Financial Dependence and Growth: The role of Input-Output Linkages

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Abstract
With this paper we aim at widening the understanding of the finance-growth nexus by investigating the relevance of IO linkages. The seminal paper by Rajan and Zingales (1998) unambiguously proves that industrial sectors that are relatively more in need of external finance develop disproportionately faster in countries with more-developed financial markets. In this paper we enlarge the scope of that original analysis and investigate whether financial development, beyond directly affecting growth of industries according to their financial dependence, also matters indirectly by potentially relaxing financial constraints of a sector’s downstream and upstream industries. More specifically, if financial development favours disproportionately more the growth of financially dependent industries, the latter’s development will also stimulate growth of upstream input providing and downstream input buyer industries. As a consequence, the benefits a sector gets from financial development will be magnified when its upstream and downstream sectors are more financial dependent.

We explore this issue in a sample of countries at different development stages over the period 1995-2007. The growth of industries’ value added is modeled as dependent on the interaction between the extent of countries’ financial development and the same, upstream and downstream industries' extent of financial dependencies.

Beyond confirming the finding by Rajan and Zingales (1998), preliminary results indicate that financial development favours disproportionately more the growth of sectors whose upstream industries’ financial dependence is higher. OLS results over the cross-section sample of countries present in the database over the whole 1995-2007 period are corroborated by the Pooled OLS estimates of the model for annual growth including a larger set of economies and industries whose data are available for a shorter number of years.

Finally, countries at a lower financial development stage seem to drive the baseline evidence on the relevance of input providing sectors’ financial dependence for triggering the beneficial effect of financial development on growth.

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Keywords: growth; financial development; financial dependence; input-output linkages