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Do Capital Inflows and Financial Development, Influence Economic Growth in West Africa? Further Evidence from Transmission Mechanisms

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ABSTRACT: This study investigates the channels through which shocks from foreign capital inflows and financial development are transmitted to economic growth in the ECOWAS region using quarterly data for the period between 2000 and 2017. The work adopted the panel vector autoregressive (pVAR) model in a generalized method of moments (GMM) framework to actualize its objective. The empirical results show that foreign direct investment (FDI), net domestic credit (CRE), and economic growth (ECG) all have significant relationships with each other, while gross capital formation (GCF), labour force (LF), and foreign aid (AID) have significant relationships with FDI, CRE and ECG. Furthermore, FDI and CRE have negative relationship with economic growth in the short run but have positive impulse response functions with economic growth in the long run. FDI and CRE exhibit positive relationship between themselves in the short run and negative relationship in the long run. Thus, the study recommends concerned policy makers to pursue financial deepening and enact credible policies that strengthen the financial system.

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In addition, a conducive socio-economic environment should be actively maintained so as to attract the required foreign capital inflows. Finally, more efforts should be made towards the establishment of a single monetary union, as it is likely to further strengthen the region and improve the trade among the member-countries. This should lead to further growth within the region.

JEL classification: F21, F36, F38, F43, G15, O16.

Keywords: Foreign Capital Inflows, Financial Development, Investment, Economic Growth, ECOWAS.

1 Introduction and motivation

Capital is an important variable for the growth of any economy. Foreign capital refers to the net capital sourced from outside the country. Foreign capital influence can come in various ways, either via an interest-free capital or with interest. Foreign capital serves as a major supplement to fill the gap in resource flows created by inadequate domestic capital flows, though some schools of thought argue that it is detrimental to domestic investment as it can crowd it out (Orji et al., 2019a). According to Ajide and Eregha (2014) and Anthony-Orji et al. (2018a), FDI is one of the major sources from which a country, especially developing country, can finance and sustain long-term growth. Orji et al. (2014) and Orji et al. (2019a) also posit that foreign aid, which is critical component of foreign inflows, can positively contribute to growth in host countries if conditions are favourable.

Financial development can refer to an increased supply of financial assets in addition to the level of ease of assessment of the financial assets in an economy (Anthony-Orji et al., 2021). The measure of financial development used in this study is the net domestic credit as a percentage of gross domestic product. Domestic credit is the amount of credit accessible to the economy from within the economy. Domestic credit often comes in the form of credit to private sector or in the form of banking sector credits, and both are usually given by the banking sector. The larger the amount of credit given the higher the level of financial development in an economy. According to Eze et al. (2016), domestic credit is a financial deepening indicator as it shows the amount of savings that the private sector mobilizes for investment, i.e., shows the extent of financial intermediation. Economic growth on the other hand, refers to the increase in the market value of goods and services produced in an economy over time and is measured by the output growth in an economy over a period. An economy is said to be experiencing economic growth when there is a positive change in output produced in an economy over the specified period due