Policy Brief 4

Differences in finance's role in economic development in sub-Saharan Africa

The ODI research series for financial development in Africa

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Key messages

Financial development has a strong relationship with economic growth when it is good 'quality' and accompanied by macroeconomic stability and institutional strength.

Finance's relationship to growth is weak in resource-dependent economies. Greater diversification of credit and improved financial access are priorities.

In low-income countries (LICs) and fragile and conflict-affected states (FCAS), policy should focus on poverty alleviation, including universal financial access.

Ethiopia and Rwanda offer a successful alternative model of state-directed credit as part of industrial policy.

More academic evidence is needed on both an empirical and theoretical basis to explore these relationships and their policy implications further.

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About this series

The ODI research series for financial development in Africa funded by FSD Africa

FSD Africa is a specialist development agency working to build and strengthen financial markets across sub-Saharan Africa. Its mission is to reduce poverty through a ‘market systems development’ approach addressing the structural, underlying causes of poverty by improving how financial market systems function.

As part of its work, FSD Africa invests in breakthrough research, analysis and intelligence-gathering projects to provide policy-makers, regulators, development actors, investors and financial service providers with vital market insights and information and that contributes to long-term change.

As part of this research, FSD Africa has partnered with ODI, the independent global development think-tank, to address policy issues in financial sector development in Africa. This includes a series of working papers by and for leading academics and an accompanying series of briefing papers focused on the policy implications of research targeted at policy-makers, regulators and the broader stakeholder community.

The research programme is accompanied by joint FSD Africa and ODI dissemination events in the region and internationally to present and debate the policy implications of the research findings.

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Acronyms

FCAS	fragile and conflicted-affected states
GDP	gross domestic product
LIC	low-income country
SMEs	small and medium sized enterprises

1 Introduction

There is broad academic evidence that financial-sector development is a key causative factor in economic growth and that it is positively associated with reduced poverty and income inequality in developing countries.

However, there is significant heterogeneity in the relationship between regions and countries and the strength of the relationships varies over time. This paper will discuss some possible reasons for these differences and the policy implications.

This is of interest for sub-Saharan Africa because emerging evidence shows that only some countries in the region are seeing a strong relationship between financial deepening and inclusive economic growth.

Recent studies have examined this issue and suggest that non-financial factors such as the political and macroeconomic environment are important. This suggests that healthy banks and more broadly strong institutions are essential if finance is to have positive effects on economic growth in sub-Saharan Africa.

Other studies suggest that key factors are the ‘quality’ of credit – such as its scale, cost and tenure – the sectoral composition of credit, and the balance between the banking sector and capital markets.

However, the evidence is mixed and sometimes contradictory. In addition, identification of the reasons behind the differences are tentative in most studies.

As such, while the current academic literature provides useful quantitative evidence, because of its shortcomings and gaps, the conclusions in this briefing remains tentative.

More detailed discussion and the full academic evidence is included in the working papers referenced at the end of this briefing.

2 Broad, stable and diversified finance

A number of countries in sub-Saharan Africa have made significant progress in financial development relative to their peers. However, of these only a select group have a strong positive relationship between financial development and economic growth.

These countries' financial development appears to be characterised by the qualities that support scaling-up of transformational investment.

Their banking sectors have grown significantly. More importantly, this has been accompanied by increasing diversification of lending by sector, growing financial access and reasonable financial stability – all supported by a broad context of stability in macroeconomic fundamentals and in political and regulatory institutions.

The best example in the region is **Kenya**, for where there is consistent econometric evidence showing that financial development has been a positive causative factor in long-term economic growth.

Key to this appears to be that while its financial sector has grown – credit to the private sector has increased significantly, reaching 27.8% of GDP in 2018, well above the regional average of 17.8% – this growth has been directed to reasonably well-diversified sectors, including through strong expansion of financial access leading to growth in lending to households, for trade, and small and medium-sized enterprises (SMEs). This has been funded by deposit mobilisation, with savings mobilisation nearly doubling since 2000 to reach 54% of GDP in 2018 – the highest in the region. Finally, this financial deepening has been accompanied by strengthening regulation, institutional soundness and deepening of capital markets. Kenya's financial sector has some shortcomings: growth in lending has been sub-optimal in agriculture, and increased competition has not reduced the cost of lending. Nevertheless, the country's financial development is an example of how broad improvements across multiple dimensions of 'quality' can provide strong positive effects on economic growth.

Conversely, in countries where these dimensions of 'quality' are weaker, there is a commensurate weakening in the strength of financial developments in driving economic growth.

Examples are Ghana and the Côte d'Ivoire, where financial development has a weaker and more volatile relationship to growth. This appears to be related to endogenous factors within the financial system as well as to macroeconomic and political economy factors.

In the **Côte d'Ivoire**, GDP growth has been strong over the last decade supported by infrastructure and private sector investments and a steady improvement in the business environment. There has also been increasing digitalisation and diversification, but the economy remains concentrated in the agricultural sector. Against this background, the banking sector has grown and strengthened, and Côte d'Ivoire has the largest stock market in the region relative to GDP. However, credit to the private sector remains low at 7.4% of GDP in 2020. New issuances on the stock markets are limited for the private sector. Financial access remains modest for a lower middle-income country. Further, approximately 20% of private banks remain undercapitalised and public banks do not comply with prudential regulations.

In the case of **Ghana**, the financial sector also shows weaknesses. Private credit relative to GDP remains low (13.9% in 2019) and the banking sector is affected by the economy's reliance on agricultural commodities. The banking sector in Ghana is also concentrated, with the three largest banks accounting for 41% of banking assets. This has impeded competition with little or no improvement in efficiency or the cost of the credit. Financial access in Ghana rose from 29% of the population in 2011 to 58% in 2019, but this is modest for the region and access remains limited among the poorest households and in rural regions.

3. Resource-dependent countries

Resource-dependent economies are prone to ‘boom and bust’ cycles in commodity prices. These appear to weaken the relationship between financial development and economic growth, with the major oil and commodity exporters in the region – including **Angola, Nigeria** and **Zambia** – all following this pattern.

This is consistent with the evidence showing that macroeconomic and financial instability reduces the effects of financial development on growth, but also that there are specific effects of resource-dependence.

It leads to bank lending being concentrated in extractives and financial services, whose clients are dominated by the government and large national and international oil companies. This can undermine the development of a competitive financial sector and result in greater inefficiency. The weakness of the private sector outside of extractors undermines investment.

Another common aspect of these countries’ financial development is low financial access for SMEs and households – making growth less inclusive, limiting employment creation, and leading to lower household resilience.

4. LICS and FCAS

The financial sectors of LICs are typically small, inefficient and concentrated in banking. Lending from banking institutions is concentrated in governments and a few elite corporations and households with low levels of financial access. These inadequacies also mean that the majority of enterprises and households in LICs are reliant on informal finance, with low access to formal sources.

Unsurprisingly, in these countries, financial underdevelopment weakens economic growth. This is driven by constrained demand for finance as well as constrained supply. For example, demand from SMEs, which dominate the economies of LICs, is low because of weak business environments.

Although some LICs have some of the lowest levels of financial development in the region (such as South Sudan, the Central African Republic and Sierra Leone), others have relatively higher levels of financial development (such as Liberia and Burundi).

This reflects the fact that a country's banking sector can be of significant scale relative to GDP. However, this is often associated with corruption and illicit outflows, especially in countries that also have significant commodity endowments.

LICs are also plagued by dollarisation and only long term micro-and political stability can reverse this.

Given these fundamental weaknesses, it is unsurprising that LICs often have a neutral or negative relationship between financial development and growth.

It should be noted, however, that the academic evidence about the financial sector in FCAS is limited, and more research is needed about how formal financial development can be reformed to support economic development in such environments.

5. State-directed credit

Outside of the region, state-directed credit has been a central part of the development process, most notably in Asia. There has been persistent scepticism about the ability to replicate such industrial policy in Africa. Various factors – most notably the political economy – are seen as too weak and corrupt to allow success.

These concerns are not to be discounted, but two countries in sub-Saharan Africa stand out as having made significant progress through state-directed development: **Ethiopia and Rwanda**.

In **Ethiopia** a key component of economic strategy is state-controlled finance. The financial sector is dominated by state-owned banks that led significant increases in mobilisation of domestic savings and then directed this into lending to priority sectors and public investment. This has been a key factor in growth in the manufacturing sector and trade over the past decade. Finance still lags needs in the agricultural sector, however.

Rwanda is another country in sub-Saharan Africa where state-directed industrial policy has been key to the development process and where state capabilities have been strong. The Rwanda Development Board was mandated to improve the investment environment and coordinate ministries and agencies to facilitate private sector investments and privatise state-owned enterprises. Foreign aid flows and foreign direct investment have been important sources of financing. Access to finance is reasonably strong (68% of adults), which has facilitated relatively high savings and deposit rates. This has enabled reasonable success in relation to mobilising finance for manufacturing, but finance for agriculture remains low.

6. Concluding remarks

This briefing paper has highlighted that the growth–finance nexus is dependent upon a broad range of factors.

The political and macroeconomic context is key, but also significant is the extent of financial access and whether finance is directed into sectors of importance for economic transformation.

Further, as economic development progresses, there is a need to develop increasingly capital-intensive, higher skill and larger firms and enterprises in conjunction with improvements in public infrastructure. This requires financing of greater intensity and scale, including from capital markets and non-banking saving institutions.

Once again, political economy remains a fundamental concern. The financial sector is particularly susceptible to state capture, leading to market distortion and corruption, where only the needs of elite households, firms and state actors are served.

Ultimately, however, further academic research is needed on both a theoretical and empirical basis before greater clarity can be achieved on these issues.

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Further reading

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Photograph suggestions (links) or photo supplied or graphic idea	None
Alt-text/caption/credit for cover photo	N/a
Short summary text for webpage (200–400 words)	Finance's relationship to growth varies between countries. This paper considers reasons for these differences and policy implications to support financial access, poverty alleviation and inclusive economic growth.
One sentence summary for web (<155 characters)	Finance's relationship to growth varies between countries driving different policy implications to support financial access, poverty alleviation and inclusive economic growth for different countries.
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