Financial Sector Development and Economic Growth: A Theoretical Exposition

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Abstract

The various literature and studies reviewed in this exposition have underscored the positive impacts of a developed financial sector on an economy. Whilst a few studies showed that finance follows growth, the majority opinion is that finance leads growth. Unfortunately, growth has not led to economic development in many developing economies, necessitating intervention by such bodies as the United Nations, International Labour Organization and United Nations Development Programme. Economists are equally concerned about this development and have, therefore, conducted studies to show the relationship between economic growth and poverty alleviation. They generally agreed that growth is good for poverty reduction.

I. Introduction

It is conventional to see an economy as consisting of the real sector and the financial sector. Whilst the real sector typically has goods and related services, the financial sector consists of financial markets, instruments, telecommunication facilities and market participants (individuals and institutions) involved in the process of financial intermediation. The relationship between the real sector and the financial sector of an economy as the economy grows has been a subject of great interest to economists and policy makers. A century ago, Schumpeter (1911) had argued that financial intermediation through banks plays a pivotal role in economic development through banks' role in allocating savings to projects with the best chances of success. Since then, there had been numerous studies seeking to establish the role that a financial sector plays in the process of economic growth and development.

The objective of this paper is to examine some of the major studies to derive some theoretical basis for the relationship between financial sector development and economic growth. Furthermore, the paper examines some topical issues in financial sector development as well as share thoughts on the seeming

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aberration that economic growth fails to lead to economic development in many developing economies.

The paper is organised in five sections. Following this introduction, major issues in financial sector development are reviewed in Section 2, while Section 3 highlights major studies and findings in respect of the relationship between financial sector development and economic growth. Section 4 reviews some related literature on growth and development. The paper is concluded in section 5.

II. Financial Sector Development

The financial sector was earlier characterised as consisting of markets, instruments, communication facilities and market participants involved in financial intermediation. The participating institutions are largely made up of operators and regulators with the common objective of efficiently mobilising financial resources from the surplus units (SSUs) for use by the deficit units (DSUs), employing appropriate financial instruments and working through competitive markets. Thus, the saving function in the economy is separated from the investment function with the result that both functions are better performed and the quantum of national saving/investment increases. The increase in total saving benefits from improved opportunity to save, interest-elasticity of saving effect and direct institutional effect where institutions are available, enhances marginal propensity to save (Lewis,1955).

The functions of a financial system have been described by Levine (1997) to include: mobilising savings, allocating capital funds, monitoring the use of funds, and managing risk. Stiglitz (1998), in noting the complex functions of finance, associated the financial system to the "brain" of the economy that performs the task of resource allocation across space and time in an uncertain environment. These functions are better performed the more the financial sector develops.

The financial sector is said to have developed if it attains operational efficiency, which requires that the sector has a large number of participants, including institutional members with specialised functions; a variety of instruments differing in tenor, amount and risk; markets that react promptly and sometimes instantaneously to available information (Fama's 1965) and competent regulatory authorities that understand, supervise and promote the markets.

The development of the financial sector of an economy can also be gauged by the level and rate of growth of financial assets relative to national income. In the literature, reported studies typically use the ratio of broad money to national income (M_2/Y) or the growth rate per capita of real money balances (Jao, 1976; Fry, 1978; and Ogun, 1986). The higher the quantum of financial assets relative to national income, the deeper or more developed is the financial sector. Typically, the financial assets included in cross-country studies were: broad money (M_2), financial assets of banking institutions, treasury bills, market value of traded shares in the stock exchange and money market funds. The problem in such studies, however, is that in many developing economies, particularly in Africa, the data on some of these assets are not available and where available, not consistent. Nonetheless, some cross-country studies of financial deepening in sub-Saharan African countries (Easterly and Levine 1994; Sachs and Warner 1995; and Ndebbio 2000) showed low levels for the ratio of financial assets, mainly M_2 to national income (Y). For the 1980 decade, the ratios ranged from the lowest of 2.8 per cent to the highest of 51.5 per cent. In developed economies, where the ratios reflect all financial assets, not merely broad money, the ratios are quite high. Meier (1984) reported that in the United States of America the ratio increased remarkably from about unity, that is, 100.0 per cent at the beginning of the last century to about 450.0 per cent in the 1980s. For Japan, the ratio is reported to have increased from 10.0 per cent in 1885 to over 150.0 per cent in the 1980s. It has been widely observed that as countries grow richer, they equally become richer in financial assets, institutions and markets such that financial assets grow faster than national income.

The Nigerian experience should not be different as a number of studies on financial deepening have tended to produce consistent results when similar methodologies were employed (Adewunmi 1997, Ndebbio 2000, Onwioduokit 2006). Much earlier, Ojo and Adewunmi (1982) computed the level of financial deepening in Nigeria for the period 1969 to 1975 using assets of financial institutions expressed as a proportion of gross national product and the average ratio ranged from 36.0 per cent to 55.0 per cent. Iganiga and Enoma (2009) used the ratio of broad money (M_2) to gross domestic product for the period 1980 to 1998 and the computed ratios ranged from 26.7 per cent to 22.8 per cent. The authors concluded that the declining ratios indicated that "financial sector reforms in Nigeria did not achieve the purpose of financial deepening that is purported by theory." The conclusion could be considered as being hasty given

the methodology that used only broad money and omitted other financial assets in the economy, particularly as financial deepening had been defined as an increase in the supply of financial assets in the economy.

There is no doubt that the quantum of financial assets had grown remarkably in Nigeria as the economy had grown over the years. For example, in 2010 the nation's gross domestic product at current market prices was ₦29.5 trillion, while total assets of banks inclusive of off-balance sheet engagements stood at ₦18.6 trillion, given a ratio of total assets to gross domestic product of 63.0 per cent. Total assets of banks stood at ₦7.2 trillion, while loan asset to GDP ratio was 24.4 per cent (NDIC 2010). These figures did not include outstanding treasury bills, money market funds and the total value of capital market instruments. In the capital market, for example, market capitalization which stood at a peak of ₦10.2 trillion in 2007, declined to ₦6.96 trillion and ₦4.98 trillion in 2008 and 2009, respectively. Given the GDP at market prices of ₦22.9 trillion in 2007, the value of stocks to GDP for that year was 44.5 per cent. Therefore, a comprehensive study of the Nigerian economy that captures the value of financial assets in the money and capital markets is most likely to show a high level of financial deepening and greater growth in financial assets than the growth in national income over the years.

III. Financial Sector Development and the Economy

How a developed financial sector impacts on the economy has been a matter of continuing interest to economists since Schumpeter raised the issue a century ago. Generally, growth theorists appear to agree that financial sector affects the economy through its impact on capital accumulation and the rate of technological progress. There is sufficient evidence in the literature to support the theory of strong linkages between financial sector deepening and economic growth. However, there are a few studies that question the direction of causation. Such studies attempt to show that financial sector development does not necessarily lead to economic growth, but that economic growth leads to financial sector deepening through increased demand for financial services.

Bagehot (1873) postulated that the financial system played a critical role in English economic growth by mobilising the needed capital for development. However, Schumpeter (1911) argued strongly that well-functioning banks spurred technological innovation by identifying and funding projects with the best

chances of success with benefit to the economy. In 1955, Lewis, an early pioneer of development economics, suggested a two-way relationship between financial deepening and economic growth. He argued that financial markets developed as a result of economic growth and that the developed markets in turn stimulated real growth.

Gerschenkron (1962) propounded a "Structuralist Hypothesis" and argued that the modes and patterns of financing by banks vary according to the relative backwardness of an economy and its structural peculiarities. In advanced economies, he argued that capital needs are likely to be met outside the banking system, that is, from financial markets. In moderately backward economies, such need would likely be met by specialised banks rather than commercial banks. In extreme backward economies, banks' contribution to capital formation is likely to be negligible; consequently government would have to provide the finance needed for capital formation.

Patrick (1966) proposed the "Stage of Development Hypothesis" wherein he argued that a financial sector deepening engenders economic growth at the early stages of economic development, but that the impact decreases as the economy grows. Thereafter, the growth in the economy begins to impact on financial development. Gurley and Shaw (1967) argued that economic growth leads to financial deepening because the growth generated increased demand for financial services. Such demand precipitates financial deepening and direction of causation is from economic growth to financial growth.

Goldsmith (1969) conducted his seminal study using data on 35 countries from 1860 to 1963 and found evidence of a relationship between financial deepening and economic growth over this period. He observed that the financial superstructure of an economy accelerates economic performance to the extent that it facilitates the migration of funds to places where they yield the highest social return. However, Goldsmith was reluctant to assert that financial development had a causal influence on economic growth because he considered that the methodology was not robust enough to arrive at a conclusion. He, therefore, challenged the next generation of economists to resolve the causal relationship question.

McKinnon (1973) and Shaw (1973), proponents of the "Financial Repression Hypothesis" highlighted the negative impacts of financial controls and the gains of free markets. The duo fervently believed that a free financial sector would contribute immensely to economic growth. They argued that such contribution would only be absent if the financial sector is repressed. They referred a repressed financial sector as "shallow finance" and a liberalised one as "deepening finance". These findings provided the theoretical basis for widespread adoption of financial liberalisation and reforms in developing economies. Their work further provided support for the structural adjustment programmes of the International Monetary Fund (IMF) and the World Bank (WB) in the 1980s.

Much analytical work has been done since Goldsmith (1969) challenged economists to resolve the question of the causal relationship between financial development and economic growth. For example, King and Levine (1993), in a study of 80 countries spanning 1960 to 1989, using different measures of financial development, found strong and positive relationship between the financial measures and economic growth. They argued that "higher levels of financial development are significantly and robustly correlated with faster current and future rates of economic growth, physical capital accumulation and economic efficiency improvements … and that finance does not only follow growth: finance seems importantly to lead economic growth".

Other economists have used more sophisticated techniques to address the question. For example, Levine, Loayza and Beck (2000) had results, which confirmed that financial deepening has major impact on economic growth. Similarly, Calderon and Liu (2003) used what has been styled innovative techniques on data from 109 countries for the period 1960 to 1964. Their results showed bi-directional causality, but the impact of finance on growth was reported to be more important than that of growth on finance, particularly in developing economies. In the literature, it was reported that over longer periods, the impact of growth on finance was becoming insignificant.

Literature has revealed a number of studies for sub-Saharan Africa (SSA). Such studies had used cross-country data for several countries to estimate the relationship between financial development and economic growth (Jao 1976; Fry 1978; Ogun 1986; and Ndebbio 2000). The studies were limited by the paucity of

consistent data on key variables of interest. For example, it was only when Jao (1976) used the ratio of M_3 to national income that the coefficient of financial development was significant for six SSA countries. In Ndebbio (2000), financial deepening was found to positively impact per capita growth of output.

However, while the result of Ndebbio's financial deepening explanatory variable had the right sign it was "insignificantly less satisfactory". The author attributed the finding to the presence of "shallow finance" and the absence of well-functioning capital markets in the SSA countries studied.

IV. Economic Growth and Economic Development

Typically, an economist is likely to define economic growth as a sustained increase in the national income whether that income is measured as Gross Domestic Product (GDP) or Gross National Product (GNP). Economic development on the other hand refers to the positive impact of economic growth on key issues like unemployment, poverty and inequality. Economic growth is, therefore, a necessary but not a sufficient condition for economic development.

Given its concern for economic development in poor member countries, the United Nations (UN) declared the first decade of the 1960s as the "Development Decade". The UN went ahead to prescribe a growth rate of 6.0 per cent for the Less Developed Countries (LDCs). The expectation was that if the LDCs were to grow annually at that rate, they would achieve economic development. The economic growth was expected to have a trickle-down effect on the welfare of the people. Fortunately, some LDCs including Nigeria, met the 6.0 per cent growth rate, but unfortunately, the welfare of their people did not improve as unemployment, poverty and inequality remained high.

Expectedly, some scholars started to question the notion of equating economic growth with economic development if the growth did not lead to improve the welfare of the people (Dudley, 1969). The scholars argued that economic growth and economic development were expected to address the challenges of the growing gap between the rich and the poor as well as ensure gender equality, without which inequality and misallocation of national resources would result.

In the 1970s, the International Labour Organization (ILO) promoted the "Basic Needs Approach" to development. The ILO viewed development as involving the provision of basic essentials required for civilised living such as shelter, food, clothing, basic education and basic health care. These basic needs were expected to be provided by government whether or not the economy was growing.

Since the 1980s, the United Nations Development Programme (UNDP) has advocated human development as being at the centre of any nation's developmental process. It defined human development as a "process of expanding human choices by enabling people to live a long, healthy and creative life". The organisation published the Human Development Report with Human Development Index (HDI) which compared human development across countries. Governments all over the world take keen interest in this publication as it enables them to compare their countries against their peers in the area of human development.

Buoyed by the contributions of ILO and UNDP, economists have continued to study the relationship between economic growth and human development. Most of the studies target poverty reduction as the economy grows. The widespread opinion amongst economists is that growth is necessary, though not sufficient condition for sustained poverty reduction. Although cross-country studies show differences in the relationship between economic growth and poverty reduction, the studies, however, showed that the incomes of the poor tend to rise (fall) proportionately with average income (Dollar and Kraay 2001; Eastwood and Lipton 2001).

In their study of 26 countries, including 16 developing economies, Jalilian and Kirkpatrick (2001) examined the link between financial development and poverty. The results of the study suggested that a percentage increase in financial development raises the incomes of the poor by about 0.4 per cent. These studies on poverty reduction relate to the role of "conventional finance" primarily from commercial banks.

Special financial programmes targeted at the poor have in recent times contributed immensely towards poverty reduction in those LDCs where such programmes exist. In Bangladesh, for example, a study by Khandker (1998) of

three micro-finance banks in that country found that 5.0 per cent of borrowers from the banks lifted their families out of poverty every year. The study, also found evidence of increase in self-employment in the villages the borrowers resided. In Bolivia, MkNelly and Dunford (1999) found that two third of clients of a credit and education programme had higher incomes after joining the programme. In Indonesia, Remenyi and Quinones (2000) observed that borrowers of the microfinance credit programme increased their incomes by 12.9 per cent, compared with 3.0 per cent increase for non-borrowers. However, Holden and Prokopenko (2001) argued that the loan portfolios of the microfinance institutions were sometimes poor because of inept management and that the institutions charged high rates of interest on loans because of the absence of competition.

There is dearth of studies on the impact of microfinance banks in reducing poverty in Nigeria. The development could be attributed to the fact that the banks are relatively new entrants into the Nigerian economy. Also, economists and other interested stakeholders might have found that data on the operations of these institutions were not readily available. However, microfinance banks in Nigeria, in spite of the difficulty they have in accessing funds for on-lending, have quite a role to play in reducing poverty. Some of these banks are able to reach out to rural farmers/traders and assist them with needed business funds without collateral. The report was that this group of borrowers meet their loan repayment obligations, unlike the professional borrowers in the cities.

Microfinance banks are in a position to significantly and positively contribute to Nigeria's economic development if properly structured and supervised. The meager resources with them can go a long way in this direction. For example, at the end of 2010, the country had 866 of these banks with operating licences and 121 with provisional licences (NDIC, 2010). The banks are reported to be mostly in urban and semi-urban areas. The Central Bank of Nigeria (CBN) should endeavour to license more rural microfinance banks.

According to statistics from the NDIC, 538 of the 866 microfinance banks rendered required returns to the Corporation in 2010. The analysis of the returns showed that their total loans and advances stood at ₦41.92 billion. If these funds had gone to those who ordinarily would not have been able to access commercial bank loans, then there is hope for the economy and for the poor.

V. Conclusion

There is ample evidence to support the proposition that financial development impacts positively on economic growth. Even if finance follows growth as a few studies show, the importance of the finance sector for development cannot be ignored. That economic growth is possible without economic development is a matter of concern to economists, the United Nations and governments, particularly of the affected LDCs. Economists who have sought to find the relationship between economic growth and poverty reduction have generally agreed that growth is good for poverty reduction. In this connection, the important roles that micro-credit institutions can play as they do in some Asian countries was stressed.

Nigeria's performance in poverty reduction can be increased if microfinance banks are refocused from urban and semi-urban centres to the rural areas. There is need for government to make funds readily available at concessionary rates to the MFBs for on-lending to the poor and small businesses. The CBN as the lead regulator in the financial system still has important role to play in financial sector development. Finally, economists need to do more work to provide greater understanding of the nation's economy. Dearth of relevant data can no longer be an excuse for not fully understanding how deep financial system is and how the system can contribute to national development.

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