Banking Sector Development on Economic Growth: Structural Equation Approach

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Banking sector development (BSD) is deemed to be a fundamental force for the acceleration of economic growth (EG). Financial sector, including banking sector, was dramatically hit by numerous scandals which caused the financial crisis and its consequences have brought a rapid decline in the economic growth of the world during the past decade. Since then financial and regulatory authorities have been focusing on innovative solutions to cope with the negative consequences of the banks' impact on global economy. Empirical findings have showed that BSD and its role in EG are still contradictory to each other. However, endogenous growth model has brought a new perspective for EG which is resulted by investment in human capital, innovation and knowledge within the economy rather than exogenously. With this background, this study explores the determinants of the BSD and its direct and indirect effects on EG for 18 countries during the period of 2006 to 2014. To explore the results, Two-Step System-Generalized Method of Moment (GMM) estimation is used to explore the impact of the determinants on the BSD. Then, a Structural Equation Model (SEM) is developed to represent the direct and indirect relationship among channel variables, economic growth and BSD estimated by Three-Stage Least Squares (3SLS) estimation technique. To investigate the mediating effect of BSD on EG, four channels of physical investment, human capital, technology and good governance are theoretically identified. Further, four indicators of the BSD, bank intermediation (IM), bank broad access (BA), bank profitability (PF) and bank liquidity (LQ), were chosen. The study found that BSD was determined by economic growth (EG), interest rate (IR), trade liberalization (TL), financial liberalization (FL) and governance infrastructure (GVI) explored by the first principal component of the six governance indicators. The results indicate that though bank access (BA) has been improved, economic growth has decreased while other results are statistically insignificant. However, bank intermediation (IM) has caused a mediating effect on economic growth in a negative manner, while bank broad access (BA) has caused a mediating effect on economic growth positively through human capital. Since, bank intermediation and bank access have created credit facilities and hassle-free banking facilities towards the business organizations and individuals out of which they have invested to develop a skilled labour providing trainings and higher education opportunities which have ultimately influenced the economic growth endogenously. The study suggested that governments and monetary authorities must review the policies towards the hassle-free financial access and prioritize the productive investment ventures by banks to become efficient intermediates in the financial systems.

Keywords: banking sector development, endogenous growth, financial crisis, generalized method of moment and three stage least square