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Institutions and the finance–growth nexus: Empirical evidence from MENA countries

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Abstract

This paper investigates the effect of institutional quality on the finance–growth nexus. To this end, an empirical model with linear interaction between financial development and institutional quality is estimated. Our main findings show that, while most indicators of financial development have a significantly negative effect on economic growth, the sign of the coefficients of interaction variables are significantly positive. This provides strong evidence that institutional quality mitigates the negative effect of financial development on economic growth. Looking to the subcomponents of our institutional index, our findings show a development of the banking sector in a country with an important score in Law and Order, Bureaucracy and Investment Profile facilitate growth. Also, countries, with an important score of investment profile, can benefit from stock market development in terms of economic growth. These results suggest that, in order to benefit from financial development, financial systems in MENA countries must be embedded within a sound institutional framework.
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1. Introduction

The fundamental economic growth question, which has preoccupied researchers, is why countries grow at different rates. Addressing this question, an important strand of literature paid special attention to the role of the financial system in the growth process. On the theoretical side, an important battery of models articulates mechanisms through which the financial system affects economic growth (e.g. King & Levine, 1993a, 1993b; McKinnon, 1973; Pagano, 1993; Shaw, 1973). These studies support Schumpeter's view which emphasizes the positive role of financial development in determining economic growth.

However, by declaring that "where enterprise leads finance follows" Robinson (1952, p. 86) provided a skeptical view stressing that financial development followed economic growth. This view was echoed by Lucas (1988) who believed that the finance–growth relationship was unimportant. Hence, he asserted that economists tended to overemphasize the role of financial factors in economic growth. Theory provides, also, conflicting predictions about the role of different subcomponents of the financial system on economic growth. Some theories emphasize the relevance of the banking system on economic growth, while others highlight the benefits of stock markets (Allen & Gale, 1999; Boot & Thakor, 1997).

On the empirical side, by using different econometric methodologies, empirical results provide evidence that a range

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of financial indicators have a significant and positive effect on economic growth.[1]

Our research extends previous evidences by investigating the conditional finance–growth relationship in Middle East and North African (MENA) countries. Specifically, we examine whether the finance–growth nexus is affected by institutional quality. In fact, as identified by North (1990), institutions are "the rules of the games in a society". These include both "formal" rules such as constitutions and laws enforced by the state and "informal" constraints such as "codes of conduct, norms of behavior, and conventions" which, generally, are enforced by the members of the relevant group (North, 1990, p. 36). "*In consideration of all these aspects, institutions ensure, define and steer the functioning of market and non-market-activities*" (Balzat, 2006, p. 20). Therefore, when either the rules change frequently or are not respected, markets do not function well. A number of papers (Knack & Keefer, 1995; Mauro, 1995; Rodrik, Subramanian, & Trebbi, 2002) supported the key role played by institutional quality in promoting economic performance. These findings are supported by Bonnal and Yaya (2015).

For the MENA region, Ben Naceur, Cherif, and Khandil's recent study (2014) showed that Institutional quality, particularly rule of law, promoted financial development by signaling confidence in the quality of the legal system in support of economic activity. Gazdar and Cherif's (2015) latest results supported that institutional quality played an important role in the MENA's financial system. However, this role is more relevant for the banking sector than for stock market development.

The main reasons, which motivated us to choose the MENA countries to perform our empirical investigations, were that few studies focused on this region. In addition, and these studies' main findings were that, while MENA countries had embarked on financial reforms since the mid-1980s, financial development had not worked as an engine of economic development in this region (Ben Naceur & Ghazouani, 2007). Over the past two decades or so, the growth performance of the MENA region has been rather disappointing. As a whole, the region experienced the weakest real per capita growth performance amongst all regions worldwide (Bhattacharya & Wolde, 2010; Nabli & Véganzonès-Varoudakis, 2004). One possible reason for these results is that the relationship between financial development and economic growth may not be linear, but rather be dependent simply on the conditions like institutional quality. In fact, an increase in financial deepening, as captured by standard indicators of financial development, may not result in increased growth because of corruption in the banking system or political interference. These may divert credit to unproductive or even wasteful activities (Demetriades & Law, 2006).

We re-investigate how financial development affects the economic growth in MENA countries. Specifically, we examine how the responsiveness of economic growth to financial development depends upon the indicator of institutional quality. Our contribution consists of determining an institutional threshold beyond which financial development can accelerate economic growth. Specifically, we aim to calculate the minimum level of institutional quality that must be attained by MENA countries to benefit from financial development in terms of economic growth.

An empirical model with linear interaction between financial development and institutional quality is estimated. As econometric methodology, we use the GMM estimators developed for dynamic panel data for a sample of 18 MENA countries over the period from 1984 to 2007. Our main findings show that, while most indicators of financial development have a significantly negative effect on economic growth, the sign of the coefficients of interaction variables are significantly positive. This provides strong evidence that institutional quality mitigates the negative effect of financial development on economic growth. These results are in line with Demetriades and Law's (2006) findings.

The rest of this study proceeds as follows. Section 2 reviews the literature exploring the connection between financial development and economic growth. Section 3 describes the data and presents the empirical methodology. Section 4 reports the main results. Section 5 reports the conclusion.

2. Literature review

In the theoretical Arrow-Debreu World, characterized by a state-contingent claim framework with no information or transaction costs, there is no need for a financial system "*that expends resources researching projects, scrutinizing managers, or designing arrangements to ease risk management and facilitate transaction*" (Levine, 1997, p. 690). A financial system becomes essential once frictions are introduced in the Arrow-Debreu model. Therefore, financial intermediaries and markets emerge to ameliorate the problems of asymmetric information and high transaction costs. The ability of the financial system to relax these frictions can lead to facilitating the allocation of resources over space and time (Levine, 1997, 2005; Merton & Bodie, 1995). Thus, in easing information, enforcement, and transactions costs, financial systems provide five broad categories of services to the economy. In a couple of papers, Levine (1997, 2005) classified the functions of financial systems into the following five categories: (1) producing information and allocation of capital; (2) monitoring firms exerting corporate control; (3) risk amelioration; (4) pooling of savings; and (5) easing exchange.

Theoreticians hold different perspectives on the link between financial developments and economic growth. While, as an important extension, the earliest theoretical studies focused on the effect of financial development on economic growth, some studies were interested in the relative merits of a bank-based financial system and a market-based financial system on economic growth. Another strand of studies extended, also,

[1] The early empirical evidences include: King and Levine (1993a, 1993b), Goldsmith (1969), and Atje and Jovanovic (1993). The recent empirical evidences include: Beck and Levine (2004), Demetriades and Law (2006), Hasan, Wachtel, and Zhou (2009a, 2009b), and Hassan, Sanchez, and Yu (2011).

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