Session I:  
Setting the Stage

The Finance-Growth Nexus:  
Theory, Evidence, and Implications for Africa

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One of the challenges facing policy makers is to reignite African economic growth. Since the 1960s, when most Sub-Saharan African countries obtained independence, per capita GDP growth has only averaged one percent per year. The comparable rate for the OECD was 2.8 percent. Even Latin America, which had a “lost decade” in the 1980s, grew almost twice as fast as Africa, 1.9 percent per year. Even more stunning, per capita GDP actually shrank in 11 of the 46 African countries that reported data. The situation does not look better if we restrict the period of analysis. From 1990 to 2004 the average rate of per capita GDP growth has only been 0.9 percent in Sub-Saharan Africa, as compared to 2.1 percent in the OECD and 1.7 percent in Latin America.¹

The causes of African economic stagnation are multi-faceted, but one crucial piece of the puzzle is the region’s inadequate financial systems. In 2006, the average ratio of private credit to GDP (a standard metric by which to measure the development of banking systems) was 110 percent in the OECD, 31 percent in (notoriously under-banked) Latin America, and only 20 percent in Sub-Saharan Africa. Worse, the average ratio for Africa is almost certainly biased upwards because a large number of countries, presumably those with miniscule banking systems, do not report any data.² This outcome, we hasten to note, is not a product of a single cross-section. In fact, Kane and Rice (2001) document that Africa’s banking systems were in a state of near-permanent crisis during the 1980s and 1990s: systemic crises were experienced in at least 50 of the region’s 60 countries, with at least ten countries undergoing multiple crises.

¹ Calculated from data on real chain weighted GDP per capita in PPP dollars in Heston, Summers, and Aten, 2006. Data covers first year of observation in the 1960s through 2004. Regional averages are unweighted.
² Calculated from data in Beck, Demirgüç-Kunt, and Levine, 2007a. Regional averages are unweighted.
The purpose of this paper is threefold. First, I draw on the extant literature in financial economics to explain why the small size of African banking systems has negative implications for economic growth. Second, I explore why African financial systems are small by drawing on the extant literature on the political economy of financial development. Finally, I explore some ways in which African banking systems might be improved, short of the kinds of broad-institutional reforms to the region’s fundamental political institutions that would be suggested by the political economy literature.

I. Finance as a Crucial Input to Growth

The idea that financial development plays a leading role in economic growth traces its origins to Schumpeter (1912), and has subsequently been firmly established by a wide variety of scholarly literatures that employ long run historical evidence, cross-country regressions, within-country studies that exploit variance across industries and regions, and combinations of all three approaches.

One body of literature has been written by economic historians, who have explored systematically the crucial role played by “financial revolutions” in the economic development of seventeenth century Holland (de Vries and van der Woude 1997; Neal 1990), eighteenth century England (North and Weingast 1989), and the nineteenth century United States (Rousseau and Sylla, 2004; Sylla 2006, 2008). One of main points of this literature is that revolutions in the way that financial markets and financial intermediaries operated not only allowed for the rapid growth of the real economy, they also were a crucial component in the rise to global economic and military hegemony of Holland, England, and the United States. There are also a sizable economic history literatures on how the absence of financial revolutions held back economic
growth in a number of developing countries, including nineteenth century Russia (Anan’ich 1999), nineteenth century Brazil (Summerhill, forthcoming), Argentina (Davis and Gallman 2001), and early twentieth century Mexico (Haber 1991, 1997; Maurer 2002; Haber, Razo, and Maurer 2003). Finally, there is a comparative historical literature, that assesses the performance of countries against one another as a function of their level of financial development (Rousseau and Wachtel 1998; Rousseau 2003; Rousseau and Sylla 2003). Indeed, the idea that successful economic development was typically preceded, or was accompanied, by a major episode of financial innovation is now taken by economic historians to be self evident.

Financial economists, employing cross-country regression techniques, have come to broadly similar conclusions. The first work on the topic, by Goldsmith (1969) and McKinnon (1973) illustrated the ties between the financial sector and the real economy. King and Levine (1993) then formalized these insights by using cross-country regressions to demonstrate that higher levels of banking system development are positively associated with faster rates of physical capital accumulation and economic growth. Crucially, their study of more than 80 countries also found that the level of financial development predicts future rates of physical capital accumulation and long-run growth. Thus, finance does not follow economic activity, it leads it. Levine and Zervos (1998) then extended this work to include the independent impact of stock markets, as well as banks, on economic growth. They find that stock market liquidity and banking sector development are independently and positively correlated with both current and future rates of capital accumulation and economic growth.

One potential objection to the King and Levine (1993) and Levine and Zervos (1998) findings is that unobserved heterogeneity across countries—for example, differences in industrial composition—explains both the variance observed in financial development and the variance
observed in growth. Another potential objection is that the regressions might induce researchers to draw spurious causal inferences: finance may not so much be a cause of growth as it a leading indicator of growth. Rajan and Zingales (1998) address these concerns by focusing on industries as well as countries. They show that industries that are relatively more in need of external finance grow disproportionately faster in countries with larger banking systems and stock markets. Their findings suggest that financial development has a substantial effect on economic growth by reducing the cost of external finance to financially dependent firms. Wurgler (2000), who also focuses on both industries and countries in order to mitigate problems of unobserved heterogeneity and spurious causal inferences, obtains roughly similar results. He finds that financially developed countries (as measured by the size of domestic stock and credit markets relative to GDP) increase investment more in their growing industries and decrease investment more in their declining industries. Thus, financially developed countries do not necessarily invest more than financially underdeveloped countries, but they allocate investments more efficiently. Fisman and Love (2004) extend the Rajan and Zingales (1998) methods in order to assess the implications of financial development for the growth of industries over the short and the long-run. Their results indicate that in the short-run, financial development facilitates the reallocation of resources to any industry with a high growth potential. In the long-run, however, financially dependent industries will be more likely to grow in countries that have well developed financial institutions. That is, countries with high levels of financial development will specialize in finance-dependent industries.

Beck, Levine, and Loayza (2000) also take on the questions of unobserved heterogeneity and spurious causality but they do so not by considering industries as well as countries, but by applying novel econometric techniques: they use an instrumental variable estimator in order to
extract the exogenous component of financial intermediary development; and they use a dynamic Generalized-Method-of Moment (GMM) panel estimator that allows simultaneously allows for the exploitation of time series variation in the data, accounts for unobserved country-specific effects, allows for the inclusion of lagged variables as regressors, and controls for endogeneity of all the explanatory variables. They also use an improved measure of financial intermediary development (financial intermediary credit to the private sector as a percentage of GDP). Their results indicate a robust, positive link between financial intermediary development and both total factor productivity growth and real GDP growth.

A third body of research, also designed to mitigate the problems of spurious causal inference and unobserved variable bias that may be present in cross-country studies, exploits variance across geographic units and across time within countries. Jayaratne and Strahan (1996) take advantage of the fact that prior to the 1970s U.S. states tended to restrict the ability of banks to open branches. They then exploit variance in the timing in which these laws were reformed in order to estimate the impact of the spread of branch banking on economic growth at the state level. They find that branch banking improved the quality of loans, but did not produce an increase in the volume of lending—implying that branching allowed banks to allocate credit more efficiently—and that branch banking produced a jump in the rate of growth of per capita income at the state level. Black and Strahan (2002) build upon these methods and findings to estimate the impact of changes in laws governing bank competition on entrepreneurial behavior. They find that states with more concentrated local banking markets have lower rates of incorporation, and when these states opened their banking markets to external competition (by allowing banks greater freedom to open branches) the rate of incorporation increased. In short, the removal of regulatory barriers increased bank competition, which, in turn, caused higher rates
of business incorporation—suggesting that access to finance had been a constraint on entrepreneurship prior to the regulatory reforms. A somewhat similar approach is taken by Dehejia and Lleras-Muney (2007), who exploit variance in branch banking laws over time within U.S. states during the period 1900-1940. They find that regulations that lowered the cost of lending, such as allowing banks to open branches, had an unambiguously positive effect: it contributed to fewer, more intensively cultivated farms, and to the growth of the manufacturing sector. These results are consistent with those of Wang (2006), whose examination of loan books from early nineteenth century U.S. banks shows that as the density of banks increased, competition among them increased as well, so much so that they began to extend credit to an increasingly broad class of borrowers, including merchants, artisans, and farmers.

Economists have recently begun to focus on the specific mechanisms that link finance and growth. Guiso, Sapienza, and Zingales (2004) exploit variance across Italian regions in order to estimate the impact of differential financial development on entrepreneurship. They find that an individual’s odds of starting a business increase by 5.6 percent if he moves from the least financially developed regions of Italy to the most financially developed. In addition, he is likely to start a business at a younger age than if he stayed in the financially underdeveloped region. As a consequence, the ratio of new firms to population is 25 percent higher in the most financially developed regions of Italy. They also find that Italy’s most financially developed regions firms grow faster (by six percent) than would be possible if they had to finance all new investments out of retained earnings. Not surprisingly, they find that per capita GDP grows faster in those regions as well.

A related body of research has focused on how financial development affects the entry of new firms in non-financial industries. Haber (1991, 1997) and Maurer and Haber (2007) exploit
the financial and industrial histories of Brazil and Mexico as natural laboratories. They find that restrictions on the growth of financial intermediaries gives rise to differential access to capital, which, in turn, gives rise to higher levels of industrial concentration than would be obtained otherwise. Haber (2003) then shows how the resulting low level of industry competition dampens the pace of productivity growth. In a related line of research, Cetorelli and Strahan (2006) find that more vigorous local banking competition across US states is associated with more funding for new firms, more firm entry, and a smaller average firm size. Cetorelli and Gamberra (2001) develop this idea in a cross country framework, and find that concentrated banking markets are associated with slower growth in downstream industries.

One implication of this research is that industries that have a larger share of small firms for technological reasons should grow faster in economies with well-developed financial systems. Beck, Demirguç-Kunt, Laeven, and Levine (2007) pursue this question by estimating a variety of panel regressions on a sample of 44 countries and 36 industries. Their results not only indicate that financial development disproportionately accelerates the growth of industries that, for technological reasons, are characterized by small firms, but they also show that small-firm industries represent a greater proportion of total manufacturing value added in countries that have higher levels of financial development.

Financial development does not just have salutary effects on economic growth generally speaking. It also appears to have positive effects on the distribution of income and the well being of the poor. Beck, Demirguç-Kunt, and Levine (2007b) pursue this issue using a variety of regression techniques on a panel data set. They find that financial development reduces income inequality, boosts the growth rate of the income share of the poorest quintile of the population,
and is associated with poverty alleviation (where poverty is measured as the fraction of the population living on less than $1 per day).

In sum, the question of the relationship between financial development and growth is now a settled matter. There is a broad consensus that finance plays a crucial role in the process of growth, and that it does so through a variety of mechanisms: by reducing the cost of capital to firms, by allocating capital more efficiently to entrepreneurs, and by encouraging greater competition among non-financial firms.

II. The Political Economy of Financial Development

If it is common knowledge that finance is a binding constraint on growth, then why don’t governments in poor countries simply create the conditions necessary for large banking systems and securities markets? This question has motivated a sizeable body of scholarship over the past decade.

One view, associated with La Porta, López-de-Silanes, Shleifer, and Vishny (1998), stresses that financial development is the outcome of the legal institutions that a country inherited during the process of colonization. In this view, whether a country inherited the British common law or French civil law determined the development of its institutions of corporate governance, and hence, the size of its equity markets. This view has come under considerable questioning and debate in recent years. Broadly speaking, there have been three lines of critique. First, the legal origins view has tended to focus more on corporate governance and equities markets than it has banking systems—but banking systems are typically more important than equities markets in the early stages of economic growth (Haber, North and Weingast 2008). Second, some scholars have raised questions about coding and measurement in the legal origins
literature (Spamann 2006). Third, Rajan and Zingales (2003a) have shown that there has been considerable variance over time within countries in their degree of financial development—and a theory based on a time-invariant factor, such as legal origin, cannot account for this within-country variance. Beck and Levine (2005) present an excellent summary of these debates.

An alternative view, which has gained considerable ground in recent years because it can account both for variance across countries and over time within countries, is that financial development is endogenous to a country’s underlying political institutions. That is, financial development will be limited unless the authority and discretion of government are constrained by mechanisms that allow citizens to sanction public officials. At its core, this “political institutions view” of financial development is concerned with the government’s inherent conflict of interest: the growth of banks and securities markets is not possible without a government that can enforce financial contracts; but the government relies on those same banks and markets to provide it with a source of finance. Unless there are political institutions that limit the government’s authority and discretion, it will have strong incentives to govern the financial system so as to facilitate its own political survival, at the expense of the development of the securities markets and banking systems that can finance the private economy. That is, the institutions of liberal democracy—broad suffrage, party competition, checks and balances—are causally linked to having a large financial sector that allocates capital broadly.

Space constraints prevent a full explication of the political institutions view of financial development.³ Permit me, however, to briefly lay out a simple framework, focusing only on the impact of political institutions on the development of banking systems. Inasmuch as securities

³ For a more complete discussion see Haber and Perotti (2007).
markets tend only to develop after there is a system of private banks, this focus on banking is the most reasonable place to start.  

A Simple Framework

The business of banking is the business of contracts. The emergence of banks, and the contracts they write, is not an automatic process. Without a series of institutions that align the incentives of government, bankers, and the firms and individuals who borrow from banks, the development of the banking system will be constrained or there will be no banking system at all.

As a first step, let us be clear what we mean by the term bank—a business whose purpose is to lend money at interest that has a charter from the government. A charter is not just a license to do business: it confers a number of very valuable concessions on its holders. These tend to include limited liability for shareholders, priority as a creditor in the event of debtor bankruptcy, insurance for depositors, and the right to create financial instruments (such as checks) that circulate as currency. In some economies, banks also serve as the government’s financial agent, collecting taxes and holding government balances. Not surprisingly, potential bankers will pay handsomely for a charter—especially if they believe that they are receiving the only one.

As a second step, let us think about the incentives of the agents that have an interest in the development of the banking system. Imagine an economy in which there are three agents: 1). A group of incumbent financiers, who have accumulated wealth in commerce or industry and

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4 Banks tend to precede securities markets in the process of financial development for several reasons. First, most firms draw on bank credit for considerable periods of time before they are large enough to go public. Second, banks tend to play a major role as underwriters of securities. Third, banks, along with utilities, tend to be among the first securities listed on emerging exchanges.
who have a comparative advantage in organizing markets and institutions; 2). A group of political entrepreneurs, who have a comparative advantage in organizing collective action and running the machinery of government; and 3). A group of entrepreneurs (farmers, manufacturers, and artisans) who need credit in order to run or expand their nascent enterprises. It will not take long to show that the incentives of these three groups are not perfectly aligned.

The goal of the financiers, first and foremost, is to maintain their control over the markets that affords them considerable rents. This means that they prefer constraints on the number of banks—and that they receive whatever small number of bank charters are granted by the government. The lack of competitively structured credit markets not only affords them high rates of return in banking, but even more importantly allows them to create financial barriers to entry in the rest of the economy because they can deny credit to rival entrepreneurs. These financial barriers to entry are particularly effective because they are stealthy: they do not require visible anti-competitive regulations, which might attract public protest, in order to persist: they may be justified on the basis that they serve the public interest by helping to maintain a stable banking system (Rajan and Zingales 2003b; Haber, Razo, and Maurer 2003, Chap. 4; Perotti and Volpin 2004).

The goal of the political entrepreneurs, first and foremost, is political survival—which is to say that they seek to maintain their control of the government (Bueno de Mesquita et. al. 2003). In order to do that, they need sources of public finance. This means that they have an obvious incentive to encourage the formation of banks, because those banks represent sources of tax income, fees for charters, or, most especially, loans.
The entrepreneurs have an obvious interest in obtaining low cost credit to finance their enterprises. Without credit they can only grow their enterprises through retained earnings. Without credit, there may be industries (such as those with high minimum efficient scales) from which they are barred from entry, because they cannot mobilize sufficient capital. They therefore favor competitive banking markets.

Aligning the incentives of these three groups regarding the banking system is not easily accomplished. There is an obvious mismatch between the interests of the financiers and the entrepreneurs: the financiers favor constraints on competition; the entrepreneurs favor competitive credit markets.

There is a less obvious, but no less consequential, problem of interest alignment between the financiers and the political entrepreneurs. The financiers need a government strong enough to enforce debt contracts and structure markets; but any government strong enough to do that is also strong enough to seize the wealth of the banks. This problem is particularly difficult to solve because the government does not have to carry out a de jure expropriation in order to appropriate bank wealth: it can borrow from the banks and then default on the loans; it can require banks to hold part of their deposit base in government bonds so as to create a “deposit reserve” and then it can raise the deposit reserve rate to 100 percent; it can print money wildly, setting off an inflation that acts as a tax on the holders of cash; or it can raise taxes to the point that it expropriates all bank profits.

There is also a mismatch in incentives of the three groups regarding the property rights system. The entrepreneurs favor a system that favors universal enforcement of property and contract rights, because such a system will allow them to collateralize their assets and
reputations. The political entrepreneurs may not, however, favor the creation of strong property rights institutions, because that will prevent them from seizing assets in the event that they need to commandeer them to maintain themselves in power. The incentives of the financiers are not clear cut, but there are conditions under which their incentives will align with the political entrepreneurs. If they have been successful in making private deals with the political entrepreneurs to limit the number of banks, they may have strong incentives to prefer low levels of public investment in the institutions that protect universal property and contract rights. They can obtain all the protection they need through private deals with government officials, while the entrepreneurs face a barrier to entry imposed by an uncertain legal environment (Sonin 2003).

The historical record suggests that there are a limited number of stable solutions to these problems of incentive alignment. Each of these solutions implies differences in the rules and regulations that govern the distribution of bank charters, differences in the size and competitive structure of the banking system, and differences in the institutions that limit the authority and discretion of government.

One quite common solution is that the financiers so fear government predation that they do not seek bank charters at all: they know that as soon as they deploy their wealth in a bank the government will expropriate it. The result is that there are no privately-owned banks. To the degree that the society has any chartered banks at all, they will be government owned and will primarily exist to finance the government or government owned firms—Iraq under Saddam Hussein being a classic case in point. In the African context, Idi Amin’s forced merger of virtually all of Uganda’s private banks into a single, government owned bank (Uganda Commercial Bank) in 1972 stands as another stark case in point (Kasekende and Sebudde 2002).
A second common solution is a coalition between the financiers and the political entrepreneurs that is based on the generation and sharing of economic rents. Such coalitions form when political entrepreneurs coax financiers to deploy their wealth in banks by granting them privileges that raise their rates of return high enough to compensate them for the risk of expropriation (Maurer and Gomberg 2004). These privileges can include lucrative concessions, such as the right to collect taxes or hold government deposits, but they always come on top of tight restrictions on the number of chartered banks. The problem is that there is nothing that prevents the political entrepreneurs from reneging on the deal once the financiers have deployed their wealth. The financiers must therefore align the incentives of the political entrepreneurs, and they typically do this by sharing some of their rents with them, by putting the political entrepreneurs on their boards of directors, by making them loans with no expectation of repayment, or by bribing them (Haber, Razo, and Maurer 2003, Chap. 2). The Suharto regime in Indonesia, in which the dictator’s family and friends populated the country’s largest corporations, is a classic case in point (Fisman 2001). These arrangements, however, come at a cost to the entrepreneurs, because their access to credit is constrained. In fact, in a political and economic system such as this, in which a set of privileged financiers has made a set of private deals with the government to constrain entry, the banks likely could not enforce arm’s length loan contracts with entrepreneurs even if they wanted to: the institutions of universal contract enforcement are likely to be underdeveloped, because the financiers can get all the property rights protection they need privately.

A third solution is that the financiers tie the hands of the political entrepreneurs by creating sets of institutions that limit their authority and discretion, thereby preventing expropriation. The exact configuration of these institutions varies across societies, but one
feature that they always have is a legislature in which the financiers are represented. Putting the financiers in the legislature in sufficient numbers to prevent expropriation does, however, also give them the power to determine the rules about bank chartering—which, as Summerhill (forthcoming) has pointed out, means that they will constrain the number of chartered banks. The acts of parliament that made the Bank of England the only joint stock, limited liability bank in the entire country from 1694 to 1825 is an obvious example of the phenomenon (Cottrell and Newton 1999; Broz and Grossman 2004). The limits on bank chartering in nineteenth century Brazil is another, somewhat less well-known example of the same mechanism at work (Summerhill, forthcoming).

What would happen if the legislature was elected by the entrepreneurs, and they had the ability to organize around the issue of the availability of credit? They would be able to pressure the government into granting more bank charters. This would be incentive compatible with the interest of the political entrepreneurs, because there is no reason why they could not use this more competitive banking system as a source of government finance. It would not, however, be incentive compatible with the interests of the financiers, because they would only receive a competitive rate of return on capital, and they would not be able to block entry into finance-dependent lines of economic activity in which they had interests. The historical record suggests that if this solution is to be stable, there have to be institutions that constrain the common people from voting in a legislature that will expropriate the banks. These other institutions typically include executive vetoes, judicial review, and super-majority voting rules in the legislature. Not surprisingly, this particular solution is found in a very limited number of countries—liberal democracies.
What it comes down to is this. Authoritarian governments either produce no banks at all, government-owned banks, or concentrated banking systems that allocate credit narrowly. Which of the three they wind up with depends on the ability of political entrepreneurs and financiers to forge a coalition. Democratic governments—which is to say governments in which the authority and discretion of political entrepreneurs is limited by political institutions, such as elected legislatures, independent judiciaries, and the like—either produce concentrated banking systems that allocate credit narrowly, or large banking systems that allocate credit broadly. Which of the two they wind up with depends on the degree to which the entrepreneurs can align the interest of political entrepreneurs with their own—and that depends crucially on whether they have access to the suffrage and other institutions of democratic governance that allow them to sanction government officials.

Evidence

The available quantitative evidence supports this political institutions view of banking development. Barth, Caprio, and Levine (2006) analyze a cross section of 65 countries in 2003 and find that democratic political institutions are associated with greater ease in obtaining a bank charter and fewer restrictions on the operation of banks. They also find that the tight regulatory restrictions on banks created by autocratic political institutions are associated with lower credit market development and less bank stability, as well as with more corruption in lending. Regulatory frameworks in autocracies also tend to discourage the private monitoring necessary for the dissemination of independent financial information. Countries that are more autocratic
also tend to use government-owned banks to direct credit toward the interests of the politically powerful. Importantly, their results are robust to controls for legal origin.

The relationship between political institutions and banking development also holds up when we look within countries over time. Bordo and Rousseau (2006) analyze a panel of 17 countries over the period 1880-1997, and find broadly similar results on the relationship between political institutions and financial development: there is a strong, independent effect of proportional representation, frequent elections, female suffrage, and political stability on the size of the financial sector. The result, while qualified because of the small cross country sample, is impressive as it is robust to controlling for initial per capita income and legal origin.

One criticism of the Barth, Caprio, and Levine and Bordo and Rousseau results is that they are based on truncated samples: the former are truncated with respect to time, the latter are truncated with respect to the cases selected. The panel data analysis of the political institutions/financial development view is still in its infancy. As a first step, however, I offer some simple regressions below that draw on the Beck, Demirgüç-Kunt, and Levine (2007a) Financial Structure database and the Jaggers and Gurr (2006) Polity IV database in order to estimate pooled, cross-sectional regressions on the relationship between the institutions that constrain the executive and the ratio of bank credit to GDP from 1960 to 2003. The results reported in specification 1 indicate that each step increase in constraints on the executive (the scale runs from 1 to 7) is associated with nearly a five percentage point increase in bank credit. If we include country dummies, in order to control for unobserved heterogeneity (specification 2), as well as Driscoll Kraay standard errors to control for serial correlation, the relationship continues to hold: a one step increase in executive constraints is associated with a 1.5 percentage point increase in private credit.
Scholars are also beginning to exploit variance over time within countries in order to test the political institutions/financial development hypothesis. The United States has proven to be particularly fertile ground for these types of studies because its political institutions both varied over time and across states. In fact, at the time that the Constitution was signed, both the president and the Senate were indirectly elected, and all of the original 13 states restricted the right to vote to male property owners (Keyssar 2000). The original organization of the banking system was also dramatically different than it is today: there was a single super-bank that was partially owned by the central government which acted as the treasury’s financial agent and that had the sole right to branch across state lines; and there was a system of segmented monopolies within each state which shared some of the resulting rents with state governments (in the form of dividend payments) and with state legislators (in the form of bribes). These banks, it should be pointed out, did not lend to all comers: they discriminated on the basis of profession, social standing and political party affiliation (Wallis, Sylla, and Legler, 1994; Bodenhorn, 2003; Haber 2008; Sylla 2008).

As the American frontier expanded westward, however, the country’s initial political institutions underwent considerable reform. States competed against one another for capital and labor. They broadened the suffrage, in large part to attract immigrants or hold on to the population they had. Moreover, the states quickly came into conflict with the federal government over its quasi-central bank (which state bankers saw as inimical to their interests). The end result was that as political institutions changed, so too did the organization of American banking.
The history of banking in the state of New York perhaps gives some sense of what occurred. From the 1810s to the late 1830s, bank chartering in New York was controlled by the Albany Regency—a political machine run by Martin Van Buren. Bank charters were only granted to friends of the Regency, in exchange for which the legislators received various bribes, such as the ability to subscribe to initial public offerings of bank stock at par, even though the stock traded for a substantial premium. The Regency’s hold on bank chartering came to an end when the state legislature was forced to change the state’s voting laws in 1826, finally allowing universal manhood suffrage. Within a decade, the Regency lost its control of the state legislature, and in 1837 the now dominant Whig Party enacted America’s first free banking law—a system in which the state legislature no longer gave charters at all, rather banks were allowed to operate so long as they deposited bonds backing their note issues with the state comptroller. By 1841, New Yorkers had established 43 free banks, with a total capital of $10.7 million. By 1849, the number of free banks mushroomed to 111, (with $16.8 million in paid capital). By 1859 there were 274 free banks with paid in capital of $100.6 million. Other states soon followed New York’s lead. By the early 1860s, 21 states adopted some variant of the New York law, and as they did so, they encouraged bank entry and increased competition (Bodenhorn 1990, 2003, 2004; Moss and Brennan 2004).

The causal relationship between the extent of electoral suffrage and a variety of financial regulations that restricted entry in the nineteenth century is studied by Benmelech and Moskowitz (2005), who exploit variation across time and across US states in the laws regarding suffrage, free banking, general incorporation, and interest rate ceilings (usury). They find that usury laws were used by industrial incumbents to control entry and lower their own costs of capital. Suffrage laws and financial regulatory policies appear strongly correlated: voting laws
that restricted the suffrage are associated both with tighter usury laws (which restricts the supply of credit, in particular to newer, riskier firms) and the lack of general incorporation laws.

In sum, there is substantial evidence that there is a causal relationship between the degree to which citizens have access to the sanctioning mechanisms of democratic governance—particularly the ability to remove public officials who work against citizen interests—and the size and structure of banking systems. The implication for African economic development, I hope is clear: the creation of liberal democratic orders is not just a good thing to do in and of itself; it will generate positive economic externalities, including more vibrant financial systems.

III. What if Political Institutions Cannot Be Reformed?

Our discussions of the central role played by finance in economic growth, and the central role played by political institutions in financial development, imply that creating vibrant financial systems in Africa will not be easy. Indeed, most of Sub-Saharan Africa is ruled by authoritarian governments or democracies that are still in the process of consolidation. Theory suggests, and the empirical evidence bears out, that such governments are not conducive to the creation of large and competitive credit markets. For somewhat similar reasons, they are also not conducive to the creation of active securities exchanges.

Given these constraints are there any practical steps that policy makers might undertake to spur the development of financial systems? One must be careful here. There may be all kinds of steps that governments might take to improve the efficiency of the financial sector, but political economy considerations may mean that, as a practical matter, they are unavailable. For example, if concentrated banking systems dominated by an entrenched elite are an endogenous outcome of authoritarianism, then it does little good to say that authoritarian governments should encourage
market entry. Similarly, if the authority and discretion of the government are not limited, then reforms designed to give bank supervisors greater powers may, as Barth, Caprio, and Levine (2006) point out, simply give the government a larger lever with which to expropriate bank assets. Finally, if the property rights environment is such that it is difficult to enforce arm’s length contracts, then regulations designed to force banks to make arms’ length loans (instead of making loans to firms related to the banks) may result in no credit being extended at all. There are, in point of fact, reasons to think that reforming the property rights or contracting environment under an authoritarian government will be difficult: an inefficient and corrupt legal system may be endogenous to a governance system in which a small group of entrenched economic incumbents gets all the property rights protection they want by making private deals with the political entrepreneurs who control the government (Sonin 2003). We therefore offer a few ideas that have been tried in other contexts of authoritarian governments with low levels of financial development.

The first of these steps is the privatization of state-owned banks. There is no evidence that state banks have been good vehicles for diffusing access to finance in developing countries. The reason is not hard to divine: state-owned banks tend to get captured by specific interests. Indeed, state-owned banks that are putatively designed to help finance small and medium-sized producers are often quickly converted into sources of credit for large industrial conglomerates that already have access to credit from the financial firms that are affiliated with them. The state-owned bank becomes, in effect, a means by which the conglomerate can socialize risks. The end result is that the state owned bank often becomes insolvent (Cull and Xu 2000; Clarke and Cull 2002; Clark, Cull, and Shirley 2005; LaPorta Lopez-de-Silanes, and Shleifer 2002; Sapienza, 2004; Del Angel Mobarak 2002, 2005). It is precisely for this reason that, in the
privatization of state-owned banks, the auction process be designed so as to make sure that the sale of the bank is not reinforcing pre-existing oligopolies. Past experience also suggests that governments should not make maximizing revenue from the sale their first priority, because this introduces problems of moral hazard (Haber 2005). In the context of an authoritarian government achieving these goals may require outside technical assistance.

The process of privatizing state-owned banks may afford an opportunity for the reform of bank accounting standards. It is typically the case that state-owned banks do not conform to Generally Accepted Accounting Principles, and that the same idiosyncratic standards apply to the private banking system as well. The reform of accounting standards will not only permit the purchasers of the state owned banks the ability to more accurately gauge the value of the bank’s assets, it will also force private banks to reveal a more accurate portrait of their financial health to their shareholders and depositors, as well as to bank supervisors. Both cross country regression evidence (Levine, Loayza, and Beck 2000; Barth, Caprio, and Levine 2008) and country case studies indicate that there are large positive returns to improving the quality of information. Indeed, a large part of the collapse of Mexico’s newly privatized banking system in the early 1990s can be tied to highly idiosyncratic accounting standards that allowed the government to hide non-performing loans from potential bank purchasers, and that later allowed the directors of the newly privatized banks to hide losses from their shareholders (Haber 2005, Del Angel, Haber, and Musacchio 2006).

A recent study by Kane and Rice (2001) provides direct evidence about the importance of the information environment in the African context. They show that bank regulators often did not have strong incentives to monitor the banks because of incentive conflicts. In this situation,
the ability of depositors to monitor the condition of their banks was crucial, but they were unable to do so because they could not obtain timely and accurate information. For example, they document that during 1995, 1996, and 1997, less than half of Kenya’s 40 banks reported any non-performing loans (NPLs) in any given year and that only seven banks actually reported any NPLs in all three years. The consequences of accounting sorcery of this type were that the stock of non-performing loans in African banking systems tended to grow over time, and that the region’s banks then followed increasingly aggressive and risky lending strategies to recoup past losses. In the end, the banks became completely insolvent, the government was forced to intervene, the intervention spurred a run on the banks, and the banking system had to be rescued at taxpayer expense.

The third of these reforms involves opening up the banking system to foreign competition. This may be difficult to do, because the same entrenched interests who resist the entry of new domestic competitors are likely to also resist the entry of foreign competitors. Nevertheless, there are occasions, such as the aftermath of a banking crisis, when governments have forced open the market to foreign banks. The effect of foreign bank entry is an area that has received considerable scholarly interest in recent years—in large part because of the rapidity with which developed countries lowered the barriers to foreign bank ownership in the 1990s. There is some evidence from studies of individual developing countries that suggests that foreign banks have a more difficult time lending to informationally-opaque small firms: they are less willing to extend credit on the basis of “soft knowledge” about a firm and its owners. Foreign bank entry may therefore wind up giving larger firms even greater advantages (Clarke, Cull, D’Amato, and Molinari, 2000; Berger, Klapper, and Udell 2001; Mian 2006). Multi-country studies indicate, however, that this pattern may not be systematic. In a study of about 3000
companies across 35 developing economies, Clark, Cull, and Martinez Peria (2006) find that enterprises in countries with high levels of foreign bank participation tend to rank interest rates and access to long term loans as lesser constraints on their operations and growth than do enterprises in countries with low levels of foreign bank participation. They also find that while large firms seem to benefit disproportionately from foreign bank entry, small firms benefit as well.

Two recent studies, on the performance of foreign-owned banks, domestically-owned banks, and one state-owned bank in Uganda, shed some light on the question of the impact of foreign entry in the African context. Kasekende and Sebudde (2002), using data aggregated by bank ownership type, find that foreign banks appear to base their lending decisions primarily on commercial viability, and hence have lower ratios of non-performing loans than their domestically owned competitors. They suggest that domestically owned banks tend to make credit decisions based on political and social criteria, and thus their lending practices tend to be characterized by concentrated loans to insiders. Cull, Haber, and Imai (2007) build upon these findings using data on the loan portfolios and financial performance of individual banks. This allows them to explore the issue of insider lending, and its impact on bank financial performance directly. Their results indicate that banks with higher shares of lending to insiders (individuals or firms connected to the bank’s directors) had lower profitability and higher shares of non-performing loans than other banks. They also find that the problems with insider lending are mostly found in domestically owned banks. Domestically owned banks with high shares of insider loans tend to have higher shares of non-performing loans and lower rates of return. However, foreign-owned banks with high shares of insider lending tend to have fewer non-performing loans and rates of return no different from banks that have low levels of insider
loans. In short, the results indicate that foreign banks appear to have better internal control mechanisms than domestic banks in terms of judging the quality of borrowers.

IV. Conclusions and Implications:

There are three general implications that can be extracted from the three broad literatures that we have addressed in this paper. The first is that finance is a driver of growth. Africa’s economic problems are multifaceted, but one crucial piece of the puzzle to slow African growth are small financial systems that allocate capital inefficiently. The second is that it is difficult to bring about broad based financial development in the absence of political reforms that enhance democratic governance. This does not mean, however, that policymakers need to sit idly by and wait decades for the consolidation of liberal democracies. There are practical steps—the privatization of state-owned banks, improved accounting standards and greater financial transparency, and opening up markets to foreign bank competition—that have been undertaken elsewhere in the absence of democratization. Indeed, there are reasons to believe that these steps might help create constituencies that would favor further economic and political reforms.
References


Heston, Alan, Robert Summers, and Bettina Aten. 2006. Penn World Table Version 6.2, Center for International Comparisons of Production, Income, and Prices at the University of Pennsylvania.


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* significant at 10%; ** significant at 5%; *** significant at 1%

Driscoll-Kraay Standard Errors (Robust to AR1 serial correlation)

Source: Constraints on the executive from Jaggers and Gurr Polity IV dataset; Private credit as percent of GDP from Beck, Demirgüç-Kunt, and Levine 2007a.