Equity, Bonds, Institutional Debt and Economic Growth: Evidence from South Africa

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Abstract : Economic theory predicts that finance promotes economic growth. Although the finance-growth link is among the most researched areas in financial economics, our understanding of the link between the two is still incomplete. This is caused by, among others, wrong econometric specifications, using weak proxies of financial development, and inability to address the endogeneity problem. Studies on the finance growth link in South Africa consistently report economic growth driving financial development. Early studies found that economic growth drives financial development in South Africa, and recent studies have confirmed this using different econometric models. However, the monetary aggregate (i.e. M2) utilized used in these studies is considered a weak proxy for financial development. Furthermore, the fact that the models employed do not address the endogeneity problem in the finance-growth link casts doubt on the validity of the conclusions. For this reason, the current study examines the finance growth link in South Africa using data for the period 1990 to 2011 by employing a generalized method of moments (GMM) technique that is capable of addressing endogeneity, simultaneity and omitted variable bias problems. Unlike previous cross country and country case studies that have also used the same technique, our contribution is that we account for the development of bond markets and non-bank financial institutions rather than being limited to stock market and banking sector development. We find that bond market development affects economic growth in South Africa, and no similar effect is observed for the bank and non-bank financial intermediaries and the stock market. Our findings show that examination of individual elements of the financial system is important in understanding the unique effect of each on growth. The observation that bond markets rather than private credit and stock market development promotes economic growth in South Africa induces an intriguing question as to what unique roles bond markets play that the intermediaries and equity markets are unable to play. Crucially, our results support observations in the literature that using appropriate measures of financial development is critical for policy advice. They also support the suggestion that individual elements of the financial system need to be studied separately to consider their unique roles in advancing economic growth. We believe that our understanding of the channels through which bond market contribute to growth would be a fertile ground for future research.

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