Chapter 7
The Growth Effects of Financial Development Over Economic Cycle in South Africa

Naser Yenus Nuru
Adigrat University, Ethiopia

Hayelom Yrgaw Gereziher
Adigrat University, Ethiopia

ABSTRACT

This study examines the effects of financial development, proxied by domestic credit, on growth for South Africa across the states of the economy over the sample period 1970Q1-2019Q3. To address this point, the authors use Jorda's local projection method to generate impulse response functions for this small developing open economy. The shocks, however, are identified by applying short-run contemporaneous restrictions in a vector autoregressive model based on Cholesky identification scheme. The states of the economy are determined by a threshold variable, namely output growth. The results indicate that one standard deviation shock in domestic credit leads to a significant increment in output in this economy. This effect, though, is a bit pronounced in recession than the expansion state. One standard deviation shock in domestic credit leads to around 0.8 and 0.5% increment in output in recession and expansion states at the fourth quarter and on impact, respectively. The results are also robust to an alternative proxy variable of financial development.

INTRODUCTION

The unanswered intuition behind the long-run sustainable economic growth and reasons for cross country growth differences between countries has always attracted considerable attention in the literature. Since the economic performance of a country determines the welfare of a country substantially researchers and economists are striving to determine the source of economic growth to implement accurate economic policies (Betül, 2014).

DOI: 10.4018/978-1-7998-4817-2.ch007

Copyright © 2021, IGI Global. Copying or distributing in print or electronic forms without written permission of IGI Global is prohibited.

In the literature of economic growth, so many explanations and empirical investigations are stated about the sources of economic growth and development. The financial crisis that has happened in the 1970s marked the fall of the Keynesian view and rise of the neoclassical (Brian and Odhiambo, 2018). As a result, according to the neoclassical theory, countries transformed their policies towards trade liberalization after the 1980s. Hence, an interaction between the financial sector and the real sector is observed recently and considerable attention is given in the finance-growth literature. The financial crisis of 2008 made economists interested in reexamining the effect of financial development on the real economy. Prior to the financial crisis, there was a strong belief that financial development leads every economy to growth and development since information asymmetry and transaction costs are minimal in financially advanced systems (Ebru, 2016).

According to Demirgüç-Kunt and Levine (2008), the overall functions of the financial system is to reduce information and transaction costs impeding economic activity. It has five core functions played by the financial system (i) financial systems produce information and allocate capita, (ii) financial systems monitor firm behavior and exert corporate governance, (iii) financial instruments, intermediaries, and markets can facilitate the trading, (iv) financial systems pool or mobilize savings from different savers for investment, and (v) at a more fundamental level, financial instruments, intermediaries, and markets can stimulate specialization, innovation, and growth by reducing transactions costs. On the other hand, Beck, *et al.* (2014) argued that an oversized financial system leads to instability, imperfect competition, wastage of resources, rent extraction, negative externalities from auxiliary financial services and implicit insurances due to bailouts. Such externalities from auxiliary financial services, for example, can be useful for some clients but not for the whole society as it may lead the financial sector to grow too large relative to its social optimum. Hence, there could be limits to the financial benefits.

Therefore, the growth effects of financial development cannot be generalized for all countries. The differences across countries lead to the unique transmission mechanism of financial development on economic growth (José, *et al*. 2019; Al-Yousif, 2002). Another explanation for the puzzling results of previous studies is that the empirical results of the growth impact of financial development are sensitive to the choice of financial development indicator (Adu *et al*., 2013). Furthermore, previous studies, at least for South Africa, ignore the effects of economic cycles on the finance-growth nexus. According to the finance constraint theory, the economic cycle has inconsistent impacts on agents depending on their exposure to agency problem and asymmetric information. Hence, agents may respond to shocks in a financial sector differently across different cycles of the economy. This gap is going to be addressed in this paper by using the case of South Africa.

Similar to other developing countries, South Africa faced the effects of the 2008 global financial crisis, which disrupted – and in some cases reverse – the achievement of Millennium Development Goals, including decent work for all. This is of particular concern given that, even in the pre-crisis period, growth patterns in certain regions, notably in Africa, led to only negligible reductions in poverty. Decent living and working conditions still remain out of reach for large numbers of people. Importantly, the crisis spread throughout the real economy by important mutually-reinforcing transmission channels including limited availability of credit for working capital and many countries attempted financial–rescue measures to restore credit liquidity (Khatiwada, 2009). Hence, it is quite essential to see how growth can be affected by financial development during such slump times in economies like South Africa.

By studying the growth effect of financial development over the economic cycle, this paper has several significant contributions to the literature and the policy practice of central bankers in South Africa. First of all, it distinguishes the impact of financial development on economic growth over expansions

15 more pages are available in the full version of this document, which may be purchased using the "Add to Cart" button on the publisher's webpage:
www.igi-global.com/chapter/the-growth-effects-of-financial-development-over-economic-cycle-in-south-africa/266979

Related Content

Tourist Taxes and Sustainability: A Systematic Literature Review and Future Research
Eva Maria Miranda, Soraia Gonçalvesand Laurentina Vareiro (2023). *Taking on Climate Change Through Green Taxation (pp. 335-349).*
www.irma-international.org/chapter/tourist-taxes-and-sustainability/328651

Stochastically Balancing Trees for File and Database Systems
Aziz Barbarand Anis Ismail (2013). *International Journal of Green Computing (pp. 58-70).*
www.irma-international.org/article/stochastically-balancing-trees-file-database/80239

The Transition of the “Traditional” Romanian Brands
Dan Marius Voicilas (2012). *International Journal of Sustainable Economies Management (pp. 51-60).*
www.irma-international.org/article/transition-traditional-romanian-brands/67113

Synergizing Innovation and Internationalization in Family Firms: A Pathway to Sustainable Leadership
Salim Bakhit Al Daraai (2024). *Contemporary Management and Global Leadership for Sustainability (pp. 196-217).*
www.irma-international.org/chapter/synergizing-innovation-and-internationalization-in-family-firms/340155

Specifics of the Assessment of the Market Value of Various Categories of Pigs on Farms in Serbia
Jonel Subic, Marko Jelocnikand Zoran Njegovan (2012). *International Journal of Sustainable Economies Management (pp. 28-37).*
www.irma-international.org/article/specifics-assessment-market-value-various/75191