**Financial Sector Performance: Evidence in twelve West African Countries**

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**Abstract**

In most of the West Africa countries, the financial sectors are the least developed area, the absence of deep efficient financial markets put major constraints in the economic growth. This study aimed to investigates the financial sector performance in twelve selected West African countries. The study employed panel data semi-log model to determine the financial sector performance. Data were collected from the World Bank Open data page from 2004-2013. The results show that, both variables match with the hypothesis indicating a positive impact in the financial sector. It indicates that the variables used in this study are major players of financial sector in the selected countries. This study makes recommendations that as financial stability, globally and within countries, generates jobs and improves productivity, more effort should be made to ensure an effective and developed financial sector system. This is so because limited and inadequate access to credit will limits the contributions of small and medium-sized enterprises to private sector development.

**Keywords:** financial sector, West Africa

**Introduction**

The financial sector of any country is rarely mentioned as one of the major areas of improvement for a country’s overall development. Simple transactions such as the payment of bills due occur probably through the financial sector. Other more complex transactions where the financial sector is crucial for business transactions and investments that occur through the financial sector. This is the stage where the most impact could be inflicted by the financial sector’s development on the growth of the economy (Levine 1997).

The events in 2008 after the crash of the financial markets around the world and the added threat of much more distress gave national governments the motivation to act. They provided buyouts larger than ever previously seen to prevent additional disasters in the financial markets that could show spillover effects over their domestic economies and trading partners’ economies (Ivashina and Scharfstein 2010). These actions of the governments reflected that the financial sector should not be ignored as it can surely impact a country’s economy. The financial sector’s development can assist in impeding its limitation to have negative effects on their domestic economies. Thus, the importance of the financial sector of developed countries for their economies is clear as they experienced a recession in the periods after the global financial crisis (Goyena and Fallis 2019). There are understandable differences between developing and developed economies. It would be interesting to assess if these differences also account for the relationship between financial sector development and economic growth. The developing countries we have chosen to focus on are located in West Africa. This particular group of countries has experienced a continued increase in the growth of their economies in the last decade. This was as a result of better policies aimed at improving sound macroeconomic conditions and positive external conditions which were the surrounding markets (Sosa, Tsounta & Kim, 2013) cited by (Didier and Schmukler 2013). According to (Didier and Schmukler 2013), the financial sector in West Africa countries has improved considerably. However, it would be interesting to know if the financial sector has an added value related to the growth of their economies. The theory regarding the relationship between economic growth and financial development has its foundation from the main functions of the financial sector’s influence on capital accumulation and the development of technologies. The financial sector plays a key role to facilitate business transactions that contribute to the growth of economies (Levine 1997). The development of the financial sector is considered an improvement of its main functions or additionally the reduction of barriers set by national governments that have a negative impact on the number of transactions conducted in the economy (Balassa 1989).

Because of these controversial debates, it was interesting to investigate if the financial sector can influence economic growth. There is a need to find development regulations and macroeconomic policies that will enhance growth. This study will examine the financial sector performance using a panel data analysis of twelve selected sub-Saharan African countries (Sierra Leone, Liberia, Ghana, Nigeria, Gambia, Senegal, Ivory Coast, Mauritania, Burkina Faso, Cape Verde, Guinea, and Mali). The choice of these developing countries is based on the fact that their economies have an average level of financial development because of their socio-economic, political and institutional history (Akinlo and Egbetunde 2010). Until the implementation of reforms in most sub-Saharan African countries in the mid-1980s, commercial banks dominated the banking system. As a result of the low level of development of stock and bond markets in sub-Saharan Africa, banks play a crucial intermediary role and represent the main source of external capital for companies World Bank (2016). On the contrary, progress is made in financial sector performance even though there remains considerable scope for further developments. This was partly a result of improvements in the institutional framework of finance such as the establishment of commercial courts and alternative dispute resolution systems, credit reference bureaus and macroeconomic stability (M. W. Beck et al. 2011).

Our objective in this paper is to verify empirically, the financial sector performance in the context of 12 Sub-Saharan African (SSA) countries for the period 2004-2013. The aim of this study is twofold first, to know if SSA countries must at present seek how to maximize the benefits of financial sector performance development while minimizing its costs. Second, to underline the fact that the financial sector may contribute to providing financial development with a predominant place in the development policies of these countries.

The first part of this paper presents the background and empirical foundations of the nature of financial development and economic growth, and then the second part exposes our review of financial development, the third part is the method of our study, the fourth part is the results and the interpretations which result from these foundations.

**Literature Review**

The primary function of the financial system is to enable the allocation of resources through space and time in an uncertain environment. Financial sector development is defined as the process of strengthening and diversifying the provision of financial services to meet the requirements of economic growth in an effective and efficient manner, thereby supporting and stimulating economic growth (Mongali, 2014). The financial systems may influence savings rate, investment decisions, technological innovation and, ultimately, long-run economic growth (Levine, 2004). On the one hand, according to Soltani *et al.*, (2014), the robustness of the information asymmetry which characterizes financial markets may be at the origin of a failure in the coordination of the allocation of savings to investment. This asymmetry of information may deform the anticipations of investors who prefer to invest in a less risky environment than in an environment that is uncertain and riskier. They do this by taking account of the degree of aversion to the risk of investors, of the imperfection of financial markets and of the high level of transaction costs. These difficulties in the financial market and this ineffective intermediation can only slow down economic growth. On the other hand, from the point of view of facts, the recent crises of banking insolvency have thrown the economies into recessionary periods. This experience has given us an example of the negative impact of banking sector development on macroeconomic performance. These banking problems may transform themselves into banking or financial crises that may lead to enormous costs to the whole economy.

The most famous works which mark current affairs are those of King and Levine, (1993). These authors show the important role of the banking system and of the financial market in the development of economic growth. They find a correlation between GDP (as an indicator of growth) and the size of the financial system. Beck, Demirgüç-kunt and Levine, (2000) also prove that the development of the banking system and of the financial market may lead to the development of economic growth, provided a few conditions are respected. This has to do with the smooth functioning of the financial system, a weak information asymmetry, a low transaction cost, and optimal allocation of resources. Vazakidis and Adamopoulos, (2009) in their joint works on the development of the financial market and economic development find that the smooth functioning of the financial market may favor growth. Similarly, in the context of China, (Shan and Jianhong 2006) argue that the contribution of financial development to economic growth is interpreted as the second force after the contribution of the incomes of workers. According to the authors, the link between the financial sphere and the economic sphere has a double sense of causality. The development of the financial system development of the banking system distribution of credits to finance investments; provides nominal GDP growth. They also maintain that the strong economic growth registered in recent years has a significant impact on the development of the financial system.

**Composition of the selected 12 West Africa Financial Sector**

There are four vital components of a financial system, namely: financial institutions, financial markets, the regulatory authorities and financial instruments. However, the financial system in West Africa has undergone some remarkable changes in terms of the followings ownership structure, the depth and breadth of instruments employed, the number of institutions established, the economic environment and the regulatory framework within which the system operates currently. The West Africa financial system include banks, capital markets, insurance, Pension asset managers and other financial institutions with the central bank as the apex institution.

**The banking subsector**

The banking subsector includes deposit money banks, microfinance banks, primary mortgage institutions, trustees and trust companies. In West Africa commercial banks (Deposit money) are the dominant operators in the industries; they are the largest in terms of size and profitability. Microfinance is financial institutions established to provide credit, banking, and other financial services to designated convenient areas or communities. Micro-finance banks are established to provide financial access to the poor who are traditionally not served by the conventional financial institutions, this is because the formal financial system provides services to approximately 20 percent of economically active population, whilst the eighty (80) percent are excluded from access to financial services, (CBN, 2008). Primary mortgage institutions also known as savings and loan companies are specialized institutions that collect household savings and originate mortgage loans. There are currently many primary mortgage institutions in Nigeria. Trustee and Trust companies are typically subsiding by banks. They provide funds and management services for organizations or individuals who set up trust funds. There are other services include portfolio management, investment advising, property management, and custodial services for non-pension funds.

**Insurance industry**

Insurance companies represent the second largest sector in the West Africa financial services industry. There are over thousands of insurance companies operating in West Africa. The minimum capital requirements to start an insurance company is 2 billion for life Insurance Companies and 8 billion for companies that provide non-life insurance depending on the country's terms and conditions. Insurance brokers also fall under this group. These companies are registered with the National Insurance Corporation of each country. In some of these countries, only a few controls a significant proportion of life and license premium income of the industry. Like in Nigeria, there are also reassurance companies within the insurance industry. There are currently 5 reassurance companies in Nigeria. In September 2005, the Federal Ministry of Finance and NICON increased the minimum capital base for reassurance business in Nigeria to N10 billion starting from February 2007. Insurance agents are representatives of Insurance companies on commission.

**Capital market**

A capital market serves as a network of financial institutions and infrastructure that interact to mobilize and allocate long-term funds in the economy. The capital market affords business firms and government the opportunity to sell stocks and bonds to raise long term funds from the savings of other economic agents. According to the Harrod-Domar model, the sourcing of long-term funds through the capital market is essential for self-sustained economic growth. A well-functioning capital market aids the mobilization of savings for economic growth and development. The capital market encourages the efficient allocation of resources through changes in wealth ownership. In this regard, the capital market acts as a catalyst in creating a healthy private sector and facilitates the promotion of rapid capital formation. Within the capital market, there are issuing houses that provide residual banking services and act as intermediaries in capital market activities. They operate between the company whose shares are being sold, the regulatory authorities and the public. Issuing houses are registered with the Securities and Exchange Commission (SEC). Many of the issuing houses in West Africa are affiliates of banks. In West Africa, stockbrokers are also involved in capital market activities. For instance, there are 581 licensed stock-brokers in Nigeria.

**Other financial institutions**

Other financial institutions refer to discount houses, finance companies, bureau de change, and development financial institution and pension fund agencies in West Africa. Many of the private equity firms are offshoots of foreign firms. Discount houses specialize in trading money market securities with the specific purpose to provide liquidity and play market-making roles for short term market instruments. Bureau is a company that carries out foreign exchange business on a small-scale basis. Development Finance Institutions (DFTs) are usually government-owned financial institutions established to finance certain developmental programs of the government usually in agriculture, commerce, manufacturing, industrial sectors, etc.

**Pension fund managers**

The pension fund managers were established for employees in West Africa as a contributory pension scheme for payment of retirement benefits of employees to whom the scheme applies. Under this Act, all employees in the public service of the Federation, and the private sector are involved, the judges and top political officeholders. The public service operates a defended and defined benefits scheme and the payment of retirement benefits were budgeted annually. The annual budgetary allocation for pension was often one of the most important parts in the budget implementation in the light of resource constraints.

**Methodology**

Data Collection

The model of the study consists of four variables with secondary yearly time series data. The variable is Gross Domestic Product (GDP), Exchange Rate *(ER),* Interest Rate (IR), Trade Openness *(TO),* and financial development *(FD).* The data for these variables were sourced from the World Bank Databank for the period 2004-2013. Specific countries were selected for this study based on the data available. The countries were Sierra Leone, Liberia, Ghana, Nigeria, Gambia, Senegal, Ivory Coast, Mauritania, Burkina Faso, Cape Verde, Guinea, and Mali. The estimated model comprises of time series *i* and cross-sectional *t* panel case.

Model Specification

To achieve the aim of the financial sector performance in West Africa, the study referred to some works by Cecchetti and Kharroubi (2012), M. W. Beck et al. (2011), Obradovic et al. (2017) and others discussed in the literature review section. Panel data is employed in this study with semi-log model, the following equation is used in the form of semi-log format and is illustrated as follows,

= + + + + + …………………(i)

Where financial development is the ratio of private credit to gross domestic product. Financial development *(FD)* is used as a proxy of dependent variable for the 12 selected West African countries in this study, while the other variables are independent variables such as interest rate *(IR)*, exchange rate *(ER)*, gross domestic product *(GDP)* and trade openness *(TO)*.

**Result and discussion**

Table 1 the estimation result of the effects of independent variables on the financial development in the 12 selected countries in West Africa

**The dependent variable is financial development**

|  |  |  |
| --- | --- | --- |
| Independent Variables | Coefficient | t-statistics |
| C | -51.83036\*\*\* | -4.097947 |
| Log(IR) | -1.888509\*\*\* | -5.408610 |
| Log(GDP) | 2.299737\*\*\* | 3.887833 |
| ER | 0.009741\*\*\* | 2.736512 |
| TO | 0.009813\*\*\* | 4.245977 |
| R-squared | 0.902818 |  |
| F-statistic | 56.35929 |  |
| Durbin-Watson statistic | 1.229386 |  |

Note: \*, \*\* and \*\*\* explain 10%, 5% and 1% significant level respectively

Table 1 show the results of fixed effects model. Both variables match with the hypothesis indicating a positive impact in the financial development with the exception of interest rate showing negative value. The R-squared show a value of (0.902818) indicating that the variables used in this study are major players in the financial sector. This also implies that 90,28 % variation of the independent variables can explain variation in the dependent variable (financial development). The F-statistics has a significant value of (56.35929). The DW Statistic has a value of (1.229386). This study is in line with the above references stating that the financial sector performance is viable in these twelve West African countries.

**Conclusion**

The aim of this article was to determine the financial sector performance in 12 West African countries. In conclusion, there is evidence that financial sector performance gives a positive impact on the economic growth of the selected 12 West Africa countries. Three variables indicator of financial sector performance (exchange rate, gross domestic product, and trade openness) influenced economic growth positively, while one (interest rate) indicator influenced economic growth negatively. However, since there is evident that financial sector can lead to economic growth, more effort should be made to ensure an effective and developed financial sector system? This is so because limited and inadequate access to credit contributes significantly to low productivity in rural areas, limits the contributions of small and medium-sized enterprises to private sector development and can slow the deepening of the banking sector.

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