Financial Development and Economic Growth: Testing Patrick's Hypothesis for Three Caribbean Economies

By

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Abstract

A heavily researched issue in the economics literature over many years is the relationship between financial development and economic growth. Central to these discussions is the nature of causality between the two variables. On the one hand there is the very popular view that financial development is important and lends to economic growth - the so-called supply-leading phenomenon. Conversely, there is the demand –following viewpoint which suggests that economic growth stimulates the development of the financial sector. Furthermore, researchers assert that a feedback relationship exists between financial development and economic growth.

As a result of the controversy surrounding the relationship between the two variables at the theoretical level, a host of researchers have subjected the finance-growth link to empirical verification. However, despite these efforts a gap remains in the literature. This stems from the fact that very few studies have focused on the "stage of development" hypothesis of Patrick (1966), where the direction of causality between financial development and economic growth changes over the course of development. The paucity of empirical studies on the Patrick Hypothesis may be as a result of data limitations.

The aim of this paper is therefore to extend the literature on the finance-growth nexus by focusing specifically on testing Patrick's stage-of-development hypothesis for the Caribbean economies of Barbados, Jamaica, and Trinidad and Tobago using time series econometrics (unit root test, co-integration and Granger causality through a Vector Error Correcting Model) over the period 1950 to 2009.