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Linkages between financial development, financial instability, financial liberalisation and economic growth in Africa

Michael Batuo[a], Kupukile Mlambo[b], Simplice Asongu[c,d,e,*]

[a] University of Westminster, 309 Regent Street, London W1B 2HW, United Kingdom
[b] Reserve Bank of Zimbabwe
[c] Africa Governance and Development Institute, P.O. Box, 8413, Yaoundé, Cameroon
[d] Department of Economics, University of South Africa, P. O. Box 392, UNISA 0003, Pretoria, South Africa
[e] Department of Economics & Development Studies, Covenant University, Ota, Ogun State, Nigeria

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ABSTRACT

In the aftermath of the 2008 global financial crisis, the implications of financial liberalisation for stability and economic growth have come under increased scrutiny. One strand of literature posits a positive relationship between financial liberalisation and economic growth and development. However, others emphasise the link between financial liberalisation is intrinsically associated with financial instability which may be harmful to economic growth and development. This study assesses linkages between financial instability, financial liberalisation, financial development and economic growth in 41 African countries for the period 1985–2010. The results suggest that financial development and financial liberalisation have positive effects on financial instability. The findings also reveal that economic growth reduces financial instability and the magnitude of reduction is higher in the pre-liberalisation period compared to post-liberalisation period.

1. Introduction

The financial crisis of 2008 cannot be viewed as a shock that was subsequently followed by struggles from actors that were rational (Asongu, 2015a). On the contrary, it demonstrates the imperative of social norms and conventions like models of management adopted to meet-up the challenges of uncertainty. In essence, the failure of political scientists and economists to forecast the crisis is at the same time embarrassing and very dismal.

Accordingly, the crisis has gone a long way to reminding scholars that we are living in a world full of risks and uncertainties, which conventional models of market and human behaviour are unable to effectively predict. Nevertheless, rational economic agents are still assumed to follow instrumental, consistent and rational norms, and this is viewed as rationally logical. However, where the parameters are for the most part not able to predict future events, as is the case in the real world, this conjecture becomes untenable. This situation has allowed market players and policy makers to become dependent on a plethora of social conventions that stabilise uncertain environments (Nelson and Katzenstein, 2011).

In the light of the recent financial crisis, the great ambitions of liberalisation policies and their relevance to economic prosperity have increasingly come under scrutiny, particularly in developing countries. According to some experts, the financial meltdown has exposed the shortcomings of liberalisation economic strategies (Kose et al., 2006; Goldberg and Veitch, 2010; Agbloyor et al., 2013; Asongu, 2014; Kose et al., 2011). In essence, emerging economies that experienced considerable inflows of capital during the past

* Corresponding author.
E-mail addresses: enowbim@wmin.ac.uk (M. Batuo), kmlambo@rbz.co.zw (K. Mlambo), asongusimplice@yahoo.com, asongus@afridev.org (S. Asongu).

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decades have been confronted with the challenging task of managing any consequential external shocks, which may be exacerbated by financial liberalisation, when those financial flows contract. Accordingly, the economic downturn has encouraged renewed interest in the theoretical underpinnings of financial liberalisation, especially in terms of how financial liberalisation has affected developing countries.[1]

Rodrik and Subramanian (2009) take the view that the theoretical underpinnings of financial globalisation are less convincing today. They consider that the global financial meltdown and its consequences, has resulted in the benefits of financial engineering becoming questionable. According to Rodrik and Subramanian (2009), financial liberalisation has substantially failed to address the needs of investment and growth in less developed countries. Thus, nations that have experienced remarkable rates of economic growth have been those that have also been less reliant on international capital flows. They sustain that globalisation has failed to smooth consumption and mitigate volatility. Clearly, in a situation where financial flows in an economy are not able to be quickly moved from one financial centre to another, due to an absence of financial liberalisation, economic volatility could be reduced in the economy. Alternatively, if financial flows are able to move rapidly across international borders, those economies losing the flows may have their banking systems and industrial bases undermined.

When the current wave of liberalisation began in the 1980s, developing and developed nations experienced considerable improvements in cross border financial flows. However, these flows were accompanied by currency crises. These negative outcomes have resulted in a renewed interest and focus in policy and academic making circles on the rewards of liberalisation. Some protagonists take the view that, relative to more advanced countries, undeveloped countries which responded by substantially opening-up their capital accounts have been more vulnerable to external shocks (Kose et al., 2011; Henry, 2007; Asongu, 2014; Ansart and Monvoisin, 2017). Despite a general consensus regarding the benefits of trade openness (Kose et al., 2006), there is an increasingly polarized debate on the effects of financial liberalisation (Asongu and De Moor, 2017).

In Africa, by the late 1980s and early 1990s, against a background of rapidly deteriorating economic and financial conditions, many African countries undertook far reaching economic reforms (see Aryeetey, 1994; Collier, 1993; Ekpenyong, 1994; Kesekende and Atingi Ego, 1999; Khan and Reinhart, 1990). These programs that were supported by the World Bank and the IMF focussed on structurally adjusting economies in order to achieve private sector led growth, via a market based system. Financial liberalisation was a significant component of these reforms, facilitating the deregulation of the foreign sector capital account and domestic financial sector, enabling the domestic stock market sector to be decoupled from the domestic financial sector (Kaminsky and Schmukler, 2002). Although the reform succeeded in liberalising the financial markets, the positive impact on growth and investment has been patchy, while the African financial system remains shallow and relatively underdeveloped (Reinhart and Tokatlidis, 2003). Indeed, financial liberalisation appeared to engender greater instability and crises, particularly in the financial sector (Demirguc-Kunt and Detragiache, 2001; Al-Suwailem, 2014).

Financial instability can manifest itself in a number of ways, such as in banking failures, asset price volatility or a collapse in market liquidity. The potential outcome of such damaging events could be severe disruption to a country's payment and settlement system and thus destabilisation of the economy in general. Financial instability affects the real (or productive) sector due to its links with the financial sector. It therefore has the potential to cause significant macroeconomic costs, as it negatively impacts on production, consumption and investment and consequently inhibits broader economic objectives such as growth and development. Kaminsky and Reinhart (1999) confirmed this negative outcome, finding financial instability was positively associated with financial development. This implies that safeguarding financial stability and identifying vulnerabilities within a financial system is essential for financial development. Some of these vulnerabilities have macroeconomic dimensions, such as changes in the conditions of household and corporate sector balance sheets and developments in credit and asset markets, all of which have the potential to affect the level and distribution of financial risk within the economy. Arguably, the need to safegauard financial stability is paramount, as this would make it easier to identify any vulnerabilities within a financial system and reduce such vulnerabilities occuring in the first place.

Many leading African economists believed the 2008 financial crisis could not affect Africa because its banking and capital markets were not fully integrated in global markets. Consequently, they considered the impact of the crisis on Africa would be minimal. However, the crisis had a substantial adverse effect on the financial sector of Africa's economies, particularly the larger economies (see Murinde, 2010).

This paper, examines the effects of financial liberalisation, financial development and economic growth on financial instablity in Africa. In particular, it investigates whether financial instability has an impact on economic growth in African countries and whether the financial development and liberalisation that has occured in Africa is linked to financial instability. Further, whether the relationship between financial development and financial instability is more pronounced in the pre-liberalisation or post-liberalisation period. These questions are significant and contemporaneous, as instability is an inherent feature of financial systems. There is also clear evidence in the economic literature that financial liberalisation raises economic costs, in terms of inflated financial fragility due to the inefficient and underdeveloped banking sector in developing countries.

These issues are clearly relevant given that financial stability preservation has become an important item on the agenda of international financial institutions. These issues are important for African countries as their financial development is rapid and there is an urgency for them to integrate their economies into the international financial structure and international financial markets

[1] The theoretical underpinnings of globalization sustain that liberalization should foster efficient capital allocation at the international level as well as the sharing of risks. According to the narrative, less developed nations should benefit more because they are considerably scarce in capital and rich in labour. Moreover, undeveloped nations are relatively more volatile with respect to output, compared to more industrialized or advanced economies (Asongu, 2013a,b, 2015b; Kose et al., 2011).

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