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# Modeling Causality between Financial Deepening and Poverty Reduction in Egypt

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**Abstract:** This study deals with the linkages between financial development and poverty reduction in Egypt using data for the period of 1975Q1-2011Q4. The stationarity properties of the variables are tested by applying Zivot-Andrews structural break unit root test. The structural break autoregressive distributed lag-bounds testing approach to cointegration is used to examine long run relationship between the variables. Our results show evidence of cointegration which confirms the presence of long run relationship between financial deepening, economic growth and poverty reduction. The VECM Granger causality results are somewhat interesting. The findings indicate that financial development reduces poverty when domestic credit to private sector is used as proxy for financial development. The direct channel that financial sector development can lead to enabling the poor to access or broaden their access to financial services, such as credit and insurance-risk services, is therefore confirmed in case of Egypt. Furthermore, the indirect channel where financial sector development contributes to poverty reduction through economic growth is also confirmed for Egypt. This is only found when  $M_2$  is used as a proxy for financial development and infant mortality per capita as proxy for poverty.

We find that the causal relationship between financial development and poverty reduction is sensitive to the proxy used to measure the level of financial development and the level of poverty. When the domestic credit to the private sector is used as a proxy for financial development, causality is found to prevail between financial development and poverty reduction in short run. However, when the broad money supply is used as a proxy, we find that financial development causes growth which in turn causes poverty reduction. These results show that the poverty-reduction programs are desirable not only because they reduce poverty but also because they possibly lead to further development of financial sector in long run. Furthermore, our results show that appropriate reforms aimed at developing a financial sector in Egypt that is well-organized and spread throughout the country can help reduce poverty by availing more domestic credit to the poor.

**Keywords:** Financial Deepening, Poverty, Growth

## **1. Introduction**

The role of financial development in driving economic growth has been the subject of enormous discussion and debate for decades. Theory suggests that financial development form a potentially important mechanism for achieving long lasting growth (Hanohan, 2004; Levine, 2004; Beck et al. 2004, Shahbaz et al. 2015). The literature provides that an efficient financial system can ameliorate risk, mobilize savings, encourages productive investment, promote specialization and reduce transaction and information costs, and so forth. Such theoretical views received considerable empirical support from numerous studies, and for a large group of countries [e.g. Levine and Zervos (1998), Darrat (1999) and, Khan and Senhadji (2000)]. In contrast to the outpouring of research on the impact of financial development on economic growth, empirical work on the relation of financial development and poverty reduction has been relatively limited. In comparison, fewer studies have examined the nexus between financial development and poverty reduction. Besides, such studies seem to produce unclear and inconsistent results from the empirical front to whether financial development actually leads to poverty reduction in developing countries. Furthermore, most previous studies that have attempted to examine such linkage have concentrated mainly on Latin America, Asia and Africa countries with the latter receiving little attention. It is worth noting that the majority of such studies, up until recently, were based mainly on a bivariate causality analysis which may suffer from bias associated with the omission of variables.

Egypt, a country with an estimated population reaching 85,294,388 (July 2013 est.) [CIA-The-world-fact book], is the most populous country in the Middle East and Africa region, with an economy that depends primarily on agriculture, tourism, media, and petroleum and natural gas

exports. In addition, an estimated 2.7 million Egyptians who live abroad contribute actively to the development of their country's economy through remittances which are estimated to have reached US\$ 7.8 billion in 2009. While the country has implemented market reforms which started in early 1990 which are improving economic growth, it has not been successful in improving the living standards in Egypt which are low by international standards, and have even declined consistently since 1990 for the average Egyptian. A government survey that was conducted recently has shown that an increasing number of Egyptians are struggling to feed and clothe them. The report by the Egyptian Food Observatory found that of the 1680 households surveyed in September 2012, 86% said their income was insufficient to cover their monthly food, clothes and shelter bill. There is no question that corruption, poverty, unemployment and an unbalanced distribution of wealth in Egypt were among the main reasons that fed into the frustration that ultimately led to the revolution in January 25, 2011. Whether the new political parties, including the Muslim Brotherhood would be able to establish and follow a stable macroeconomic base that result in improving the living standards of Egyptians in the long run remains to be seen.

The country's economic situation, however, is not likely to improve in the near future as the economic conditions are forecasted to deteriorate further against a strained political situation (March, 2013). According to the Oxford Analytica Country Profiles (Mar 8, 2013). Growth is expected to reach just 2.6% in the 2012-13 fiscal year compared to 5.5% prior to the 2011 uprising. Egypt's economic outlook has become increasingly fragile since mid-December, with the country's foreign exchange reserves falling below the level that covers three months of imports and with the pound losing almost 10% of its value against the dollar. All these factors

will make it harder to control rising inflation, the rising budget deficit, and to implement the longstanding subsidy reform, tax rises and other reforms agreed as part of the IMF loan. The implications for the average Egyptian do not seem to be promising at least in the near future. It is against this background that this study attempts to investigate the dynamic linkage between financial development and poverty reduction in Egypt by incorporating growth of GDP as an intermittent variable – thereby creating a simple trivariate setting.

The remainder of the paper is organized as follows: Section-2 will survey the relevant literature; Section-3 presents the estimation techniques and empirical analysis. Section-4 concludes the study and provides policy implications.

## **II. Financial Sector Development and Poverty Reduction: A Literature Review:**

This section reviews the theoretical and empirical literature on the role of financial sector development in reducing poverty. There are theoretical convincing point of views that financial sector development plays a critical role in facilitating economic growth and poverty reduction. These views tend to substantiate that a well developed efficient financial system tends to facilitate the process of capital accumulation which increases the level of economic growth which in turn assist in reducing poverty. Zhuang et al. (2009) argued that financial sector development can impact poverty through two channels, indirect and direct. The first is a major channel where financial sector development contributes to poverty reduction through economic growth. This is what is referred to in the literature as trickledown theory where economic growth is seen to either trickle down to the poor through job creation and other economic opportunities. Furthermore, economic growth also is seen to create the required conditions for the broader

distribution of the benefits of growth (Todaro, 1997). This has been supported by a number of studies such as Ravallion and Datt (2002), Mellor (1999), Dollar and Kraay (2002), and Fan et al. (2005) among others. Here, the impact is seen in various areas as follows. First, economic growth could possibly create jobs for the poor. Second, higher rate of economic growth would benefit the poor because it could result in the reduction of the wage differentials between skilled and unskilled labor (Galor and Tsiddon, 1996). Third, higher tax revenues resulting from growth could lead to an increase in government social spending (health, education, and social protection) which benefit the poor who as a result can invest more in human capital (Perroti, 1993). Fourth, more funds would become available to the poor for investment purposes, with the resulting increase in capital accumulation, which will increase their income (Aghion and Bolton, 1997).

The second channel relates to the argument that financial sector development can lead to enabling the poor to access or broaden their access to financial services such as credit and insurance-risk services. This will reinforce the productive assets of the poor, which will augment their productivity and boost their economic potential (World Bank, 2001; Jalilian and Kirkpatrick, 2002). In this regards, credit constraints produced by informational asymmetries are seen as compulsory on the poor who are unable to finance their own projects or use collateral to obtain bank credit (Aghion and Bolton 1997 and, Galor and Zeira 1993).

A large body of empirical literature assesses whether financial sector development leads to poverty reduction directly or indirectly. Some of the studies include Uddin et al. (2012), Fowowe and Abidoye, (2012), Kar et al. (2011), Ho and Odhiambo, (2011), Perez-Moreno, (2011), Ellahi, (2011), Shahbaz, (2009b) among others. Below, we review such studies. Uddin et al. (2012),

investigate the relationship using data over the period of 1976-2010 for Bangladesh using the ARDL bounds testing approach to cointegration and the VECM Granger causality. They reported cointegration between the variables and found feedback effect between financial development and poverty reduction. Fowowe and Abidoeye, (2012) investigated the impact of financial development, inflation and trade openness on poverty reduction in a sample of African countries. Their results showed that financial development does not reduce poverty but they found that poverty is reduced by trade openness and low inflation. Kar et al. (2011) to detect the direction of causal relationship between financial development, economic growth and poverty reduction applying the VECM Granger causality approach for the Turkish economy. Their empirical evidence found that poverty reduction is Granger caused by economic growth and unidirectional but they also reported weak causality running from financial development to poverty in short span of time.

Odhiambo, (2009) examined the causal relationship between financial development, economic growth and poverty reduction using South African data. The author exposed that poverty reduction is Granger cause of financial development and economic growth and demand-side hypothesis is validated by causality running from economic growth to financial development. For Indian economy, Pradhan (2010) explored the relationship between financial development, economic growth and poverty reduction using time series data over the period of 1951-2008. The author found that in short run, the feedback effect is found between economic growth and poverty reduction and poverty reduction is Granger cause of financial development. Odhiambo, (2010a) investigated the relationship between financial development and poverty reduction in Kenya. He found that unidirectional causality running from financial development to poverty

reduction and the feedback effect exists between domestic savings and poverty reduction. Odhiambo, (2010a) further noted that relationship between financial development and poverty reduction is sensitive with proxy used to measure financial development. For example, author reported that poverty reduction Granger causes financial development ( $M_2/GDP$ ) but when domestic credit to private sector is used as measure of financial development then poverty reduction is Granger cause of financial development. Ho and Odhiambo, (2011) using Chinese data, explored the relationship over the period of 1978-2008. They reported that in long run, poverty reduction Granger causes financial development. Furthermore, they reported a feedback effect between financial development and poverty reduction in short run. Perez-Moreno, (2011) analyzed the relationship using data of 35 developing economies. He found unidirectional causality running from financial development to poverty reduction but not the other way round.

In case of Pakistan, Shahbaz, (2009b) studied the impact of financial development and financial instability on poverty reduction by applying the autoregressive distributed lag model (ARDL) for long run relationship between the variables by controlling economic growth, inflation, agricultural growth, manufacturing and trade openness. He reported results showing the variables are cointegrated for long run relationship over the period of 1973-2005. Furthermore, results found that financial development is negative related with poverty while financial instability increases poverty. Agriculture growth, manufacturing and trade openness seem to reduce poverty and inflation raises it. Ellahi, (2011) investigated the relationship between financial development and poverty reduction by incorporating economic growth as potential variable affecting both financial development and poverty. They reported cointegration between the variables. Financial development, investment and poverty reduction was found to Granger cause economic growth.



Odhiambo (2013) applied the bounds testing to examine the relationship between financial development and reduction in poverty for Tanzanian economy. They found that poverty is reduced by an increase in financial development. Dhrifi and Maktouf, (2013) applied GMM method to investigate the relationship between financial liberalization and poverty reduction. They found that financial liberalization leads financial development which in turn, reduces poverty after a threshold level of financial development.

Later on, Rehman and Shahbaz, (2014) explored the causal relationship between financial deepening, economic growth and poverty reduction by applying the ARDL bounds testing approach to cointegration. They found that cointegration exists between the variables and causality results are sensitive with the use of proxy for poverty reduction as well as methodology to be applied. Uddin et al. (2014) examined the relationship between financial development and poverty reduction in Bangladesh economy. They found cointegration between the variables and noted that poverty reduction is cause of financial development. Shahbaz et al. (2015) reported that financial development improves income distribution which in resulting, reduces poverty in Iran.

In addition to the above, many other studies that have attempted to examine the relationship between financial development and poverty reduction such as Jalilian and Kirkpatrick, (2002, 2005); Kirkpatrick, (2000); Beck et al. (2007); Jeanneney and Kpodar, (2008), Honohan, (2004), Geda et al. (2006), Quartey (2005) among others. This large body of literature which investigated the extent to which economic growth leads to poverty reduction reported inconclusive conclusions. However, one can observe that while there were different views on

the growth–poverty reduction nexus in the earlier literature a consensus view has surfacing lately that support view that financial development leads to poverty reduction.

### III. Estimation Strategy and Data Collection

The basic objective of present study is to investigate the causality between financial depending, economic growth and poverty reduction in case of Egypt using quarter frequency data over the period of 1975Q1-2011Q4. In doing so, we have applied series of unit root tests. The long run relationship between the variable is investigated by applying the ARDL bounds testing to cointegration in the presence of structural breaks. The direction of causality is tested by using the VECM Granger causality approach. These tests are detailed one by one.

Historically, in order to test stationary properties of the variables unit root tests like ADF by Dickey and Fuller (1979), P-P by Philips and Perron (1988), KPSS by Kwiatkowski et al. (1992), DF-GLS by Elliott et al. (1996) and Ng-Perron by Ng-Perron (2001) have been used extensively. However, due to lack of information on structural breaks stemming in the series, these tests produce unreliable results. To remove this anomaly Zivot and Andrews, (1992) suggested another model that allows to accommodate single structural break point in the variables at level form, in slope of trend component, and in intercept and trend function. Using Zivot-Andrews, (1992) model the structural break in the series can be tested as:

$$\Delta x_t = a + ax_{t-1} + bt + cDU_t + \sum_{j=1}^k d_j \Delta x_{t-j} + \mu_t \quad (1)$$

$$\Delta x_t = b + bx_{t-1} + ct + bDT_t + \sum_{j=1}^k d_j \Delta x_{t-j} + \mu_t \quad (2)$$

$$\Delta x_t = c + cx_{t-1} + ct + dDU_t + dDT_t + \sum_{j=1}^k d_j \Delta x_{t-j} + \mu_t \quad (3)$$

Where  $DU_t$  denotes dummy variable and gives the mean shift incurred at each point while  $DT_t$ <sup>1</sup> denotes trend shift variable.

$$DU_t = \begin{cases} 1 & \text{if } t > TB \\ 0 & \text{if } t < TB \end{cases} \quad \text{and} \quad DT_t = \begin{cases} t - TB & \text{if } t > TB \\ 0 & \text{if } t < TB \end{cases}$$

The null hypothesis of unit root break date is  $c = 0$  which indicates that series is not stationary with a drift not having information about structural break stemming in the series while  $c < 0$  hypothesis implies that the variable is found to be trend-stationary with one unknown time break. Zivot-Andrews unit root test fixes all points as potential for possible time break and does estimation through regression for all possible structural breaks successively. Then, this unit root test selects that time break which decreases one-sided t-statistic to test  $\hat{c}(= c - 1) = 1$ . Zivot-Andrews intimate that in the presence of end points, asymptotic distribution of the statistics is diverged to infinity point. It is necessary to choose a region where end points of sample period are excluded. Further, Zivot-Andrews suggested the trimming regions i.e. (0.15T, 0.85T) are followed.

Since traditional approaches to cointegration have certain demerits, we have used the structural break autoregressive distributed lag model or the ARDL bounds testing approach to

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<sup>1</sup>We used model-4 for empirical estimations following Sen (2003)

cointegration in the presence of structural break stemming in the series. The ARDL bounds testing approach to cointegration has certain merits like it is flexible regarding integrating order of the variables whether variables are found to be stationary at I(1) or I(0) or I(1) / I(0). In addition, Monte Carlo investigation confirms that this approach is better suited for small sample size (Pesaran and Shin, 1999). Moreover, a dynamic unrestricted error correction model (UECM) can be derived from the ARDL bounds testing through a simple linear transformation. The UECM integrates the short run dynamics with the long run equilibrium without losing any information for long run. The empirical formulation of the ARDL bounds testing approach to cointegration is given below:

$$\begin{aligned} \Delta \ln P_t = & \alpha_1 + \alpha_T T + \alpha_{DUM} DUM + \alpha_P \ln P_{t-1} + \alpha_F \ln F_{t-1} + \alpha_Y \ln Y_{t-1} + \sum_{i=1}^p \alpha_i \Delta \ln P_{t-i} \\ & + \sum_{j=0}^q \alpha_j \Delta \ln F_{t-j} + \sum_{k=0}^r \alpha_k \Delta \ln Y_{t-k} + \mu_t \end{aligned} \quad (4)$$

$$\begin{aligned} \Delta \ln F_t = & \alpha_1 + \alpha_T T + \alpha_{DUM} DUM + \alpha_P \ln P_{t-1} + \alpha_F \ln F_{t-1} + \alpha_Y \ln Y_{t-1} + \sum_{i=1}^p \beta_i \Delta \ln F_{t-i} \\ & + \sum_{j=0}^q \beta_j \Delta \ln P_{t-j} + \sum_{k=0}^r \beta_k \Delta \ln Y_{t-k} + \mu_t \end{aligned} \quad (5)$$

$$\begin{aligned} \Delta \ln Y_t = & \alpha_1 + \alpha_T T + \alpha_{DUM} DUM + \alpha_P \ln P_{t-1} + \alpha_F \ln F_{t-1} + \alpha_Y \ln Y_{t-1} + \sum_{i=1}^p \beta_i \Delta \ln Y_{t-i} \\ & + \sum_{j=0}^q \beta_j \Delta \ln P_{t-j} + \sum_{k=0}^r \beta_k \Delta \ln F_{t-k} + \mu_t \end{aligned} \quad (6)$$

Where,  $\ln P_t$ ,  $\ln F_t$  and  $\ln Y_t$  indicates natural log of poverty (we have used two indicators of poverty reduction. Head-count ratio is denoted by  $PH_t$  and infant mortality rate by  $PI_t$ ), natural log of financial development (proxies by domestic credit to private sector per capita ( $F_t$  and real liquid liabilities ( $M_t$ ) per capita) and real income per capita.  $\Delta$  is for difference operator,  $\mu_s$  denotes residual terms, and  $DUM$  denotes dummy variable to capture the structural breaks arising in the series<sup>2</sup>. F-statistics are computed to compare with upper and lower critical bounds generated by Pesaran et al. (2001) to test for existence of cointegration. The null hypothesis to examine the existence of long run relationship between the variables is  $H_0 : \alpha_p = \alpha_f = \alpha_y = 0$  against alternate hypothesis ( $H_a : \alpha_p \neq \alpha_f \neq \alpha_y \neq 0$ ) of cointegration for equation-4. Using Pesaran et al. (2001) critical bounds, if computed F-statistic is more than upper critical bound (UCB) there is cointegration between the variables. If computed F-statistic does not exceed lower critical bound (LCB) the variables are not cointegrated for long run relationship. If computed F-statistic falls between lower and upper critical bounds then decision regarding cointegration between the variables is uncertain. However, since our sample size is large (160 observations) and critical bounds generated by Pesaran et al. (2001) may be suitable. Therefore, we use lower and upper critical bounds developed by Pesaran et al. (2001) rather than Narayan (2005). Once long run relationship is confirmed between the variables then next step is examine the direction of causality as below:

$$(1-L) \begin{bmatrix} \ln P_t \\ \ln F_t \\ \ln Y_t \end{bmatrix} = \begin{bmatrix} a_1 \\ a_2 \\ a_3 \end{bmatrix} + \sum_{i=1}^p (1-L) \begin{bmatrix} b_{11i} b_{12i} b_{13i} \\ b_{21i} b_{22i} b_{23i} \\ b_{31i} b_{32i} b_{33i} \end{bmatrix} \times \begin{bmatrix} \ln P_{t-1} \\ \ln F_{t-1} \\ \ln Y_{t-1} \end{bmatrix} + \begin{bmatrix} \alpha \\ \beta \\ \delta \end{bmatrix} ECT_{t-1} + \begin{bmatrix} \varepsilon_{1t} \\ \varepsilon_{2t} \\ \varepsilon_{3t} \end{bmatrix} \quad (7)$$

<sup>2</sup> The structural breaks are based on Zivot-Andrews (1992)

Where  $(1-L)$  denotes the difference operator and  $ECT_{t-1}$  denotes the lagged residual term generated from long run relationship,  $\varepsilon_{1t}, \varepsilon_{2t}$  and  $\varepsilon_{3t}$  are error terms assumed to be normally distributed with mean zero and finite covariance matrix. The long run causality is indicated by the significance of t-statistic connecting to the coefficient of error correction term ( $ECT_{t-1}$ ) and statistical significance of F-statistic in first differences of the variables shows the evidence of short run causality between variables of interest. Additionally, joint long-and-short runs causal relationship can be estimated by joint significance of both  $ECT_{t-1}$  and the estimate of lagged independent variables. For instance,  $b_{12,i} \neq 0 \forall_i$  shows that financial development Granger-causes poverty reduction and causality is running from poverty reduction to financial development indicated by  $b_{21,i} \neq 0 \forall_i$ . The same hypothesis can be drawn for other variables.

The data of all the variables is taken from world development indicators (CD-ROM, 2013). We use two proxies for poverty i.e. head count ratio and infant mortality rate (see Gassebner and Luechinger, 2011). Financial development is measured by two indicators such as real domestic credit to private sector per capita and real  $M_2$  (liquid liabilities) per capita. Real GDP per capita is used for economic growth. The study covers data period of 1975-2011. We have converted the annual frequency data into quarter frequency data using interpolation method following Romero, (2005).

### **III. Results and their Discussions**

The Table-1 reports the descriptive statistics and we find that all the series are normally distributed as confirmed by Jarque-Bera test statistics. We have applied Ng-Perron, (2001) unit

root test to test the stationary properties of the variables. This unit root test is superior to traditional unit root tests such as ADF, PP, DF-GLS and KPSS etc. The Ng-Perron unit root test would not over-accept the null hypothesis when it is false like ADF unit root test. The results are reported in Table-2. Our results reveal that all the variables have unit root problem at level with intercept and trend. This implies that order of integration of the variables is I(1) as all the variables found to be stationary at 1<sup>st</sup> difference.

**Table-1: Descriptive Statistics**

Variables	$\ln PH_t$	$\ln PI_t$	$\ln Y_t$	$\ln F_t$	$\ln M_t$
Mean	6.0532	2.6037	6.4032	5.2413	6.0872
Median	6.0707	2.6652	6.3902	5.1402	6.1680
Maximum	6.5320	3.5627	6.9380	6.0508	6.6710
Minimum	5.4552	1.4228	5.6627	3.9002	4.8452
Std. Dev.	0.2669	0.6259	0.3065	0.65749	0.4930
Skewness	-0.3640	-0.1981	-0.2595	-0.3665	-1.0653
Kurtosis	2.5705	1.8457	2.4253	2.0341	3.3770
Jarque-Bera	4.4056	3.1852	3.6978	4.0671	2.8733
Probability	0.1104	0.1711	0.1574	0.1272	0.2010

**Table-2: Unit Root Analysis  
Ng-Perron Unit Root Test**

Variables	MZa	MZt	MSB	MPT
$\ln PH_t$	-2.3391 (2)	-1.0783	0.4610	38.8155
$\ln PI_t$	-8.4419 (4)	-1.8519	0.2193	11.4705

$\ln Y_t$	-1.0867 (3)	-0.6900	0.6350	75.2707
$\ln F_t$	-0.5305 (3)	-0.2207	0.4159	43.2945
$\ln M_t$	-1.5616 (5)	-0.7165	0.4588	43.2992
$\Delta \ln PH_t$	-49.9699 (3)*	-4.9953	0.0999	1.8395
$\Delta \ln PI_t$	-40.4821 (3)*	-4.4615	0.1102	2.4524
$\Delta \ln Y_t$	-19.3997 (0)**	-3.0940	0.1594	4.8241
$\Delta \ln F_t$	-28.5305 (4)*	-3.7694	0.1321	3.2386
$\Delta \ln M_t$	-24.0352 (2)*	-3.4599	0.1439	3.8321
Note: * and ** indicate significant at 1% and 5% levels respectively. Optimal lag order of the variables is shown in small parentheses.				

Since the structural breaks stemming in the series are not reflected on these unit root tests, such tests tend to provide unreliable and biased results. In such an environment, application of these tests becomes questionable. To deal with this problem, we decided to apply Zivot-Andrews (Zivot and Andrews, 1992) structural break unit root test which allows for having information about an unknown structural break point stemming in the time series.

**Table-3: Zivot-Andrews Structural Break Unit Root Test**

Variable	At Level		At 1 <sup>st</sup> Difference	
	T-statistic	Time Break	T-statistic	Time Break
$\ln PH_t$	-4.376 (2)	2002Q1	-10.122 (3)*	1980Q3
$\ln PI_t$	-2.576 (2)	1987Q3	-6.014 (2)*	1985Q3



$\ln Y_t$	-4.153 (2)	1990Q3	-8.099 (3)*	1985Q3
$\ln F_t$	-2.936 (1)	1997Q3	-10.110 (3)*	1993Q3
$\ln M_t$	-5.021 (2)	1979Q3	-7.187 (3)*	1983Q3
Note: * represents significant at 1% level. Critical T-values are -5.57 and -5.08 at 1% and 5% levels respectively. Lag order is shown in parenthesis.				

The results are reported in Table-3. The results indicate that variables do have unit root problem at level with a structural break both in intercept and trend. The both variables are found to be stationary at 1<sup>st</sup> difference. This implies that the variables are integrated at I(1). The unique integrating properties of the both series leads us to implement the ARDL bounds testing approach to cointegration examining the long run relationship between financial development, economic growth and poverty reduction over the study period of 1975Q1-2011Q4 in case of Egypt. An appropriate lag order of the variables is needed to apply the ARDL bounds testing. Various lag length criterion are available indicated in Table-4. We followed Akaike information criteria to select appropriate lag length. It is pointed by Lütkepohl, (2006) that AIC has superior power properties for small sample data compared to any lag length criterion. Our decision about lag length is based on the minimum value of AIC. The results are reported in Table-4. It is found that we cannot take lag more than 6 in such sample data.

The next step is to estimate the ARDL F-statistic to examine the existence of cointegration between financial development, economic growth and poverty reduction over the study period of 1975Q1-2011Q4 in case of Egypt. The results of the ARDL F-statistic are reported in Table-4. The results indicate that our computed F-statistics are more that upper critical bounds as we

treaded poverty reduction (indicated by head-count ratio) and economic growth as dependent variables. This relationship is statistically significant at 1% and 5% respectively. This shows that there are two cointegrating vectors. The results are little-bit different once we use infant mortality rate as an indicator of poverty reduction but we find the cointegration between the variables. This confirms that the variables have long run relationship between the variables over the period of 1975Q1-2011Q4 in case of Egypt.

**Table-4: The Results of ARDL Cointegration Test**

The Bounds Testing to Cointegration			
Estimated Models	Optimal lag length	F-statistics	Structural Break
$F_{P_H}(P_H/Y, F)$	6, 5, 5	4.133**	2002Q1
$F_Y(Y/P_H, F)$	5, 6, 5	5.185*	1990Q3
$F_F(F/P_H, Y)$	6, 6, 6	2.41	1997Q3
$F_{P_H}(P_H/Y, M)$	6, 6, 6	8.285*	2002Q1
$F_Y(Y/P_H, M)$	6, 6, 6	4.143**	1990Q3
$F_M(M/P_H, Y)$	6, 6, 6	4.572	1979Q3
$F_{P_I}(P_I/Y, F)$	6, 6, 5	6.015*	1987Q3
$F_Y(Y/P_I, F)$	6, 6, 5	3.787**	1990Q3
$F_F(F/P_I, Y)$	6, 6, 6	1.407	1997Q3
$F_{P_I}(P_I/Y, M)$	6, 6, 6	3.195	1987Q3
$F_Y(Y/P_I, M)$	6, 5, 5	3.984**	1990Q3

$F_M(M/P_t, Y)$	6, 6, 6	8.852*	1979Q3
Significant level	Critical values (T= 148) <sup>#</sup>		
	Lower bounds $I(0)$	Upper bounds $I(1)$	
1 per cent level	3.15	4.43	
5 per cent level	2.45	3.61	
10 per cent level	2.12	3.23	

### The VECM Granger Causality Analysis

The presence of cointegration among the variables implies that causality relation must be existed at least from one side. The directional relationship between financial development, economic growth and poverty reduction will provide help in articulating comprehensive economic policy to reduce poverty and sustain economic growth for long span of time. We applied Granger causality test within the VECM framework to detect the causality between the variables. Table-5 reports the results of the VECM Granger causality analysis (once we used head-count ratio as poverty reduction indicator). The long run causality is captured by a significant t-test on a negative coefficient of the lagged error-correction term  $ECM_{t-1}$ . The jointly significant LR test on the lagged explanatory variables shows short-run causality.

The long run causality results show that the feedback effect is found between poverty reduction and economic growth. Financial development indicated both by real domestic credit to private sector per capita and real liquid liabilities per capita Granger causes poverty and economic growth (see Table-5). In short run, Table-5 reveals that the relationship between poverty reduction and economic growth is bidirectional. The feedback effect exists between financial

development and economic growth. Financial development (real domestic credit to private sector per capita) does not Granger cause poverty and same is true from opposite side. The bidirectional causality is found between financial development (real liquid liabilities per capita) and poverty reduction. The neutral effect is found between financial development (real liquid liabilities per capita) and economic growth.

**Table-5: The VECM Granger Causality Analysis**

Dependent Variable	Direction of Causality						
	Short Run			Long Run	Joint Long-and-Short Run Causality		
	$\Delta \ln PH_{t-1}$	$\Delta \ln Y_{t-1}$	$\Delta \ln F_{t-1}$	$ECT_{t-1}$	$\Delta \ln PH_{t-1}, ECT_{t-1}$	$\Delta \ln Y_{t-1}, ECT_{t-1}$	$\Delta \ln F_{t-1}, ECT_{t-1}$
$\Delta \ln PH_t$	.... [0.0000]	18.4750* [0.0000]	0.2657 [0.7670]	-0.1092* [-4.9843]	....	20.3469* [0.0000]	8.8957* [0.0000]
$\Delta \ln Y_t$	19.2216* [0.0000]	....	12.6076 [0.0000]	-0.0416* [-2.8141]	13.0913* [0.0000]	....	11.0819* [0.0000]
$\Delta \ln F_t$	0.9733 [0.3804]	12.7576* [0.0000]	....	....	....	....	....
Variables	$\Delta \ln PH_{t-1}$	$\Delta \ln Y_{t-1}$	$\Delta \ln M_{t-1}$	$ECT_{t-1}$	$\Delta \ln PH_{t-1}, ECT_{t-1}$	$\Delta \ln Y_{t-1}, ECT_{t-1}$	$\Delta \ln M_{t-1}, ECT_{t-1}$
$\Delta \ln PH_t$	.... [0.0000]	15.9473* [0.0000]	4.8222* [0.0094]	-0.0710* [-3.5382]	....	15.3198* [0.0000]	9.4335* [0.0001]
$\Delta \ln Y_t$	15.3942* [0.0000]	....	0.4990 [0.6082]	-0.0244*** [-1.8018]	10.2914* [0.0000]	....	7.2186* [0.0012]
$\Delta \ln M_t$	8.9780* [0.0002]	2.8884 [0.1052]	....	-0.0138*** [-1.8598]	7.1901 [0.0002]	3.7488** [0.0125]	....
Note: *, ** and *** show significance at 1, 5 and 10 per cent levels respectively.							

**Table-6: The VECM Granger Causality Analysis**

Dependent Variable	Direction of Causality						
	Short Run			Long Run	Joint Long-and-Short Run Causality		
	$\Delta \ln PI_{t-1}$	$\Delta \ln Y_{t-1}$	$\Delta \ln F_{t-1}$	$ECT_{t-1}$	$\Delta \ln PI_{t-1}, ECT_{t-1}$	$\Delta \ln Y_{t-1}, ECT_{t-1}$	$\Delta \ln F_{t-1}, ECT_{t-1}$
$\Delta \ln PI_t$	....	6.1080* [0.0029]	19.9074* [0.0000]	-0.0011*** [-1.7252]	....	2.8661** [0.0391]	10.0163* [0.000]
$\Delta \ln Y_t$	5.6417* [0.0044]	....	17.7054* [0.0000]	-0.0249* [-3.1829]	7.5519* [0.0001]	....	18.6881* [0.0000]
$\Delta \ln F_t$	18.8951* [0.0000]	20.5114* [0.0000]	....	-0.0234*** [-1.8363]	13.2951* [0.0000]	....	15.3026* [0.0000]
Variables	$\Delta \ln PI_{t-1}$	$\Delta \ln Y_{t-1}$	$\Delta \ln M_{t-1}$	$ECT_{t-1}$	$\Delta \ln PI_{t-1}, ECT_{t-1}$	$\Delta \ln Y_{t-1}, ECT_{t-1}$	$\Delta \ln M_{t-1}, ECT_{t-1}$
$\Delta \ln PI_t$	....	3.0631** [0.0504]	9.0622 [0.0002]	....	....	....	....
$\Delta \ln Y_t$	3.2594*** [0.0908]	....	3.2723** [0.0409]	-0.0375** [-2.7694]	2.4671*** [0.0654]	....	5.7640* [0.0010]
$\Delta \ln M_t$	9.5573* [0.0001]	6.1749* [0.0027]	....	-0.0218** [-2.4656]	8.0889* [0.0001]	7.7854* [0.0001]	....

Note: \*, \*\* and \*\*\* show significance at 1, 5 and 10 per cent levels respectively.

Table-6 reveals the results of causality once we used infant mortality rate as measure of poverty. In long run, we find that relationship between economic growth and poverty (infant mortality rate) is bidirectional (in Granger sense). Financial development and infant mortality (poverty) are complementary as bidirectional Granger causality is confirmed between both variables. The unidirectional running from financial development to economic growth supporting supply-side hypothesis and demand-side hypothesis is also true as economic growth Granger causes financial development. The results vary when we used real liquid liabilities ( $M_2$ ) per capita s measure of financial development. The feedback effect is found between financial development and economic growth. Economic growth and financial development Granger cause poverty reduction.

In short run, we find the bidirectional causality between financial development (measured by real domestic credit to private sector per capita) and poverty reduction (indicated by infant mortality rate). The relationship between economic growth and poverty reduction is bidirectional and feedback hypothesis is validated between financial development and economic growth. Furthermore, poverty reduction is Granger cause of economic growth and financial development (proxies by real liquid liabilities per capita). There is complementary relationship is found between economic growth and financial development i.e. bidirectional.

#### **4. Summary and Conclusions**

This study dealt with the association between financial development and poverty reduction in case of Egypt using data for the period of 1975Q1-2011Q4. Unlike the majority of the previous studies, we have estimated a trivariate causality model that includes real GDP per capita as an

intermittent variable. The stationary properties of the variables are tested by applying Zivot-Andrews structural break unit root test. The structural break autoregressive distributed lag-bounds testing approach to cointegration is used to examine long run relationship between the variables. The estimated results confirmed the existence of long run equilibrium relationship between financial development, economic growth and poverty reduction in Egypt. Our results show that financial sector development plays a vital role in facilitating economic growth in Egypt. A sound financial system supports economic growth through mobilizing and pooling savings. This contributes to poverty reduction through a major channel that is through economic growth.

Furthermore, our results show that financial sector development in Egypt also directly supports poverty reduction by broadening the access to finance of the poor. Finance transactions by smoothen consumption, enables poor households to accumulate assets and enables them to increase their income. This suggests that financial development in Egypt, like other countries, seems to lessen poverty beyond its effect on growth or what is referred to in the literature as trickledown theory. The study, therefore, concludes that financial development in Egypt seems to be pro-poor.

The above results help us provide two significant policy implications as follows. First, the government of Egypt should pay more attention to the types of economic activities occurring in the country, and the country's legal environment as it design and implement policies aiming at increasing the level of financial development in the country. Making desired legal environment that stimulate most wanted growth in economic activities that also reduce poverty should be a



priority. In this regard, changes in the role played by small local banks on the country's financial system are worth examining further. This is important as small, local banks tend to have more information about small, local firms, and consumers and therefore will be at a better position than large banks to facilitate lending to new small local entrepreneurs. This is significant for a country like Egypt like many developing countries that need more small banks and microfinance to meet many of basic financial needs of the poor. There is evidence that small domestic banks tend to have more small clients as larger banks "cream-skim" the large good borrowers. Second, we suggest that the Egyptian government in considering development assistance to its financial sector should focus on achieving financial deepening involving microcredit programs to SMEs businesses. This will contribute to poverty reduction by broadening the access to, and reducing the cost of finance for SMEs as development assistance involving microcredit programs has been found to contribute to poverty reduction by broadening the access to, and reducing the cost of, finance for SMEs. This is important given that SME credit programs and microfinance have shown to advance poor households' economic and social wellbeing and reduce poverty in many countries.

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