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Financial Structure and Economic Growth: Evidence from Sub-Saharan Africa

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Financial structure, the extent to which a country's financial system is either bank-based or market-based has been shown to have an effect on some countries economic growth, while in other countries, it has been shown to be of no economic significance. Many of the studies have focused on developed and emerging economies that have well developed financial systems relative to the financial systems of developing countries.

Countries in Sub-Saharan Africa (SSA) began establishing stock markets at the behest of the World Bank and the International Monetary Fund in the 1980's, despite the underdeveloped nature of their banking systems. While this was seen as necessary to promote economic growth, critics questioned whether stock markets in SSA were established at the right time and for the right reasons, with some describing them as "casinos".

In this paper, we investigate the effect of financial structure on economic growth in selected countries in SSA both in the long-run and in the short-run. The limited number of studies on SSA informs the choice of the region, as well as the availability of data on the characteristics of financial system in the region, provided by the World Bank. The study is limited to countries with functioning stock markets that have been in existence for over a decade regardless of the level of development in the banking sector.

Our results show that in the long-run, financial structure is not significant in influencing growth in SSA. Even after controlling for countries with better developed financial systems (Mauritius and South Africa), the results did not change and the main conclusion that financial structure does not matter for long-run growth still holds.

We then estimated the role of financial structure while controlling for the level of financial development as measured by the ratio of credit to the private sector to GDP. The results still showed that financial structure does not matter in the long run. However, the level of financial development was found to have a negative and significant effect on economic growth, contrary to the financial services view. The financial services view postulates that it is the collective financial services offered by both the banking sector and the financial markets that matter, and not the weight of either the banks or the financial markets.

This finding was attributed to an inefficient financial system, whose services are not geared towards the productive sectors of the economies in Sub-Saharan Africa. Likewise, credit directed to households for consumption smoothing may not be as productive as credit directed to firms for investment purposes.

In the short-run however, the results were country specific. For example, financial structure was found to be consistently insignificant in 10 of the 14 countries (Botswana, Cote d'Ivoire, Ghana, Kenya, Mauritius, Namibia, South Africa, Tanzania, Uganda, and Zambia). Furthermore, while a market-based system was found to be more conducive to growth in Zimbabwe, a bank-based system was found to be more beneficial for growth in Malawi. This finding from the short-run estimates implies that forcing equality of parameters by assuming homogeneity (as was done for the long-run results) may lead to misleading generalisations about the effect of financial structure on growth based on regional studies. These heterogeneous results found in the short-run provide evidence that results can vary considerably across countries depending on the institutional characteristics of the countries, as well as other country circumstances.

There are implications for policy makers from the finding that financial services have a negative effect on growth. While finance is important for economic growth, it is important for governments in SSA to focus on developing the banking sector to a level where it is able to support the financial needs of the economy, especially for small and micro enterprises, which are the engine for growth in the region. These enterprises have been shown not to participate in stock markets, because they do not meet the listing requirements. They therefore do not benefit from the existence of a stock market.

We do note, however, that most recently, a number of countries in SSA have begun establishing segments within the stock markets that cater for SMEs, and these need to be further strengthened amidst encouraging the participation of SMEs. For example, Kenya opened the Growth and Enterprise Market (GEM) in 2013, Zambia opened the Lusaka Stock Exchange Alternative Market in 2015 and Ghana opened up the Ghana Alternative Market (GAM) in 2013. It is expected that this will increase availability of equity finance, allowing SMEs more growth opportunities in the future and eventually contribute to economic growth.