In the fifth column, we include both total capitalization and accounting standards. The coefficient for total capitalization is no longer different from zero and its magnitude falls to one-fifth of its level in the first column. Similar results are obtained when we replace total capitalization by domestic credit to the private sector (coefficients not reported). This suggests that accounting standards capture the information about development that is contained in the capitalization measures. For this reason, we will use accounting standards as our measure of development in the rest of the paper. The reader should be assured, however, that the results are qualitatively similar when capitalization measures of development are used.

Because of potential concerns about endogeneity, we will, however, instrument accounting standards with predetermined institutional variables. Rafael La Porta et al. (1996) suggest that the origin of a country's legal system has an effect on the development of a domestic capital market and on the nature of the accounting system. Countries colonized by the British, in particular, tend to have sophisticated accounting standards while countries influenced by the French tend to have poor standards. This suggests using the colonial origin of a country's legal system (indicators for whether it is British, French, German, or Scandinavian) as reported in La Porta et al. as one instrument. Also, countries differ in the extent to which laws are enforced. So we use an index for the efficiency and integrity of the legal system produced by Business International Corporation (a country-risk rating agency) as another instrument. As the sixth column of Table 4 shows, the fundamental interaction becomes even stronger in magnitude when we estimate it using instrumental variables.

Before going further, consider the actual (rather than estimated) effects of development on the growth of specific industries. In Table 5, we summarize for the three least-dependent and three most-dependent industries, the residual growth rate obtained after partialling out industry and country effects. The pattern is remarkable. For countries below the median in accounting standards, the residual growth rate of the three least-dependent industries is positive, while the residual growth rate of the three most-dependent industries is negative. The pattern reverses for countries above the median. Clearly, this suggests no single country or industry drives our results and the realized differential in growth rates is systematic and large.

TABLE 5—EFFECT OF FINANCIAL DEVELOPMENT ON ACTUAL GROWTH RATES IN DIFFERENT INDUSTRIES

	Countries below the median in accounting standards	Countries above the median in accounting standards
Least financially dependent industries		
Tobacco	0.53	−0.60
Pottery	0.25	−0.30
Leather	0.77	−0.77
Most financially dependent industries		
Drug	−1.11	1.30
Plastics	−0.21	0.21
Computers	−2.00	1.80

Notes: This table reports the mean residual growth rate (in percentage terms) obtained after regressing the annual compounded growth rate in real value added for the period 1980–1990 on industry and country dummies.

2. *Varying Measures of Dependence.*—We now check that our measure of dependence is, indeed, reasonable. We do this in two ways. First, we check that past financing in a country is related to the external dependence of industries in the country. Second, we check that our result is robust to different measures of dependence.

Total capitalization is a (crude) measure of how much finance has been raised in the past in the country. If external dependence is a proxy for an industry's technological need for external finance outside the United States, then countries more specialized in externally dependent industries should have higher capitalization. We calculate the weighted average dependence for each country by multiplying an industry's dependence on external finance by the fraction that the industry contributes to value added in the manufacturing sector in 1980. We then regress total capitalization