

Financial Development, Political Institutions and Economic Growth in
The ECOWAS Sub-Region: An Empirical Analysis

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1. Introduction

The enormous cross-country differences in economic development and growth in recent years, have led to a resurgence of research interest in the determinants of economic growth, a subject which has been extensively debated. The resultant literature contains competing explanations of economic development and growth and the notable ones are the roles of institutions (Easterly and Levine, 2003; and Rodrik et al 2002), importance of geography, culture and history (Acemoglu et al. 2001) and quality of macroeconomic policies (Frankel and Romer, 1999; Aryeetey and Fosu, 2002; and Berg and Krueger, 2003). A common characteristic of the series of research papers that have examined this issue is that they relate to a combination of developed and developing countries. Interestingly, the results have been very persuasive, but not conclusive and this characterizes the issue as one of continuous research importance.

One component of the literature that has received considerable scrutiny by researchers and practitioners of financial economics is the importance of institutional development and quality in explaining economic growth. For instance, following the

seminal studies of McKinnon (1973) and Shaw (1973), there has been a vast literature on the effects of financial sector development on economic growth. King and Levine (1993), Levine and Maksimovic (2001), Wachtel (2001) and Rousseau and Wachtel (2002) are some of the studies that have examined the issue from an empirical perspective. The predominant view is that the increased availability of financial instruments and institutions reduces transaction and information costs in an economy helping economic agents to hedge, trade, and pool risk which in turn raise investment and economic growth. Accordingly, the general conclusion in the literature is that financial development exerts a strong positive effect on economic growth. Equally, many previous studies have recognised the crucial importance of politics or political institutions in explaining economic growth. Jones (2002) indicates that politics matters for economic growth since factors determining the profitability of investment, which positively influence economic growth, are mostly related to political institutions. Other researchers such as Barro and Lee (1993) argue, rightly, that economic instability is often the result of political instability and vice versa. In Africa, the story is even more threatening. Aryeetey and Tarp (2000) indicate that political instability contributes significantly to the macroeconomic instability in Ghana, a characteristic that epitomizes the situation across the African continent.

This paper contributes to the on-going debate on the importance of institutions for economic development and growth by specifically highlighting the roles of financial sector development and politics in explaining economic growth among countries in the ECOWAS Sub-Region. It attempts to provide an answer to the following question: What factors explain the significant differences in economic growth across ECOWAS countries? This question is examined empirically, considering the impact of each factor (financial sector development and politics) on economic growth, and growth volatility. Specifically, the paper aims at taking stock of recent work on the influence of institutions on economic growth, advancing the debate through new empirical analysis (using data on ECOWAS countries), and to generate some conclusions that may be relevant for policymakers.

2. Data and Methodology

The study uses mainly secondary data. The panel data used have been constructed starting from the World Bank's World Development Indicators, the International Monetary Fund's International Financial Statistics and the African Development

Bank's Country Profile Statistics. All the 15 ECOWAS countries except Liberia (excluded for non-availability of data) are included and there are observations for 21 years between 1980 and 2000.

The financial ratios used as proxies for economic growth and financial sector development are drawn from previous studies (see, e.g., King and Levine, 1993). The dependent variable is the growth rate in per capita GDP; while for the independent variables, we use the money and quasi-money to GDP ratio (MGDP) and credit to the private sector as a percentage of GDP (CREDITPR) to measure the size and development of the financial sector. A rising MGDP is associated with financial deepening and CREDITPR gives information about the amount of loans, which are directed to the private sector. The political variables are dummy ones representing the type of political system (democracy or dictatorship) and the absence of politically driven conflicts or otherwise. To assess the strength of an independent link between financial development and political, and economic growth variables, we use various conditioning information sets (variables) in line with previous studies. This is aimed to control for other factors associated with economic development and growth. Finally, in econometric terms, the study follows recent development in the literature (see, e.g., Levine et al. 2000) and employs the dynamic panel model of generalized-method-of-moments (GMM) technique. This technique is acclaimed to be capable of avoiding estimation problems associated with other methods such as Ordinary Least Square (OLS).

3. Conclusion

There are no initial findings for the study. All the required data has been gathered and treated and is now ready for the empirical analysis. We hope to obtain results that will be relevant to policymakers in Ghana in particular and countries in the ECOWAS union in general.

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