Influence of Financial Sector Development on Economic Growth in the Baltic Countries

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Abstract

The empirical evidence that financial sector development (credit growth, larger securities markets etc) fosters economic growth and improves financial stability has been accumulating over the last two decades, stimulated by new theoretical developments and new databases. From 2000 to 2007, Estonia, Latvia and Lithuania experienced real GDP growth rates of 3.8% to 12%. At the same time, the favourable macroeconomic development and decreasing interest rates have accelerated the growth of the credit stocks in the Baltic countries. The main goal of this paper is to investigate the relationship between financial development and economic growth in the Baltic countries. Results from the cross-section fixed effects panel estimates do not support the hypothesis that financial development, as measured by different proxies, has been strongly positively contributing to the output level of the countries in the sample. The positive and significant link is confirmed only between stock market capitalisation and real GDP per capita growth rate, but only a minor effect was identified on economic growth. In the current study, in stark contrast to studies in other Central and Eastern European countries, domestic credit by banking sector to GDP shows a negative effect on economic growth.

JEL classification codes: **E44, G20, O16, O52**
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