

Finance in the tropics: Understanding Structural Gaps and Policy Challenges

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Motivation and background

- Ambiguity about financial depth
 - Positive relationship between financial depth and long-term growth
 - Rapid financial deepening is crisis predictor
 - Crisis has shed doubt on finance-growth link
- What drives financial deepening (history, policies, politics)
- Challenge: how to compare financial depth across countries
 - Similar to discussion on trade openness
 - Is there a “natural” level of financial depth
- Related work
 - Access possibilities frontier (Beck and de la Torre, 2007)
 - Benchmarking Financial Development (Beck et al., 2008)

Questions to be asked?

- How far can and should countries go in facilitating financial deepening?
- How fast can we expect LICs to catch up to MICs and MICs to HICs?
- Should 100% of population have access to savings/credit services?
- Might there be levels/speeds of financial deepening too high for good of economy and society?

Framework

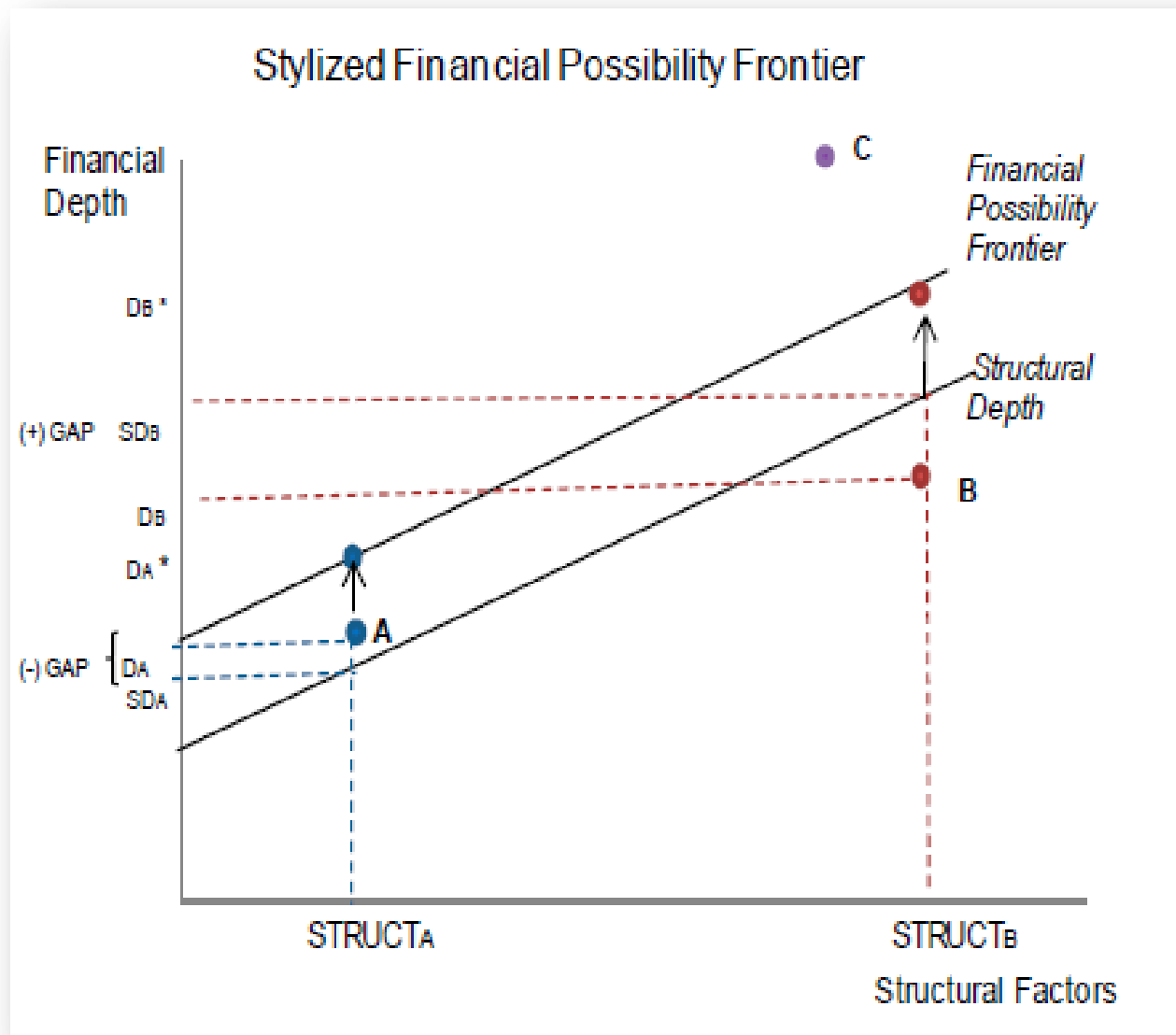
Market frictions

- Transaction costs
- Idiosyncratic and systemic risk

State variables:

- Invariant in the short-run and impose an upper limit on financial deepening
- Socio-economic factors (income, market size, population density, age dependency ratio, conflict)
- Macroeconomic management and credibility
- Contractual and information frameworks
- Available technology and infrastructure

Graphical illustration



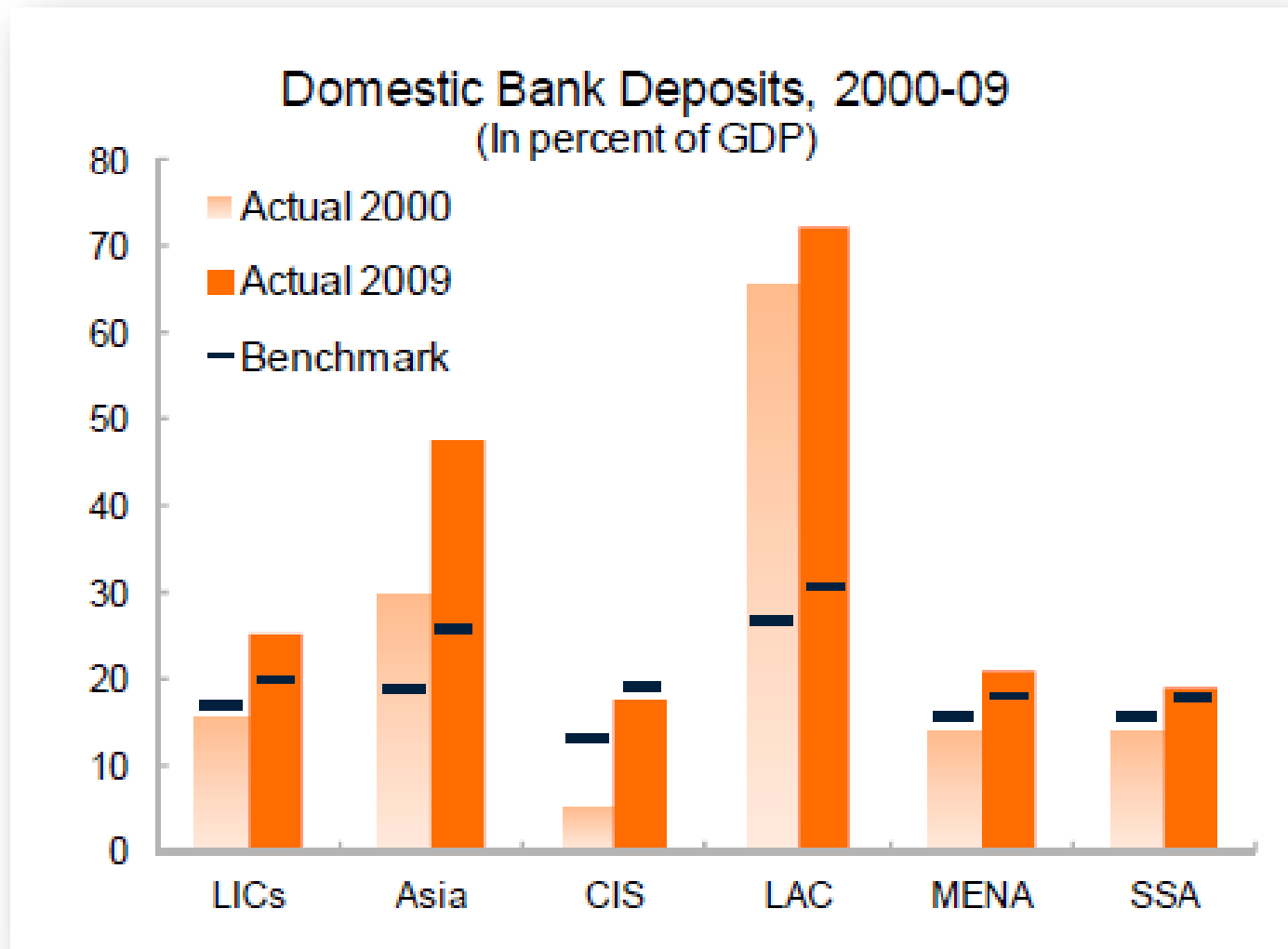
Taxonomy of challenges

- Frontier too low
 - Structural variables
 - Institutional variables
 - Market-developing policies
- Financial system below frontier
 - Lack of competition
 - Regulatory constraints
 - Demand-side constraints
 - Market-enabling policies
- Financial system beyond frontier
 - Incentive compatible regulatory framework
 - Also on demand-side
 - Market-harnessing policies

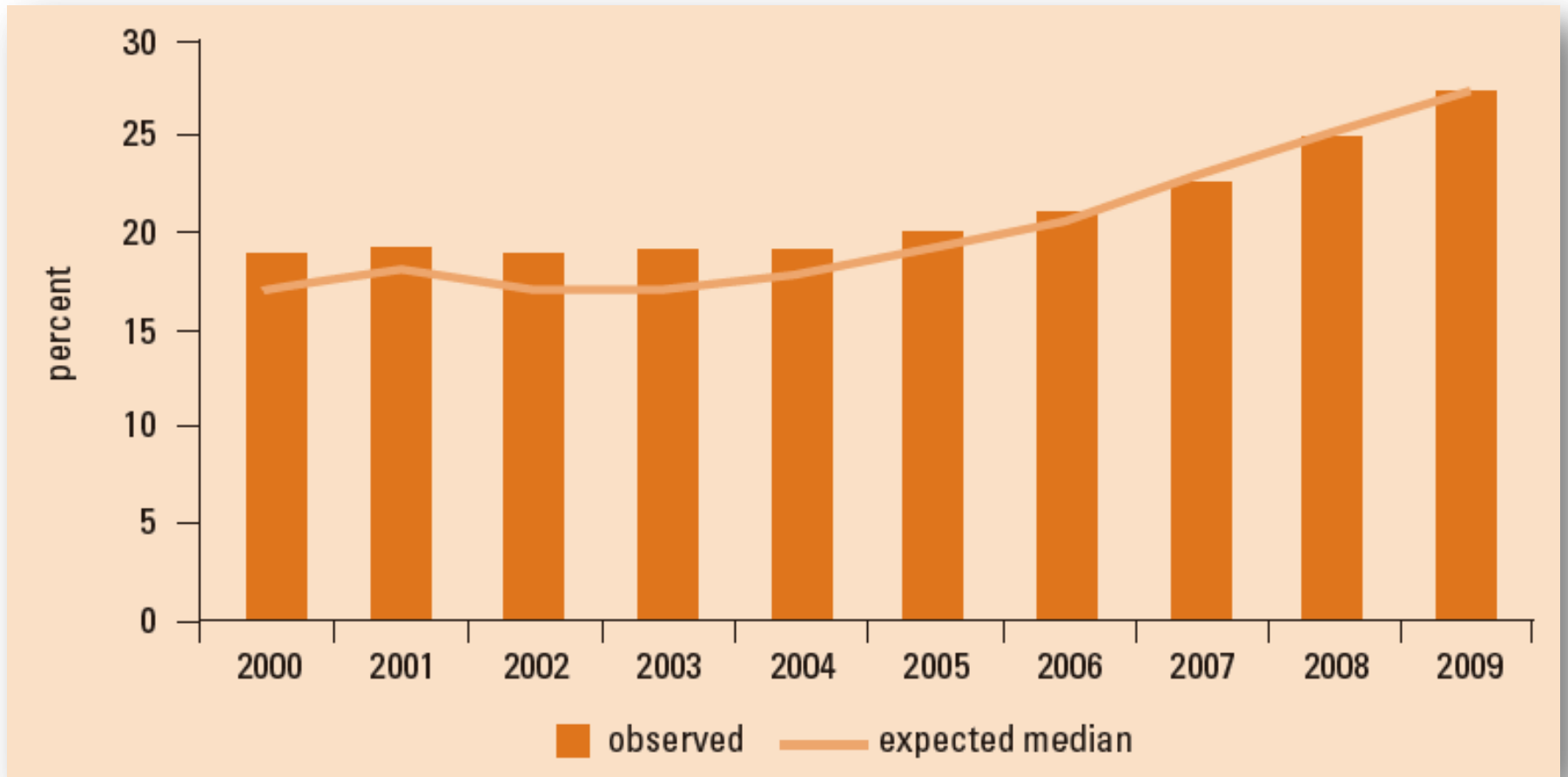
Repercussions for policy work

- How to compare countries?
 - Benchmarking model (Feyen et al., 2011; World Bank FinStats)
- Gap? Overshooting?
- What explains discrepancy
 - Cross-country comparisons
 - Country-level analysis

Bank deposits across regions



Private Credit to GDP: Expected Versus Actual across Africa



How to deepen financial systems?

Challenges:

- Small financial systems
 - Scale diseconomies
 - Heavily bank-based
 - Lack of competition, low efficiency
- Short maturities
- Governance challenges

Solutions:

- Role of competition
- Role of financial innovation
- Role of globalization
- Role of government

What role for competition?

- Focus on the necessary services and look beyond existing institutions
 - Service provision should be priority
 - Look beyond banks to NBFIs
 - Look beyond stock exchanges to private equity
 - Look beyond financial sector to new delivery channels
- Focus on users, looking beyond supply constraints
 - Supply constraints only part of story
 - SMEs: business environment; turn investment into bankable projects
 - Households: lack of financial literacy and trust

What role for financial innovation?

- Can push out the frontier; examples abound
 - Cell phone as delivery channel (transaction costs)
 - Credit scoring, rainfall insurance (more effective risk management)
- Use of technology subject to regulatory framework and competitive pressures
 - Compare variation in use of cell phone based banking across Africa
 - How to get to the expanded frontier?
- Financial innovation requires adaptation of regulatory framework
 - New risks; new players; new interlinkages etc.
 - Risks of credit overexpansion can lead financial system beyond frontier

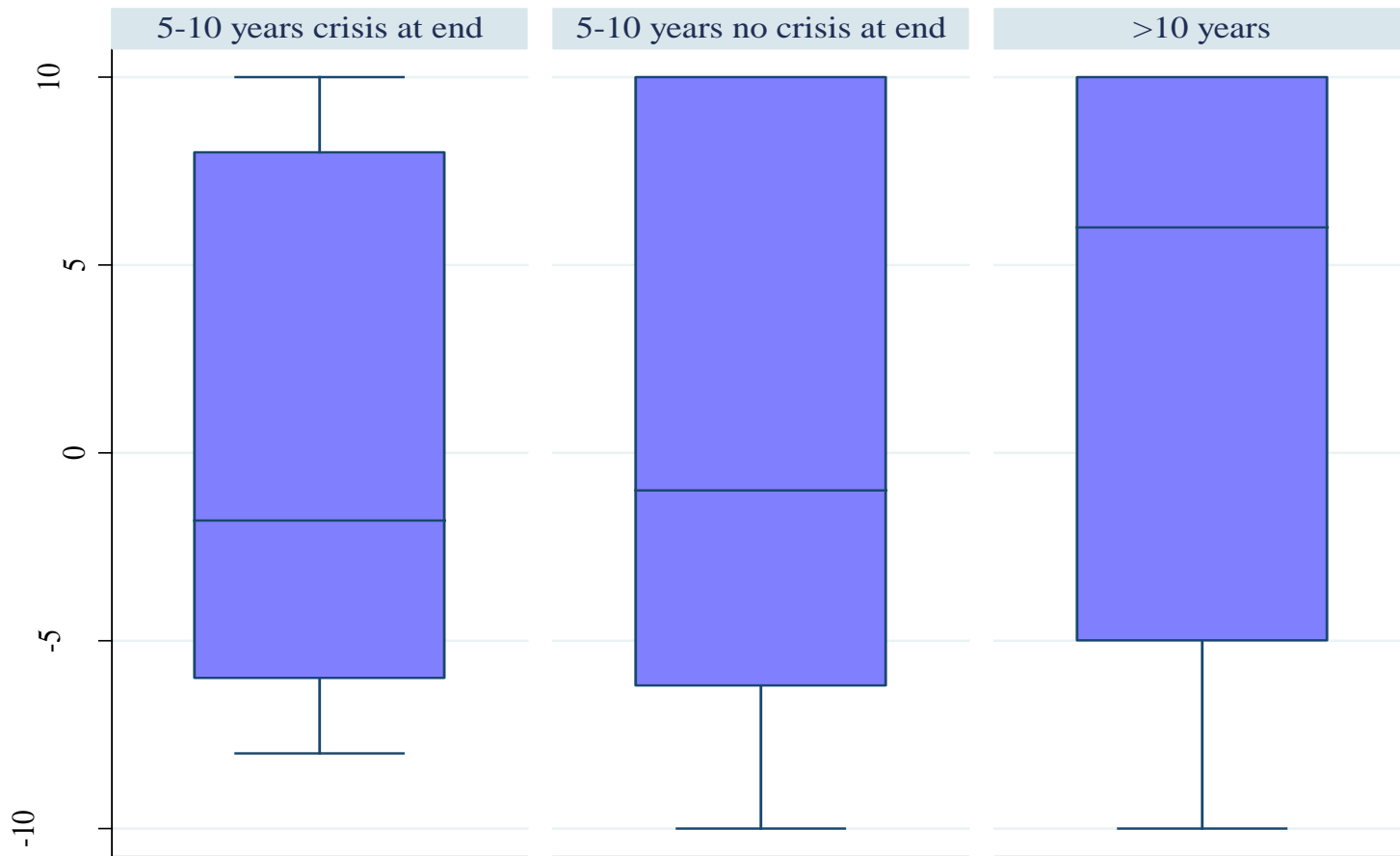
What role for globalization?

- Might allow overcoming of scale diseconomies in small economies
- Might increase contestability and competition; introduction of new technologies, thus moving financial system closer to frontier
 - New lending techniques for SMEs
- Challenges for bank supervisors:
 - Contagion risk
 - Cooperation between regulators
 - Asymmetry of interests between home and host country regulators
- Open capital account: new resources, but also new challenges for macroeconomic management

What role for government?

- Beyond improving state variables
- Focusing on contestability of financial markets
 - Low entry barriers
 - Infrastructure open to all financial institutions
 - No regulatory barriers to innovation
 - Mix of open market and activist policies
- Pro-market activism
 - Do not replace markets, but help overcome market failures
 - Well-designed, limited (time, resources etc.) interventions might help
 - Demonstration effect for private sector
 - Subsidizing transaction costs
 - Partial credit guarantee schemes
 - Success often a function of political economy
- Market-harnessing policies:
 - Regulatory framework
 - Both supply- and demand-side

Looking beyond policies...



Source: Quintyn and Verdier (2012)

Conclusions

- Gauge financial system relative to benchmark; financial possibility frontier as conceptual framework
- Position of country's financial system relative to frontier determines policy focus
- Financial innovation can be key to financial deepening and broadening across many developing countries
- All financial sector policy is local!
- Don't ignore the politics!
- Best fit rather than best practice!