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## On Recessive and Expansionary Impact of Financial Development: Empirical Evidence

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**ON RECESSIVE AND EXPANSIONARY IMPACT OF FINANCIAL  
DEVELOPMENT:  
*Empirical evidence***

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**Abstract**

This paper mainly examines the effect of financial development on the recession, while controlling for potential recession factors. Using panel data of 129 countries spanning 1990-2010, we implemented “Locally Weighted Scatterplot Smoothing”, “Local Linear” and “Iteratively Reweighted Least Squares” regression methods along with a *Sasabuchi* test to verify the inverse U-shape to estimate the extreme point for the non-linear specification. We mainly found a nonlinear and thus U-shaped relationship between recession and financial development with a threshold effect of 1.1528, which validate financial development recessive and expansionary real impacts. The financial development process presents an expansionary impact for countries with financial performance less than 1.1528, and countries with financial performance above the threshold of 1.1528 present a recessionary impact of financial development. Moreover, we found that trade openness contributes to increasing recession independently to the estimation method. Thus during economic crises of recession, policymakers should hold-on regional integration along with globalization doctrines. On the contrary, fuels for South Asia (SASIA) and Latin America and Caribbean (LAC) countries and financial openness for sub-Saharan Africa (SSA) countries impact negatively recessions; countries who manage their oil production in a good manner will also reduce the probability and impact of recessions, and appear to have an expansionary real impact only. Thus, to fight against recession, SASIA and LAC countries should well manage oil production and usage while SSA countries may manage their financial openness. Verifying the robustness permit us to confirm the baseline and extended model specification findings in terms of coefficients sign and significance; furthermore, to highlight SSA, SASIA and LAC as the order of continental/regional importance in increasing magnitude. Finally, the semiparametric regression shows that the results of the parametric part converge with the previous results in general, and bear out with illustration the functional form of the nonlinear relation between recession and financial development.

**Keywords:** Economic recession – Financial development – Macroeconomic disaster – Barro & Ursha database.

**JEL Code :** E32, E44, O16; O50.

## Introduction

How can we explain the cyclical fluctuations of the economy in general and the economic recession in particular? This is one of the most addressed and controversial issues among economists. According to Minsky (1975), the cumulative chain of increasing oversupply and insolvency of borrowers was probably at the heart of the "Great Depression" of the 1930s, and also did happen during the "Great Recession" of the 2000s. This assertion is based on Fisher's (1933) analysis of "debt deflation". According to him, the decrease in prices due to free-market play can trigger a deflationary spiral, leading to insolvency and chain bankruptcies; indeed, deflation increases the real value of corporate debt. To reimburse, they stop investing and hiring and destock greatly. What makes it important to focus on finance is its impact on the recession through its role in triggering crises. Since its invention, it has been associated with episodes of excessive risk-taking and financial asset price bubbles. Such episodes usually had a bad end, causing job and income losses far beyond the financial industry. Considering this, we are entitled to verify the assumption of whether solving the problem of borrower insolvency through private domestic credit development would help or not combat the recession.

A recession is different from a simple slowdown in the economy that corresponds to a decline in the GDP<sup>1</sup> growth rate over two consecutive quarters. The National Bureau of Economic Research, through the Committee to date business cycles define it as a "*significant decline in economic activity affecting all sectors, for several months, normally visible in production, employment, real income and other indicators. A recession begins when the economy reaches a climax and ends when it reaches its lowest point*". The term depression, on the other hand, refers to a more intense and longer-lasting fall in production as experienced in the United States after the stock market crash of 1929.

Financial development for its parts involves improvements in the following functions provided by the financial systems: (i) pooling of savings; (ii) allocating capital for investments; (iii) monitoring investments; (iv) risk diversification; and (v) exchange of goods and services (Levine, 2005). Moreover, funds allocation, savings and investment decisions are sensitive to each of these financial functions. As a consequence, total factor productivity along with physical and human capital accumulation are the main channels through which finance impact economic growth. With the possibility of reduction of information asymmetries and insurance of risk sharing, the financial sector can absorb shocks and reduce the amplification of cycles via the financial accelerator, and thus lowering inequality volatility (Bernanke et al., 1999).

While it is true that developing countries have experienced very few depressions throughout the years, these countries faced and are facing many types of crises; the current health crises<sup>2</sup> is the last ever-lived phenomenon with effective and potential recessive and/or expansionary impacts. Before it, the global economy tipped into recession in 2008 due to the 2007 financial

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<sup>1</sup> Gross Domestic Product.

<sup>2</sup> Coronavirus which started end 2019 in China and became a global pandemic later.

crises<sup>3</sup>. This recession has driven firstly a contraction in demand from households and businesses due to the tightening of credit standards by banks and the fall of their earned income, resulting from the rise in unemployment and the collapse of world trade (Redoulès, 2009). In such context, policymakers need to set robust diagnostic to comprehensively assess the impact of recent and past crises on the real economy, and the economic impact of financial development that would insidiously be associated with an underlying recession.

This brief theoretical and empirical presentation about the necessity to combat the recession and the importance of financial development implies the necessity to check the existence and the nature of the relationship between both phenomena. To contribute to the existing literature, we intend in this paper to give interest to the question of the importance of financial sector development in the fight against economic recession. Practically, we examined this question using 129 countries with average contemporary data for the period 1990-2010; given the heterogeneity of our sample, we implemented a panel database empirical investigation considering the global sample of developing countries and a grouping sample excluding some regions; this mainly because the financial sectors for different regions present divergent characteristic of less of well-developed relatively to other countries/regions. Indeed Demirgüç-Kunt & Levine (1999) shown that the level of development and structure of financial systems is correlated with the level of wealth. Moreover, we implemented the Sasabuchi test to confirm the inverse U-shape and estimate the extreme point.

Such an investigation has a fourfold interest. Firstly, the focus on seeking solutions on hold issue such as recession linked to the past economic crisis and depression (The “Great Depression” of the 1930s, the "Great Recession" of 2007-2009 following by the last financial crisis) and, more interestingly, to the current health crisis which is starting to imply an economic crisis. Secondly, we present a literature review and especially a theoretical framework on the important question of financial development and its link with the economic recession. Thirdly, our empirical methodology is based on a sample of 129 developing countries from all regions of the world. Fourthly, we use primary and hitherto, almost unexploited “Rare macroeconomic disasters” data from Barro & Ursua (2012); this database permits us to have a specific proxy of "economic recession" more close to the reality; compared with data from other sources (IMF<sup>4</sup>, World Bank) this recent dataset on economic recession from the said source should provide findings with updated and more focused policy implications. Fifthly, as far as we have reviewed, no study has employed the empirical approach we used in tackling the problem; thus, the paper also contributes to the existing literature on the methodological aspect. Finally, given the challenges of globalization, especially considering financial sector performance, the analysis could serve as a basis for the implementation and/or revision of policies towards banking and financial system development by authorities/international organisations.

We mainly found that: the nonlinearity and thus U-shaped relationship is effective; when financial development increases, this is accompanied by a reduction in the depth of

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<sup>3</sup> This financial crisis that began in the US financial market in general and in the subprime market in particular, was then amplified and propagated in advanced economies and the major emerging countries creating the recession.

<sup>4</sup> International Monetary Fund.

recessions; and this, up to a certain threshold. Exceeding this threshold, financial development correlates with deep recessions. Thus, instead of inverted U-shaped, we found a U-shaped relationship between recession and financial development. The *Kuznets curve* is therefore not valid considering these phenomena. Finally, these results appeared to be consistent with the robustness check analysis.

The rest of the paper is organized as follows: In section 1, we present the updated literature review on the subject; in section 2, the theoretical framework and stylized facts; in section 3 we specify the model, discuss the data as well as sensitivity analyses for robustness checks. The empirical analysis is presented in Section 4. Section 5 concludes with policy recommendations.

## **I. Recessive and expansionary impact of finance: a literature review**

Firstly, we start by the presentation of an overall up to date empirical studies analysing the relationship between financial development and economic recession and; secondly fall into a classification, step by step based on major results in the literature and different methodologies used and/or geographical orientation.

### **I.1. Empirical studies on the relationship between finance and economic recession**

When a country is in recession, all the sectors affected are normally visible in production, employment, real income and other indicators. This is the main reason why, the literature on the relationship between financial development and economic recession, is usually analysing the effect on the previously stated indicators.

Several studies show that there are various speculative and financial causes of the deep recession which have affected capitalist economies after each crisis, such as the one of 1929 and 2007. Brahmi & Zouari (2014) for example, described the global economic conditions after the last financial crisis, its causes and effects on the global economy and recommendations or actions to take. He concluded that the financial crisis affected the financial system development and was the main explanation for the global recession which followed.

Mody al. (2007) show that there is a strong correlation between economic cycles in developed countries. The presence of financial accelerator mechanisms seems to prevent for the moment any decoupling cycles, given the global distribution of financial centres and the globalized nature of finance. However, they indicate that a shock of credit is more persistent in Europe than in North America, and they explain it by disparities in the way the financial sector operates (financial renegotiations of loans, variable rates ...etc.) and a lower depth of European markets. Accelerator effects are felt 15 quarters (4 years) in European countries, while they disappear after 7 quarters (less than two years) in North America. On the other hand, the investment's response to a temporary shock on credit access for businesses is initially stronger in the United States than in Europe (65% elasticity in the United States compared to 43% in France).

Focusing on the achievement of Millennium Development Goals in the Tunisian context, Bashir et al. (2010) described the causes and consequences of the 2007 financial crisis along with its effects on the world economy. He found that Tunisian banks were not directly

affected by the credit crisis and bullet premiums since they do not have many assets abroad. Additionally, given the fact that policymakers continued lowering tariffs to meet international commitments and stimulate economic exchanges with the global economy, the crisis did not affect the programs openness to the rest of the world established. The global recession had removed 38,000 jobs in Tunisian manufacturing sector.

Following the 2007 great recession and financial crisis, households were less optimistic than companies about their future economic prospects; using American data collected between 2008 and 2009, Hurd & Rohwedder (2010) shows that more than 39% of American households were unemployed, had not been treated fairly and had housing payment arrears. Moreover, they forecasted an increase in goods and services market prices and real estate prices.

Maswana (2009) investigates the impact of the global financial and economic crisis on African economic development focussing on Botswana, Cameroon, Cote d'Ivoire, DRC<sup>5</sup>, Ghana, Kenya, Mauritius, Nigeria, Senegal, South-Africa, Tanzania and Zambia. He used a nonlinear generalization of integration, the threshold auto-regression model (TAR), applying the method of Chan (1993) to estimate the threshold value because larger shocks bring about different responses than do smaller shocks. The main finding was that the current financial meltdown and economic recession crisis might have spread into Africa via business cycle and trade co-movement rather than financial links.

Beachy (2012), analysed what provoked the largest financial and economic collapse in decades. He showed that while the main causes of the recent crisis are the housing bubble and subprime mortgage lending boom, we have besides, errant economic assumptions, skewed incentives in the financial sector and inequitable socioeconomic structures as regular roots. According to Fernald (2014), mainly due to a decrease in the USA<sup>6</sup> labour and total factor productivity growth before the great recession, the developing countries pre-recession trends reflected a reduction of the potential level of production in 2013. One explanation can be found on disruptions since the beginning of the recession, and speculative bubbles related to housing finance activities.

Overall, in reviewing the literature regarding major empirical findings, the different contributions to the analysis of the relationship between finance and the recession reveal many twists and turn in the results (Eggoh, 2009). The first line of research concerns the works that concentrate their research on the study of the relationship between financial development and overall indicators of the economic situation of the country including GDP growth. Then, the next line consists of the works that address this relationship through other transmission channels, and finally, the authors who analysed the direct effect of policies.

While the first works reveal in general a positive link between financial development and economic growth in line with the contribution of Keynesian authors (with the works of Mac Kinnon, 1973 and Shaw, 1973), a small part highlighted a negative relationship caused by an

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<sup>5</sup> Democratic Republic of Congo

<sup>6</sup> United States of America

alternative version of the changes in interest rates, the dualism between formal finance and informal finance, and financial market imperfections.

The second major results derived from this literature are those in which the development of the financial system through time facilitates the transmission of a recession even if the financial systems of some countries are weakly connected to the global financial system. However, the authors do not seem to agree to the effects of each channel on the real economy.

## **I.2. Review of empirical studies based on the methodology used**

Considering the methodology used to analyse the relationship between financial development and recession, two approaches can be identified: macroeconomic and microeconomic approaches. Regarding the macroeconomic approaches, we distinguish, on one hand, studies that use descriptive statistical methods to explain the contagion of the financial development on the real economy, and on the other hand, studies that evaluate the impact of financial development on the level of economic activity (GDP) through different transmission channels such as exports level, inflation, remittances, and/or ODA<sup>7</sup>.

Several indicators are used in the empirical analysis of the link between financial development and growth or recession. The most commonly used indicators for financial development and recession available for many developing countries over a long period are: the GDP growth rate, liquid assets, or loans granted by financial intermediaries (excluding central banks and government agencies) to the private sector.

Thus, the first research using statistical data simply analyses the overall development of different transmission channels of the financial crisis from one country while comparing them with those of other countries in the sub-region. Regarding the transmission channels of the crisis which are often considered by the authors, the first and most used in the macroeconomic analysis is the GDP growth rate; this method is used to observe the trend during the recession (Siddiqui, 2009 for Japan; Petralias et al., 2013 for Greece; Parejo & Sudrià, 2012 for Italy; Beachy, 2012 and Fernald, 2014 for the less developed country; Ball, 2014 for the developed country). The second channel addressed is the regional exchange of securities (Aka, 2008), then comes the growth rate of exports/imports, the level of unemployment etc.

The second research axes consist of studies using traditional models of endogenous growth autoregression which are most often estimated using a separate set of econometric methods that differ depending on whether one is in a longitudinal section study or cross-sectional (Petralias et al., 2013). Thus, there is the analysis of panel data on a set of countries estimated by error correction models or VAR as we want to take into account or not the interdependencies between macroeconomic variables (ILO, 2009), the fixed-effects models, the co-integration methods, or the nonlinear generalization of integration (Maswana, 2009). From a microeconomic point of view, fewer studies have focused on the social domain such as child abuse, worsening hunger and malnutrition and rising unemployment due to the lower wages on the labour market.

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<sup>7</sup> Official Development Assistance

### **I.3. Review of empirical studies based on the geographical orientation**

With the objective of grouping by region, we can mainly say that there are two different workgroups. The first is the studies that are interested only on developed countries or advanced and major emerging countries (China, India and Japan) such as the study of Brahmi & Zouari (2014); the second are those who try to see the impact of financial development on the developing countries in general and Africa in particular (ILO, 2009; Bechir et al., 2010).

The major geographical grouping is in developed countries, namely the European Union and the United States that are mostly affected by the economic and financial crises and in which the recession is the most maligned. However, some individual works on some countries (Greece, Italy, Spain, Japan etc.), are also part of this burgeoning literature, but their goals are diverse (Petralias et al., 2013; Siddiqui, 2009).

Overall, because the geographical orientation of empirical works previously implemented until today never used 129 countries worldwide and the use of Barro & Ursua (2012) is missing in the literature; we undertake the assignment to contribute to this literature review with the main objective to fill this specific gap.

## **II: The potential recessive and/or expansionary impact of financial development: Theoretical framework and Stylized facts**

### **II.1. From hold debate to new theoretical frameworks.**

To build the theoretical framework, we move between hold debate, IS PM and financial accelerator theoretical models.

#### **✓ *Hold debate***

Two approaches (the classical and the Keynesian) belonging to the economic cycle and crises have refined the analysis of economic crises: mainly, we have on one hand classical and neoclassical which consider economic crises as an exogenous phenomenon (There is autoregulation of the economy and crises only come from state actions); and Marxist, Keynesian and neo-Keynesian which consider it as an endogenous phenomenon (crises is linked to the capitalism mechanism) on the other hand. For our own, we assume that crises, as well as recessions, are endogenous phenomena.

#### **✓ *IS PM theoretical model***

The question of the interaction between the financial bloc and the real bloc along with the explanation of recessions/economic crises has been the source of several analyses since Adam Smith. Indeed, from the invisible hand-related solution to Tirole's economic regulation and Keynes' economic policies, we are still confronted with the reality: economic recessions are present and even if they are resolved, nothing reassures us that they are impossible to reappear. Many empirical studies have addressed this issue with different approaches and samples. When considering the major controversies in economic theory, one can only be struck by the resurgence, at regular intervals, of a fundamental debate on the explanation of economic crises and unemployment and on the effectiveness of state intervention in



combating fluctuations. Thus, in the second half of the 19<sup>th</sup> century, during a clash with Malthus, Say refuted the possibility of crises of overproduction, despite the periodic collapse of the markets.

In the great depression of the 1930s, it was Pigou (1933) who denied the involuntary nature of unemployment as an equilibrium phenomenon, of which Keynes tried to make the pillar of his macroeconomic analysis. In the 1970s, it was the proponents of the “new classic economy” who questioned Keynesian intervention policies, at a time when Western countries were experiencing oil shocks and a significant slump in growth synonym of recession. More recently, in the early 1980s, a current called “real cycles” has been developed, denying any legitimacy to stabilization policies, and particularly monetary policies, and insisting on the "real" nature of fluctuations, while monetary and financial shocks seem to have become decisive in the origin of cyclical disturbances, as evidenced by the succession of crises experienced by the world economy from the years 1990s. On each occasion, the observation seems to contradict the dominant model; which raises the question of whether we can trust theories that are contradicted by the facts. This question cannot be answered immediately, not without confirming our analysis with empirical investigation.

The IS-PM model provides an interesting theoretical framework for describing the mechanisms of economic and financial crises. The “Great Recession” of 2007-2009 following the last financial crisis has upset the consensus of stabilizing fluctuations and flattening cycles that had been successful until then. While monetary policies had become powerless, states were forced to intervene massively to bail out the banking system and support activity, thus exacerbating the imbalance in their public finances. This relative inefficiency of cyclical policies may have given a possibility to observe the potential of structural policies.

The pro-cyclical nature of the dynamics of the banking sector can, therefore, explain the recessive consequences associated with banking crises and/or in a direct way explain the economic recession. This places the level reached by the size and activity of financial intermediaries when banking crises approach at the centre of mechanisms to explain the cost of the real economy of these banking crises. This is why, beyond the effect of financial development on the likelihood of the occurrence of banking crises studied in a vast literature, it is essential to analyze now the recessive and/or expansionary effect of financial development given financial crises.

#### ✓ *Financial accelerator*

The role of the financial accelerator is at the bases of the transmission of financial sector movements on the real sector. The financial accelerator can generally be defined as a catalyst, causing the amplification and spread of a financial shock to economic activity. This mechanism is self-feeding. As a result, the degradation agents' wealth causes aggregate demand to slow down and domestic production, which creates a further decline of the wealth. If no economic policy measures are taken to counteract the effects of the accelerator, a sustainable economic recession may follow.

The accelerator mechanism has its roots in imperfections financial systems. The presence of information asymmetries, between “principal” (lenders) and “agents” (borrowers), involves agency costs related to the need for monitoring and information gathering on the quality of the projects to be financed (Stiglitz and Weiss, 1981).

The financial accelerator acts through the “balance sheet channel” or “credit channel”: it is the deterioration of the balance sheet position of the agents which triggers the spread of the initial shock (Bernanke et al., 1996 & 1999). This mechanism helps to explain why there are strong links between the real sphere and the financial sphere, as it strengthens significantly the effect of a simple decrease in the volume of banks loans, known as the “narrow channel of credit”. By analyzing the cycle of credit, Kiyotaki and Moore (1997) point out that, considering that a large number of tangible assets serve both as a factor in production and collateral to credit, a shock on the value of these assets results in an increased tightening of the intermediary finance access conditions. Pro-cyclical fluctuations in asset prices generate changes in the value of collateral, reduce the possibilities and therefore the expenses of agents, which reduces the value of the company’s assets and therefore the agents’ lending opportunities to the period. This degenerative dynamic is referred to by authors under the terminology of “inter-temporal multiplier effect”.

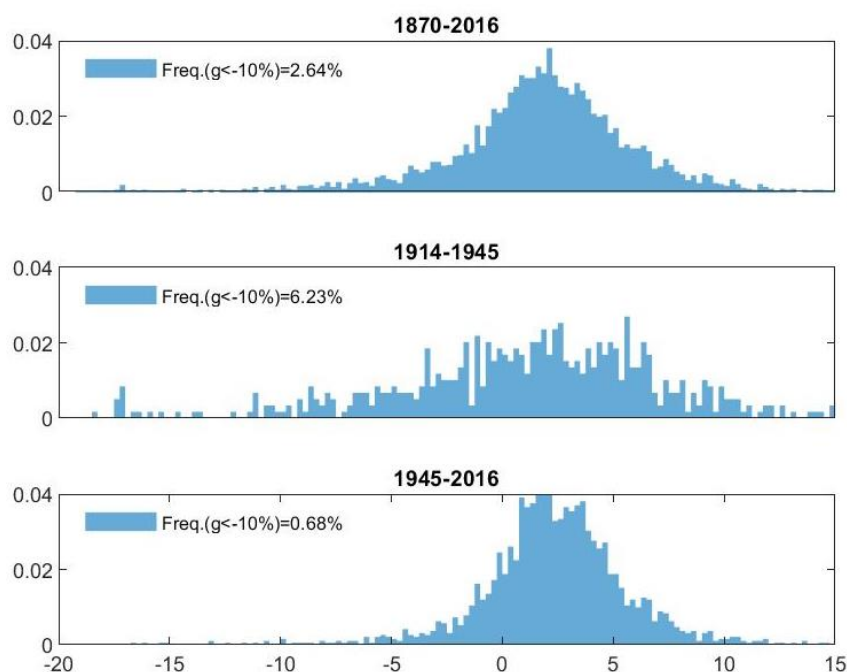
Overall, we can affirm that while the IS-PM model provides a good theoretical framework for describing the mechanisms of economic and financial crises, the role of the financial accelerator is at the bases of the transmission of financial sector movements on the real sector. The following part of the paper presents some statistical analysis and stylized facts.

## **II.2. Brief statistical analysis and stylized facts**

Economic analysis of large recessions has been developed strongly over the past two decades and provides several insights. As shown in figure 1 bellow, a recession is by nature a rare phenomenon. It is, therefore, necessary to look to the past to gather a sufficient number of observations to characterize this phenomenon. This is what Barro did by mobilizing macroeconomic and financial data since the 19<sup>th</sup> century. He has created a database of nearly two hundred economic recessions in which output fell by at least 10%.

The analysis of this database provides the following main lessons: Firstly, the origin of recessions is varied. A large recession can be the consequence of purely economic phenomena (such as the Great Depression), but also political (such as the two world wars), natural (such as earthquakes and tsunamis) or health (such as the Spanish flu). Secondly, the decrease in production observed during economic disasters averages 20% and can exceed 60% during wartime periods. Thirdly, the risk of an economic recession is around 3%, which means that an economy experiences an average of three large recessions per century. There is, therefore, a 3% chance each year that we will experience a 20% decrease in production as a result of an economic, political, natural or health event.

**Figure 1. The frequency of economic recessions since 1870: Real GDP growth rate per capita**



*Reading:* For each period, these graphs show the distribution of real GDP growth rates per capita in 27 countries, i.e. the frequency of observation of each of the values of the growth rates reported in abscises. The legend specifies the frequency of observation of growth rates below -10%. For example, over the period 1870-2016, 2.64% of growth rates were below -10%.

*Countries selected on these charts:* Australia, Austria, Belgium, Brazil, Canada, Chile, Colombia, Denmark, Spain, United States, Finland, France, Greece, Italy, Japan, New Zealand, Norway, Netherlands, Peru, Portugal, United Kingdom, Sri Lanka, Sweden, Switzerland, Uruguay, Venezuela.

*Source:* Maddison Project Database (MPD) 2018. [www.gdc.net/maddison](http://www.gdc.net/maddison).

### III. Data and methodology

#### III.1. Data presentation and statistical test

We examine a sample of 129 countries from all regions of the world with average contemporary data for the period 1990-2010. This sample is constituted of countries from different regions, then we implemented additional estimation with 3 specific regions<sup>8</sup> samples extracted from the global sample to verify the robustness by controlling the heterogeneity of the regions. Since our main dependant variable is the recession, we consider that there the sample is well representative and that there is no more action to take to rearrange it; indeed all the countries are facing crises and recessions. The table A2 in annexe show the description of our statistics. The number of observations for each variable range between 128 and 180. Apart Democracy and fuel variables which present respectively a mean of 5.5 and 16.5, the means rest of the variables move between 0.5 and 3.8. The table A3 in annexe presents the potential correlation between the recession and the other explanatory variables. Like almost all other variables, our main exogenous variable of financial development index presents a negative correlation with the recession.

##### III.1.1. Dependent variable: Economic recession

<sup>8</sup> Sub-Saharan Africa (SSA), South Asia (SASIA) and Latin America and Caribbean (LAC).

The table A1 present the definition and the source of our variables. For the specific case of recession index, the empirical works on recessions considered many alternative GDP based recession indicator.

Following the methodology proposed by Anas and Ferrara (2002, 2004) focusing on USA recession indicator and based on Markov-Switching economic processes highlighted by Hamilton (1989), Laurent (2006) proposed a new monthly index to detect the start and the end of an economic recession phase in real-time for the Euro area. However, this indicator is a Start-End Recession Indicator (SERI) and thus is only able to reproduce all the recession phases experienced by a specific area. Additionally, this last index is predicting recession probabilities than other thing and is therefore not useful for us given our research question.

More recently, Hamilton (2020) and Sahm (2020) constructed respectively a monthly recession indicator called “Real-time Sahm Rule Recession Indicator” for the USA mainly based on the national unemployment rate; and a probability that an economy was in a recession during an indicated quarter. The Sahm (2020) indicator signals the start of a recession when there is three-month average moving up of the national unemployment rate; while the Hamilton (2020) index corresponds to the probability that the fundamental real economic system is related to a recession based on the available data. However they are both not useful for us given our research question since firstly they are new and relatively still under verification measure; secondly, they are more adapted to the USA than other country and data are only available for the USA for now; and finally, the Hamilton (2020) index is more predicting recession probabilities than other things.

Therefore for our part and consistent with Berge & Jordà (2011), Liu & Moench (2016) and Huang et al. (2018), we defined a recession period relative to the National Bureau of Economic Research (NBER)'s classification of a recession. More specifically, we constructed a binary dummy indicator series (1 if a country was in a large recession, and 0 otherwise) following Barro & Ursúa (2012); they consider large recessions indexed by using as a threshold 5% decline in GDP per capita growth. This specific last aspect makes it the best indicator of recession given our empirical model.

### ***III.1.2. Explanatory variables***

The independent variable of interest is the financial development indexed by private domestic credit as a percentage of GDP; this is an indicator highly and extensively used in the empirical literature to index financial intermediation rather than the financial market itself (Easterly, 1993; Demirguc-Kunt & Levine, 1999; Beck, Levine, et Loayza, 2000; Ang, 2013; Ang & Kumar, 2014). Moreover, for our case, we consider that the existence in our sample of some countries with less, non-useful or non-existent financial markets is another reason justifying the choice of this variable.

We control for: financial openness, trade openness, GDP per capita, democracy, institution and fuel. The definitions of the variables, summary statistics and correlation matrix are provided in the Appendix. We discuss the expected signs concurrently with the estimation of results.

### ***III.1.3. Statistical tests***

First, we can start at the point that our database is trustable since it has been published by a well-known institution such as the National Bureau of Economic Research and World Bank. However, after the consolidation of our database as mentioned above, we implemented the following usual preliminary tests to our sample data: Heteroscedasticity, Ramsey Regression Equation Specification Error Test (RESET), Multicollinearity and Normality tests; the results of all these tests were mainly conclusive and allowed us to move forward.

### III.2. Testable hypothesis and empirical specification and estimation method

Based on the theory of the financial accelerator and the statistical correlation analysis presented above, our testable hypothesis is that financial development can have both recessive and expansionary real impact. With this general setup, we analyse the effect of financial development on the recession, while controlling for potential recession determinants. We expect that we can have either a recessive or an expansionary impact depending on the level of the development of the financial sector which closely related to the speed. Indeed, we consider that the speed of financial development decrease while the financial market increase in development; we move from growth at an increasing rate to growth at a decreasing rate of the financial sector. We assume therefore that the real effect of financial development depends on the stage of development of the financial sector.

These different theoretical arguments and assumptions at the bases of the real effect of financial movements allow us to present the following baseline linear and non-linear specification of our equation of the recession respectively:

$$Recession_{it} = \alpha_1 + \alpha_2 FD_{it} + \alpha_3 X_{it} + \varepsilon_{it} \quad (1)$$

$$Recession_{it} = \alpha_1 + \alpha_2 FD_{it} + \alpha_2 FD_{it}^2 + \alpha_3 X_{it} + \varepsilon_{it} \quad (2)$$

Where:  $Recession_i$  and  $FD_{it}$  represents recession and financial development indicator for countries; derived from the equation (1), the model specification (2) objective is to assess the non-linear relation between recession and financial development. We expect a positive sign of the parameter of  $FD_{it}^2$  in line with the theoretical assumption of both recessive and expansionary impact of financial development depending on the states of financial activities.

$X$  is the vector of control variables which represent variables considered in the literature as a potential cause of the economic recession. It consists principally of the level of trade openness, the GDP per capita, the level of financial openness, the institutional along with the democracy aspect and finally energy at the bases of enterprises production aspect indexed by fuels.

$\alpha_1$  is a constant and  $\varepsilon_i$  the error term. Concerning the estimation method of equation (2), following the structure of our database and the results of preliminary tests, we will be able to apply Feasible Generalized Least Squares (FGLS) along with Iteratively Reweighted Least Squares (IRLS) regression methods to our data sample.

Additionally, with the assumption of the existence of a quadratic form and exploiting Lind and Mehlum's (2010) statistical method, we will implement a *Sasabuchi* test which is best

suitable for testing U-shaped patterns. Indeed, Lind & Mehlum (2010)<sup>9</sup> showed in a recent study that having statistically significant regression coefficients of a variable and its squared term and a computed extreme value based on these estimated coefficients, are only necessary but not sufficient to prove the existence of a U-shaped (or inverted U-shaped) relationship. Specifically, Lind & Mehlum (2010, p.110) argue that “*this criterion is too weak. The problem arises when the true relationship is convex but monotone over relevant data values. A quadratic specification may then erroneously yield an extreme point and hence a U shape*”. Considering this, standard estimation methodology is no longer valid for the U-shape test of the composite null hypothesis that the relationship is decreasing at the left-hand side of the interval and/or is increasing at the right-hand side (resp. the opposite in case of an inverted U shape). Lind & Mehlum (2010) adopt a general framework developed by Sasabuchi (1980) to test for the presence of a U-shaped or inverted U-shaped pattern and propose to estimate the confidence interval for the extreme value using the method of Fieller (1954).

After the confirmation of our non-linear model, considering the non-parametric approach, instead of the model (1) we consider the Local Linear Regression (LLR) model which can be specified as follow:

$$Recession = \alpha + f(Y) + \gamma X + \varepsilon, \quad (3)$$

Where  $X$  is a set of only explanatory variables that are assumed to have a linear effect on *Recession*; assuming that the non-linear test is conclusive, these variables are the level of trade openness, the Gross Domestic Product per capita, the level of financial openness, the institutional aspect along also with the democracy and finally energy at the bases of enterprises production indexed by fuels.

A nonparametric approach is natural, and one nonparametric method is known as local linear regression (LLR). The idea of this method is that if  $f(\cdot)$  has sufficient smoothness (say twice-differentiable), then the model will look linear in small regions of input-space.  $f(\cdot)$  is an unknown smooth function of  $Y$ , which we expect to be nonlinear, and  $\varepsilon$  is a random error term. Thus,  $X$  represents the parametric and  $f(Y)$  the nonparametric part of the model. We use the approach proposed by Yatchew & Bos (1997) to fit the local linear model, which consists of four steps: (1) the data is sorted by ascending values of  $Y$ , and first differences of all the sorted data are calculated; (2) The parameters are computed with Ordinary Least Square (OLS), using the differences of  $X$  and recession variable; (3) The original dependent variable *Recession* is adjusted for the linear effects by computing  $Recession - \gamma X$ ; (4) The resulting “purged” dependent variable is used for a local linear regression on the independent variable  $Y$  to obtain an estimate of  $f(\cdot)$ . Note that the use of higher-order differences increases the efficiency of the estimator (Lessmann, 2011).

Following Yatchew & Bos (1997) procedure of the semi-parametric regression and instead of doing a Locally weighted regression (LWR)<sup>10</sup>, we choose to implement a Locally Weighted Scatterplot Smoothing (LOWESS), sometimes called Locally Weighted Smoothing (LOESS). The LOESS is a tool mostly used in regression analysis that creates a smooth line through a

<sup>9</sup> All computations use Stata 10.0 along with the ado-file *u-test* provided by Lind and Mehlum.

<sup>10</sup> LWR is a memory-based method that performs a regression around a point of interest using only training data that are “local” to that point.

time-plot or scatter-plot which highlight the relationship between variables and predict trends. Mainly, the LOESS is typically used for fitting a line to a scatter plot or time plot where noisy data values, sparse data points or weak interrelationships interfere with your ability to see a line of best fit; for linear regression where least-squares fitting doesn't create a line of good fit or is too labour-intensive to use; and for social sciences data exploration and analysis. LOESS, and least-squares fitting in general, are non-parametric strategies for fitting a smooth curve to data points. "Parametric" means that the researcher or analyst assumes in advance that the data fits some type of distribution (i.e. the normal distribution). Because some type of distribution is assumed in advance, parametric fitting can lead to fitting a smooth curve that misrepresents the data. In those cases, non-parametric smoothers may be a better choice. Without considering the data must fit some distribution shape, non-parametric smoothers like LOESS try to find a curve of best fit. In general, both types of smoothers are used for the same set of data to offset the advantages and disadvantages of each type of smoother.

The interest is to assess the behaviour of the variables of interest when a region is excluded from the sample. This is also a means of controlling for extreme values that could influence the baseline findings. The relatively lower correlation coefficient observed when regions are excluded implies that the excluded region has a higher level of recession. In the same line of intuition, a relatively higher correlation coefficient upon the exclusion of a region means the excluded region has a larger change and more related variables to financial development. Moreover, we also use Feasible Generalized Least Squares (FGLS) and Iteratively Reweighted Least Squares (IRWLS) estimation methods.

#### **IV. Recessive and expansionary impacts of financial development: Empirical results**

According to the empirical strategy set up in the previous sections, the present section is divided into the two following parts: the results of parametric and the semi-parametric regressions. Moreover and for robustness constraint, we will consider baseline and extended model specifications along with regional exclusion sample regressions.

##### **IV.1. Results discussion of parametric regressions and non-linearity test**

The equation (2) is estimated using: (1) baseline and extended model specifications; (2) regional exclusion samples along with (3) Feasible Generalized Least Squares (FGLS) and Iteratively Reweighted Least Squares (IRWLS) estimation methods. We start accordingly by the test of inverted U relation.

##### ***IV.1.1. With or Without U? Testing the Hypothesis of an Inverted U-Shaped finance-recession Relationship***

In table 1 above, the probability of the *Sasabuschi* test indicates that the nonlinearity is effective. This probability is given for the first specification and the last specification. There is an extremum point of 1.195 and 1.1528 depending on the model specification. Considering the sign of the coefficient of the scarred value of financial development, we find that these extremums are minimum.

Given our objective of testing the inverted U-shape hypothesis, we focus only on the estimated coefficients of the financial development and financial development squared index.

Our results accept the hypothesis of an inverted U-shaped pattern of financial development in recession with a minimum of 1.1528. This is absolute and robust evidence since the Sasabuchi test have been implemented two times using diverse model specification and with the acceptance of our hypothesis at 1 per cent for all of the models. The Fieller confidence interval is also rather specific, spanning a financial development performance from 0.95 to 1.64.

Table A2 in annexe show that maximum value and minimum value of our financial development index are respectively 0.019 and 2.303; the turning point is therefore 1.1528 and the Fieller confidence interval is included into this min-max interval. This turning point can permit to divide our sample into two part: on one hand countries or regions which are eligible to an expansionary impact of financial development, and on the other hand, countries or region with a recessive impact of financial development.

**Table 1: Test of an inverse U-shaped relationship between finance and recession.**

	eq1	eq2	eq3	eq4	eq5	eq6	eq7
<b>Private credit (DF)</b>	-6,034*** (1,472)	-7,508*** (1,531)	-7,437*** (1,516)	-7,546*** (1,743)	-7,745*** (2,166)	-7,106*** (2,190)	-6,918*** (2,342)
<b>Private credit squared</b>	2,523*** (0,773)	3,233*** (0,803)	3,158*** (0,795)	3,305*** (0,890)	3,373*** (1,040)	3,058*** (1,039)	3,000*** (1,064)
<b>Observations</b>	129	126	126	114	112	96	96
<b>R<sup>2</sup></b>	0,146	0,185	0,185	0,172	0,162	0,180	0,180
<b>Sasabuchi-test of inverse U-shape in DF prob-value</b>	.00504					.00597	
<b>Estimated extreme point (years) (bounds of 95% Fieller interval)</b>	[1.0576497; 1.6399369]					[.94628621; 1.5265758]	
<b>Extremum point</b>	1.195					1.1528	

Note: 0.01 - \*\*\*; 0.05 - \*\*; 0.1 - \*; We estimate 7 equations based on 7 different specifications; this table report only the variables of interest which are financial development and financial development squared. For more details concerning other variables, check the table 2 in the next sub-section.

Source: Author's computation

#### ***IV.1.2. Baseline and extended non-linear specification regressions***

Consecutively to the validation of the non-linearity test, table 2 bellow presents findings based on the non-linear regression specification in equation (2) above. We find that our variable of interest is significant independently to the model specification. Moreover, the results show that there is a U-shaped relationship: financial development increases are accompanied by a reduction in the depth of recessions; and this, up to a certain threshold. Above this threshold, financial development correlates with deep recessions.

Additionally, the above *Sasabuschi* test has shown that the impact of financial development on recession depends on its current level. Considering the sign of the financial development and the squared financial development index, it is now possible to affirm that: the financial development process presents an expansionary impact for countries with financial performance less than 1.1528, and countries with financial performance above the threshold



of 1.1528 present a recessionary financial development process. Concerning recession, policymaker should not implement financial development policies in an absolute manner as confirmed by most of the hold and recent literature; but implement financial development policies relative to the current financial sector performance to avoid the dark side of the process which is recessive impact.

Moreover, trade openness appears also to be recessive. This is line with the theory about globalisation which considers that this phenomenon contributes to putting the domestic economy on a relative bad connexion with other economies; thus this connexion allows financial crisis to impact the local economy and therefore cause an economic recession. This results highlight a relative campaign for the conclusion of Bekaert *et al.* (2011) that globalization tends to decrease during crisis periods.

**Table 2: Parametric estimation results of the baseline and extended specification**

	eq1	eq2	eq3	eq4	eq5	eq6	eq7
<b>Private credit (DF)</b>	-6,034*** (1,472)	-7,508*** (1,531)	-7,437*** (1,516)	-7,546*** (1,743)	-7,745*** (2,166)	-7,106*** (2,190)	-6,918*** (2,342)
<b>Private credit squared</b>	2,523*** (0,773)	3,233*** (0,803)	3,158*** (0,795)	3,305*** (0,890)	3,373*** (1,040)	3,058*** (1,039)	3,000*** (1,064)
<b>Trade openness</b>		0,883*** (0,285)	0,817* (0,429)	1,273** (0,526)	1,263** (0,534)	1,056* (0,542)	1,073* (0,559)
<b>Financial openness</b>			0,035 (0,141)	-0,132 (0,131)	-0,161 (0,136)	-0,140 (0,130)	-0,142 (0,130)
<b>Democracy</b>				0,089 (0,082)	0,062 (0,087)	0,011 (0,092)	0,018 (0,098)
<b>Institution</b>					0,089 (0,176)	0,056 (0,174)	0,068 (0,170)
<b>Fuels</b>						-0,018 (0,013)	-0,017 (0,013)
<b>GDP per capita (log)</b>							-0,083 (0,377)
<b>_cons</b>	4,499*** (0,509)	4,189*** (0,514)	4,173*** (0,507)	3,530*** (0,630)	3,807*** (0,886)	4,356*** (0,988)	4,935* (2,843)
<b>Observations</b>	129	126	126	114	112	96	96
<b>R<sup>2</sup></b>	0,146	0,185	0,185	0,172	0,162	0,180	0,180

Note: 0.01 - \*\*\*; 0.05 - \*\*; 0.1 - \*;

Source: Author's computation

Next step of the methodology presented above is to verify the effect of region extractions and implementation of different estimation methods.

#### ***IV.1.3. Non-linear effect considering influential observations and regional exclusion***

In the first column of Table 2 below, we present the results using the Iteratively Reweighted Least Squares (IRWLS) to control the extremes values. The next columns of the table present a further robustness check in which we exclude regions according to the methodology presented above. More interestingly, this division of our global sample implicitly allows us to

verify the robustness of our results. In addition to the fact that the above baseline and extended specifications findings are confirmed in terms of magnitude and significance of the coefficients, we found the following order of regional importance in increasing magnitude: sub-Saharan Africa (SSA), South Asia (SASIA) and Latin America and Caribbean (LAC).

Moreover, financial openness appears to have an expansionary real impact For SSA countries only; fuels for LAC countries only also which means that countries who manage their oil production in a good manner will also reduce the probability and impact of recessions. However, trade openness for SSA and LAC countries impact positively on recessions. Thus, to fight against recession, SASIA and LAC countries will have to well manage oil production and usage while SSA countries may manage their financial and trade openness.

**Table 3: Robustness check considering influential observations and regional exclusion**

	<b>IRWLS</b>	<b>SSA</b>	<b>SASIA</b>	<b>LAC</b>
	<b>(1)</b>	<b>(2)</b>	<b>(3)</b>	<b>(4)</b>
<b>Private credit</b>	-7,858*** (2,474)	-8,573*** (1,858)	-6,535*** (2,355)	-4,850* (2,854)
<b>Private credit squared</b>	3,501*** (1,249)	3,611*** (0,878)	2,759** (1,070)	2,035 (1,247)
<b>Trade openness</b>	0,975 (0,664)	1,333** (0,507)	0,911 (0,559)	1,252** (0,603)
<b>Financial openness</b>	-0,173 (0,187)	-0,252** (0,106)	-0,146 (0,125)	-0,158 (0,138)
<b>Democracy</b>	0,050 (0,097)	0,080 (0,097)	0,006 (0,103)	0,058 (0,102)
<b>Institution</b>	0,140 (0,198)	0,179 (0,127)	0,023 (0,172)	0,042 (0,196)
<b>Fuels</b>	-0,022* (0,012)	-0,011 (0,015)	-0,021 (0,014)	-0,024** (0,012)
<b>GDP per capita (log)</b>	-0,072 (0,440)	0,282 (0,421)	-0,040 (0,377)	-0,359 (0,449)
<b>Constant</b>	4,782 (3,231)	1,484 (3,256)	4,895* (2,859)	6,599** (3,150)
<b>Number of observations</b>	96	74	92	80
<b>R<sup>2</sup></b>	0,206	0,241	0,201	0,214

Note: 0.01 - \*\*\*; 0.05 - \*\*; 0.1 - \*;

Source: Author's computation

The validation of non-linear relation is sufficient with the estimation of semi parametric regressions.

## IV.2. Result discussion of semi-parametric regressions

All other things equal, from our overall sample of 129 countries, we implement estimation with full sample and by country groups based on geographical position. The idea is that consideration of the level of development and wealth specific to heterogeneous regions can give us information that the overall estimate hides. Thus we divided our global sample of 126

countries into the three following group of countries: Sub-Saharan Africa (SSA), South Asia (SASIA) and Latin America and Caribbean (LAC).

The estimation procedure follows the one used and provided by Lokshin (2006). The estimation output consists of two parts: (1) a table which reports the regression coefficients of the linear part of the model, and (2) a graph which illustrates the functional form of the nonlinear relationship between recession and financial development.

#### ***IV.2.1. Result discussion of local linear regressions***

In table 3 below, we present estimation results using the Yatchew & Bos (1997) technics of the semi-parametric regression corresponding to the equation (3) above.

Moreover, table 3 above reports the following corresponding results. In general, the results of the parametric part converge with the previous results. The nonparametric part is validated by the p-value of test V, which attests that the relationship is non-linear. Moreover and consistent with the theory, fuels appears to be negatively related with economic recession for SASIA and LAC exclusion; this results which are in line with the expected impact confirm the fact that fuels as principal input for any industry or production enterprises, can be used to fight against recession. The countries who manage their oil production in a good manner will also reduce the probability and impact of recessions.

**Table 4: Semiparametric regressions**

	<b>Full sample</b>	<b>SSA</b>	<b>SASIA</b>	<b>LAC</b>
<b>Trade openness</b>	1.054 (.913)	1.599* (.751)	.859 (.905)	1.433* (.831)
<b>Financial openness</b>	-.091 (.326)	-.280 (.264)	-.155 (.323)	-.125 (.288)
<b>Democracy</b>	.001 (.137)	.110 (.131)	-.1267 (.146)	-.022 (.119)
<b>Institution</b>	-.043 (.290)	.149 (.245)	-.001 (.284)	.022 (.285)
<b>Fuels</b>	-.024 (.017)	-.016 (.014)	-.0329* (.017)	-.028* (.015)
<b>GDP per capita (log)</b>	.269 (.619)	.071 (.672)	.486 (.639)	-.642 (.615)
<b>Number of observations</b>	95	73	91	79
<b>R<sup>2</sup></b>	0.061	0.155	0.076	0.183
<b>Significance test on Financial development V (p-value)</b>	0.046	0.078	0.020	0.316

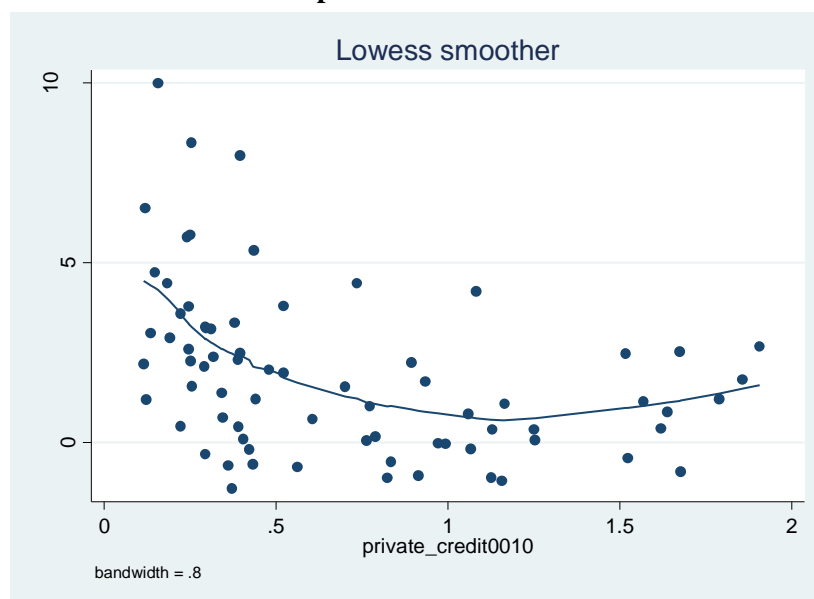
**Note: 0.01 - \*\*\*; 0.05 - \*\*; 0.1 - \*;**

Source: Author's computation

#### ***IV.2.2. Locally Weighted Scatterplot Smoothing Result***

Following Yatchew & Bos (1997) procedure of the semi-parametric regression and instead of doing a Locally Weighted Regression (LWR)<sup>11</sup>, we choose to implement a Locally Weighted Scatterplot Smoothing (LOWESS), sometimes called locally weighted smoothing (LOESS). The LOESS is a tool mainly used in regression analysis that creates a smooth line through a time-plot or scatter-plot which help to observe the relationship between variables and prognosticate trends. As you can see by observing the figure 1 bellow, the nonlinear specification is confirmed; thus overall there is a nonlinear relation between financial development and economic recession independently of empirical method and model specification.

**Figure 2. Recession and financial development: a nonlinear relation illustration**



Source: Author's computation

### **Conclusion**

This main objective of this paper was to examine the effect of financial development on the recession while controlling for potential recession factors. The theoretical/empirical framework and literature review about financial development and economic recession issue highlighted the fact that there could be a positive or negative relationship between financial development and economic recession. To fill the gap in the existing literature, the present research paper gave a full interest to the question of the level of sensitivity of economic recession to the financial sector performance.

For an assessment of the nexus between recession and financial development, we mainly used a panel data of 129 countries spanning 1990-2010 and implemented “Locally Weighted Scatterplot Smoothing”, “Local Linear” and “Iteratively Reweighted Least Squares” regression methods along with a Sasabuchi test to verify the inverse U-shape to estimate the extreme point for the non-linear specification. Moreover, we controlled also potential factors which consisted principally of the level of trade openness, the Gross Domestic Product per capita, the level of financial openness, the institutional aspect along also with the democracy

<sup>11</sup> LWR is a memory-based method that performs a regression around a point of interest using only training data that are “local” to that point.

and finally energy at the bases of enterprises production indexed by fuels. At the end of our econometric gymnastic, we found the following main results:

The nonlinearity is effective. There is thus a nonlinear and thus U-shaped relationship between recession and financial development with a threshold effect of 1.1528 which validate financial development recessive and expansionary real impacts: when financial development increases, this is accompanied by a reduction in the depth of recessions; and this, up to a certain threshold. Exceeding this threshold, financial development correlates with deep recessions. The financial development process presents an expansionary impact for countries with financial performance less than 1.1528, and countries with financial performance above the threshold of 1.1528 present a recessionary financial development process.

For robustness check, we implemented several estimations using (1) Iteratively Reweighted Least Squares (IRWLS) to control the extreme values that could influence the baseline findings and (2) exclusion of regions to assess the behaviour of the variables of interest when a continent is excluded from the sample. We implemented also “Locally Weighted Scatterplot Smoothing”, “Local Linear” regression method. In addition to the baseline findings being confirmed in terms of sign and significance in the correlation coefficients, the following is the order of continental importance in regions in increasing magnitude: sub-Saharan Africa (SSA), South Asia (SASIA) and Latin America and Caribbean (LAC).

Finally, we implemented several estimations based on different specification using a semi-parametric regression with a procedure provided by Lokshin (2006). The estimation output consisted of two parts: (1) a table that reports the regression coefficients of the linear part of the model and (2) a graph that illustrates the functional form of the nonlinear part, of the relationship between recession and financial development.

In general, the results of the parametric part converge with the previous results. The nonparametric part is validated by the p-value of test V, which attests that the relationship is non-linear. Moreover and consistent with the theory, fuels appears to be negatively related with economic recession for SASIA and LAC exclusion; this results which are in line with the expected impact confirm the fact that fuels as principal input for any industry or production enterprises, can be used to fight against recession. The countries who manage their oil production in a good manner will also reduce the probability and impact of recessions. Moreover, the LOESS confirmed the non-linearity of the relation.

To the best of our knowledge, this is the first study that examines this relationship using newly primary and hitherto almost unexploited “Rare macroeconomic disasters” data from Barro and Ursua (2012) which allows us to build a more specific proxy of the variable “economic recession”.

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## Appendix A. Data sources and summary statistics of variables

**Table A1. Definitions and Sources of variables.**

Variables	Definition	Source
Private credit	Value of financial intermediaries credits to the private sector as a share of GDP (excludes credit to the public sector and credit issued by central and development banks)	World Bank WDI online database; Beck et al. (2010)
GDP per capita (log)		Pen World Tables 7v
Trade openness	Sum of exports and imports of goods and services as a share of GDP in 2000	World Bank WDI online Database
Financial openness	Sum of gross stock of foreign assets and liabilities as a share of GDP in 2000	Lane et al. (2007)
Large Recession	Using real GDP per capita from the World Development Indicators, large recessions are identified by following Barro and Ursúa 2012 and using as a threshold a 5% decline in GDP per capita growth from peak to trough. The constructed variable is a dummy variable (1 if a country was in a large recession, and 0 otherwise). <b>Data sources:</b> Barro, Robert J., and José F. Ursúa, (2012), “Rare Macroeconomic Disasters,” <i>Annual Review of Economics</i> 4 (1): 83–109), with data available at <a href="http://scholar.harvard.edu/barro/publications/barroursua-macroeconomic-data">http://scholar.harvard.edu/barro/publications/barroursua-macroeconomic-data</a> ; World Bank national accounts data, at <a href="http://data.worldbank.org">http://data.worldbank.org</a> ; OECD National Accounts data, at <a href="http://stats.oecd.org/">http://stats.oecd.org/</a> .	World Bank. 2013. <i>World Development Report 2014: Risk and Opportunity—Managing Risk for Development</i> . Washington, DC: World Bank. DOI: 10.1596/978-0-8213-9903-3.
Institution	Quality of formal institutions. We consider an index that averages six	World Bank Governance



Indicators from the Worldwide Governance Indicators (WGI), averaged over 1996-2010: 1) Voice and Accountability; 2) Political Stability and Absence of Violence; 3) Government Effectiveness; 4) Regulatory Quality; 5) Rule of Law; and 6) Control of Corruption. indicator. The measures come from the dataset compiled by Kaufmann, Kraay and Mastruzzi at the World Bank, (2010)

Democracy

Politics IV

**Table A2. Descriptive statistics**

Variables	Observations	Mean	Standard Deviation	Minimum	Maximum
Private credit	180	0.504	0.463	0.019	2.303
Large recession	133	2.669	2.862	0	11
Trade openness	180	.902	.550	.011	3.720
Democracy	144	5.535	3.881	0	10
Financial openness	177	2.156	2.521	0.424	23.977
Fuel	128	16.448	25.603	0	97.909
Institution	189	2.338	3.782	-6.654	9.419
GDP per capita	180	8.528	1.304	5.561	11.142

**Table A3. Correlation Matrix**

	Recession	Private credit	Trade open	Financial openness	Democracy	Institution	Fuel	GDP per capita
Recession	1.0000							
Private credit	-0.3041	1.0000						
Trade open	-0.0000	0.2320	1.0000					
Financial openness	-0.1153	0.5105	0.5187	1.0000				
Democracy	-0.1266	0.4546	0.0472	0.2488	1.0000			
Institution	-0.2042	0.6735	0.3289	0.5487	0.6128	1.0000		
Fuel	-0.0940	-0.2085	-0.0837	-0.1484	-0.2980	-0.2737	1.0000	
GDP per capita	-0.2962	0.7316	0.3019	0.4174	0.5922	0.7349	0.0300	1.0000