	2.437 (0.001) [0.626]	1.522 (0.001) [0.581]	359
First differences	Simple	1.135 (0.035) [0.319]	2.007 (0.002) [0.184]	1.699 (0.001) [0.192]	285
	Policy	1.446 (0.249) [0.080]	2.065 (0.010) [0.330]	0.663 (0.001) [0.315]	285
Levels	Simple	1.848 (0.012) [0.472]	4.813 (0.011) [0.445]	1.838 (0.001) [0.345]	359
	Policy	2.958 (0.001) [0.346]	3.267 (0.001) [0.155]	2.073 (0.001) [0.180]	359

Source: Authors' calculations.

a. Numbers in parentheses are p values for the coefficient, and numbers in brackets are p values for the Sargan test.

b. Defined in the notes to table 2.

c. Defined in the notes to table 3.

indicators are given. Table 5 gives the full results from *system* dynamic-panel estimation. The analysis was conducted with two conditioning information sets. The first uses the simple conditioning information set, which includes initial income and educational attainment. The second uses the policy conditioning information set, and includes initial income, educational attainment, government size, openness to trade, inflation, and the black market exchange rate premium.²⁵ Table 5 also presents (1) the Sargan test, where the null hypothesis is that the instrumental variables are uncorrelated with the residuals and (2) the serial correlation test, where the null hypothesis is that the errors in the differenced equation exhibit no second-order serial correlation.

25. We do not use the full conditioning information set with data on political and institutional variables in the panel estimates. These variables frequently have very limited, if any, time dimension.

Table 5. Financial Intermediation and Growth: Dynamic Panel Regressions, System Estimator^a

Regressor	Regression		
	(1)	(2)	(3)
Constant	0.06 (0.954)	-5.677 (0.001)	4.239 (0.001)
Log of initial income per capita	-0.742 (0.001)	-0.117 (0.223)	-0.364 (0.001)
Government size ^b	-1.341 (0.001)	-1.13 (0.001)	-1.987 (0.001)
Openness to trade ^b	0.325 (0.169)	0.497 (0.002)	0.442 (0.010)
Inflation ^c	1.748 (0.001)	-1.772 (0.001)	-0.178 (0.543)
Years of secondary schooling	0.78 (0.001)	0.638 (0.001)	0.639 (0.001)
Black market premium ^c	-2.076 (0.001)	-1.044 (0.001)	-1.027 (0.001)
LIQUID LIABILITIES ^b	2.952 (0.001)	...	...
COMMERCIAL - CENTRAL BANK ^b	...	2.437 (0.001)	...
PRIVATE CREDIT ^b	...	...	1.522 (0.001)
Dummy 1971–75	-1.074 (0.001)	-0.792 (0.001)	-0.959 (0.001)
Dummy 1976–80	-1.298 (0.001)	-0.825 (0.001)	-1.177 (0.001)
Dummy 1981–85	-3.328 (0.001)	-2.616 (0.001)	-3.179 (0.001)
Dummy 1986–90	-2.614 (0.001)	-1.894 (0.001)	-2.434 (0.001)
Dummy 1991–95	-3.631 (0.001)	-2.770 (0.001)	-3.308 (0.001)
<i>Summary statistic</i>			
P value (sargan test) ^d	0.713	0.626	0.581
P value (serial correlation test) ^e	0.588	0.957	0.764

Source: Authors' calculations.

a. P values are in parentheses.

b. Included in the regression as log (variable).

c. Included in the regression as log (1 + variable).

d. The null hypothesis is that the instruments used are not correlated with the residuals.

e. The null hypothesis is that the errors in the first-difference regression exhibit no second-order serial correlation.

The three financial intermediary development indicators (LIQUID LIABILITIES, COMMERCIAL-CENTRAL BANK, and PRIVATE CREDIT) are significant at the 0.05 significance level in the *levels*, *difference*, and *system* dynamic panel growth regressions, with one exception. The coefficient on LIQUID LIABILITIES is insignificant

in the *difference* dynamic panel growth regression with the policy conditioning information set. While this may indicate a somewhat less robust link when using a purely “size” measure of financial intermediary development, LIQUID LIABILITIES enters the levels and system dynamic panel growth regressions significantly in all specifications. Put differently, after controlling for country-specific effects, endogeneity, and potential problems associated with lagged dependent variables and weak instruments, the data suggest a strong, positive link between financial intermediary development and economic growth.

The regressions satisfy the specification tests. There is no evidence of second order serial correlation and the regressions pass the Sargan specification test. It is also worth noting that many of the other regressors enter significantly with the expected signs (table 5).

The regression estimates are also economically large. As shown the coefficients that emerge from the dynamic panel estimation are very close to those that we obtain from the purely cross-section, instrumental variable estimation. For example, PRIVATE CREDIT has a coefficient of 2.5 in the cross-section results (the simple conditioning information set regression in table 3), while PRIVATE CREDIT has a coefficient of 2.2 in the system dynamic-panel results reported in table 4.²⁶ As noted earlier, these coefficients suggest that exogenous changes in financial intermediary development imply large changes in economic growth.

2.3 Sensitivity Analyses and Discussion

The dynamic panel results are also robust to a variety of sensitivity analyses. For instance, when we use alternative measures of financial intermediary development (deposit money bank credit to the private sector divided by GDP; and the ratio of total deposit money bank domestic assets to GDP), we still find a strong of finance on growth. Furthermore, if we control for terms of trade changes and

26. There is some divergence in coefficient estimates between the *system* dynamic panel estimates, table 4, and the cross-sectional instrumental variables regressions, table 3, when the conditioning information set is expanded to include the policy conditioning information set. The cross-section regression produces a coefficient estimate of 3.2 on PRIVATE CREDIT, while the panel yields a coefficient of 1.4. Besides exploiting the time-series dimension of the data, the dynamic-panel also recognizes the endogeneity of the other regressors, which may help account for the different coefficient estimates.

population growth, we obtain virtually identical results to those reported in tables 4 and 5.²⁷ Finally, when we include the legal origin variables as instruments in the dynamic panel estimates, we still find a strong, positive relationship between the exogenous component of financial intermediary development and economic growth.²⁸

3. SEARCHING FOR DETERMINANTS OF FINANCIAL INTERMEDIARY DEVELOPMENT

This section undertakes a limited search of potential legal and accounting determinants of financial intermediary development. We use LLSV's (1998) data. Instead of examining the links between the legal/regulatory environment and measures of bond market and equity market development as in LLSV (1997, 1998), we study the ties between the legal environment and measures of financial intermediary development. Moreover, unlike earlier studies, we use instrumental variables to assess whether the positive association between legal/regulatory indicators and financial development is due to simultaneity bias.

3.1 The Legal and Accounting Environment

We use three LLSV (1998) indicators of national legal and regulatory systems: the legal rights of creditors, the soundness of contract enforcement, and the level of corporate accounting standards.

Creditor rights. The degree to which the legal system supports the rights of creditors will fundamentally influence financial contracting

27. Note that in the *system* dynamic panel regressions with the policy conditioning information set, the number of instrumental variables is larger than the number of cross-sectional observations (i.e., countries). This "over-fitting" of the data can bias the *t* statistics upwards. This arises when the variance-covariance matrix is constructed from the first-stage residuals in order to allow for nonspherical distributions of the error term – and thereby get more efficient estimates in the second stage. However, this "over-fitting" problem does not plague (a) the simple conditioning information set regressions, or (b) the *level* or *difference* estimators because there are many more countries than instruments in these specifications. More generally, the two-step GMM estimator sometimes converges to its asymptotic distribution only slowly. Thus, we also considered the first-stage results, which assume homoskedasticity and independence of the error terms. These first-stage results also indicate that financial intermediary development exerts a causal impact on economic growth.

28. These results are available on request.

and the functioning of financial intermediaries. Specifically, legal systems differ in terms of the rights of creditors to (i) repossess collateral or liquidate firms in the case of default, (ii) remove managers in corporate reorganizations, and (iii) have a high priority relative to other claimants in corporate bankruptcy.

AUTOSTAY equals one if a country's laws impose an automatic stay on the assets of firms upon filing a reorganization petition. AUTOSTAY equals 0 if this restriction does not appear in the nation's legal codes. The restriction would prevent creditors from gaining possession of collateral or liquidating a firm to meet a loan obligation. Thus, all else equal, AUTOSTAY should be negatively correlated with the activities of credit issuing intermediaries.

MANAGES equals one if firm managers continue to administer the firm's affairs pending the resolution of reorganization processes, and zero otherwise. In some countries, management stays in place until a final decision is made about the resolution of claims. In other countries, a team selected by the creditors replaces management. If management stays pending resolution, this reduces pressure on management to pay creditors. Thus, MANAGES should be negatively correlated with the activities of credit issuing intermediaries.²⁹

The third measure of the legal rights of credits is SECURED1, which equals one if secured creditors are ranked first in the distribution of the proceeds that result from the disposition of the assets of a bankrupt firm. SECURED1 equals zero if nonsecured creditors, such as the government or workers, get paid before secured creditors. In cases where SECURED1 equals zero, this certainly reduces the attractiveness of lending secured credit. SECURED1 should be positively correlated with activities of intermediaries engaged in secured transactions, holding everything else constant.

CREDITOR is a cumulative index of these creditor rights indicators and equals $CREDITOR = SECURED1 - AUTOSTAY - MANAGES$.

29. Here it is important to highlight a substantive weakness with AUTOSTAY and MANAGES. They do not measure the efficiency of the legal and regulatory system in coping with bankruptcy. For instance, two countries could have very similar legal codes, such that management stays in place pending the resolution of a bankruptcy hearing and there is an automatic stay on the assets of a firm until the bankruptcy courts process the reorganization petition. However, the two countries' legal and regulatory systems may process bankruptcy and reorganization very differently. One country's system may take a long-time and be subject to great uncertainty. The other may be very rapid, efficient, and transparent. Thus, a major difference across countries may be the quality of the bankruptcy system, not the laws themselves. Currently, there do not exist cross-country measures of the speed, transparency, and fairness of bankruptcy systems.

CREDITOR takes on values between 1 (best) and -2 (worst).³⁰ One would expect countries with higher values of CREDITOR to have stronger creditor rights and better-developed financial intermediaries, all else equal.

Table 6 gives summary statistics on CREDITOR, and the data are listed in appendix table A3. As shown there is substantial cross-country variation in CREDITOR, where the maximum value is 1, the minimum value is -2 , and the standard deviation is about 1. Brazil, Colombia, France, Mexico, Peru, and the Philippines (all countries with a French legal origin) are countries where CREDITOR = -2 , indicating that their legal systems do not stress the rights of creditors. In contrast, the legal codes of Egypt, Hong Kong, India, Indonesia, Israel, Korea, Malaysia, Nigeria, Pakistan, Singapore, Thailand, United Kingdom, and Zimbabwe stress the rights of creditors, such that CREDITOR = 1. CREDITOR is an indicator of legal codes, however, it does not incorporate information regarding enforcement.

Enforcement. The effectiveness of the legal system in enforcing contracts will materially influence financial sector activities. RULELAW, from LLSV (1998), is an assessment of the law and order

Table 6. Summary Statistics on the Legal and Accounting Environment^a

<i>Statistic</i>	<i>CREDITOR^b</i>	<i>ENFORCE^c</i>	<i>ACCOUNT^d</i>
Mean	-0.3	7.5	61.2
Median	0	8.2	64.0
Maximum	1	10.0	83.0
Minimum	-2	3.6	24.0
Standard deviation	1.1	2.0	13.5
No. of observations	44	44	40

Source: Authors' calculations.

a. Values for the legal environment indicators are averages over 1982-95. Values of accounting quality are assessments of company reports in 1990.

b. Index of secured creditor rights.

c. Index of law and contract enforcement.

d. Index of the comprehensiveness and quality of company reports.

30. We could have redefined AUTOSTAY and MANAGES such that values of one indicated stronger (instead of weaker) creditor rights. This would have produced values of CREDITOR between 0 and 3 and would not have altered the results. We did not do this for consistency: the variables in this paper are defined the same as the variables in LLSV (1997, 1998).

tradition of the country that ranges from 10, strong law and order tradition, to 1, weak law and order tradition. This measure was constructed by the *International Country Risk Guide* (ICRG) and is an average over the period 1982-95. Given the contractual nature of banking, higher values of RULELAW are likely to positively influence banking development. CONRISK, also from LLSV (1998), is an assessment of the risk that a government will—and therefore can—modify a contract after it has been signed. CONRISK ranges from 10, low risk of contract modification, to 1, high risk of contract modification. Specifically, “modification” means repudiation, postponement, or reducing the government’s financial obligation. This measure was constructed by ICRG and is an average over the period 1982-95. Legal systems that effectively enforce contracts will tend to support banking activities.

ENFORCE equals the average of RULELAW and CONRISK. The empirical analyses focus on this aggregate index of the efficiency of the legal system in enforcing contracts. Summary statistics on ENFORCE are given in table 6, and the data are listed in appendix table A3. As shown, there is substantial cross-country variation in ENFORCE, where the maximum value is 9.99, the minimum value is 3.55, and the standard deviation is 2.2. The countries with very high values of enforcement, values of ENFORCE greater than 9, are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Japan, Netherlands, New Zealand, Norway, Sweden, and Switzerland. In contrast, countries where contract enforcement is poor, values of ENFORCE less than 5, include Colombia, Nigeria, Pakistan, Philippines, Peru, and Zimbabwe.

Accounting standards. Information about corporations is critical for exerting corporate governance and identifying the best investments. Accounting standards that simplify the interpretability and comparability of information across corporations will simplify financial contracting. Furthermore, financial contracts that use accounting measures to trigger particular actions can only be enforced if accounting measures are sufficiently clear. ACCOUNT, from LLSV (1998), is an index of the comprehensiveness of company reports. The maximum possible value is 90 and the minimum is 0. The Center for International Financial Analysis and Research assessed general accounting information, income statements, balance sheets, funds flow statements, accounting standards, and stock data in company reports in 1990. We expect ACCOUNT to be positively

correlated with financial intermediary development.³¹ As shown in table 6, ACCOUNT exhibits substantial cross-country variation. The data are listed in appendix table A3. The maximum value is 83, Sweden, while the minimum value in our sample is Egypt (24). The United States has a value of 71, which is well above the mean value of 61.

3.2 Determinants of Financial Intermediary Development

Table 7 shows that cross-country differences in creditor rights, enforcement quality, and accounting standards help explain cross-country differences in financial intermediary development, even after controlling for the level of income per capita. Jointly, the variables CREDITOR, ENFORCE, and ACCOUNT explain a significant amount of the cross-country variation in the three financial intermediary indicators (PRIVATE CREDIT, LIQUID LIABILITIES, and COMMERCIAL-CENTRAL BANK). Each of the legal/accounting indicators, however, is not significantly correlated with all of the intermediary measures. For instance LIQUID LIABILITIES is most closely associated with ENFORCE and CREDITOR. In turn, PRIVATE CREDIT is very strongly linked with ENFORCE and ACCOUNT.³²

Simultaneity bias does not seem to be driving these results. As instrumental variables, we use the legal origin dummy variables for

31. This is not necessarily true and raises the need for a general conceptual qualification. An economy with perfect information, perfect contract enforcement and perfect legal codes (i.e., an economy with essentially zero transaction and information costs) would have little reason for financial intermediaries. Put differently, market frictions motivate the emergence of financial intermediaries, e.g., Boyd and Prescott (1986). Conceptually, this implies that at very high levels of legal system development and information dissemination, a marginal increase in legal efficiency or information quality may cause a *reduction* in the role and importance of financial intermediaries. However, quadratic expressions for ACCOUNT and CONRISK never entered significantly.

32. Since CREDITOR, ENFORCE, and ACCOUNT are measured over the 1980s and 1990s, we use financial intermediary measures over the same period. However, we get very similar results when the analysis uses financial intermediary measures over the period 1960-95. These results are available on request.

Table 7. Legal Environment and Financial Intermediary Development, 1980-95^a

<i>Explanatory variable</i>	<i>LIQUID LIABILITIES^b</i>				<i>COMMERCIAL-CENTRAL BANK^b</i>				<i>PRIVATE CREDIT^b</i>			
	<i>OLS</i>	<i>OLS</i>	<i>OLS</i>	<i>IV</i>	<i>OLS</i>	<i>OLS</i>	<i>OLS</i>	<i>IV</i>	<i>OLS</i>	<i>OLS</i>	<i>OLS</i>	<i>IV</i>
Constant	2.830 (0.000)	3.880 (0.002)	4.830 (0.000)	4.402 (0.000)	3.950 (0.000)	3.640 (0.000)	4.200 (0.001)	4.403 (0.000)	1.480 (0.000)	2.557 (0.020)	4.368 (0.001)	4.322 (0.003)
CREDITOR ^c	0.216 (0.001)	0.179 (0.027)	...	...	0.009 (0.641)	0.020 (0.504)	...	...	0.125 (0.033)	0.088 (0.173)	...	...
ENFORCE ^c	0.178 (0.000)	0.229 (0.003)	...	...	0.008 (0.022)	0.014 (0.454)	...	...	0.200 (0.000)	0.253 (0.000)	...	...
ACCOUNT ^c	-0.002 (0.745)	-0.001 (0.866)	...	...	0.005 (0.024)	0.004 (0.042)	...	...	0.017 (0.005)	0.018 (0.002)	...	...
INCOME ^b	...	-0.174 (0.395)	-0.099 (0.387)	-0.05 (0.672)	...	0.052 (0.236)	0.031 (0.325)	0.007 (0.844)	...	-0.179 (0.262)	-0.044 (0.711)	-0.039 (0.804)
LEGAL ^d	...	...	0.412 (0.003)	0.361 (0.009)	...	...	0.091 (0.014)	0.115 (0.002)	...	...	0.606 (0.001)	0.600 (0.001)
<i>Summary statistic</i>												
P value (<i>F</i> test)	(0.000)	(0.000)	(0.000)	(0.003)	(0.000)	(0.001)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
<i>R</i> ²	0.57	0.59	0.39	0.39	0.51	0.52	0.51	0.50	0.68	0.69	0.66	0.66
No. of observations	36	36	36	36	36	36	36	36	36	36	36	36

Source: Authors' calculations.

a. Numbers in parentheses are p values. OLS, ordinary least-squares method; IV, instrumental variables method.

b. Defined in the notes to table 2.

c. Defined in the notes to table 6.

d. Index of the legal environment. Specifically, it is the first standardized principal component of CREDITOR, ENFORCE, and ACCOUNT.

countries with French, English, and German legal origins.³³ Since we only have three instruments, we construct a general index of the legal and regulatory environment. We compute the first standardized principal component of CREDITOR, ENFORCE, and ACCOUNT and use this as the index of the legal/regulatory environment governing financial transactions. We call this index LEGAL. In the simple OLS regression, LEGAL explains a substantial amount of the cross-country variation in *all* of the financial intermediary development indicators, even after controlling for the level of real per capita GDP. When we use an instrumental variables estimator to control for simultaneity bias, the results are unchanged.³⁴ The basic message that emerges from table 7 is that countries with (i) laws that give a high priority to secured creditors, (ii) legal systems that rigorously enforce contracts, and (iii) accounting standards that produce comprehensive and comparable corporate financial statements tend to have better developed financial intermediaries.³⁵

3.3 Discussion of Causes

These findings—in conjunction with those in LLSV (1998)—are *consistent* with the view that countries with particular legal origins tend to create particular types of laws, regulations, and enforcement mechanisms. These laws, regulations, and enforcement mechanisms

33. First, note that the legal origin variables help explain cross-country differences in creditor rights, enforcement quality, and accounting standards. As shown by LLSV (1998), English legal tradition countries have laws that emphasize the rights of creditors to a greater degree than the French, German, and Scandinavian countries. French civil law countries protect creditors the least, with German and Scandinavian civil law countries falling in the middle. In terms of enforcement quality, countries with a French legal heritage have the lowest quality of law enforcement, while countries with German and Scandinavian legal traditions tend to be the best at enforcing contracts. Finally, LLSV (1998) show that countries with an English legal tradition tend to have much better accounting standards than French or German civil law countries.

34. None of these findings changes when the instrumental variable set is expanded to include the LLSV (1999) exogenous variables, i.e., religious composition of the population, ethnic diversity, and distance from the equator. These results are available on request.

35. The evidence we provide suggests that the strong link between financial sector development on the one hand and the legal/regulatory environment on the other is not due to simultaneity bias. These results do not suggest that the legal/regulatory environment only impacts growth through financial intermediary development. Rather, these results imply that the legal/regulatory environment has an important impact on financial intermediary development.

directly influence the functioning of financial intermediaries. Financial intermediaries that are better at ameliorating information and transactions costs induce a more efficient allocation of resources and faster growth.³⁶ While it is difficult to change legal origin, the results offer a strategy for boosting financial development and accelerating long-run growth. Countries can target reforms that ensure that lenders have confidence that the legal system will quickly, transparently, and effectively enforce their claims against borrowers and that outside investors have easy access to high-quality, comprehensive, and comparable information about firms.

4. CONCLUSIONS

This paper first examined the nature of the effect of financial intermediary development on economic growth. We used two econometric approaches. The first, GMM dynamic panel estimators, are specifically designed to deal with key problems plaguing past studies of the finance-growth nexus: simultaneity bias and omitted variable bias, including that derived from unobserved country-specific effects. As a consistency check, we also used a pure cross-sectional, instrumental variable. The panel and cross-sectional results tell the same story: the exogenous component of financial intermediary development is positively associated with economic growth; specifically, the large, positive link between financial intermediary development and economic growth is not due to potential biases induced by omitted variables, simultaneity or reverse causation. In a sequel to this paper, Beck, Levine, and Loayza (1999) examine the channels through which financial intermediary development is associated with growth. In that paper, we argue that the finance-growth nexus runs primarily through total factor productivity growth and not through savings and physical capital accumulation.

36. Put differently, when countries are endowed with a certain legal heritage, this produces a probability distribution regarding the laws, regulations, and enforcement mechanisms that they are likely to adopt. Thus, for example, the data suggest that countries with a French Civil Code have a lower probability of selecting laws that give a higher priority to secured credits, selecting accounting standards that produce high-quality corporate financial statements, and enforcing contracts than countries with English, German, and Scandinavian legal systems. The resultant laws, regulations, and enforcement mechanisms then affect the ability of the financial system to research firms, exert corporate control, mobilize savings, and provide risk management and transactions services.

Next, we investigated whether cross-country differences in the legal rights of creditors, the efficiency of contract enforcement, and accounting system standards help explain cross-country differences in the level of financial intermediary development. The results are clear: countries with (1) laws that give a high priority to secured creditors getting the full present value of their claims against firms, (2) legal systems that rigorously enforce contracts, including government contracts, and (3) accounting standards that produce high-quality, comprehensive and comparable corporate financial statements tend to have better developed financial intermediaries. The paper's findings are consistent with the view that legal and accounting reforms that strengthen creditor rights, contract enforcement, and accounting practices can boost financial intermediary development and thereby accelerate economic growth. Due to data limitations, however, we do not conduct a comprehensive evaluation of the regulatory determinants of financial intermediary development (e.g., see Calomiris, 1989; Kane, 1985, 1989; Barth, Nolle, and Rice, 1997; BIS, 1997; Calomiris and Gorton, 1991; Kroszner and Rajan, 1994; Kroszner and Strahan, 1996; Barth, Caprio, and Levine, 1999). Future work would substantially broaden and deepen our understanding of the determinants of financial intermediary development by obtaining additional measures of the legal, supervisory, and regulatory factors that determine the level of financial intermediary development.

APPENDIX

Table A1. Countries in the Sample

Algeria ^a	Greece	Norway
Argentina	Guatemala	Pakistan
Australia	Guyana ^b	Panama
Austria	Haiti	Papua New Guinea
Bangladesh ^b	Honduras	Paraguay
Barbados ^b	Iceland ^b	Peru
Belgium	India	Philippines
Bolivia	Indonesia ^a	Portugal
Brazil	Iran ^a	Rwanda ^a
Cameroon ^a	Ireland	Senegal
Canada	Israel	Sierra Leone
Central African Republic ^a	Italy	South Africa
Chile	Jamaica	Spain
Colombia	Japan	Sri Lanka
Costa Rica	Kenya	Sudan ^a
Cyprus	Korea	Sweden
Denmark	Lesotho ^a	Switzerland
Dominican Republic	Liberia ^b	Syria
Ecuador	Malawi ^a	Taiwan ^b
Egypt ^a	Malaysia	Thailand
El Salvador	Malta ^b	Togo
Fiji ^b	Mauritius	Trinidad and Tobago
Finland	Mexico	United States
France	Nepal ^b	Uruguay
Gambia ^a	Netherlands	Venezuela
Germany	New Zealand	Zaire
Ghana	Nicaragua ^a	Zimbabwe
Great Britain	Niger	

a. Not in the 71-country pure cross-sectional data set.

b. Not in the 74-country panel data set.

Table A2. Variables and Sources

<i>Variable</i>	<i>Definition</i>	<i>Original source</i>	<i>Secondary source</i>
Level and growth rate of GDP	Real GDP per capita	World Bank, <i>World Development Indicators</i> (Penn World Tables for initial GDP in cross-section regressions)	Loayza and others (1998)
Government size	Government expenditure as share of GDP	World Bank, <i>World Development Indicators</i>	Loayza and others (1998)
Openness to trade	Sum of real exports and imports as share of real GDP	World Bank, <i>World Development Indicators</i>	Loayza and others (1998)
Growth rate of terms of trade	Log difference of the terms of trade, divided by 5	World Bank, <i>World Development Indicators</i>	Loayza and others (1998)
Population growth rate	Log difference of the total population, divided by 5	World Bank, International Economics Department	Loayza and others (1998)
Inflation rate	Log difference of consumer price index (CPI)	International Monetary Fund, <i>International Financial Statistics</i> (IFS), line 64	
Average years of schooling	Average years of schooling in the population over 25	Barro and Lee (1996)	
Average years of secondary schooling	Average years of secondary schooling in the population over 15	Barro and Lee (1996)	
Black market premium	Ratio of black market exchange rate to official exchange rate minus 1	<i>Pick's Currency Yearbook</i> through 1989; <i>World Currency Yearbook</i> thereafter	
LIQUID LIABILITIES	$\{(0.5) * [F(t)/P_e(t) + F(t-1)/P_e(t-1)] / [\text{GDP}(t)/P_a(t)]\}$, where F is liquid liabilities (line 55l), GDP is line 99b, P_e is end-of-period CPI (line 64), and P_a is average annual CPI	IFS	
COMMERCIAL-CENTRAL BANK	$\text{DBA}(t) / [\text{DBA}(t) + \text{CBA}(t)]$, where DBA is assets of deposit money banks (lines 22a-d), and CBA is central bank assets (lines 12 a-d).	IFS	

Table A2. (continued)

<i>Variable</i>	<i>Definition</i>	<i>Original source</i>	<i>Secondary source</i>
PRIVATE CREDIT	$\{(0.5) * [F(t)/P_e(t) + F(t-1)/P_e(t-1)] / [\text{GDP}(t)/P_a(t)]$, where F is credit by deposit money banks and the other financial institutions to the private sector (lines 22d + 42d), GDP is line 99b, P_e is end-of-period CPI (line 64), and P_a is the average CPI for the year.	IFS	
Bank assets	$\{(0.5) * [F(t)/P_e(t) + F(t-1)/P_e(t-1)] / [\text{GDP}(t)/P_a(t)]$, where F is domestic assets of deposit money banks (lines 22a-d), GDP is line 99b, P_e is end-of-period CPI (line 64), and P_a is the average CPI for the year.	IFS	
Bank credit	$\{(0.5) * [F(t)/P_e(t) + F(t-1)/P_e(t-1)] / [\text{GDP}(t)/P_a(t)]$, where F is credit by deposit money banks (line 22d), GDP is line 99b, P_e is end-of-period CPI (line 64), and P_a is the average CPI for the year.	IFS	
Legal origin	Dummy variables for British, French, German, and Scandinavian legal origin	Reynolds and Flores (1996)	LLSV (1998) and own coding
Accounting	Index created by examining and rating companies' 1990 annual reports on their inclusion or omission of 90 items in balance sheets and income statements. The maximum is 90, the minimum 0.	Center for International Financial Analysis & Research, Inc.	LLSV (1998)
RULELAW	Measure of the law and order tradition of a country. It is an average over 1982-95. It ranges from 10 (strong tradition) to 1 (weak tradition).	Political Risk Services, <i>International Country Risk Guide</i> (ICRG).	LLSV (1998)
CONRISK	Measure of the risk that a government will modify a contract after it has been signed. It ranges from 10 (low risk) to 1 (high risk) and is averaged over 1982-95.	ICRG	Knack and Keefer (1995)

Table A2. (continued)

<i>Variable</i>	<i>Definition</i>	<i>Original source</i>	<i>Secondary source</i>
AUTOSTAY, MANAGES, SECURED1	AUTOSTAY equals 1 if a country's laws impose an automatic stay on the assets of firms upon filing a reorganization petition, and 0 otherwise. MANAGES equals 1 if firm managers continue to administer the firm's affairs pending the resolution of reorganization processes, and 0 otherwise. SECURED1 equals 1 if secured creditors are ranked first in the distribution of the proceeds that result from the disposition of the assets of a bankrupt firm, and 0 otherwise.	National bankruptcy and reorganization laws	LLSV (1998)
Revolutions and coups	A revolution is defined as any illegal or forced change in the top governmental elite, any attempt at such a change, or any successful or unsuccessful armed rebellion whose aim is independence from central government. A coup d'etat is defined as an extraconstitutional or forced change in the top government elite and/or its effective control of the nation's power structure in a given year. Unsuccessful coups are not counted. Data are averaged over 1960-90.	Banks (1994)	
Assassinations	Number of assassinations per thousand inhabitants. Data are averaged over 1960-90.	Banks (1994)	
Ethnic fractionalization	Average value of five indices of ethnolinguistic fractionalization, with values ranging from 0 to 1, where higher values denote greater fractionalization.	<i>Atlas Narodov Mira</i> (1964), Muller (1964), Roberts (1962), Gunnemark (1991)	Easterly and Levine (1997)
Bureaucratic efficiency	Average of three indices published by Business International Corporation: efficiency of the judiciary system, red tape, and corruption. Data are averages over 1980-83.	Business International Corporation (1984)	Mauro (1995)

Table A2. (continued)

<i>Variable</i>	<i>Definition</i>	<i>Original source</i>	<i>Secondary source</i>
Corruption	Measure of corruption, with the scale readjusted to 0 (high corruption) to 10 (low corruption). Data are averages over 1982-95.	ICRG	Knack and Keefer (1995)
Index of state-owned enterprises	Measures the role of state-owned enterprises in the economy, ranging from 0 to 10, with data averaged over 1975-95. Higher scores denote countries with fewer such enterprises, which are estimated to produce less of the country's output.	Gwartney, Lawson, and Block (1996)	LLSV (1999)
Property rights	Rating of property rights on a scale from 1 to 5. The more protection private property receives, the higher the score.	Holmes, Johnson, and Kirkpatrick (1997)	LLSV (1999)
Cost of business regulation	Rating of regulation policies related to opening and keeping open a business. The scale ranges from 0 to 5, with higher scores meaning that regulations are straightforward and applied uniformly to all businesses and that regulations are less of a burden to business.	Holmes, Johnson, and Kirkpatrick (1997)	LLSV (1999)
Risk of expropriation	Assessment of risk of outright confiscation or forced nationalization. It ranges from 0 to 10, with lower scores indicating a higher risk. Data are averages over 1982-95.	ICRG	Knack and Keefer (1995)
Religious composition	Percentages of the population that were Roman Catholic, Protestant, or Muslim in 1980.	Barrett (1982), <i>Worldmark Encyclopedia of Nations</i> 1995, <i>Statistical Abstract of the World</i> (1995), <i>United Nations Demographic Yearbook</i> (1995), <i>CIA World Factbook</i> (1996).	LLSV (1999)
Distance from equator	The distance of the country from the equator, scaled between 0 and 1.	<i>CIA World Factbook</i> (1996).	LLSV (1999)

Table A3. Economic Growth, Financial Development, and Policies across Countries^a

Country code	Country	Average annual GDP growth rate, 1960-95 (percent)	Financial development indicators			Legal origin ^e	Policy variables		
			LIQUID LIABILITIES ^b	COMMERCIAL- CENTRAL BANK ^c	PRIVATE CREDIT ^d		CREDITOR ^f	ENFORCE ^g	ACCOUNT ^h
ARG	Argentina	0.62	18.34	74.16	15.69	F	-1	5.13	45
AUS	Australia	1.98	51.73	92.67	54.82	E	-1	9.36	75
AUT	Austria	2.89	67.50	98.44	65.30	G	0	9.80	54
BGD	Bangladesh*	0.71	24.69	86.38	13.55	E	...	...	...
BRB	Barbados*	2.65	51.59	91.85	40.79	E	...	...	...
BEL	Belgium	2.65	49.02	92.01	25.65	F	0	9.74	61
BOL	Bolivia*	0.36	16.39	31.60	13.14	F	...	...	...
BRA	Brazil	2.93	19.16	61.68	22.10	F	-2	6.31	54
CAN	Canada	2.39	56.50	89.00	60.86	E	-1	9.48	74
CHL	Chile	1.45	22.96	52.81	27.81	F	-1	6.91	52
COL	Colombia	2.23	22.41	80.16	22.08	F	-2	4.55	50
CRI	Costa Rica*	1.61	29.38	72.82	21.77	F	...	...	...
CYP	Cyprus*	5.38	74.49	92.72	62.39	E	...	...	...
DNK	Denmark	2.18	49.48	88.10	42.45	S	0	9.66	62
DOM	Dominican Republic*	2.50	20.58	73.34	19.11	F	...	...	...
ECU	Ecuador	2.39	20.05	62.16	17.99	F	1	5.93	...
SLV	El Salvador*	-0.61	26.94	72.04	22.85	F	...	...	...
FJI	Fiji*	1.85	37.48	96.95	23.65	E	...	...	...
FIN	Finland	2.80	45.35	97.22	51.78	S	-1	9.58	77
FRA	France	2.43	63.37	96.54	75.47	F	-2	9.09	69
DEU	Germany	2.45	57.46	97.57	76.46	G	0	9.50	62
GHA	Ghana*	-0.96	17.58	39.78	5.07	E	...	...	...
GRC	Greece	3.22	53.34	74.36	36.72	F	-1	6.40	55
GTM	Guatemala*	0.93	20.22	75.16	13.32	F	...	...	...
GUY	Guyana*	-0.28	52.96	58.02	20.52	E	...	...	...
HTI	Haiti*	-0.66	22.60	23.72	7.71	F	...	...	...

Table A3. (continued)

Country code	Country	Average annual GDP growth rate, 1960-95 (percent)	Financial development indicators			Legal origin ^e	Policy variables		
			LIQUID LIABILITIES ^b	COMMERCIAL- CENTRAL BANK ^c	PRIVATE CREDIT ^d		CREDITOR ^f	ENFORCE ^g	ACCOUNT ^h
HND	Honduras*	0.60	23.04	76.54	23.86	F	...	...	...
ISL	Iceland*	3.01	31.76	88.94	34.79	S	...	...	...
IND	India	1.92	32.95	63.68	19.53	E	1	5.14	57
IRL	Ireland	3.25	54.74	94.73	49.14	E	-1	8.38	...
ISR	Israel	2.81	51.95	84.28	37.43	E	1	6.18	64
ITA	Italy	2.93	77.48	87.77	59.03	F	-1	8.75	62
JAM	Jamaica*	0.42	36.85	78.09	24.55	E	...	...	...
JPN	Japan	4.30	125.94	96.72	128.38	G	0	9.34	65
KEN	Kenya	1.96	35.74	81.27	23.93	E	1	5.54	...
KOR	Korea, Republic of	7.16	41.02	83.95	66.52	G	1	6.97	62
LBR	Liberia*	-0.47	9.73	37.90	10.16	E	...	...	...
MYS	Malaysia	4.11	63.74	96.45	47.20	E	1	7.11	76
MLT	Malta*	6.65	143.43	92.57	43.97	E	...	...	...
MUS	Mauritius*	3.02	46.87	82.21	24.36	F	...	...	...
MEX	Mexico	1.97	25.57	69.38	22.89	F	-2	5.95	60
NPL	Nepal*	0.77	20.27	57.86	7.72	E	...	...	...
NLD	Netherlands	2.20	71.41	98.10	86.69	F	-1	9.68	64
NZL	New Zealand	1.12	49.63	82.43	37.59	E	0	9.65	70
NER	Niger*	-2.75	14.43	83.89	13.05	F	...	...	...
NOR	Norway	3.18	54.04	90.02	81.62	S	-1	9.86	74
PAK	Pakistan	2.70	38.68	67.89	20.77	E	1	3.95	...
PAN	Panama*	2.03	33.37	71.97	40.22	F	...	...	...
PNG	Papua New Guinea*	1.12	31.05	89.12	20.84	E	...	...	...
PRY	Paraguay*	2.38	17.62	65.29	14.52	F	...	...	...
PER	Peru	0.06	18.52	86.04	13.32	F	-2	3.59	38
PHL	Philippines	1.16	27.50	81.40	27.01	F	-2	3.77	65
PRT	Portugal	3.65	78.02	90.35	55.01	F	-1	8.63	36
SEN	Senegal*	-0.44	22.80	84.54	27.51	F	...	...	...
SLE	Sierra Leone*	-0.34	16.83	49.55	5.07	E	...	...	...

Table A3. (continued)

Country code	Country	Average annual GDP growth rate, 1960-95 (percent)	Financial development indicators			Legal origin ^e	Policy variables		
			LIQUID LIABILITIES ^b	COMMERCIAL-CENTRAL BANK ^c	PRIVATE CREDIT ^d		CREDITOR ^f	ENFORCE ^g	ACCOUNT ^h
ZAF	South Africa	0.39	51.44	94.77	71.94	E	0	5.85	70
ESP	Spain	2.88	70.31	92.74	65.05	F	0	8.10	64
LKA	Sri Lanka	2.70	30.34	57.80	17.11	E	0	3.58	...
SWE	Sweden	1.89	53.49	88.94	89.11	S	-1	9.79	83
CHE	Switzerland	1.42	123.41	98.99	141.30	G	-1	9.99	68
SYR	Syrian Arab Rep.*	2.51	43.32	46.93	8.83	F	...	...	...
TWN	Taiwan, China	6.62	66.97	95.72	57.32	G	0	8.84	65
THA	Thailand	4.88	47.79	84.66	48.52	E	1	6.91	64
TGO	Togo*	0.46	32.90	82.05	21.88	F	...	...	...
TTO	Trinidad and Tobago*	1.12	37.46	91.72	31.20	E	...	...	...
GBR	United Kingdom	1.96	48.63	83.55	46.31	E	1	9.10	78
USA	United States	1.71	62.12	93.11	113.07	E	-1	9.50	71
URY	Uruguay	1.03	29.47	59.24	21.21	F	0	6.15	31
VEN	Venezuela	-0.88	36.84	90.90	33.12	F	...	6.34	40
ZAR	Zaire*	-2.81	16.03	28.58	4.08	F	...	...	...
ZWE	Zimbabwe	0.84	46.92	75.80	23.04	E	1	4.36	...

- a. Asterisks indicate countries added to the LLSV (1998) sample. Values for the financial intermediary development indicators are averages over the 1960-95 period.
- b. Liquid liabilities of the financial system (currency plus demand and interest-bearing liabilities of banks and nonbank financial intermediaries) divided by GDP, times 100.
- c. Assets of deposit money banks divided by assets of deposit money banks plus central bank assets, times 100.
- d. Credit by deposit money banks and other financial institutions to the private sector divided by GDP, times 100.
- e. E = English, F = French, G = German, S = Scandinavian.
- f. Index of secured creditor rights.
- g. Index of law and contract enforcement.
- h. Index of the comprehensiveness and quality of company reports.

Table A4. Descriptive Statistics and Correlations, Cross-Sectional Data, 1960-95

<i>Descriptive statistic</i>	<i>GDP growth</i>	<i>Initial income per capita</i>	<i>Average years of schooling</i>	<i>PRIVATE CREDIT</i>	<i>COMMERCIAL-CENTRAL BANK</i>	<i>LIQUID LIABILITIES</i>	<i>Government size</i>	<i>Openness to trade</i>	<i>Inflation rate</i>	<i>Black market premium</i>	<i>Revolution and coups</i>	<i>Assassinations</i>	<i>Ethnic fractionalization</i>
Mean	1.95	3120	4.06	40.86	79.26	45.21	14.75	59.46	15.56	23.34	0.16	0.29	0.29
Median	1.98	2019	3.65	27.81	83.89	41.02	13.16	54.33	9.08	5.36	0.07	0.10	0.19
Maximum	7.16	9895	10.07	141.30	98.99	143.43	31.37	231.69	90.78	277.42	0.97	2.47	0.87
Minimum	-2.81	367	0.20	4.08	23.72	14.43	6.68	14.05	3.63	0.00	0.00	0.00	0.00
Standard deviation	1.92	2519	2.50	29.16	17.37	26.26	5.23	36.43	18.25	49.31	0.22	0.50	0.27
No of observations	63	63	63	63	63	63	63	63	63	63	63	63	63
<i>Correlations</i>													
GDP growth	1.00												
Initial income per capita	0.04	1.00											
Average years of schooling	0.30	0.82	1.00										
PRIVATE CREDIT	0.43	0.63	0.57	1.00									
COMMERCIAL-CENTRAL BANK	0.46	0.48	0.43	0.64	1.00								
LIQUID LIABILITIES	0.56	0.39	0.45	0.77	0.59	1.00							
Government size	0.21	0.36	0.46	0.30	0.38	0.30	1.00						
Openness to trade	0.19	-0.18	-0.04	-0.09	0.08	0.30	0.31	1.00					
Inflation rate	-0.28	-0.15	-0.10	-0.38	-0.48	-0.42	-0.24	-0.28	1.00				
Black market premium	-0.38	-0.28	-0.30	-0.37	-0.54	-0.26	-0.11	0.36	0.27	1.00			
Revolution and coups	-0.24	-0.35	-0.30	-0.40	-0.46	-0.44	-0.42	-0.23	0.41	0.20	1.00		
Assassinations	-0.15	-0.09	-0.14	-0.14	-0.07	-0.17	-0.31	-0.27	0.24	0.02	0.51	1.00	
Ethnic fractionalization	-0.35	-0.43	-0.47	-0.34	-0.20	-0.29	-0.06	0.07	0.03	0.20	0.16	0.01	1.00

Table A5. Descriptive Statistics and Correlations, Panel Data, 1960-95

<i>Descriptive statistic</i>	<i>GDP growth</i>	<i>Initial income per capita</i>	<i>Average years of schooling</i>	<i>PRIVATE CREDIT</i>	<i>COMMERCIAL-CENTRAL BANK</i>	<i>LIQUID LIABILITIES</i>	<i>Government size</i>	<i>Openness to trade</i>	<i>Inflation rate</i>	<i>Black market premium</i>
Mean	1.56	4710	1.30	42.71	77.67	45.14	14.83	54.44	17.80	74.31
Maximum	9.86	20135	5.15	205.95	99.98	191.44	38.02	180.09	344.40	10990.70
Minimum	-10.02	188	0.04	1.56	14.02	6.72	4.89	9.29	-3.06	-3.68
Standard deviation	2.76	5229	0.95	35.16	20.07	27.07	5.36	27.57	33.03	608.65
No. of observations	359	359	359	359	359	359	359	359	359	359
<i>Correlations</i>										
GDP growth	1.00									
Initial income per capita	0.12	1.00								
Average years of schooling	0.13	0.69	1.00							
PRIVATE CREDIT	0.20	0.76	0.62	1.00						
COMMERCIAL-CENTRAL BANK	0.33	0.54	0.34	0.60	1.00					
LIQUID LIABILITIES	0.22	0.61	0.47	0.84	0.51	1.00				
Government size	-0.04	0.45	0.27	0.24	0.27	0.21	1.00			
Openness to trade	0.13	0.05	0.09	0.09	0.22	0.13	0.20	1.00		
Inflation rate	-0.29	-0.18	-0.08	-0.26	-0.26	-0.26	-0.05	-0.22	1.00	
Black market premium	-0.20	-0.08	-0.06	-0.09	-0.11	-0.03	0.10	-0.10	0.54	1.00

REFERENCES

- Alonso-Borrego, C., and M. Arellano. 1996. "Symmetrically Normalised Instrumental-Variable Estimation Using Panel Data." *Journal of Business and Economic Statistics* 36-49.
- Arellano, M., and S. Bond. 1991. "Some Tests of Specification for Panel Data: Monte Carlo Evidence and an Application to Employment Equations." *Review of Economic Studies* 58: 277-97.
- Arellano, M., and O. Bover. 1995. "Another Look at the Instrumental-Variable Estimation of Error-Components Models." *Journal of Econometrics* 68: 29-52.
- Atlas Narodov Mira*. 1964. Moscow: Miklukho-Maklai Ethnological Institute at the Department of Geodesy and Cartography of the State Geological Committee of the Soviet Union.
- Bagehot, W. 1873. *Lombard Street*. Reprint. Homewood, Ill.: Richard D. Irwin, 1962.
- Banks, A. S. 1994. *Cross-National Time Series Data Archive*. Center for Social Analysis, State University of New York at Binghamton.
- Barrett, D. B., ed. 1982. *World Christian Encyclopedia: A Comparative Study of Churches and Religions in the Modern World, AD 1900-2000*. New York: Oxford University Press.
- Barro, R. J., and J. Lee. 1996. "International Measures of Schooling Years and Schooling Quality." *American Economic Review* 86 (*Papers and Proceedings*) 218-23.
- Barro, R. J., and X. Sala-i-Martin. 1995. *Economic Growth*. New York: McGraw-Hill, New York.
- Barth, J. R., G. Caprio, Jr., and R. Levine. 1999. "Financial Regulation and Performance: Cross-Country Evidence." Policy Research Working Paper 2037. Washington: World Bank.
- Barth, J. R., D. E. Nolle, and T. N. Rice. 1997. "Commercial Banking Structure, Regulation, and Performance: An International Comparison." Economics Working Paper. Washington: Office of the Comptroller of the Currency.
- Beck, T., R. Levine, and N. Loayza. 1999. "Finance and the Sources of Growth." *Journal of Financial Economics* (forthcoming).
- Bencivenga, V. R., and B. D. Smith. 1991. "Financial Intermediation and Endogenous Growth." *Review of Economics Studies* 58: 195-209.
- Berman, H. J. 1997. *Law and Revolution: The Formation of the Western Legal Tradition*. Cambridge, Mass.: Harvard University Press.

- BIS. 1997. *Core Principles for Effective Banking Supervision*. No. 30. Basle Committee on Bank Supervision.
- Blundell, R., and S. Bond. 1997. "Initial Conditions and Moment Restrictions in Dynamic Panel Data Models." University College London Discussion Paper in Economics 97-07. London.
- Boyd, J. H., and E. C. Prescott. 1986. "Financial Intermediary-Coalitions." *Journal of Economic Theory* 38: 211-32.
- Business International Corporation. 1984. *Introduction to the Country Assessment Service*. New York.
- Calomiris, C. W. 1989. "Deposit Insurance: Lessons from the Record". Federal Reserve Bank of Chicago *Economic Perspectives* 10-30.
- Calomiris, C. W., and G. Gorton. 1991. "The Origins of Banking Panics: Models, Facts, and Bank Regulation." In *Financial Markets and Financial Crises*, edited by R. G. Hubbard. University of Chicago Press.
- Caprio, G., Jr., I. Atiyas, and J. A. Hanson. 1994. *Financial Reform, Theory and Experience*. New York: Cambridge University Press.
- Caselli, F., G. Esquivel, and F. LeFort. 1996. "Reopening the Convergence Debate: A New Look at Cross-Country Growth Empirics." *Journal of Economic Growth* 1: 363-89.
- Central Intelligence Agency. 1996. *CIA World Factbook* (online edition). Washington.
- Demirgüç-Kunt, A., and V. Maksimovic. 1998. "Law, Finance, and Firm Growth." *Journal of Finance* 53: 2107-37.
- Diamond, D. W. 1984. "Financial Intermediation and Delegated Monitoring." *Review of Economic Studies* 51: 393-414.
- Diamond, D. W., and P. H. Dybvig. 1983. "Banking Runs, Deposit Insurance, and Liquidity." *Journal of Political Economy* 91: 401-19.
- Easterly, W. 1994. "Economic Stagnation, Fixed Effects, and Policy Thresholds." *Journal of Monetary Economics* 33: 525-57.
- Easterly, W., and R. Levine. 1997. "Africa's Growth Tragedy: Policies and Ethnic Divisions." *Quarterly Journal of Economics* 112: 1203-50.
- Easterly, W., N. Loayza, and P. Montiel. 1997. "Has Latin America's Post Reform Growth Been Disappointing?" *Journal of International Economics* 43: 287-311.
- Easterly, W., and S. Rebelo. 1993. "Fiscal Policy and Economic Growth: An Empirical Investigation." *Journal of Monetary Economics* 32: 417-58.
- Fischer, S. 1993. "The Role of Macroeconomic Factors in Growth." *Journal of Monetary Economics* 32: 485-512.

- Gale, D., and M. Hellwig. 1985. "Incentive-Compatible Debt Contracts: The One-Period Problem." *Review of Economic Studies* 52: 647-63.
- Gelbard, E., and P. Leite. 1999. "Measuring Financial Development in Sub-Saharan Africa." IMF Working Paper. Washington: International Monetary Fund (African Department).
- Gertler, M. 1988. "Financial Structure and Aggregate Economic Activity: An Overview." *Journal of Money, Credit, and Banking* 20: 559-88.
- Glendon, M. A., M. W. Gordon, and C. Osakwe. 1982. *Comparative Legal Tradition in a Nutshell*. St. Paul, Minn.: West Publishing.
- Goldsmith, R. W. 1969. *Financial Structure and Development*. New Haven, Conn.: Yale University Press.
- Greenwood, J., and B. Jovanovic. 1990. "Financial Development, Growth, and the Distribution of Income." *Journal of Political Economy* 98: 1076-1107.
- Griliches, Z., and J. Hausman. 1986. "Errors in Variables in Panel Data." *Journal of Econometrics* 31: 93-118.
- Gunnemark, E. V. 1991. *Countries, Peoples, and Their Languages: The Geolinguistic Handbook*. Gothenburg, Sweden: Lanstryckeriet.
- Gwartney, J., R. Lawson, and W. Block. 1996. *Economic Freedom of the World 1975-1995*. Vancouver, Canada: The Fraser Institute.
- Hammond, B. 1991. *Banks and Politics in America: From the Revolution to the Civil War*. Princeton, N.J.: Princeton University Press.
- Hansen, L. P. 1982. "Large Sample Properties of Generalized Method of Moments Estimators." *Econometrica* 50: 1029-54.
- Holmes, K. R., B. T. Johnson, and M. Kirkpatrick. 1997. *1997 Index of Economic Freedom*. Washington: Heritage Foundation, and New York: Dow Jones & Company.
- Holtz-Eakin, D., W. Newey, and H. Rosen. 1990. "Estimating Vector Autoregressions with Panel Data." *Econometrica* 56: 1371-95.
- Jayarathne, J., and P. E. Strahan. 1996. "The Finance-Growth Nexus: Evidence from Bank Branch Deregulation." *Quarterly Journal of Economics* 111: 639-70.
- Kane, E. J. 1985. *The Gathering Crisis in Federal Deposit Insurance*. Cambridge, Mass.: MIT Press.
- . 1989. "How Incentive-Incompatible Deposit-Insurance Funds Fail." NBER Working Paper 2836. Cambridge, Mass.: National Bureau of Economic Research.

- King, R. G., and R. Levine. 1993a. "Finance and Growth: Schumpeter Might Be Right." *Quarterly Journal of Economics* 108: 717-38.
- . 1993b. "Finance, Entrepreneurship, and Growth: Theory and Evidence." *Journal of Monetary Economics* 32: 513-42.
- Knack, S., and P. Keefer. 1995. "Institutions and Economic Performance: Cross-Country Tests Using Alternative Institutional Measures." *Economics and Politics* 7: 207-27.
- Kroszner, R. S., and R. G. Rajan. 1994. "Is the Glass-Steagall Act Justified? A Study of the US Experience with Universal Banking Before 1933." *American Economic Review* 84: 810-32.
- Kroszner, R. S., and P. E. Strahan. 1996. "Regulatory Incentives and the Thrift Crisis: Dividends, Mutual-to-Stock Conversions, and Financial Distress." *Journal of Finance* 51: 1285-1320.
- La Porta, R., F. Lopez-de-Silanes, A. Shleifer, and R. W. Vishny. 1997. "Legal Determinants of External Finance." *Journal of Finance* 52: 1131-50.
- . 1998. "Law and Finance." *Journal of Political Economy* 106: 1113-55.
- . 1999. "The Quality of Government." *Journal of Law, Economics, and Organization* 15: 222-79.
- Levine, R. 1997. "Financial Development and Economic Growth: Views and Agenda." *Journal of Economic Literature* 35: 688-726.
- . 1998. "The Legal Environment, Banks, and Long-Run Economic Growth." *Journal of Money, Credit, and Banking* 30: 596-620.
- Levine, R., and S. Zervos. 1998. "Stock Markets, Banks, and Economic Growth." *American Economic Review* 88: 537-58.
- Loayza, N., H. López, K. Schmidt-Hebbel, and L. Servén. 1998. "World Saving Database." Manuscript. Washington: World Bank.
- Lucas, R. E., Jr. 1988. "On the Mechanics of Economic Development." *Journal of Monetary Economics* 22: 3-42.
- Mauro, P. 1995. "Corruption and Growth." *Quarterly Journal of Economics* 110: 681-712.
- McKinnon, R. I. 1973. *Money and Capital in Economic Development*. Washington: Brookings Institution.
- Mehran, H. 1998. "Financial Sector Development in Sub-Saharan African Countries." IMF Occasional Paper 169. Washington: International Monetary Fund.
- Muller, S. 1964. *The World's Living Languages: Basic Facts of Their Structure, Kinship, Location, and Number of Speakers*. New York: Ungar.

- Neusser, K., and M. Kugler. 1998. "Manufacturing Growth and Financial Development: Evidence from OECD Countries." *Review of Economics and Statistics* 80: 638-46.
- Newey, W., and K. West. 1987. "Hypothesis Testing with Efficient Method of Moments Estimation." *International Economic Review* 28: 777-87.
- Patrick, H. 1966. "Financial Development and Economic Growth in Underdeveloped Countries." *Economic Development and Cultural Change* 14: 174-89.
- Pick's Currency Yearbook*. Various years. New York: Pick Publishing.
- Political Risk Services. Various years. *International Country Risk Guide*. Syracuse, N.Y.
- Rajan, R. G., and L. Zingales. 1998. "Financial Dependence and Growth." *American Economic Review* 88: 559-86.
- Reynolds, T. H., and A. A. Flores. 1996. *Foreign Law: Current Sources of Codes and Basic Legislation in Jurisdictions of the World*. Littleton, Colo.: Fred B. Rothman & Co.
- Roberts, J. 1962. "Sociocultural Change and Communication Problems." In *Study of the Role of Second Languages in Asia, Africa, and Latin America*, edited by F. A. Rice. Washington: Center for Applied Linguistics of the Modern Language Association of America.
- Robinson, J. 1952. "The Generalization of the General Theory." In *The Rate of Interest and Other Essays*. London: MacMillan.
- Rousseau, P. L., and P. Wachtel. 1998. "Financial Intermediation and Economic Performance: Historical Evidence from Five Industrial Countries." *Journal of Money, Credit, and Banking* 30: 657-78.
- Schumpeter, J. A. 1912 (transl. 1934). *The Theory of Economic Development*, translated by R. Opie. Cambridge, Mass.: Harvard University Press.
- Sheng, A. 1996. *Bank Restructuring: Lessons from the 1980s*. Washington: World Bank.
- Statistical Abstract of the World*. 1995. New York: Gale Research.
- Townsend, R. M. 1979. "Optimal Contracts and Competitive Markets with Costly State Verification." *Journal of Economic Theory* 21: 265-93.
- United Nations Demographic Yearbook*. 1995. New York: Department of Economic and Social Affairs, Statistical Office, United Nations.

World Currency Yearbook. Various issues. New York: International
Currency Analysis.

Worldmark Encyclopedia of the Nations, 8th ed. 1996. Detroit, Mich.:
Gale Research.

