The Need of Effective Institutions for Financial Development in Developing Countries:
Case of African Countries

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ABSTRACT

The aim of this paper is to investigate the institution effects of financial development in African countries. We find that the positive institution effect of financial development is related to the disclosure and the corporate governance. But the creditor protection and central banks in African countries don’t lead the financial development. The findings here suggest that the increase of Disclosure, Corporate governance level, public intervention for more Creditor protection and effective Central banks independence will lead the entire region reaching the financial development.
1. Introduction

Financial market and institutions are central to economic performance. For African countries, both can enhance economic growth and lead it to more inclusive growth and less volatile growth. Over the past decades, financial development has progressed in most African countries. The overview of the progress show that the financial sector has deepened— with an increasing ratio of private sector credit to GDP; the region is involved in innovative financial services based on mobile telephony and internet; and Microfinance has also grown rapidly touching a large parts of the population.

However, while financial development enhanced African countries’ growth and reduced the region’s economic growth volatility, together financial markets and financial institutions are less developed compared with other developing regions. It clearly seems that to catch up the full advantages of financial development, the formulation and the implementation of appropriate policies are a necessary condition (See Enowbi-Batuo and Kupukile, 2010; Mlachila and al., 2016).

The primary issue with financial markets is information. And to process information efficiently, financial arrangements (bank or other financial institutions) require institutional support. In the case of African countries, referring to Mlachila and al., (2016) while macroeconomic fundamentals have been driving financial development, because of weak institutional arrangements its financial development is still low. Therefore, improvements in institutional arrangements seem to be the most issue to deal with in order to boost financial development in the region. Our focus here is on some version of creditor protection, corporate governance, disclosure and Central banks that are required for an effective financial system.

The primary concern of this study is to define the virtues of good institution as leading economic performance. The study aims as well to make a contribution to the development of African countries’ financial markets. Specifically, it analyzes the effect of creditor protection, corporate governance, disclosure and Central banks on the financial expansion.

The paper follows such organization: Section 2 provides a literature review. In the Section 3, we describe the data. Our model and the methodology applied are specified in the Section 4 of the paper. Section 5 analyzes the empirical results and Section 6 provides conclusions and some policy implications.
2. Literature Review

The literature on how institutions behave in financial development is related to the “Law and Finance theory”. And research in that area began probably with the studies conducted by La Porta and al. (1997, 1998).

La Porta and al. (1997, 1998) were the first to figure out the importance of the legal institutions such as creditor rights for financial sector development. Moreover, the national legal origin of the institutions matters in the explanation of cross-country differences in financial development (See La Porta and al. 1997, 1998 and Beck and al., 2003). Further studies have also shown that high levels of shareholder rights or greater creditor rights are positively associated with a high level of equity market and the financial development (Levine and al., 2000; Claessens and al., 2002a; Caprio and al., 2004). And more other discussions on the legal institutions and financial development nexus, among others Levine (1998, 2002), Stultz (1999), Acemoglu and al. (2001), Beim and Calomiris (2001), Pagano and Volpin (2001), and Rajan and Zingales (2003) have been carried out. Generally, those institutions might have a significant impact on the development of the finance.

Furthermore, the literature on the link between institutions and financial development highlights that other institutional arrangements such as governance (Fligstein, 2001), better contract enforcement (Fergusson, 2006), strong rule of law (Modigliani and Perotti, 2000), political stability (Roe and Siegel, 2011) and other institutional factors (Anayiotos and Toroyan, 2009) clearly foster financial sector development.

In some studies, information disclosures have also been shown as a determinant of financial development. Among those studies, Mayer and Sussman (2001) emphasize that information disclosure and other forms of regulations in accounting, insurance and banking practice do appear to have significant effects on financial development. McDonald and Schumacher (2007) reached to the same conclusion that information sharing has deeper effects on financial development.

The studies about corporate governance show that weak corporate governance has a negative impact on the performance of financial corporation (Caprio and al., 2007; Andres and Valledado, 2008; Rezaee, 2008; Cornett and al., 2009). By the same token a weaker corporate governance quality may not be in favor on financial development (Diamond and Rajan, 2009). Moreover, some studies find that improved corporate governance is associated with better financial environment (see Akhigbe and Martin, 2006, 2008).
Many studies emphasize the role of central bank, the stability and general health of the financial system. They show that if run well, if run independently, central banks play an important role in the economy, particularly as lenders of last resort and as monetary policy maker (e.g., Healey, 2001). Indeed, Central Bank Independence (CBI) or “regulatory and supervisory independence”, as well as price stability, fosters financial stability (Quintyn and Taylor, 2002; Arnone et al., 2009; Bernanke, 2010a). Moreover, some empirical findings support the same view by providing evidence that the likelihood of a banking crisis become lower with a higher values of CBI indicators (García Herrero and Del Río, 2003) or that there is a negative relation between CBI and financial instability (Klomp and de Haan, 2009). But there is sharp contrast to the view that CBI fosters financial stability. Berger and Kißmer (2013) highlight that the willingness of bankers to prevent financial crises decrease with the degree of independence of the central banks.

3. Data

Since, our independent variable the financial development was multidimensional, the literature didn’t find a single index of financial development. It is usually measured following some five categories of indicator: quantity measures, structural measures, financial prices, product range and transaction cost. The conventional indicators of financial development on which most of studies is based are the Liquid Liabilities, the Private Credit, the Commercial-Central Bank, the Overhead Costs, the Net Interest Margin, the Stock Market Capitalization, the Total Value Traded and the Turnover Ratio. Within this list of indicators, six lower level sub-indices of financial development are constructed. These six indices measure the deep, access, and efficiency of financial institutions and financial markets. Finally, the measure of overall financial development is the aggregation of financial institution and financial market sub-indices based on the eight components of financial dependence. Data on financial development according to a New Broad-based Index of Financial Development are cited form the International Monetary Fund.

The Dependent Variables on which our study is based are Creditor protection, Corporate governance, Disclosure and Central banks.

The measure of Creditor protection is the Strength of legal rights index. The indicator represents how collateral and bankruptcy laws protect the rights of lenders and borrowers and how lending is facilitated. The lower degree of the index is 0, meaning a weak designed legal
right to expand access to credit, while the strongest legal right is indexed by 12. The data of that measure of Creditor protection are cited on Doing Business project form the World Bank.

We measured the Corporate governance using the investor protection index (0-10). It is the degree indicating the protection of investors through disclosure of ownership and financial information. The data are also form Doing Business project.

The Disclosure index, ranged from 0 to 10, measures the extent to which investors are protected through disclosure of ownership and financial information. The lower values indicate less disclosure and higher values more disclosure. Data on disclosure, namely Business extent of disclosure index, are from World Bank.

The independence is the most important condition in attaining the objectives which have been attributed to central banks. For our study, it shows how well central banks run and how well it plays its role in financial development. The data about Central Bank Independence (CBI) are drawn from the work of Garriga (2016).

Table 1 shows definition and description for the variables used in this paper.

<table>
<thead>
<tr>
<th>Variable</th>
<th>Definition</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>$fd$</td>
<td>Financial Development</td>
<td>Level of financial Development</td>
</tr>
<tr>
<td>$slr$</td>
<td>Strength of legal rights index</td>
<td>Index ranges from 0 to 12 (0=weak to 12=strong)</td>
</tr>
<tr>
<td>$ipi$</td>
<td>Investor protection index</td>
<td>Index ranges from 0 to 10 (0=weak protection to 10=strong protection)</td>
</tr>
<tr>
<td>$bed$</td>
<td>Business extent of disclosure index</td>
<td>Index ranges from 0 to 10 (0=less disclosure to 10=more disclosure)</td>
</tr>
<tr>
<td>$cbi$</td>
<td>Central Bank Independence</td>
<td>Level of Central Bank Independence</td>
</tr>
</tbody>
</table>
4. Model Specification and Methodology

The model used to carry out of study can be written as follows:

\[ y_{i,t} = \alpha + \beta Z_{i,t} + \eta_i + \xi_t + \epsilon_{i,t} \]

where our response variable, Financial Development, is denoted \( y_{i,t} \) and \( Z_{i,t} \), a set of explanatory variables. \( \eta_i \) stands for unobserved and constant individual-specific effects that might affect financial development; \( \xi_t \) is an unobserved time-specific effect and \( \epsilon_{i,t} \) is the stochastic error term.

It follows that we employed the mixed-effects ordered probit regression on panel data analysis as the econometric analysis technique to control heterogeneity of cross-section units and give also better unbiased estimation than others analysis techniques.

5. Empirical Results

This section is about the empirical results of the paper. Table 2 shows estimated results for the financial development level by the probit estimation procedure for each model considering the measure of central bank independence.

<table>
<thead>
<tr>
<th>Variable</th>
<th>Model 1</th>
<th>Model 2</th>
<th>Model 3</th>
<th>Model 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>slr</td>
<td>0.0309</td>
<td>0.0320</td>
<td>0.0458</td>
<td>0.0478</td>
</tr>
<tr>
<td></td>
<td>(0.0788)</td>
<td>(0.0789)</td>
<td>(0.0777)</td>
<td>(0.0776)</td>
</tr>
<tr>
<td>ipi</td>
<td>0.2610**</td>
<td>0.2500**</td>
<td>0.2681**</td>
<td>0.2699468**</td>
</tr>
<tr>
<td></td>
<td>(0.1187)</td>
<td>(0.1217)</td>
<td>(0.1156)</td>
<td>(0.1153)</td>
</tr>
<tr>
<td>bed</td>
<td>0.3277***</td>
<td>0.3184***</td>
<td>0.3277***</td>
<td>0.3247***</td>
</tr>
<tr>
<td></td>
<td>(0.1221)</td>
<td>(0.1217)</td>
<td>(0.1222)</td>
<td>(0.1220)</td>
</tr>
<tr>
<td>cbi_1</td>
<td>-0.7940</td>
<td>-0.9073</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(1.0964)</td>
<td>(1.2159)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>cbi_2</td>
<td></td>
<td>-2.5253</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>(345.2919)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>cbi_inc</td>
<td></td>
<td></td>
<td>0.2278</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(0.7657)</td>
<td></td>
</tr>
<tr>
<td>cbi_dec</td>
<td></td>
<td></td>
<td></td>
<td>-2.5253</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(345.2919)</td>
</tr>
</tbody>
</table>

Notes: *** 1% of significance, ** 5% of significance, * 10% of significance

The results suggest that when we focus on institutional arrangements to explain the level of financial development in Africa countries, the most important factors are the Disclosure and Corporate governance. Ended, they show a positive sign and are highly significant. This suggest that the higher level of Disclosure and Corporate governance, the stronger the
positive effect of that particular variable on financial development of African countries will be, and the more the economy will be transformed.

On the other hand, Creditor protection and Central banks are either insignificant or show negative sign which is in contrast to our hypothesis that the two variables lead also to the financial development. This contrast deserves further investigation and policy implications for African countries.

6. Conclusion and Policy Implications

The primary concern of this study is to define the virtues of good institution as leading economic performance. The study aims as well to make a contribution to the development of African countries’ financial markets. It analyzes the effect of creditor protection, corporate governance, disclosure and Central banks on the financial expansion.

We established the literature on the role of institutions in financial development related to the “Law and Finance theory”. The review emphasized the positive effect of the variables on which our study is based on the financial development. The mixed-effects ordered probit regression on panel data that we have employed as the econometric analysis technique shows the findings of our study. The results indicate that on one hand the most important factors of financial development of African countries are the Disclosure and Corporate governance but on the other hand, Creditor protection and Central banks in African countries don’t lead the financial development.

Some policy implications could figure out from the findings of this study. First of all, the financial development should be one of the prime priorities in policy target for African countries.

The most important policy implication of our analysis should combine the improvement of Disclosure and Corporate governance level in overall Africa. Indeed, a very few list of African countries is reaching the highest index in disclosure and corporate governance. The ultimate goal of these policies mix should be the financial inclusion and the reaching of the structural transformation.

As shown in the theoretical model and other empirical studies, the Creditor protection and Central banks should be financial development leading. If not (the case of African countries), then public intervention is need in order to make the Creditor protection and Central banks significant to the financial development of all the region. It should be such as institutional reforms to protect more creditors and effectively independent the central banks. We agree
with Enowbi-Batuo and Kupukile (2010) and Mlachila and al., (2016) that all these policies are critical and necessary condition for creating an institutional environment that enhances financial development and improve the sector.

References


