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Full Length Article

Does central banking promote financial development?

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Abstract

This paper examines the influence of central bank characteristics and their monetary policies on the level of financial development.

Initially, on the basis of a review of the literature, we selected the central characteristics of the central banks as well as their monetary policies likely to influence the level of financial development.

Next, we estimated an econometric model linking the level of financial development with measures of central bank characteristics and their monetary policies using panel data econometrics. The sample is made up of a panel of 89 countries, including 22 developed countries, 34 emerging countries and 33 developing countries over the period 1980−2010. The results show that there is a very significant influence of central bank characteristics as well as their monetary policies on the fluctuation of the level of financial development for the three categories of countries.

JEL: E58; E52; E44

Keywords: Characteristics of central banks; Monetary policies; Level of financial development

1. Introduction

The importance of financial sector to contribute to economic growth and to create and distribute economic opportunities makes understanding its development an increasingly significant research topic. A large body of economic literature focusing not only on the relationship between financial development and growth or financial stability, but also on the determinants of financial development, including institutional factors, macroeconomics factors, geographic factors and others. Imran and Nishat (2013) found that bank credit to the private sector in the long run in Pakistan is explained by the foreign liabilities, domestic deposits, economic growth, exchange rate, and the monetary conditions, Raza, Shahzadi, and Akram (2014) find that the credit to private sector, as measure of financial development, depends on population growth, share of agriculture sector in GDP, Real GDP growth, trade openness as percent of GDP, net foreign direct investment as percent of GDP, government spending as percent of GDP, Dem index of democracy, and the rule of law. Mbulawa (2015) show that financial development was positively influenced by credit to the public sector, per capita gross domestic product, gross fixed capital formation, financial openness, interest rates and institutional factors while savings and government debt have a negative influence.

The role of institutional factors on financial development is one of the most studied researches, especially factors promoting the development of healthy financial system. La Porta, Lopez-de-Silanes, Lopez-de-Silanes, and Vishny (1997, 1998), Levine (1998) and Levine and Zervos (1998) find that countries where institutions better protect and enforce property right, are countries with higher levels of financial development. Law and Azman-Saini (2008) and Gazdar (2011) show that the quality of institutions appears to be an important determinant for the development of the banking sector while it has no effect on the development of the stock market. Evidence shows that strong institutions, adequate implementation of financial reforms, increased financial development level,

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(Huang (2005); Mandaci, Aktan, Gumus, and Tvaronaviciene (2013); Aduda, Masila, and Onsongo (2012); Huang (2005); Mandaci et al. (2013) and Aduda et al. (2012)). Ahokpossi, Ismail, Karmarkar, and Koulet-Vickot (2012) show that strong rule of law and institutional infrastructure as well as collection and dissemination of credit information leads to an increase in bank lending to the private sector. Ayadi, Arbak, Naceur, and De Groen (2013), show that strong legal institutions, good governance and adequate implementation of financial reforms can have a substantial positive impact on financial development only when, they are all taken together. Acemoglu, Aghion, and Zilibotti (2006) and Anderlini, Felli, Immordino, and Riboni (2013) argue that more rigid legal environments can impede economic development through their negative effect on financial development. A recent study by Le, Kim, and Lee (2016) reports that better governance and institutional quality foster financial sector development in developing economies. Muye and Muye (2017) find a positive long run relationship among globalization, institutions and financial development.

Based on political economy approach, several studies argued that financial development is limited in economies where interest groups exert significant pressure on policy makers who can intervene on financial markets regulation. Rajan and Zingales (2003) examine the role of interest group in the process of financial development. They argue that policy influence of incumbents on financial development may be weakening if trade openness and financial openness are encouraged. Huang (2005-a) supports that political liberalization is followed by a stronger financial development. Nevertheless, Huang (2005 b) argues that extend of democracy may have a negative effects on financial development. Chinn and Ito (2006) hypothesize that under a certain level of institutional and legal development, capital account liberalization is a significant determinant of financial development. Baltagi, Demetriades, and Law (2009) show that financial and trade openness is positively correlated with banking sector development. Girma and Shotland (2008); Do and Levchenko (2004); and Huang and Temple (2005) argue that fuller democracy promote financial development. Voghouei, Azali, and Jamali (2011) show that political economy factors, which can have both direct and indirect effects through other determinants, can be considered as the most influential factors in financial development. Roe and Siegel (2011) show that the political stability has a positive impact on financial development.

The impact of financial liberalization on financial development is carried out in several directions. Based on Mc Kinon-Shaw model (McKinnon, 1973; Shaw, 1973), which argues that financial liberalization can faster economic growth by increasing investment and productivity, others research find that the positive correlation between financial liberalization and financial development cannot be supported without risk (World Bank, 1989; Demirgüç-Kunt & Detragiache, 1998). Bailliu (2000) and Chinn and Ito (2006) argue that the positive link between capita account liberalization and financial development may have destabilizing effects. Claessens, Demirguic-Kunt, and Huizinga (1998) and Leaven (2000) support that banking sector liberalization may improve the functioning of national banking and the quality of financial services stimulating financial development.

Other studies highlight the importance of macroeconomics policies such as maintaining lower inflation or higher investment to improve financial development. Huybens and Smith (1999); Boyd, Levine, and Smith (2001); and Rousseau and Wachtel (2002) show that economies with high inflation rates are likely to be less financially developed. The stock market development is also driven by the movements in macroeconomic variables like interest rates and exchange rates as well as the overall security of the market, Kaehler, Weber, and Aref (2013). David, Mlachila, and Moheeput (2014), found that trade openness is important for financial development for countries with better institutional quality. Dabla-Norris & Narapong (2013) study the relationship between macroeconomic volatility and financial development and find that financial development acts as a shock absorber against volatility but only up to a point; beyond a certain level, financial systems exacerbate shocks and increase volatility.

Barajas et al. (2013a) suggest that the level of financial development in a country depends on both structural characteristics such as income, population, demographics, and other fundamentals that are outside policy control in the short to medium run, and on policy and institutional variables. (Beck and Torre, 2007; and; Beck & Feyen, 2013).

Others variables are considered as financial development determinants, such as trade openness, investment profile and population, per capita income and economic growth which has a long term relationship (Baltagi, Demetriades, & Law, 2007; and; Shaheen, Awan, Waqas, & Aslam, 2011; Takyi & Obeng, 2013), religious, language and ethic characteristics (Stulz & Williamson, 2003). Kumar, Jeremy, and Spalt (2011) suggest that religious-induced gambling attitudes have a significant effect on financial outcomes. They show that in countries with higher concentrations of Catholics relative to Protestants, investors are more likely to participate in stock markets, employees are more likely to accept stock-option plans, and initial public offerings tend to be more successful. Ben Naceur and Kandil (2014) find that higher GDP growth has a positive impact on the stock market; however it does not seem to promote banking activities.Khalfaoui (2015) shows that financial development determinants are mainly related to banking and financial sector and the level of economic and human development for developed and developing countries. Whereas, the determinants related to economic stability and the legal and institutional framework have a significant impact on financial development only in the developed countries.

Few studies consider the impact of modern central bank functions on financial development.

There is an ample evidence that monetary policy institutions do affect financial development (Khan, Senhadji, & Smith, 2006; Piazzesi & Schneider, 2009; and; Boyd et al., 2001) through the resulting level and prediction of inflation. In this sense, the classic case for central bank independence of Rogoff (1985) applies. The issue is not yet settled however, since the recent financial crisis has renewed concerns over the optimality