
**Motivation: finance matters for growth**
- mobilize savings
- allocate funds to their most efficient use (project evaluation, risk management, monitor managers)
- facilitate transactions

**Financial indicators variables:**

DEPTH: currency held outside of the banking system plus demand and interest-bearing liabilities of banks and nonblank financial intermediaries divided by GDP (a measure of the size of the formal financial intermediary sector)

BANK: deposit money bank domestic assets divided by deposit money bank domestic assets plus central bank domestic assets (a measure to capture the total activities of banks which are more likely to play a role in entrepreneurial selection as opposed to central banks)

PRIVATE: credit issued to private enterprises divided by credit issued to central and local governments plus credit issued to public and private enterprises. (a measure to capture the role of credit issued to private enterprises as opposed to public enterprises)

PRIVATE/Y: credit issued to private enterprises divided by GDP. (a measure the capture the role of private credit in total GDP)
Growth indicators:

GYP : real per capita GDP growth rate
GK : growth rate of the real per capita capital stock
INV : ratio of annual investment to GDP
EFF : rate of productivity growth (once the growth rate of per capita physical capital is taken into account)

Empirical methodology and results:

1st method:
- Look for contemporaneous relationships between growth and financial indicators.
- Regress each growth indicator on a set of explanatory variables, one of which is a financial indicator. Use averages for the period (1960-1989).

The control variables are
  LYO : logarithm of initial income (1960)
  LSEC: logarithm of initial secondary schooling (1960)
  GOV : average government spending/GDP
  PI : average inflation rate.
  TRD : the ratio of trade to GDP

Results (Table VII):
Estimated coefficients for all financial indicators are positive and statistically significant at 5% level, some at 1% level. The impact of a larger financing sector on growth can be sizeable (see the calculation on p728, par 2)
2\textsuperscript{nd} method:

Look for the impact of initial indicators on growth.

- Calculate decade averages for growth indicators. Regress each growth indicator on a set of explanatory variables. The explanatory variables are the values at the beginning of each decade (e.g. BANK\(_{ij}\) is the value of banking for country \(j\) in year 1960, 1970 and 1980.).

The control variables are as before LYO, LSEC, GOV, PI and TRD, this time all as initial variables though. In addition, the authors use time dummies for each decade.

Results (Table IX):

Initial financial indicators are positively and significantly correlated with average growth rate observed in a decade (in almost all cases). The authors argue then that “the level of financial sector development is a good predictor of subsequent economic growth.”

The impact of a better financial sector on growth can be sizeable (see the calculation on p.734, par 1).