ICHRAF OUECHTATI
Faculty of Economic Sciences and Management of Tunis, Tunisia

MACROECONOMIC FLUCTUATIONS, FINANCIAL INSTABILITY AND INSTITUTIONS: THE CASE OF DEVELOPING COUNTRIES

Abstract:

This study employs dynamic panel generalized method of moment (GMM) technique to empirically examine the role of institutions in explaining the causal relationship between macroeconomic fluctuations and financial instability for a sample of 44 emerging and developing countries over the 1996- 2010 period.

In this work, Granger causality tests will be performed with panel data. Similar to Chamberlain (1984) and Holtz- Eakin and al. (1988), we test the non causality hypothesis by examining whether the coefficients of the lagged or the lagged difference of independent variables are zero, that is, (Wald test).

We use, in this analysis, the method of GMM system proposed by Arellano and Bover (1995) and Blundell and Bond (1998). Their estimator augments Arellano and Bond (1991) by establishing an additional assumption, that first differences of instrumenting variables are uncorrelated with the fixed effects. It builds a system of two equations- the original equation as well as the transformed one- and is known as "system GMM". As an empirical matter, the significance of the test for AR(2) in first differences is necessary in order to detect autocorrelation in levels. The validity of the additional instruments can be tested using standard Sargan/ Hansen tests of over- identifiying restrictions, or using Difference Sargan or Hansen comparisons between the first differenced GMM and system GMM results.

We find a bidirectional causality going from financial instability to macroeconomic volatility. The impact of financial sector fluctuations is extremely high compared to macroeconomic fluctuations. Financial instability has an effect of 1.623% on real sector volatility, while the opposite effect is only 0.004%.

Taking into account the institutional framework in the estimation of our causal relationship, we find that : (1) the insignificance of institutional interaction terms in most estimation cases can be explained by the deficiency of institutions in developing countries, (2) the market- oriented regulations reinforce the volatile effects of financial structures and macroeconomic fluctuations. However, the positive impact of financial instability on macroeconomic volatility is reduced by a high governance performance. Our results show the importance of the regulatory framework for a better financial and economic stability.

Keywords:

Macroeconomic fluctuations, financial structure, institutions

JEL Classification: E32, G01, K20