Non-Technical Summry

Financial Development and Growth in Direct Firm-Level Comparisons

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Despite a long-recognized positive association between financial-sector development and economic growth, economists continue to disagree whether the state of the financial sector merely reflects a country's stage of economic development or whether it represents one of its key determinants. Trying to disentangle the finance-growth nexus empirically raises a fundamental identification problem: one needs to isolate the part of the variation in financial development that is unrelated to current and future growth opportunities, which are inherently unobservable.

In this paper, we use the establishment of the `single market' of the EU-15 economies in 1993 as a unique opportunity to study the effect of financial development on growth. We assume that in the absence of differences in financial development, growth of similar firms in a given industry would be very similar across the EU-15 countries between 1995-2003. We follow early country-level work in the literature in that we relate pre-determined levels of financial development to subsequent growth. We also follow the recent finance and growth literature in that we study within-industry growth rates; that is, we assume that industry differences in both technology and growth opportunities are highly comparable across the EU-15 countries. We omit from analysis those industries that display only weak growth synchronization, that is, industries that are likely to be affected by country-level regulation. In order to check for the possibility that current financial development merely reflects future growth opportunities, we also control for

differences in aggregate future growth opportunities implied by pre-existing industrial structure.

The sign of the estimated finance-growth effects confirms the results in the literature, which are based on different identification strategies. Using volume-of-finance activity measures, we find that moving from the least to the most developed financial system within the EU-15 boosts a firm's average annual value added growth rate from 1995 to 2003 by about three percentage points. The effects of institutional quality, proxied here by a measure of accounting standards and a measure of investor protection (control premia), are also positive and significant, but more varied in size. Allowing for the presence of financial integration by interacting the initial financial development level with a time trend suggests that the disadvantages in firm-level growth due to under-developed financial markets was much larger in the mid 1990s than in the late 1990s, and that the growth gap related to country-level financial development was fully closed by 2003. Taking these findings at face value implies successful financial integration of the EU-15 area in the sense that the real economic activity as measured by corporate growth is no longer affected by a firm's location.