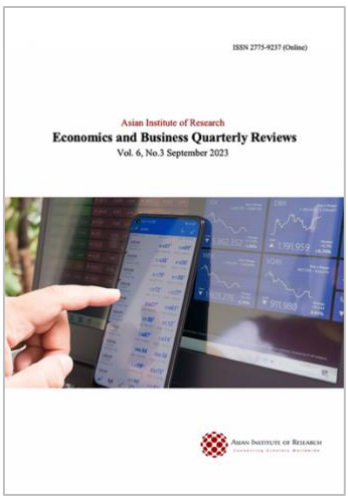


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# Does Banking Sector Advancement Provide a Growth-Supporting Role to Tanzania Economy?

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**Abstract**
This paper aimed at examining the role of banking sector development on economic growth in Tanzania. To explore the long-run relationship between financial growth and economic development a log-linear equation with auto-regressive term, accounting for serial correlation, is estimated after conducting a regression diagnostic test. The results show that financial depth positively influence economic growth, and this technically shows that the financial depth accelerates economic growth through expanding access to those who do not have adequate access to finance. The paper recommends the Government to have a policy of subsidizing access to finance to enable informal businesses, which do not have easy access to finance, to boost the growth of their businesses. Furthermore, the policymakers are encouraged to embrace an efficient banking system, and more specifically, Central Bank of Tanzania must spearhead the policy of lowering banking lending rates so as to promote investment which will ultimately foster economic growth.

**Keywords:** Financial Sector Development, Economic Growth, Banking Sector

## 1. Introduction

Banking sector plays a critical role in the modern world economies by mobilizing savings of the individuals and lending them out to business, people and manufacturers (Anginer *et al.* 2014). A functioning Banking system has been documented to play a key role for economic growth through liquidity and safe transferring of resources (King & Levine, 1993). The banking sector is essential to the smooth operation of the financial system (Dia *et al*; 2020). To make the economy more prosperous, banks collect depositors' money and distribute it to investors. Economic activity cannot run efficiently without a strong financial system (Dietrich and Wanzenried, 2011). Economic growth is made possible by banks (Levine and Zervos, 1998), and banks are a precondition for economic advancement. Despite the banking sector being acknowledged as playing an essential role in nations, leading to considerable reforms, the causation link between economic growth and the development of the banking sector remains a contentious topic. This stems from the ongoing argument over whether financial development drives economic growth or the other way around.

Several researchers have investigated the link between the development of the banking sector and economic growth, and the results reveal that bank sector expansion is helpful to economic growth, as reported by Bojanic

(2012) in their study on financial development and trade on the economic growth of Bolivia; Chaiechi (2012) in their paper on the impact of financial development shocks on key macroeconomic indicators in South Korea; Kar *et al*;(2011) in their paper on impact of financial development and on economic growth in the MENA countries; Jalil *et al*; (2010) in their paper on the financial sector development-growth nexus; Wu *et al*; (2010) in their paper on the dynamic impacts of financial institutions on economic growth in China

In contrast, a considerable number academic work has investigated the link between the development of the banking sector and economic growth, and found that economic expansion leads to the development of the banking sector. This has been reported by Odhiambo (2010) in his study on finance-investment-growth nexus in South Africa; Panopoulou (2009) in his study on impact of financial variables on Euro area economic growth , and Ang and McKibbin (2007) in their paper on Financial liberalization, financial sector development and growth in Malaysia According to this theory, as the economy grows, so does demand for financial services, resulting in the development of these services, but this growth does not result into economic advancement. Wolde-Rufael (2009), Lee and Chang (2009), and Dritsakis and Adamopoulos (2004), for example, claim to have identified "feedback," in which causality is bidirectional.

On the verge of recognizing key role of banking sector, government of countries embarked into different strategies and reforms to sustain its growth and well serving the economies (Berger *et al.*; 2009).Financial sector liberalization in Tanzania marks the root of banking sector development with the aim of stimulating economic growth through the mobilization of financial resources, increasing competition in the financial market, and enhancing the quality and efficiency of credit allocation in the economies. As a result of liberalization, the banking sector started to boom with currently, the sector comprises both local and foreign banks. According to BOT (2021) there are currently 55 financial institutions in Tanzania, 36 commercial banks and 19 licensed institutions.

On top of that banking sector in Tanzania has been increasing in size in terms of market capitalization, increasing asset size and profitability. According to URT (2020) as at the end of 2019 total assets for the banking subsector were at TZS 33,083.5 billion mainly financed by billion TZS 3,839 capital, deposits being TZS 22,227 billion and Loans, advances and overdrafts being TZS 16,196 billion. For the past five years the banking sector has roughly remained sound and stable with capital and liquidity levels being above minimum regulatory requirements. Despite such a tremendous trend and improvements of Tanzania economy to the extent of being promoted from lower up to the middle-income countries in the year 2020, still the role of banking sector development on economic growth has not been well established.

A growing number of literatures provides empirical support for banking sector development as a predictor of economic growth (Hassan *et al.*,2011; Esrada *et al.;* 2010; Guiso *et al.;* 2009; Beck and Levine, 2004; Beck *et al.*, 2000; Levine *et al*; 2000; Levine, 1997; Levine, *et al.*; 1997; King and Levine, 1993a; King and Levine, 1993b) agree that banking sector development can boost economic productivity and increase efficiency among firms. Contrarily, other studies came up with contradictory evidence that banking sector development does not support economic growth (Arcand *et al.*, 2012; Al-Malkawi *et al.*, 2012; Rousseau and Wachtel, 2011; Wachtel, 2003; Favara, 2003; Deidda and Fattouh, 2002'; Kaminsky and Reinhart, 1999).

Following two decades of sustained growth and notable growth of banking sector, Tanzania reached an important milestone in July 2020, when it formally graduated from low-income country to lower-middle-income country status, a position which didn't last long before it got reinstated to its original position in 2021. Currently the country is improving its GDP from 4.7% in 2021 to 5.5%. Tanzania's achievement reflects sustained macroeconomic stability that has supported growth, in addition to the country's rich natural endowments and strategic geographic position.

A more efficient financial sector has a great possibility of allocating scarce resources to their most productive use. As this happens, economic growth could attain its full potential. Besides, since the chief task of financial intermediaries is to channel funds to the most profitable investments they identify, then efficient financial markets improve the quality of investments which eventually improves economic growth. Finally, a well-developed financial system could improve the efficiency of financing decisions and favoring a better allocation of resources

and consequently, accelerates economic growth. As evidenced in the literature, a good number of studies have been conducted to consider general financial sector development to economic growth with majority of studies being conducted outside Tanzania focusing on banking industry development and economic development with contradictory results. In light of empirical strand and current economic performance, this study was conducted to examine the role of banking sector development in economic growth in Tanzania. The contribution of this paper is to fill the empirical gap in the literature of finance and growth, specifically focusing on the banking sector of Tanzania.

## 2. Related Literature

### *2.1 Theoretical Framework*

Theoretical groundwork of financial development and economic growth mainly branch from works by McKinnon (1973). Most literature argue on points of financial repression and financial liberalization, bordering on the extent that they encourage economic growth. The key argument by Schumpeter was the vital role played by financial institutions in inspiring technological innovation and economic activities. The financial activities of savings mobilization, project evaluation, risk monitoring and management facilitate the two functions. The school of thought advocated by McKinnon postulates that financial development is exploited by restrictive government regulations, interest rate ceilings, loan subsidies and high reserve requirements for the banking sector

This study is guided by both demand and supply-leading hypotheses. According to the Supply-Leading Hypothesis, there is a causal relationship between financial sector development and economic growth. It is suggested that the building of financial institutions and markets increases the supply of financial services, resulting in to economic growth. The presence of well-functioning financial intermediation in channelling limited resources from surplus to deficit units promotes efficient resource allocation and accelerates development in other economic sectors.

The principal indicators of financial development used in the study include variables representing both the development of banking sector as well as stock market of an economy. Banking sector development indicators include: financial depth (FDP), a measure of the size of the financial intermediaries of an economy which is measured as the percentage of bank's liquid liabilities to gross domestic product (GDP) [Levine (1997), Adusei (2013) and Guru and Yadav (2018)]; bank size (BS), a measure of the depth of a bank which is measured as a ratio of commercial bank assets to deposit money bank assets plus central bank assets [Demirgüç-Kunt and Harry (2011), Levine (1997) and Guru and Yadav (2018)] ; credit to deposit ratio (CDR), a measure of financial stability within the country and the extent of banking penetration which is measured as percentage of bank credit to bank deposits; and domestic credit to private sector, which is measured as domestic CPS as percentage of GDP [Levine (1997), Levine and Zervos (1998), Saci *et al.* (2009), Adusei 2013) and Guru and Yadav (2018), Kapaya (2020) Marshal *et al.* (2019)]

### *2.2 Empirical Literature*

There is only a handful of the countless research that support the supply-leading phenomenon including McKinnon (1973), King and Levine (1993a, b), Neusser and Kugler (1998), and Levine *et al*. (2000). The Demand-Leading Hypothesis, on the other hand, assumes a causal relationship between economic growth and financial development. The increased demand for financial services propels the financial sector's growth. This theory holds that fast-economic development creates a demand for financial instruments and arrangements, to which financial markets react. This idea is supported by Gurley and Shaw (1967), Jung (1986), and Harrison *et al*. (1999), among others.

Many empirical studies to establish link between financial market development and economic growth have been widely hypothesized and practically investigated. It was the goal of the empirical studies in this field to establish the existence of any link between financial development and economic growth. Levine et al. (2000) and Beck et al. (2000) found that stronger banking sector development enhanced economic growth and total factor productivity.

Guru and Yadav (2018) investigated the link between financial development and economic growth in five key developing economies and the results showed that indices of banking sector development and stock market development work together to boost economic growth.

Marshal *et al.* (2019) reports an insufficient long-term relationship between bank domestic credit measures and gross domestic products in Nigeria. Kmar and Bird (2020) investigated the link between bank profitability and economic growth in Asia-Pacific and the results suggest that a profitable banking sector is an essential prerequisite for economic growth in the Asia-Pacific region, and that the influence of bank profitability on economic growth is greater in small banking sectors. Additionally, their data suggest that profitability has a far larger effect on economic growth in established countries than in small and large emerging economies.

Padha et al., (20219) studied the impact of external shocks like US Fed rate and world oil price fluctuation on economic growth in India, and the results show that that GDP responded negatively to such external shocks while inflation gives mixed responses. On the other hand, the study reports that interest rate channel is to some extent crucial in monetary policy transmission.

Along the same line, the finding by Padha et al. (2020) in their study on identifying the linkage between monetary policy and financial stability in India, shows that the corporate sector along with real output growth and banking sector variables induces a significant change in policy rate when a shock is introduced implying that the monetary policy safeguards financial stability in India.

Ijaz *et al*. (2020) confirmed that bank stability is critical to Europe's economic prosperity. Likewise, economic growth slows significantly during times of crisis (both the global financial crisis and the local banking crisis), highlighting the crucial necessity of a healthy banking system during these times.

Kapaya (2020) performed an empirical examination of the evidence supporting the influence of financial depth, liquidity and efficiency on economic growth in Tanzania and results revealed that although financial system depth is favourably correlated with economic growth in the short run, financial system liquidity and efficiency are significantly adversely correlated with economic growth in both the short and long run.

Sarwar *et al*. (2020) evaluated the fundamentals of financial development, human capital and their interactions with economic growth and results indicated that financial development has a significant positive effect on economic growth. Additionally, human capital was reported to have a beneficial influence on economic development in developing economies.

## 3. Research Methodology

### *3.1 Data and Variables*

The study employed time series secondary data set covering 31 years from 1990 to 2020. The data was extracted from the Bank of Tanzania (BOT) annual financial stability report and World Bank financial and economic development indicators. The variables used in this study are described in table 1 below;

Table 1: Variables description

| Variable | Measurement | Reference |
|---|---|---|
| Financial Depth (FDP) | Percentage of bank's liquid liabilities to gross domesticproduct (GDP). | Levine (1997), Adusei (2013)and Guru and Yadav (2018) |
| Banking sector size (BSZ), | log of total banking sector assets | Demirgüç-Kunt and Harry (2011), Levine (1997) and Guru and Yadav (2018). |
| Banking Sector Stability(BSS) | Banking Sector Z-Score | Bayar et al. (2020) |

| | | |
|---|---|---|
| Banking sector domestic credit to private sector (CPS) | Banking sector domestic credit to private sector as percentage of GDP | Levine (1997), Levine and Zervos (1998), Saci *et al* (2009), Adusei 2013) and Guru and Yadav (2018), Kapaya (2020) Marshal *et al* (2019) |
| Economic Growth | Gross fixed Capital Formation as a percentage of GDP | Megbowon *et al* (2017) |

### *3.2 Model Specification*

To explore the long-run relationship between financial growth and economic development a log-linear equation with autoregressive term accounting for serial correlation is estimated after conducting a regression diagnostic test shown in the preceding section. The estimated model is presented as follows;

$$\text{Log (EG)} = ß_0 + ß_1\text{log (FDP)} + ß_2\text{log (BSZ)} + ß_3\text{log (BSS)} + ß_4\text{log DCPS)} + ß_5\text{log (INFL)} + \mu t$$

*Where;*

EG = Economic Growth
FDP = Financial Sector Depth;
BSZ = Banking Size;
BSS = Banking Sector Stability;
DCPS = Domestic Credit to Private Sector; and
INFL = Inflation (Control Variable).
$\mu t$ = Error Term

## 4. Empirical Results

### *4.1 Diagnostic Tests*

We focus on a long - run relationship between financial development and economic growth. The ARDL technique is applied for cointegration test, and the following steps are observed: checking stationarity to avoid the spurious relationship; using F-statistics to establish the long - run relationship among variables; find the long - run and short - run coefficients. To ensure that variables are not I (2) stationary avoiding spurious results the order of integration was investigated. Specifically, the study conducted Augmented Dickey-Fullers (ADF) to check the validity of stationarity level in the data sets as presented in table 2 below. An augmented Dickey–Fuller test (ADF) tests the null hypothesis that a unit root is present in a time series sample. The findings show that all variables were contracting at order 1(1) meaning that they are stationary at level by considering both intercepts and trends since their probability values are less than 0.05.

Table 2: Augmented Dickey-Fullers (ADF) Test

| Variables | At level | | At First Difference | | Order |
|---|---|---|---|---|---|
| | *t-Stat* | *P-Values* | *t-stat* | *P Values* | |
| EG | 6.4634 | 0.0000 | 5.3522 | 0.0031 | *I(I)* |
| DCPS | 3.9595 | 0.0066 | 4.6142 | 0.0010 | *I(I)* |
| FSD | 3.2224 | 0.0014 | 3.4578 | 0.0152 | *I(I)* |
| BSZ | 3.4042 | 0.0000 | 4.1254 | 0.0025 | *I(I)* |
| BSS | 4.4696 | 0.0021 | -4.0467 | 0.0044 | *I(I)* |

After establishing that none of the selected series is I (2) or beyond, a co-integration test was employed to check whether the linear combinations of the variables could result in a long-run relationship among the variables. Cointegration tests identify scenarios where two or more non-stationary time series are integrated together in a

way that they cannot deviate from equilibrium in the long term. The tests are used to identify the degree of sensitivity of two variables to the same average price over a specified period of time. The co-integration result presented in Table 3 indicates that the null hypothesis of co-integrating vector is accepted at "atmost 3" co-integrating vector at 5% significance level denoting four co-integrating vector equations for both the Trace and Maximum Eigen tests.

Table 3: Co-integration Test Results

| **Hp: rank = p (no deterministic trend in the data)Hr: rank r < p (co-integration relations)** | | | | | |
|---|---|---|---|---|---|
| **Series: EG DCPS FSD BSZ BSS Lag interval: 1 to 3** | | | | | |
| **Hypothesized No. of CE(s)** | Eigenvalue | Trace Statistics | | Max-Eigen Statistics | |
| | | Likelihood Ratio | 5% Sig. lev. | Likelihood Ratio | 0.05 Crit. Val. |
| **At most 0** | 0.9999 | 441.575* | 85.7537 | 269.850* | 20.0776 |
| **At most 1** | 0.9952 | 144.725* | 59.8189 | 145.661* | 13.8469 |
| **At most 2** | 0.6938 | 69.1736* | 57.8561 | 26.6906* | 17.5843 |
| **At most 3** | 0.6369 | 52.5730* | 39.7972 | 21.4018* | 11.1316 |
| **At most 4** | 0.1960 | 9.0613 | 15.4947 | 5.76338 | 10.2646 |
| **At most 5** | 0.1297 | 3.3079* | 2.8415 | 3.3078* | 2.7415 |

Furthermore, the study conducted linearity test to uncover if there exists a linear relationship between the dependent variable and the predictors. To do so, ANOVA test was conducted, and the results (p-value less than 0.05) indicate a linear relationship among variables as shown in table 4 below.

Table 4: ANOVA Test

| Method | Df | Value | Probability |
|---|---|---|---|
| ANOVA F-test | (5, 179) | 104.3252 | 0.0000 |
| Welch F-test* | (5, 81.0338) | 345.5566 | 0.0000 |

Another diagnostic test conducted is multicollinearity test where Variance Inflation Factor (VIF) was applied to find out if there is or there is no exact linear relationship among independent variables. VIF is a measure of the amount of multi-collinearity in a set of multiple regression variables. The results in table 5 indicate no problem of multi-colineality among independent variables since there is no any variable with centered VIF greater than 10 as previously indicated in Lotto (2020).

Table 5: VIF Test

| Variable | Coefficient Variance | Centered VIF |
|---|---|---|
| DCPS | 0.002791 | 1.923681 |
| EG | 0.026699 | 2.750851 |
| CPS | 0.012209 | 1.014589 |
| FSD | 0.008125 | 3.185564 |
| BSZ | 0.000560 | 1.276053 |
| BSS | 0.032367 | NA |

Finally, we conducted heteroscedasticity test to find out if error term is constant. Breusch-Pagan-Godfrey test was run and results presented in table 6. The results showed no evidence of heteroscedasticity, since the likelihood of the observed Chi-Squared was higher than 0.05 (0.57).

Table 6: Breusch-Pagan-Godfrey Test

| F-s statistic | 0.741217 | Prob. F (4,25) | 0.5729 |
|---|---|---|---|
| **Obs*R-squared** | 3.180633 | Prob. Chi-Square (4) | 0.5281 |

*4.2 Regression Results*

The long-run estimates using the modified ordinary least square method for the model are presented in Table 7. The findings show that about 85% of the variability observed in the target variables is explained by the regression model. This may confirm that the independent variables-banking sector development variables used in this study are collectively good explanatory variables of economic growth. The F-statistic with its p-value of 0.000 reveals that all explanatory variables are jointly significant in explaining economic growth. The results also confirm a good sample representativeness of the population as depicted by the low standard error of the regression model (SE) (0.10).

The findings further show that financial depth is positively related to economic growth and the relationship is statistically significant at 1% significant level. The results are in line with both the supply-leading theory and demand-following theory. Consistent to the findings of this study, Abubakar and Gani (2013) Türsoy and Faisal (2018), Durak and Eroglu (2019) and Kapaya (2020) consider liquid liabilities as the measure of financial depth with significant positive influence on economic growth. However, the results of the study are in contrary to Saci *et al.* (2009) who hold those liquid liabilities, influence growth negatively.

Furthermore, results indicate that banking sector stability supports economic growth, as indicated by the positive statistically significant relationship between banking stability and economic growth at 1% significance level. The findings are contrary to Kapaya (2020) but in line with Ijaz *et al.* (2020), Bayar *et al.* (2020) and Ozil (2018). Meanwhile, the results are consistent with the supply-leading Hypothesis which support a causal relationship between a financial sector development and economic growth. This means that the establishment of financial institutions and markets increases the supply of financial services and this leads to economic growth. Also, the findings are conflicting Demand-Following Hypothesis which concurs with a causal relationship that runs from economic growth to financial development.

Furthermore, the findings presented in table 7 indicate that domestic credit to private sector play positive role on economic growth with a relationship which is statistically significant at 1% significant level. These findings are in line with Sarwar et al. (2020), Marshal *et al.* (2019), Guru and Yadav (2018), and who agree that domestic credit to private sectors fosters economic growth. The results are contrary to Koivu (2002), Saci *et al* (2009) Abubakar and Gani (2013), Kjosevski (2013) and Paun et *al* (2019). The results further point out that domestic credit which include both credit to private and state-owned enterprises is a very vital financial development indicator, which echoes the efficiency of banking institutions in providing the credit sources.

Likewise, the findings of the study are consistent with the Supply-Leading Theory, implying that the construction of financial institutions and markets improves the supply of financial services, which results in to economic growth. Additionally, the results contradict the Demand-Following Theory, which implies that there is a causal link between economic growth and financial development.

Regarding the impact of the size of banking sector on economic growth the findings indicate that size of the banking sector doesn't affect economic growth as indicated by a negative statistically insignificant relationship as presented in table 7. Unexpectedly, the inflation exhibits no impact to economic growth as presented in table 7.

Table 7: Regression Results

| Variable | Coefficient | Std. Error | t-Stat | Prob. |
|---|---|---|---|---|
| CREDIT_TO_PS | 0.670 | 0.053 | 12.687 | 0.000*** |
| FINANCIAL_D | 0.641 | 0.163 | 3.920 | 0.001*** |
| INFLATION | 0.175 | 0.110 | 1.583 | 0.127 |
| SIZE | -0.170 | 0.090 | -1.585 | 0.172 |
| STABILITY | 0.065 | 0.024 | 2.730 | 0.012** |
| C | -0.858 | 0.180 | -4.768 | 0.000*** |
| R-s quared | 0.874 | | | |
| Adjusted R-s quared | 0.848 | | | |
| F-s statistic | 33.407 | | | |
| Prob (F-statistic) | 0.000 | | | |

## 5. A Concluding Remark and Policy Implication

This study aimed at examining the role of banking sector development on economic growth in Tanzania employing a time series data from 1990 to 2020. The data was sourced from Bank of Tanzania annual financial stability report and World Bank economic and financial development indicators. The results show that financial depth positively influence economic growth, and this technically shows that the financial depth accelerates economic growth through expanding access to those who do not have adequate sources of finance. Although, in underdeveloped financial systems like Tanzania, only formal businesses can easily access financial services to facilitate growth of their businesses via internally accumulated resources. It is, therefore, recommended to Government that access to finance should be subsidized to enable informal businesses, which do not usually have easy access to finance, to boost the growth of their businesses.

Elsewhere, research indicates that largely available formal finance can produce informal intermediation, an unintended form of entrepreneurship. Accordingly, it is also recommended that the relevant should broaden the depth of financial institutions by giving more credit to the private sector. Besides, the financial institutions should be expanded to increase their accessibility to the mass and take some measures to promote their efficiency.

On one hand, results indicate that banking sector stability supports economic growth, meaning that the establishment of financial institutions and markets increases the supply of financial services which leads to economic growth. On the other hand, the findings indicate that domestic credit to private sector play positive role on economic growth pointing out that domestic credit, which include both credit to private and state-owned enterprises, is a very vital financial development indicator, and this echoes the efficiency of banking institutions in providing the credit sources to entrepreneurs.

Overall, the evidence from this study supports the notion that improved financial sector has a crucial role to play in sustaining economic growth of the country. Although, in underdeveloped financial systems like Tanzania, it is the formal entrepreneurs who can easily access financial services to improve their businesses, this paper recommends to Government to have a policy of subsidizing access to finance to enable informal businesses, which do not have easy access to finance, to boost the growth of their businesses. Furthermore, to improve the ability of banking system to genuinely support Tanzania economic growth, the policymakers are required to be oriented towards the factors that influence interest margin, which means that to have an efficient banking system the spread between margin should be relatively lower. In this case, to have an impact of credit to the private sector to economic growth the Bank of Tanzania must spearhead the policy of lowering banking lending rates so as to promote investment which will ultimately foster economic growth.

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