Causality Relationships between financial development, economic growth and income inequality

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Abstract

This study investigates the causal relationships between financial development, economic growth and income inequality for 23 European Union countries during the period 1987-2017. Additionally, ten proxies of financial development are chosen to capture different characteristics of banking development and financial markets development. For the empirical analysis, the study employs cross-sectional dependence tests, second generation unit root test, panel co-integration tests and Granger non-causality test in heterogeneous panels. The findings are mixed and sensitive to the measures of financial development. Most importantly, the results reveal that there is a unidirectional causality from financial development to economic growth when private credit, stock market capitalization, net margin interest rate and Z-score are chosen as financial indicators. There is a bidirectional causality between bank assets, liquid liabilities, non-performing loans and economic growth and a unidirectional causality running from economic growth to value traded and turnover ratio. There exists no causal relationship between stock price volatility and economic growth. Concerning the causality relationship between economic growth and inequality, the results indicate a one-way causality running from inequality to economic growth. Finally, unidirectional causality exists from income inequality to financial development. However, one-way causality is found with direction from private credit to income inequality and bidirectional causality between bank assets and inequality. There is no evidence of causality between income inequality and turnover ratio, Z-score and stock price volatility.

Keywords: CIPS test, cointegration, Dumitrescu-Hurlin test, finance, panel data.