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Effect of Financial Development on Economic Growth in sub-Saharan African: Does Sectoral Growth Matter?

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Introduction

The role of financial sector development in economic growth has received an extensive attention in the literature. Indeed, a well–developed domestic financial sector such as those of developed countries, can significantly contribute growth by increasing savings and investment, improves technological innovations and efficiently allocates resources. The development of the financial sector entails the institutionalization of policies governing the sector. Financial development in sub–Saharan Africa (SSA) remains low although the sector continues to grow in recent times with the hope that such improvement in the financial sector will enhance economic growth. Extant studies in the literature on finance–growth nexus remain inconclusive and little is also known on the overall effect on growth via the interaction of the real and financial sector. Given the relationship between financial development and economic growth, the central theme of this paper is that the extent to which finance helps growth depends crucially on the simultaneous growth of real and financial sectors. By relying on data spanning 1980–2014 for 29 SSA countries, this paper examines the effect on economic growth when credit growth outstrips the solvency needs of the real sector, and how this impacts on growth. We present crucial findings on the effect of disproportionate sectoral growth rates from the lenses of developing economies. Our evidence resolves the seemingly conflicting and highly contested findings in the finance–growth literature and provides crucial guidance for conducting effective monetary policy aimed at propelling growth.

Key Results and Implications

Investigating the credit growth trend in SSA reveals that more than two–thirds of the countries have experienced a rapid credit growth relative to real sector needs with majority of the credit boom occurred during region’s financial reforms period in an attempt to improve financial sector development. More so, much of the booms occur in countries with soft or hard exchange rate pegs involving currency boards, loose monetary policies and lax financial sector supervision. Our key finding reveals that although financial development promises an unequivocal positive effect on growth, such growth effects is contingent on the relative speed of growth in finance and real sector as an unbalanced sectoral growth does not promote long run economic growth. Maximum growth is attained with a balanced sectoral growth. Credit growth over and above the optimal level required by firms permits the financing of unproductive investments and as a consequence shifting resources away from efficient use thus fueling undesired growth. When the credit growth exceeds real sector demand, bad and risky investments get financed on the back of hypertrophic credit. This heightens both returns and growth volatility with the preeminent effect on overall economic growth. Beyond damaging capital formation, excess finance increases macroeconomic instability by magnifying inflation. Indeed, excess supply of credit permits higher private consumption expenditure (relative to investment) thereby increasing aggregate demand and general price levels.

Our findings present important implications for conducting macroeconomic and monetary policy. First, a good understanding of the optimal level of financial development consistent with long run economic growth is needed to guide the financial–growth nexus. Effective financial sector supervision and central bank independence are desirable to deal with hypertrophic finance and early symptoms of credit boom. There is also the need to boost real sector growth which requires firms to develop a detailed understanding of specific emerging markets opportunities, as well as the needs of their clients. A key priority of firms should be on skills and capacity of their workers and to develop a granular understanding of their operations, investment in R&D as well as expertise in product design for the complex supply and value chains. Supporting industries entails a well–grounded policy based on comprehensive appreciation of the diverse industry fragments of the economy as well as the intrinsic factors affecting them.

Concluding remarks

The process of financial development can involve substantial trade–offs, particularly when rapid financial development is not accompanied by real sector growth. The relatively abundant credit does not necessarily promote economic growth. Excess finance may be used to finance unproductive investments and personal consumption thus exacerbating growth vagaries through higher inflation and bad investments. What is clear from the study is the pass–through excess finance–economic growth effect via investment exceedingly stronger than the growth responsiveness of excess finance to changes in consumption. The key contribution of this paper suggests that existence of an undisturbed equilibrated growth of real and financial sectors is a necessary condition for a smooth economic growth.