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Financial liberalization, financial fragility and economic growth in Sub-Saharan Africa☆

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ABSTRACT

This paper investigates the dual role of financial liberalization on growth using a bank crisis model and a growth model. It applies panel econometric techniques on data covering 34 countries in Sub-Saharan Africa over the period 1983–2008. The results indicate that the growth retarding effects of financial liberalization, are dominant over growth enhancing effects, which show mixed results. The results also indicate that institutional variables, human capital formation and foreign aid are key factors in explaining growth in Sub-Saharan Africa. The study therefore recommends adoption of a 'managed financial openness' policy and institutional reform measures.

1. Introduction

In the past three decades nearly all countries in Sub-Saharan Africa have implemented liberalization of the financial sector. During this period most countries eased or lifted bank interest rates caps, reduced interference in credit allocation decisions, lowered compulsory reserve requirements and entry barriers, and privatised many state owned commercial banks.

In addition, financial liberalization period has seen most countries in Africa seek to develop local stock markets, and encourage entry of foreign financial intermediaries. As shown by Demirguc-Kunt and Degatriache (1998), financial liberalization in developing countries is generally viewed as a way of moving away from state intervention in a financially repressed economy as advocated by the influential work of McKinnon (1973) and Shaw (1973). However, the envisaged positive role of financial liberalization has been clouded by, among other factors, increased financial fragility experienced after financial sector liberalization. The banking sector in Africa, in the 1980s and 1990s experienced a number of problems, some of which graduated to full-fledged systematic crises as shown by Caprio and Klingebiel (1996) and Lindgren et al. (1996).

In the literature therefore, financial liberalization is viewed as one of the most controversial policies, not only because of its associated potential risks to the entire global economy but also its potential negative effect on the finance-growth nexus. In the past two decades, the consensus on finance-growth link was firmly entrenched, however, recent literature suggests a dual role of finance that diminishes the importance attached to the original consensus. This is particularly in the wake of recent episodes of financial crises and their linkages to financial liberalization policies besides the credit growth stagnation experience in some countries following liberalization (Reinhart and Ioannis, 2003).

It is against this background and coupled with the fact that financial liberalization policy has been extensively embraced as a route towards financial deepening and hence increased growth in African economies, that this study seeks to address the following research questions: first, can any of the episodes of crisis experienced in Africa be explained by financial liberalization and second, how have the two separate effects of financial liberalization identified in the literature, if applicable to Africa, interacted with growth. Answering these concerns will provide policy insights on the direction of future reform and possibly provide direction on any mitigation measures against financial instability in the process of financial reform.

The main objective of this study therefore is to understand the financial liberalization–fragility–growth linkage and hence shed

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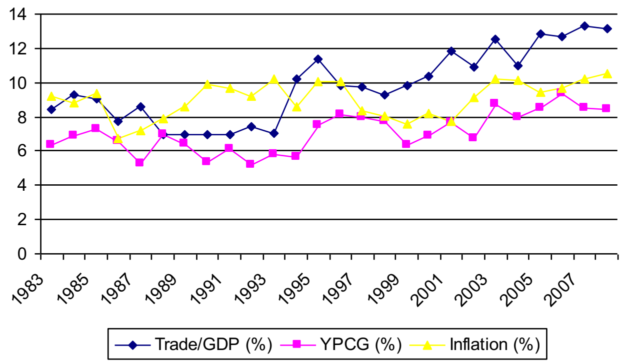

Source: World Bank: African Development Indicators, 2009

Fig. 1. Growth of GDP, trade openness and inflation in Africa (1983–2008). *Source*: World Bank: African Development Indicators, 2009.

light on the economic significance of financial liberalization. The study addresses the following two specific objectives:

(i) Empirical examination of the linkage between financial liberalization and fragility.
(ii) Empirical examination of the dual effects of financial liberalization on growth.

The rest of the paper proceeds as follows; Section 2 discusses key developments of macro economic variables; Section 3 reviews previous work on the relationships between financial liberalization and growth; Section 4 outlines the methodology; Section 5 reports empirical results and Section 6 concludes.

2. Review of macroeconomic performance

Financial liberalization process took place in a number of countries in the 1980s and 1990s as shown in Table A1 in the appendix. In our sample, Mauritius and South Africa lead the pack of countries that liberalized in the 1980s. Despite, being the first to embrace financial liberalization, Mauritius has not witnessed neither banking nor currency crisis during the period after liberalization. Other countries that have not witnessed banking crisis include Gambia, Ethiopia, Sudan and Chad.

Among the countries in our sample Kenya, Democratic Republic of Congo and Burkina Faso experienced banking sector crisis following financial liberalization. Kenya liberalized the financial sector in 1991 and experienced banking crisis in 1991, Democratic Republic of Congo liberalized in 1990 and had a banking crisis in 1991 while Burkina Faso liberalized the financial sector in 1989 and suffered banking crisis in 1990. This is the classic examples of countries which experienced banking crisis following liberalization. Other countries experienced banking crisis with a lag of 4–5 years. However, Rwanda, Ethiopia, Guinea and Cape Verde had not liberalized their economies at the time they experienced banking crisis which may suggest that liberalization may not be solely responsible for the banking sector crisis witnessed in the 1980s and 1990s in Africa.

Fig. 1 shows growth of GDP per capita (YPCG) during the period 1983–2008. Growth during this period seems to have been in the region of 5 percent to 10 percent on average. During the 1980s the growth performance averaged 6.5 percent with the lowest figure of 5.2 percent reported in 1987 and the highest figure of 7.2 percent reported in 1985. Compared with the 1990s, there appears to be a marginal improvement in GDP per capita growth to 6.6 percent with the highest growth performance of 8.1 percent being reported in 1996.

During the period 2000–2008 the average growth rate of GDP per capita stood at 8.1 percent. This is the period when nearly all the countries in this study had liberalized their economies. Therefore, since most countries had liberalized their economies in the 1990s, an event which was followed by higher growth performance it can be concluded that higher growth may have been occasioned by financial liberalization. In addition, comparing GDP per capita growth and trade openness as measured by the ratio of total trade to GDP ratio reveals higher growth of GDP per capita is associated with higher trade to GDP ratio.

3. Theories of financial liberalization–growth nexus

Two opposing views on financial liberalization–growth relationship exist in the literature. On the one hand, financial liberalization tends to relax borrowing constraints, leading to higher investment and higher average growth. The positive linkages between financial liberalization and growth are embedded in the work of Goldsmith (1969), who attributed poor performance of investment and growth in developing countries to controls of financial variables by government, a condition often referred to as financial repression. Since then, extensive research has been done in which case the proponents of financial liberalization argue that it promotes more efficient allocation of capital, enhances better risk management through diversification, allows unlimited international capital flows, lowers the cost of capital and generally deepens the financial system hence encouraging investments with higher returns (Olaf et al., 2008; Fowowe, 2008; Bekaert et al., 2005; Henry, 2003; Ross and Sava, 1996; Bekaert, 1995).

In the capital market, international asset pricing models predict that liberalization leads to a drop in the cost of equity and debt capital through integration of segmented markets. In addition, better corporate governance and investor protection arising from capital market liberalization promotes financial development and hence growth (Bekaert et al., 2005; King and Levine, 1993a,b). Further discussions of the growth associated benefits of capital market liberalization are available in Tswamuno et al. (2007).

Another strand of literature argues that financial liberalization induces excessive risk-taking, increases macro-economic volatility, generates financial fragility and increases the probability of financial crises with negative implications on economic growth (Rousseau and Wachtel, 2007). Three theoretical arguments linking financial liberalization to fragility and growth have been extensively expounded on by Loayza and Ranciere (2006) who summarize the works of Giovanni and Marquez (2006); and Rajan (1994).

According to these authors, first, in emerging market economies, the opportunity cost of full insurance, given by the marginal rate of return to investment is too high, thus it is less optimal for banks in such economies to fully insure against the risk of bank runs. Thus in the short-run after financial liberalization, there is a chance that emerging market economies will face financial crises, switch from non-crisis to crisis equilibria and thus experience volatility of credit and low output growth. Second, when financial markets are liberalized, banks have less incentives to screen their pool of applicants which include new and untested funding requests. This creates a risk of adverse selection and possible decline of bank's portfolio, a situation that breeds financial instability and output losses. Third, bank managers have a tendency of practicing a procyclical credit lending in a liberalized credit environment which leads to financing of bad projects in good times and squeezing credit away worthy firms in distress periods. In most countries, after liberalization a