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Influence of Real Exchange Rate on the Finance-Growth Nexus in the West African Region

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Abstract: This study examines the moderating effects of the real exchange rate and its volatility on the finance-growth nexus in the West African region. It also determines the marginal effects of financial development on economic growth at various levels of the real exchange rates and its volatility. The findings show that financial development has a long-term positive impact on economic growth, but this impact is weakened by real exchange rate and its volatility. The marginal effects of financial development on economic growth vary with the levels of the real exchange rate and its volatility. The higher the real exchange rate and its volatility, the less finance spurs growth. We also provide evidence of this scenario in individual specific countries in the region. The implication of this study is that the development of the financial sector would not provide the desirable economic benefits except it is accompanied by a reduction and stability in the real exchange rates. Based on the findings, the study makes some policy recommendations.

Keywords: real exchange rate; volatility; financial development; economic growth

JEL Classification: G20; F31; O47

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1. Introduction

Some empirical studies have emphasized the fundamental role of institutional quality, level of financial development, per capita income and inflation in moderating the impact of financial development on economic growth in developed and developing countries (e.g., Arcand et al. 2015; Ehigiamusoe et al. 2018; Law et al. 2018; Law and Singh 2014). However, the role of the real exchange rate or its volatility on the finance-growth nexus has not been thoroughly explored. The economic benefits of financial development could vary with the level of the real exchange rate. This is because real exchange rate has the capacity to influence economic growth. For instance, some studies reported that real exchange rate has a positive impact on economic growth (e.g., Razmi et al. 2012; Rodrik 2008; Tarawalie 2010), whereas other studies documented a negative linkage (e.g., Bleaney and Greenaway 2001; Conrad and Jagessar 2018; Elbadawi et al. 2012) or insignificant relationship (e.g., Tang 2015). Moreover, Aghion et al. (2009) showed that real exchange rate volatility has a negative impact on productivity growth, while Vieira et al. (2013) revealed that high real exchange rate volatility has a negative impact on economic growth, albeit the impact of low volatility is positive. However, Comunale (2017) noted that exchange rate volatility does not have any robust effect on GDP growth.

Besides its direct effect on economic growth, studies have shown that real exchange rate and financial development could have a dynamic relationship. Lin and Ye (2011) posited that financial development has a significant effect on the choice of exchange rate regime, whereas Katusiime (2018) reported that exchange rate has a significant effect on the growth of private sector credit. Thus, countries with less developed financial markets are more likely to adopt a fixed exchange rate, while