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Review

Financial liberalization and growth in African economies: The role of policy complementarities

Ousmanou Njikam

Faculty of Economics & Management, University of Yaoundé II, Cameroon

Abstract

This paper examines whether the effect of financial liberalization on economic growth depends on reform complementarities. A non-linear growth regression specification that interacts a proxy of financial liberalization with proxies of reform complementarities is estimated using a panel of 45 Sub-Saharan Africa (SSA) countries. The cross-country, panel-data evidence shows no clear relationship between financial liberalization and growth. The study however finds that financial liberalization is more likely to positively and significantly increase growth across the SSA region if the following complementary reforms are undertaken e.g. improvement in educational attainment, macroeconomic and external stability, and overall governance.

JEL classification: O11; O16; O38; O55

Keywords: Financial liberalization; Growth; Economic reform; Policy complementarity; Africa

Contents

1. Introduction

Financial liberalization is an important catalyst for economic growth (Stiglitz, 2000). At the domestic front, financial liberalization affects growth through the following channels: it reduces quantitative controls, allows interest rates to be market determined; produces higher interest rates and allocates capital toward higher return projects. Market determination of interest rates results in positive real interest rates, which improve financial intermediation and provide incentives for borrowers to invest in more productive activity (Gibson and Tsakalotos, 1994). At the external front, financial openness creates large capital flows and larger financial markets mean cheaper and more credit (Özdemir, 2014). The inflows of foreign savings augment domestic investment and capital-poor economies can free themselves from a binding constraint on economic growth e.g. lack of capital (Levine, 2001). Financial liberalization is also associated with increased domestic competition and technology transfers with a potential positive influence on economic growth (Levine, 2006).

E-mail address: onjikam2002@yahoo.fr

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But, critics assert that its benefits have not been demonstrated mainly because countries have lagged behind in terms of reform complementarities (Williamson, 1993; Rodrik and Subramanian, 2009). For example, the growth effect of financial liberalization can be disappointing if implemented in a context of poor human capital unable to welcome foreign capital inflows and the associated technology (Rodrik, 1999; Edison et al., 2002; Abed, 2003).

Since 1980, growth in Sub-Saharan Africa (SSA) has declined at almost 1% per annum (Collier and Gunning, 1999).[1] The choice of bad policies e.g. financial repression seems to be the main cause of this slow growth (Azam et al., 2002). In order to achieve higher levels of economic growth, financial openness became the appropriate development strategy of SSA countries.[2] Contrary to expectations, after nearly three decades, financial liberalization is not growth enhancing in SSA economies (Reinhart and Tokatlidis, 2003).

The empirical studies on financial openness in SSA focused on its design, difficulties, implementation, and growth effect (Chang and Mendy, 2012; Ahmed, 2013). But, less attention has been given to the role of complementary reforms in the financial liberalization-growth nexus. The aim of this article is twofold: investigate empirically the impact of financial liberalization on economic growth over the sample period of 1970–2010 and then examine whether the growth effect of financial liberalization is contingent on complementary policies. This article is the first study to tackle these questions focusing on the SSA countries. Our findings show no relationship between financial liberalization and growth while the growth effect of financial liberalization is significantly positive if accompanied by improvement in schooling, macroeconomic and external stability, and overall governance.

The rest of the paper is as follows. Section 2 presents the model and data. Section 3 presents and discusses the results and Section 4 concludes.

2. Model specification and data

2.1. Model specification

Financial liberalization is not growth enhancing in the presence of distortions. To test this prediction, we estimate the following equation,

$$\Delta y_{it} = c + \beta_0 y_{it-1} + \beta_1 FL_{it} + \beta_2 CR_{it} + \beta_3 (FL_{it} \times y_{it-1}) + \beta_4 (FL_{it} \times CR_{it}) + \mu_t + \eta_i + \varepsilon_{it} \quad (1)$$

where the subscripts i and t represent country and time period, respectively; y is the log of GDP per capita; y_{t-1} is the level of per capita GDP at the start of the corresponding period; CR is a set of complementary reform variables; FL represents financial liberalization i.e. a dummy indicator or the Chinn and Ito (2008) index to capture the impact of domestic and external financial liberalization, respectively; μ_t and η_i denote unobserved time- and country-specific effects, respectively; and ε is the error term. To allow the growth effect of financial liberalization to vary with the complementary reforms, FL is interacted with CR_{it} one at a time. This strategy allows the derivation of different set of coefficients for 'without' and 'with' policy complementarity. Hence, the coefficient β_1 measures the growth effect of financial liberalization while the pattern of complementarity is captured by $\beta_1 + \beta_4$ when using the dummy and $\beta_1 + \beta_4 \times CR_{it}$ when the Chinn-Ito's index is the measure of financial openness. We expect $\beta_1 + \beta_4 \times CR_{it}$ to be positive for the variable whose increase indicates progress and negative for the variables whose decline denotes improvement (e.g. inflation, size of government, external debt). If β_4 is significant, then the effect of financial liberalization on growth depends on what happens to a given complementary reform variable. The rate of conditional convergence when using the 0–1 dummy or Chinn-Ito's index is measured by $\beta_0 + \beta_3$ and $\beta_0 + \beta_3 \times FL_{it}$, respectively. If β_3 is significant and positive, then a greater financial liberalization contributes to a faster rate of conditional convergence.

We used the system-GMM estimator i.e. we estimate a system of equations in differences and in levels (see Arellano and Bover, 1995; Blundell and Bond, 1998). For the equation in differences and variables measured as period averages e.g. inflation, public infrastructure, government size, trade openness, external debt, and governance index, the instrument is the average of period $t-2$, while for the variables in initial values e.g. per capita GDP and secondary school enrolment, the instrument is the observation at the start of period $t-1$. For the equation in level, the instruments are given by the lagged differences.[3]

2.2. Data

We follow the convention for the studies in this area and focus on the SSA countries, setting aside the North African countries.[4] The sample consists of an unbalanced panel dataset that comprises 45 SSA countries in 1970–2010. To control for business cycles, the dataset is structured as a panel with observations for each country consisting of non-overlapping 5-year averages for each variable. Thus, each country has 8 observations – the averages for 1970–1974, 1975–1979, 1980–1984, 1985–1989, 1990–1994, 1995–1999, 2000–2004, and 2005–2010.[5]

[1] Though economic performance in SSA has markedly improved since the mid-1990s, the low and unsustained level of growth in SSA remains a major challenge to economists.

[2] Beginning in the 1990s, many SSA countries liberalized interest rates, phased out directed credit, moved to indirect monetary policy instruments, restructured and privatized banks, and reinforced banking sector supervision and microfinance. At the external front, they abolished controls on international capital movements. See among others Mehran et al. (1998) for a compact description of the financial reforms in SSA countries.

[3] The system GMM estimates are obtained using the STATA command – xtabond2 – which provides the first-order, second-order, and the Sargan/Hansen test statistics.

[4] The main reason is that the North African countries e.g. Algeria, Egypt, Libya, Morocco and Tunisia are part of a different regional economy – the MENA – with its own distinctive set of economic issues.

[5] The last panel rather consists of a 6-year average spanning the 2005–2010 period. Appendix Table A provides the full list of countries in the sample.

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