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Financial development, structure, and economic growth: the case of Egypt, 1974–2002

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Abstract

The paper studies Egypt's financial structure and its relation to total factor productivity (TFP) during the 1974–2002 period. It first highlights Egypt's economic performance; and then focuses on the main features of its financial sector: the banking system and the securities market. The effect of financial development on TFP is then modeled by interacting bank – and market – based financial indicators with two enabling factors, per capita income and private net resource flows. The results show that bank-based indicators have a *negative* effect on TFP unless they are associated with a threshold level of per capita income; whereas the effect of market-based indicators is *positively* reinforced by private net resource flows. The paper stresses that widening the financial sector to include the securities market has benefited TFP and growth in Egypt, but more reforms is needed towards that end.

JEL classification: F23; F36; 053

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1. Introduction

Any system that performs what finance should perform has to have an impact on economic growth.[1] King and Levine (1993) initiated a torrent of empirical studies documenting this impact, which also got support from theoretical models of endogenous growth. These models, most prominently by Greenwood and Jovanovic (1990) and Bencivenga and Smith (1991), showed that financial institutions can increase total factor productivity (TFP) and the marginal productivity of capital by stimulating savers to hold more of their wealth in productive assets and by funding riskier but more productive technologies. The end result is that financial development can have a *permanent* and *continuous* effect on the steady-state growth rate of income.

An interesting policy question is: if financial development can have an ongoing effect on growth, then how should it proceed? Does it deepen the financial structure already in place, or does it try to widen it, or does it do both? In the context of developing countries, these issues translate to whether to deepen the structure dominated by commercial banks – strengthening competition, supervision, universality, etc. – or to encourage securities markets besides it. The latter route has some convincing arguments going for it (at least regarding stock markets), and they include: equity finance is not subject to adverse selection; it provides an important channel to access international capital; and it promotes risky, entrepreneurial investments through their risk-sharing and monitoring functions. And these arguments also have some decent empirical evidence to back them up, for Levine and Zevros (1998) showed that developments in both the stock market and banking system enhance growth because each system provides a separate financial function.

Perhaps more interesting, there is an emerging synthesis or consensus now that goes beyond the mere bank-based/market-based distinction and that stresses the importance of the quality of financial services – limiting transaction and information costs, better risk management, etc. – that either system should provide.[2] It also emphasizes that financial development is a *multifaceted process*, encompassing in addition aspects that have to do with regulation and supervision, monetary policy, financial openness, and institutional capacities.[3] In this regard, the recent concern with legal and regulatory reforms that strengthen creditor rights, contract enforcement, and accounting practices is a crucial development.[4] In fact, it represents one of the few delineated ways on *how* to develop financial markets — an area that remains surprisingly under-studied in spite of its significant importance.

Turning back to the empirical evidence, its record has not been totally untainted. This is because the voluminous literature on finance and growth deals largely with cross-country regressions that do not necessarily reflect individual country circumstances. In this sense,

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[1] A list of the important functions of the financial system includes: mobilizing and the efficient allocation of capital; generating financial information and prices; providing liquidity and the management of risk; ensuring corporate governance and the exchange of corporate control; conducting settlement and payment transactions; and acting as the medium through which monetary policy is transmitted. For a survey of the issues on the link between financial development and growth, see Khan and Senhadji (2000).

[2] See Durham (2000). This is reinforced by the fact that developed financial sectors have both better-developed banks and stock markets.

[3] See Creane et al. (2003).

[4] See La Porta et al. (1997).