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Financial Development, Human Capital Accumulation and Economic Growth: Empirical Evidence from the Economic Community of West African States (ECOWAS)

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Abstract

Recently, much attention is given to financial-growth nexus, but largely via the physical capital accumulation channel. This study differed by examining this nexus, via the human capital accumulation channel in the ECOWAS region. It employed panel cointegration approaches as well as the FMOLS, DOLS. The results revealed that bank private credit and domestic private credit contribute significantly to economic growth in the ECOWAS, both directly and through their influence on human capital accumulation. These results imply that providing access to credit to both enterprises and individuals, through appropriate financial policies, will encourage economic growth in the ECOWAS region.

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Keywords: Financial development, human capital, economic growth, ECOWAS, panel cointegration, panel causality.

1. Introduction

African countries exhibited the weakest economic performance relative to other regions of the world. For instance, in 2010 the average per capita GDP in Africa is US$ 1669, which is far below the lower middle income groups' average, of US$ 2530.5. This poor economic performance is more severe in the West African region under its umbrella organization the ECOWAS; in 2010 average GDP per capita of the ECOWAS region was US$ 669.5; this placed the region into the low income group (World Bank, 2013). From the perspective of the endogenous growth models, the

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weak economic performance of ECOWAS in particular, can be located in the major engine of growth, which is human capital accumulation. The endogenous growth models, especially by Romer (1986) and Lucas (1988), stressed knowledge or human capital accumulation as very significant in determining long term economic growth. In the ECOWAS region, except for Ghana and Cape Verde, the remaining 13 ECOWAS countries are in low human development group (UNDP, 2013).

Recently, the activities of financial intermediaries and their level of development have been recognized as the potential determinants of economic growth, by enhancing the accumulation of physical capital and productivity. This line of argument was championed by Schumpeter (1911/1934), who argued that the activities of banks facilitate investment in physical capital, the adoption of new technology, innovation among others and hence economic growth. Similarly, the advancement of the financial repression theory by McKinnon (1973) and Shaw (1973), together with the insight from the endogenous growth models add an impetus to and provide an analytical basis for the finance-growth relationship.

Consequently, endogenous growth models have generally been used in the literature as the theoretical basis of studies on finance-growth nexus; this is because of the role it assigns to financial development through productivity of investments among others. However, though capital accumulation is identified as one of the intermediating channels, it is narrowly confined to physical capital accumulation. This is despite human capital being recognized to be the major engine of growth in the new growth theories. Therefore, any inquiry into the effect of finance on growth is supposed to explore the human capital channel. Unfortunately, this is not the case for the vast majority of literature in this area, this study aim to fill this gap by exploring among others how financial development impacts on output through its influence on human capital accumulation in the ECOWAS sub-region.

2. Literature Review

The interest to empirically investigating the finance-growth relationship was rekindled by King and Levine (1993) found that the development of the financial sector is robustly related to per capita GDP growth and it positively enhance the accumulation of physical capital, as well as improves the efficacy of economies in employing physical capital. In a related development, Levine and Zervos (1998) show that even after controlling for economic and political factors, the accumulation of capital and productivity and hence GDP, are positively predicted by the development of the banking sector and stock market liquidity in 47 countries, over the period from1976 to 1993.

The above studies were however implicit on the development characteristics of countries, which may affect the degree of the development of their financial sectors. Taking this in to consideration Rioja and Valev (2003) studied a diverse groups of countries; both industrial as well as developing countries from 1961-1995. Using the General Method of Moment (GMM) approach, they found that in highly developed countries, the development of the financial sector positively effecting productivity. Conversely, the effect of finance on output growth in less developed economies is transmitted mainly through capital accumulation. This implies that in less developed countries financial intermediaries have less ability to identify and allocate funds to productive investments as well as effectively monitor them.

In the case of ECOWAS, Esso (2010) examined finance-growth nexus and found that long-run relationship exist between them, but causality runs in different directions. However, by employing only private credit as the indicator of financial development, could not wholly reveal the dynamic linkages between finance and development in the ECOWAS countries. Moreover, even though the study considered the ECOWAS region, it analyses each country individually, instead of collectively as a panel, which would have improved the efficiency of the parameter estimates and reveal cross sectional dependencies if any.

Employing the panel co-integration and fully modified OLS approaches, Christopoulos and Tsionas, (2003) in 10 developing countries. They established that financial depth wields an equilibrium relationship with the real economy. Moreover, financial depth was found to cause GDP growth. Similarly, Kiran, Yavuz and Güriş, (2009) investigated if cointegration relationship exists amongst finance and growth. Covering ten emerging countries over 1968 to 2007 periods and adopting the panel co-integration technique developed by Pedroni, the results revealed that financial development positively and significantly influence growth.

Generally, although, finance and growth literature is largely based on the endogenous growth models, it however, neglected human capital accumulation as an important channel through which financial development can influence