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

Domestic Bank Deposits, 2000-09
(In percent of GDP)

- LICs
- Asia
- CIS
- LAC
- MENA
- SSA
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 NBFI
  - 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!