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Monetization, Financial Development, and Growth: Time Series Evidence from 22 Countries in Sub-Saharan Africa

PETER L. ROUSSEAU
Vanderbilt University, Nashville, TN, USA

and

ALEXANDRA D'ONOFRIO *
LUISS Guido Carli, Rome, Italy
University of Rome Tor Vergata, Italy

Summary. — Does financial development enable economic growth in developing countries? We find evidence for this in sub-Saharan Africa, a region where there is an urgent need to promote growth. Using a modern time series methodology and data for 22 countries over the period from 1960 to 2009, we find unidirectional links from financial development to measures of real activity for about two-thirds of them. In most cases the effects come from narrow money rather than more broadly-defined financial aggregates. This suggests that monetization plays a distinct role in capital accumulation and growth in many of these countries.
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Key words — real money balances, investment, real activity, vector autoregressive model, vector error correction model, sub-Saharan Africa

1. INTRODUCTION

A large literature relates financial development to economic growth. [1] But does the relationship hold for countries in sub-Saharan Africa, which includes some of the world's poorest economies? The question is particularly important because there is an urgent need for growth in the region and many financial systems there remain quite undeveloped, which suggests a potential for high returns to financial deepening (Beck, Maimbo, Faye, & Triki, 2011). To address it, we conduct a comparative investigation of 22 countries in the region with data from 1960 to 2009 using a time series methodology, and find a distinct role for monetization, measured as the size of real M1 balances, in the growth and investment performance of more than two-thirds of them. Our emphasis on a more fundamental measure of financial development in conjunction with broader ones, such as the quantity of domestic credit allocated to the private sector, allows more focused testing of the role of finance in growth than studies using only broader aggregates.

The circled countries in Figure 1 show the locations of the 22 mostly Central and West African countries that we study and Table 1 provides summary statistics. [2] Looking at gross domestic product (GDP) it is clear that sub-Saharan Africa remains generally under-developed economically, even when compared to the average per capita income in Latin America shown in the final row. There is also a good deal of heterogeneity across countries. [3] Oil-rich countries such as Gabon and Congo have relatively high GDP per capita, as does resource-rich South Africa. Yet countries in Central and East Africa such as Burundi, the Central African Republic, and Malawi still have among the lowest per capita incomes in the world. The World Bank classifies Gabon as high income, Congo and South Africa as upper middle income, Burundi, Central African Republic, Malawi, Niger, Sierra Leone, and Togo as low income, and the other 12 countries as lower middle income. [4]

The measures of financial development on the right-hand side of Table 1 are relatively low also, and in most cases well below the average of countries in Latin America. Given the indicators in Table 1, it is not surprising that Demetriades and James (2011) emphasize the dysfunctional nature of the region's capital markets. They describe the link between finance and growth in sub-Saharan Africa as "broken" and provide evidence from panel data that, if anything, banking system development follows economic growth. Gries, Kraft, and Meierrieks (2009) also study linkages between broad measures of financial deepening, trade openness, and economic development for 16 sub-Saharan African countries and find little support for a leading role for financial factors.

Our findings are not inconsistent with these contributions. But by considering narrow financial aggregates together with broader ones we demonstrate that sustainable development may be possible through more fundamental forms of financial development. In other words, we propose that some countries in the region are experiencing improvements in monetary stability consistent with the order of financial liberalization proposed by McKinnon (1973, 1991), in which basic monetization and the establishment of banks are first steps that are later followed by the emergence of more sophisticated financial

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Figure 1. *Sub-Saharan Africa with the 22 countries in the study circled.*

Table 1. *Macroeconomic and financial development indicators, 2008 Source: World Bank's World Development Indicators (2010).*

	Per capita GDP (international US$)	M2 (% of GDP)	M1 (% of GDP)	Domestic credit provided by the banking sector (% of GDP)	Domestic credit provided to the private sector (% of GDP)
Benin	1,485	32.9	25.1	14.8	20.9
Burkina Faso	1,174	22.5	14.0	15.3	18.4
Burundi	386	34.2	23.3	35.4	21.4
Cameroon	2,191	19.7	12.8	5.8	10.5
Central African Republic	747	14.4	12.8	18.0	7.0
Congo, Republic	3,976	17.6	16.2	18.5	3.5
Cote d'Ivoire	1,666	27.8	19.1	20.1	16.3
Gabon	14,690	16.8	11.9	6.1	8.5
Gambia	1,377	49.5	28.1	33.8	17.3
Ghana	1,501	29.2[a]	10.7[a]	32.9[a]	17.8[a]
Kenya	1,560	39.8	22.7	40.1	30.0
Madagascar	1,061	20.4	14.0	9.3	11.1
Malawi	752	18.8	11.8	26.2	11.4
Mauritania	1,977	13.1[b]	9.5[b]	6.1[b]	27.0[b]
Niger	704	15.7	12.1	6.2	11.0
Nigeria	2,116	30.1	19.1	26.7	33.9
Rwanda	1,112	17.5[c]	9.7[a]	8.7[a]	12.1[a]
Senegal	1,808	33.4	21.1	24.7	24.2
Sierra Leone	789	20.6	11.4	7.4	7.1
South Africa	10,481	64.3	18.2	215.5	145.1
Sudan	2,142	17.6	11.2	16.5	10.5
Togo	842	37.8	25.9	24.8	18.7
Latin America	10,794	40.7	n.a.	71.9	38.2

[a] 2006.
[b] 2003.
[c] 2005.

institutions and markets. In particular, increases in real M1 balances can serve as a fundamental store of value in economies that are less financially developed, allowing agents to overcome project indivisibilities and encouraging capital accumulation. They also can draw more transactions into the formal monetized sector that would otherwise occur through barter or some other moneyless device, thereby improving allocation of scarce economic resources.

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