Rethinking Financial Deepening: Stability and Growth in Emerging Markets

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Based on IMF Staff Discussion Note "Rethinking Financial Deepening: Stability and Growth in Emerging Markets" (SDN/15/8).
Also incorporates IMF SDN 15/17 "Financial Inclusion: Can It Meet Multiple Macroeconomic Goals?" and WB Working Paper WPS 7722.
The paper: https://www.imf.org/external/ns/cs.aspx?id=353, the data: http://www.imf.org/external/pubs/cat/longres.aspx?sk=42868.
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Motivation

Macroeconomic benefits and risks of financial depth: lessons from recent evidence?

Financial depth, inclusion, and stability: what role for regulation?

Recent data availability

ROADMAP

1. Introduction and stylized facts
2. Financial deepening: a rethink
3. Zooming in on the role of financial inclusion
4. Policy implications and discussion

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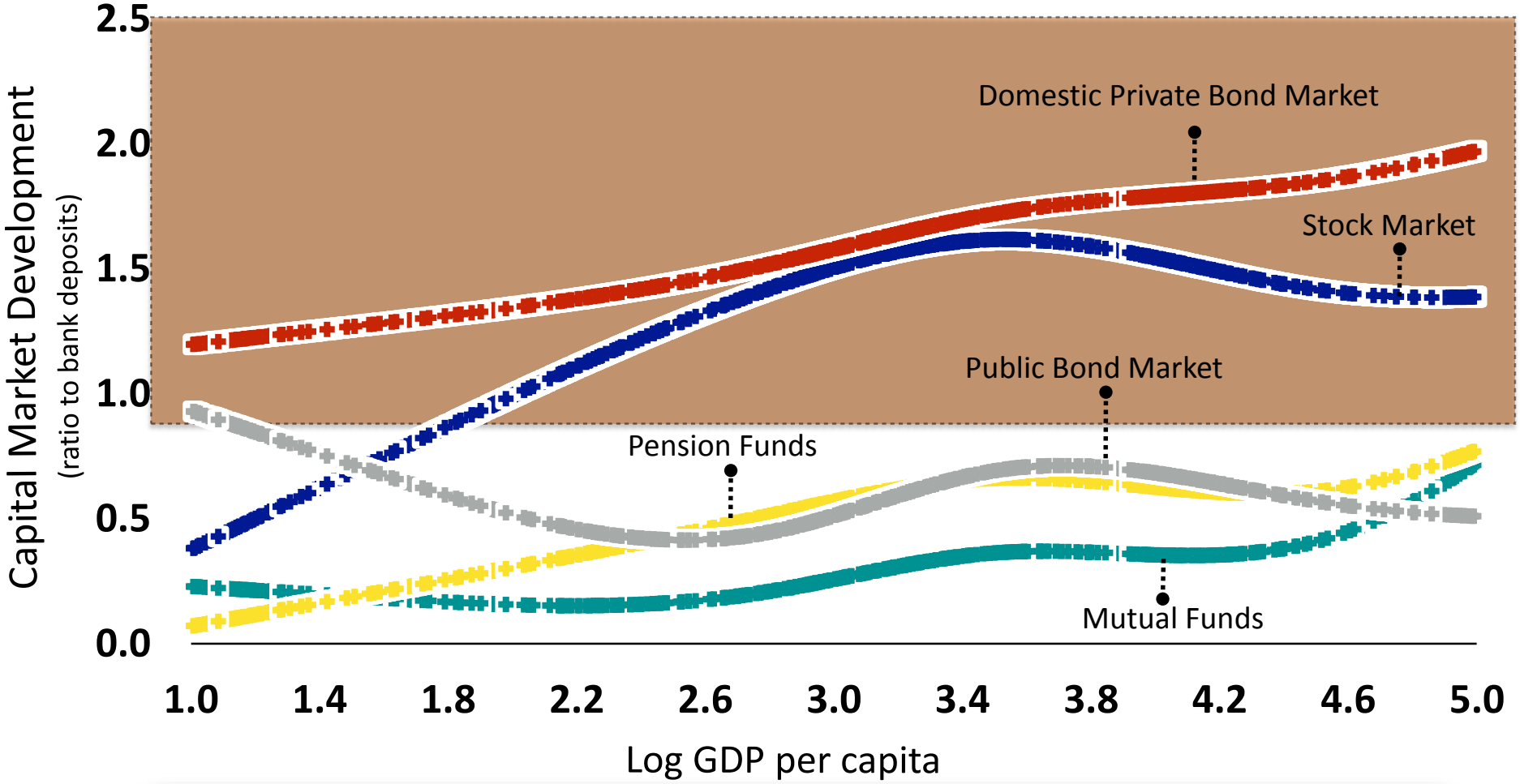
1

Introduction and Stylized Facts

AS ECONOMIES GROW…

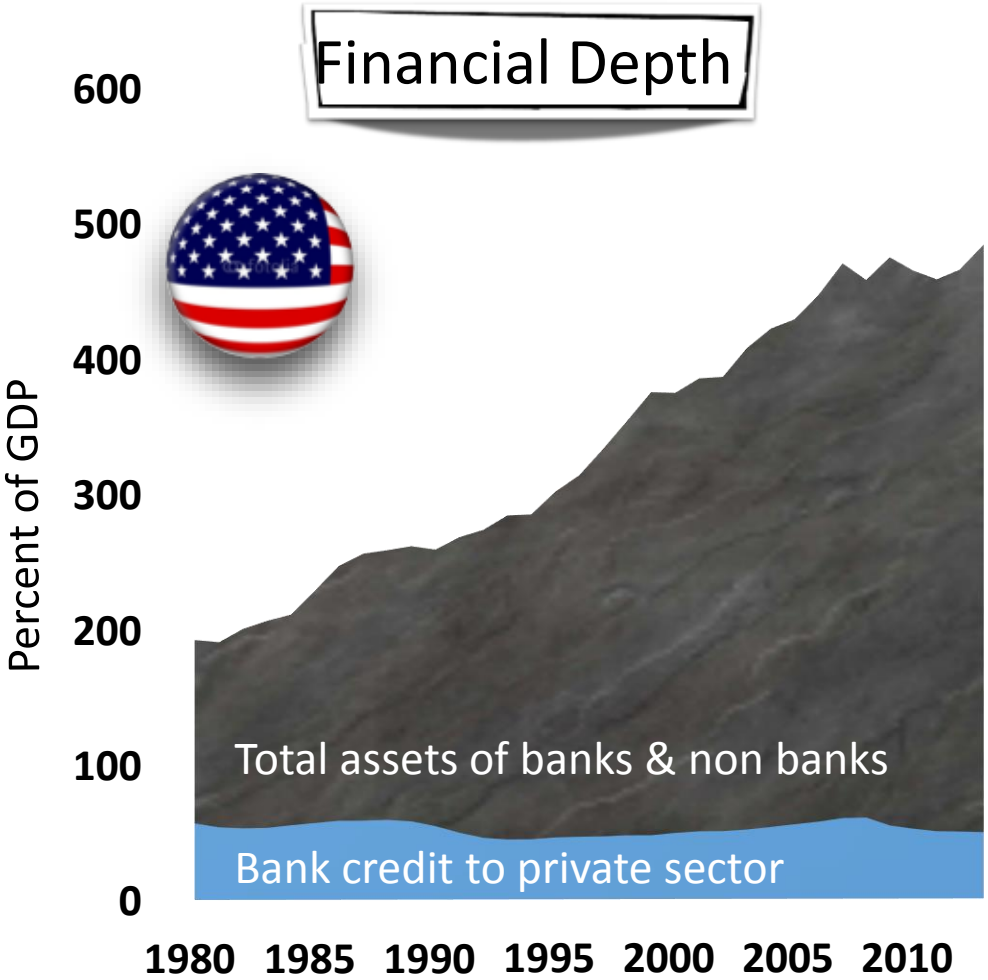
Nonbanks & private financial markets increase relative to banks

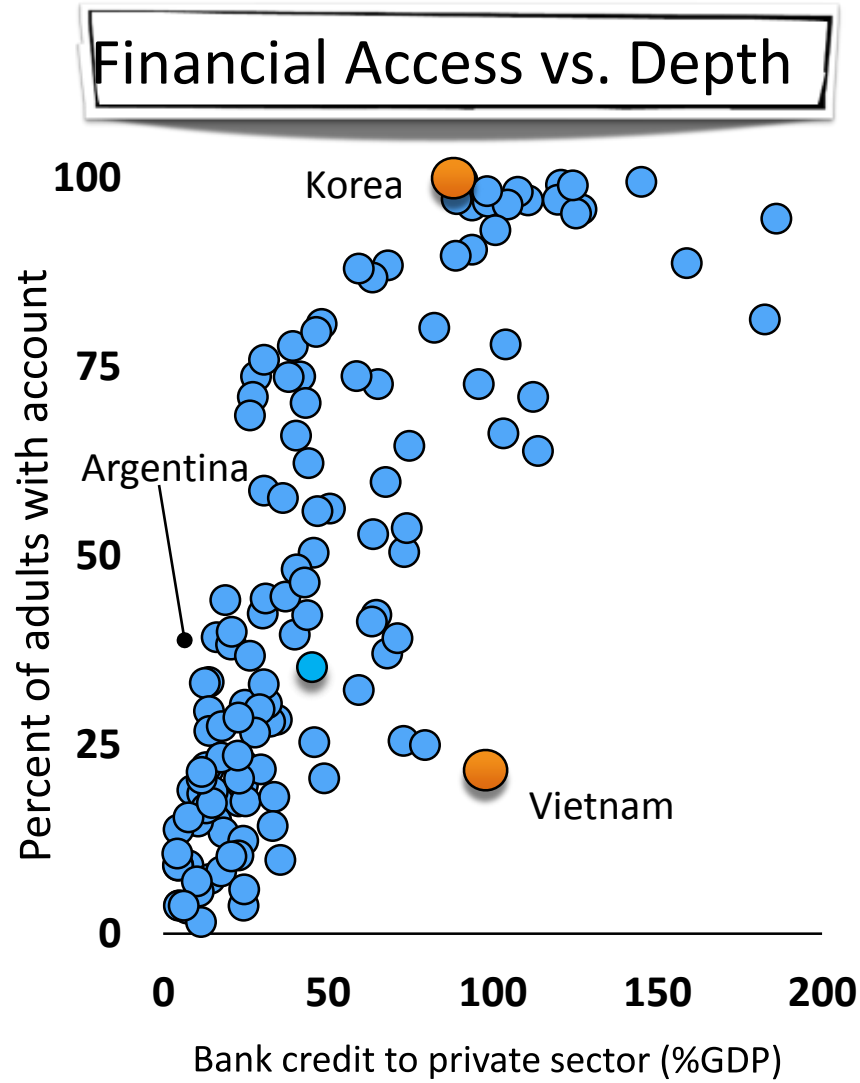


… bank-related measures not a good proxy for financial development

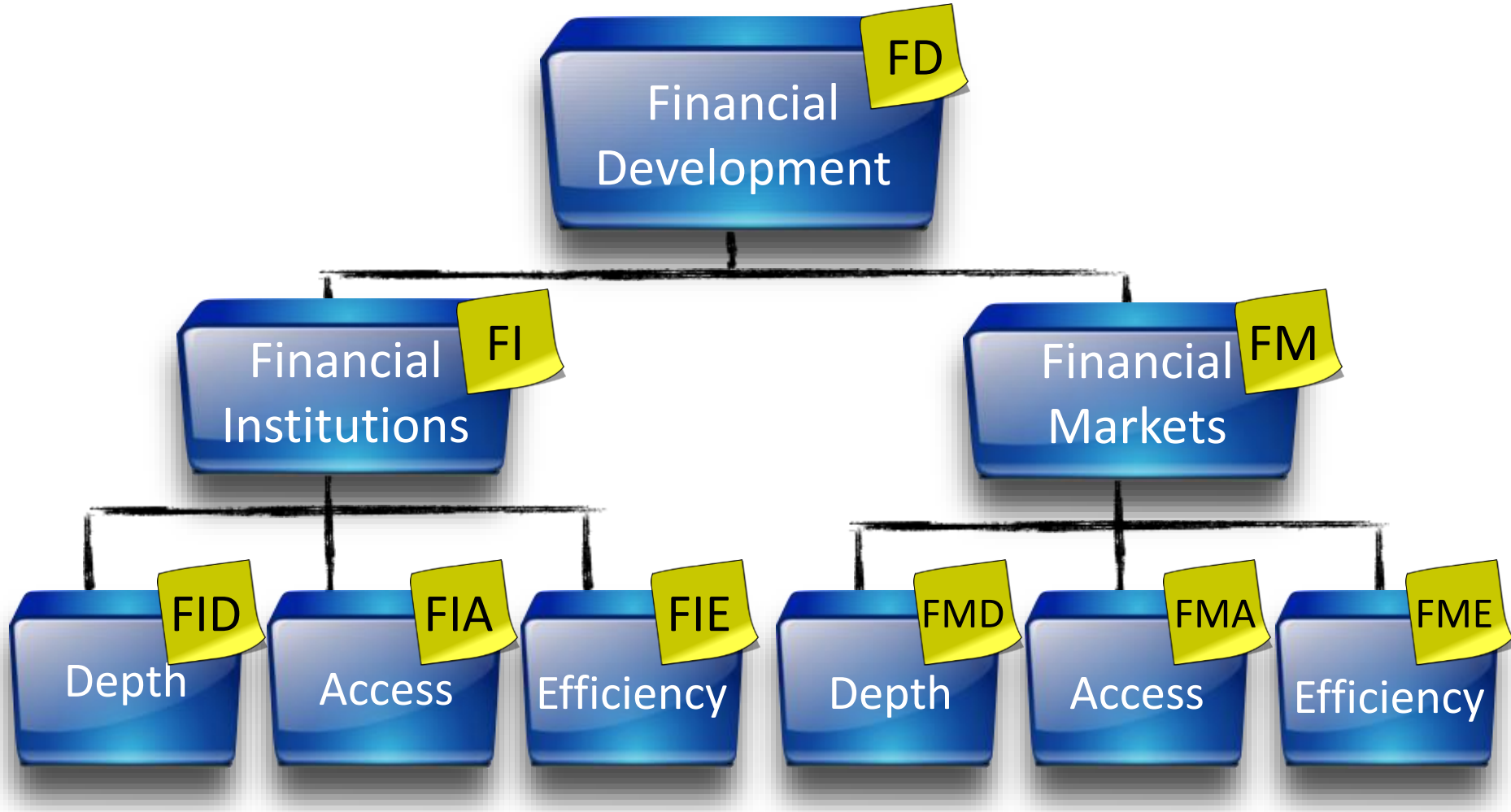
BANK CREDIT TO THE PRIVATE SECTOR CAN BE MISLEADING

For measuring financial depth & access



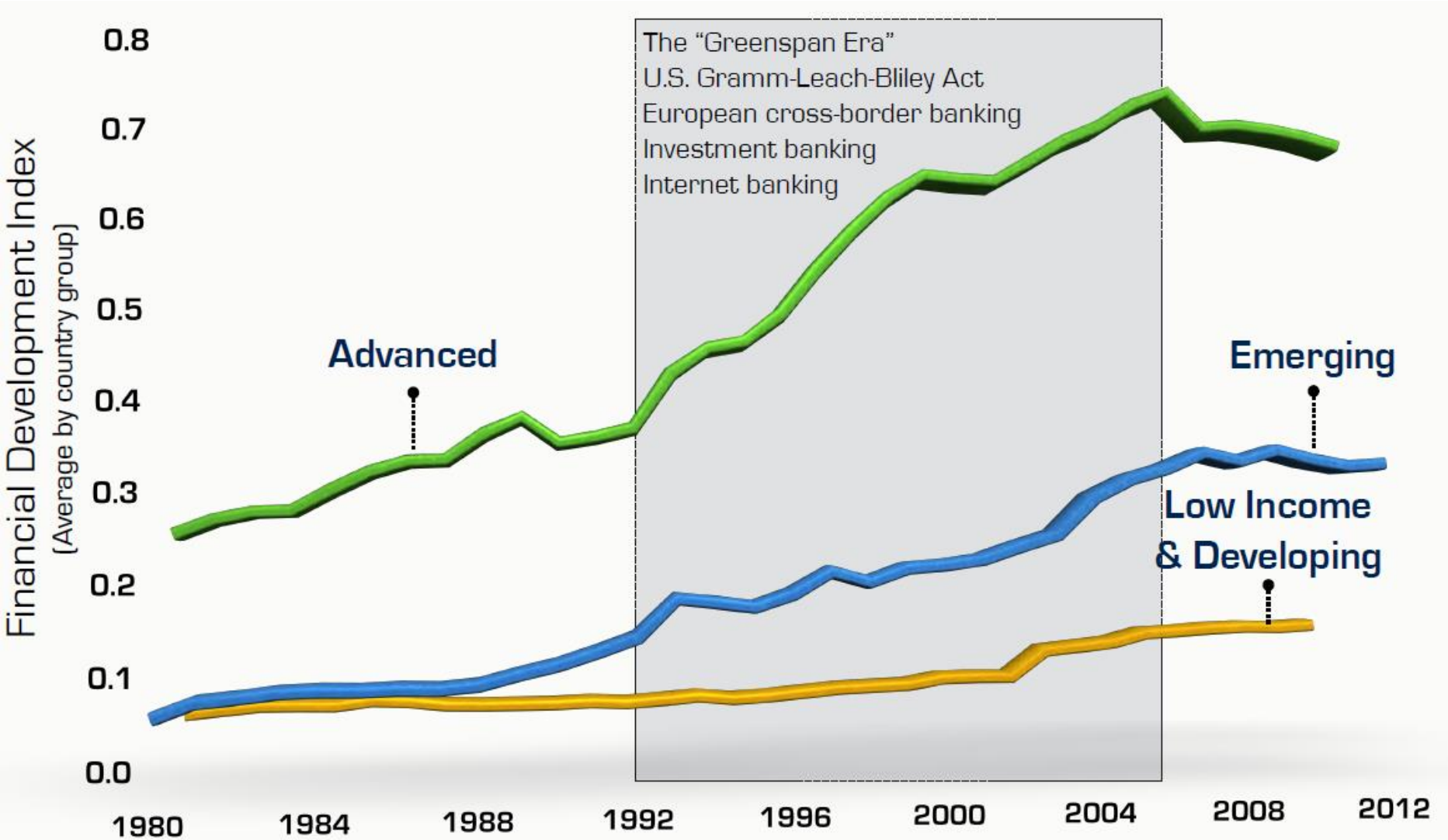


A NEW COMPREHENSIVE INDEX OF FINANCIAL DEVELOPMENT



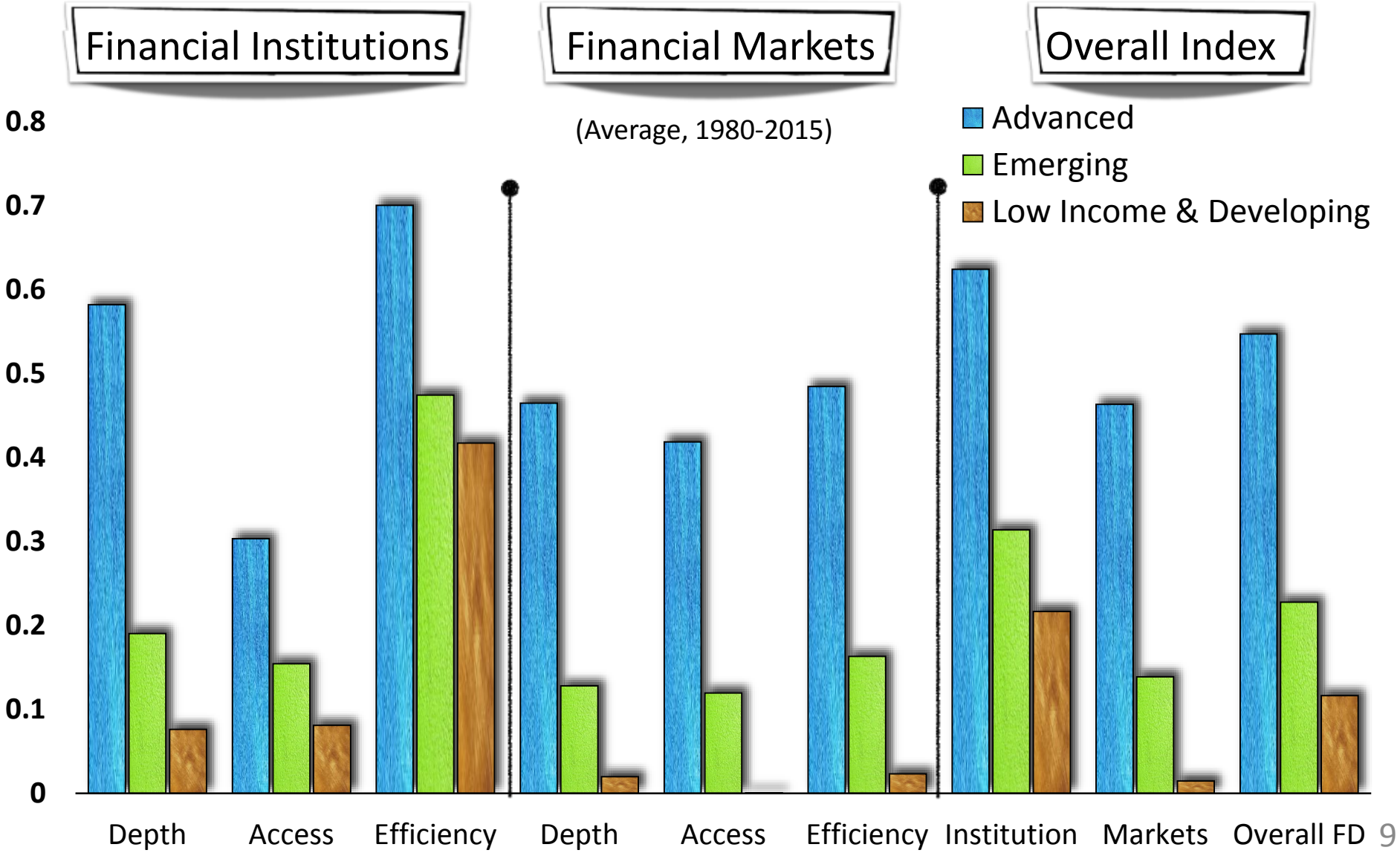
FINANCIAL DEVELOPMENT

The long view



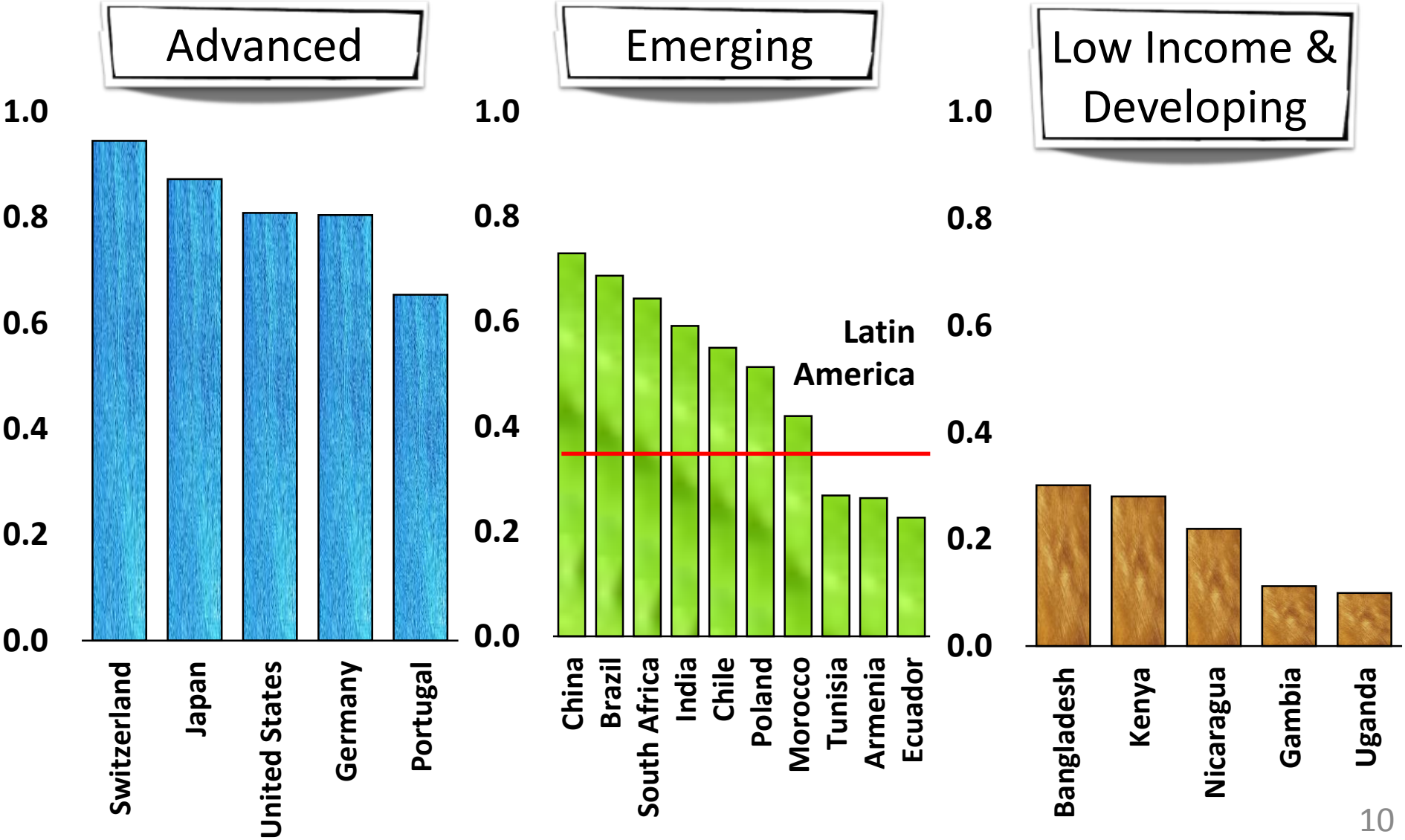
FINANCIAL DEVELOPMENT

Peer group comparison



FINANCIAL DEVELOPMENT

Country examples



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Financial Deepening: A Rethink

PREVIOUS STUDIES

Since 1970s

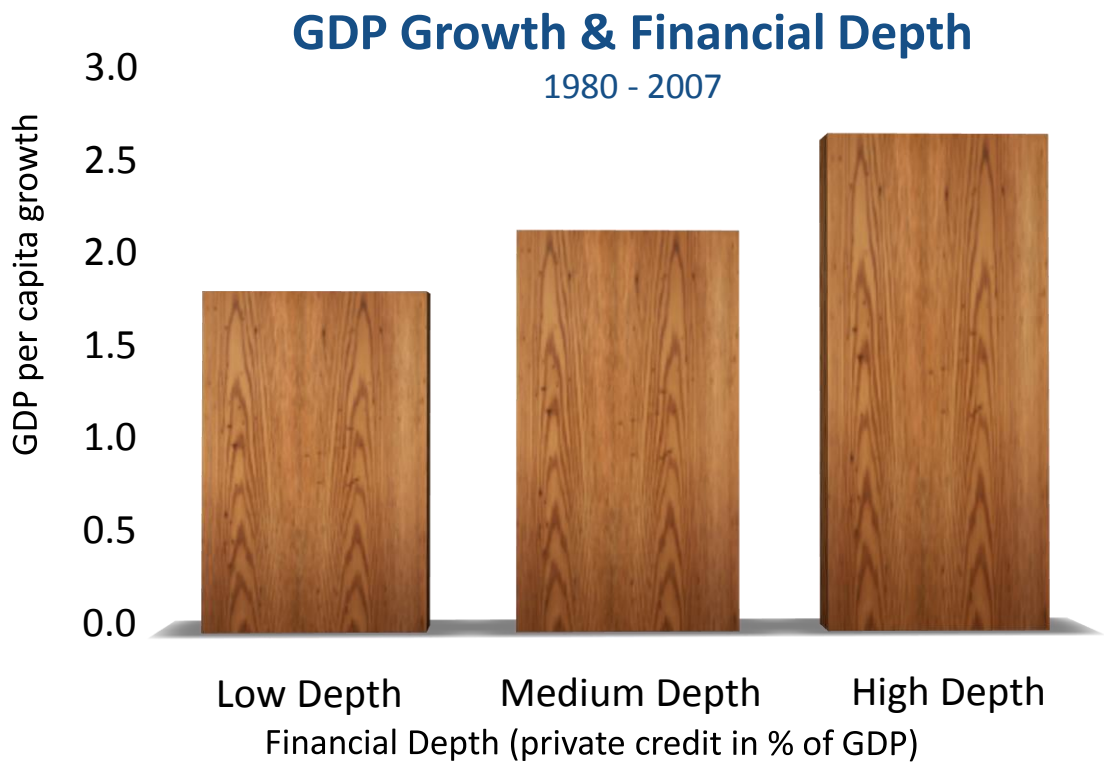
- Development of conceptual framework of finance-growth link

Since 1990s

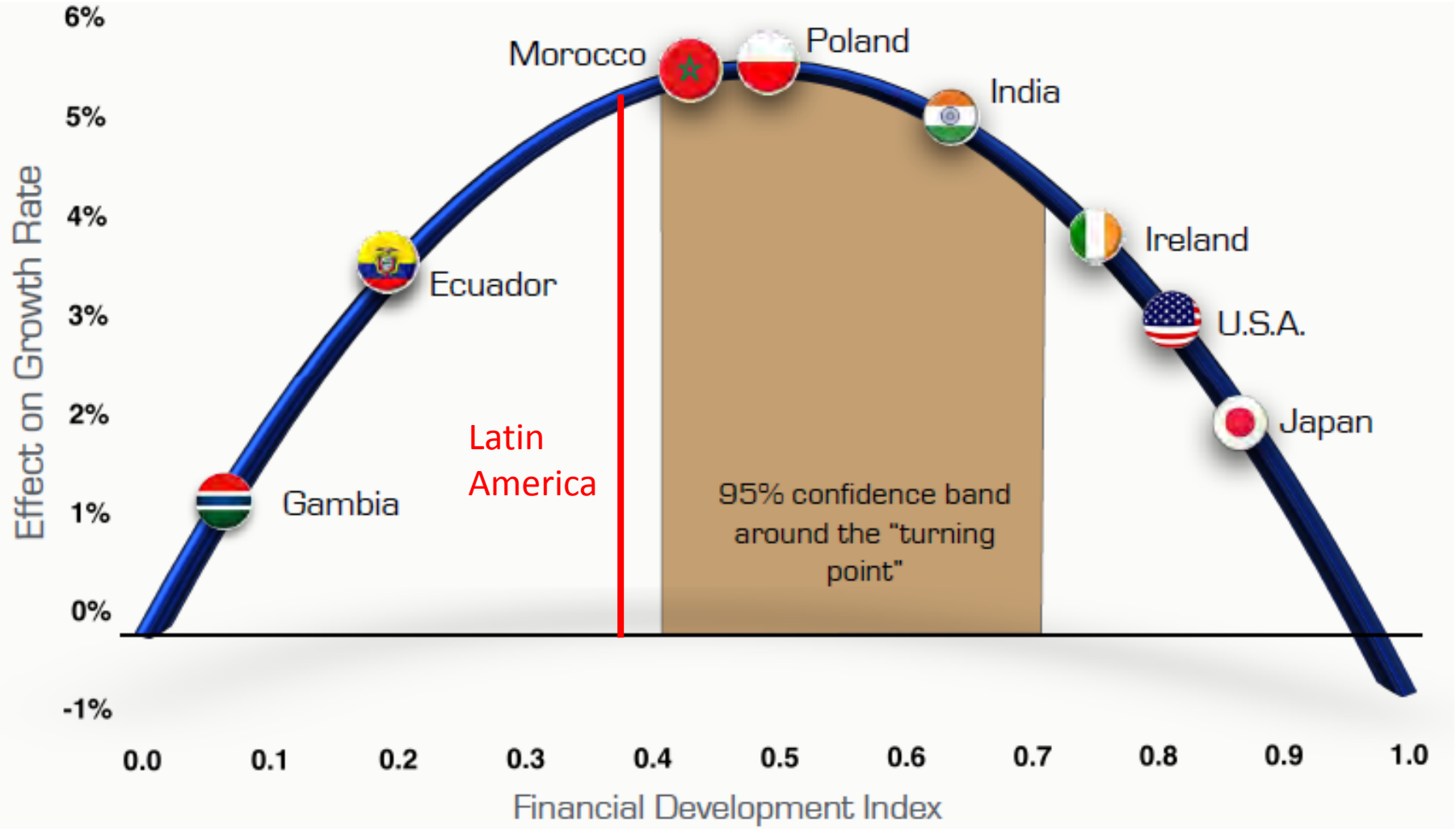
- Positive empirical link established

More Recently

- Weakening link, nonlinearities, heterogeneity of country experience



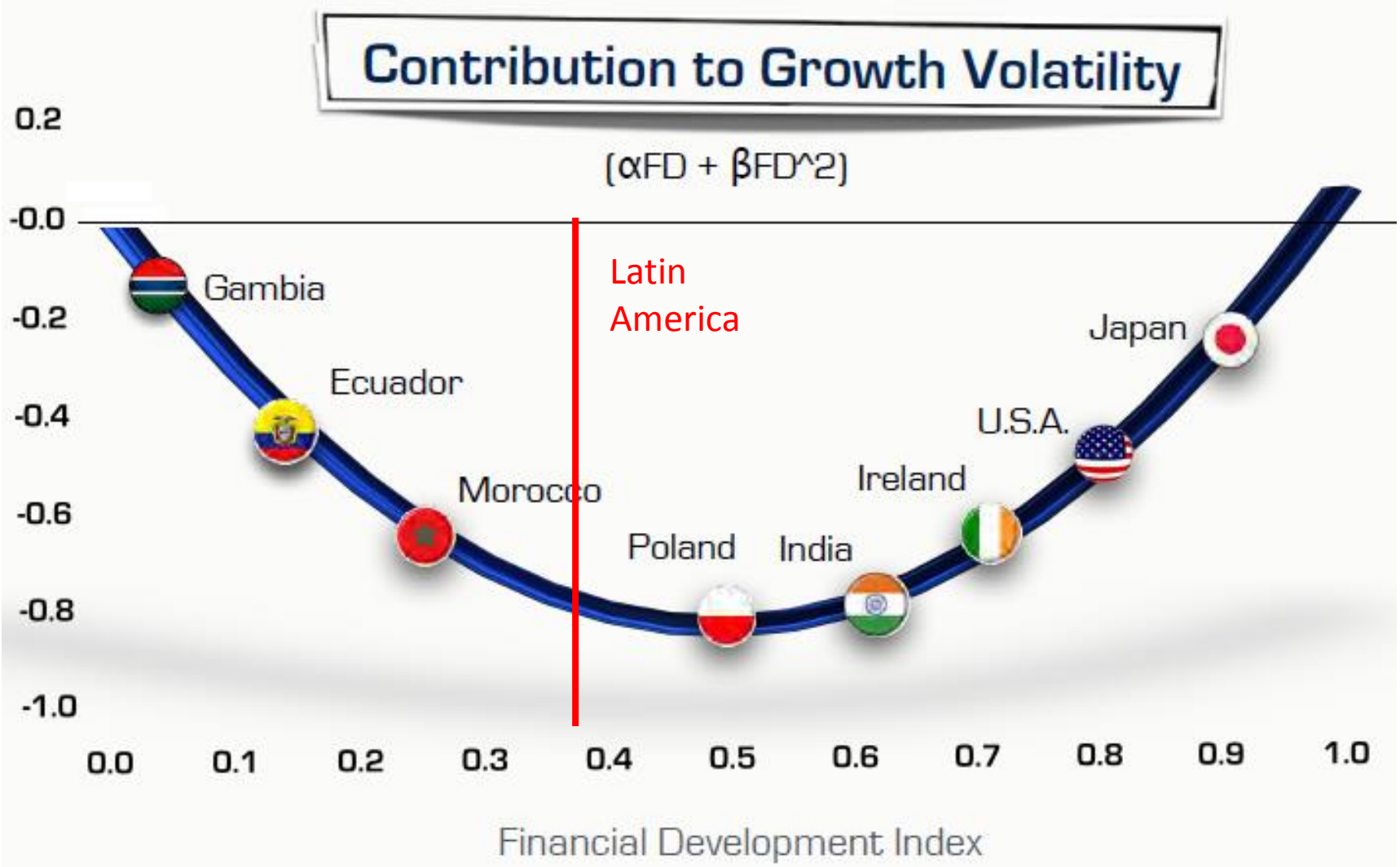
FINANCIAL DEVELOPMENT HELPS GROWTH
But there is a turning point



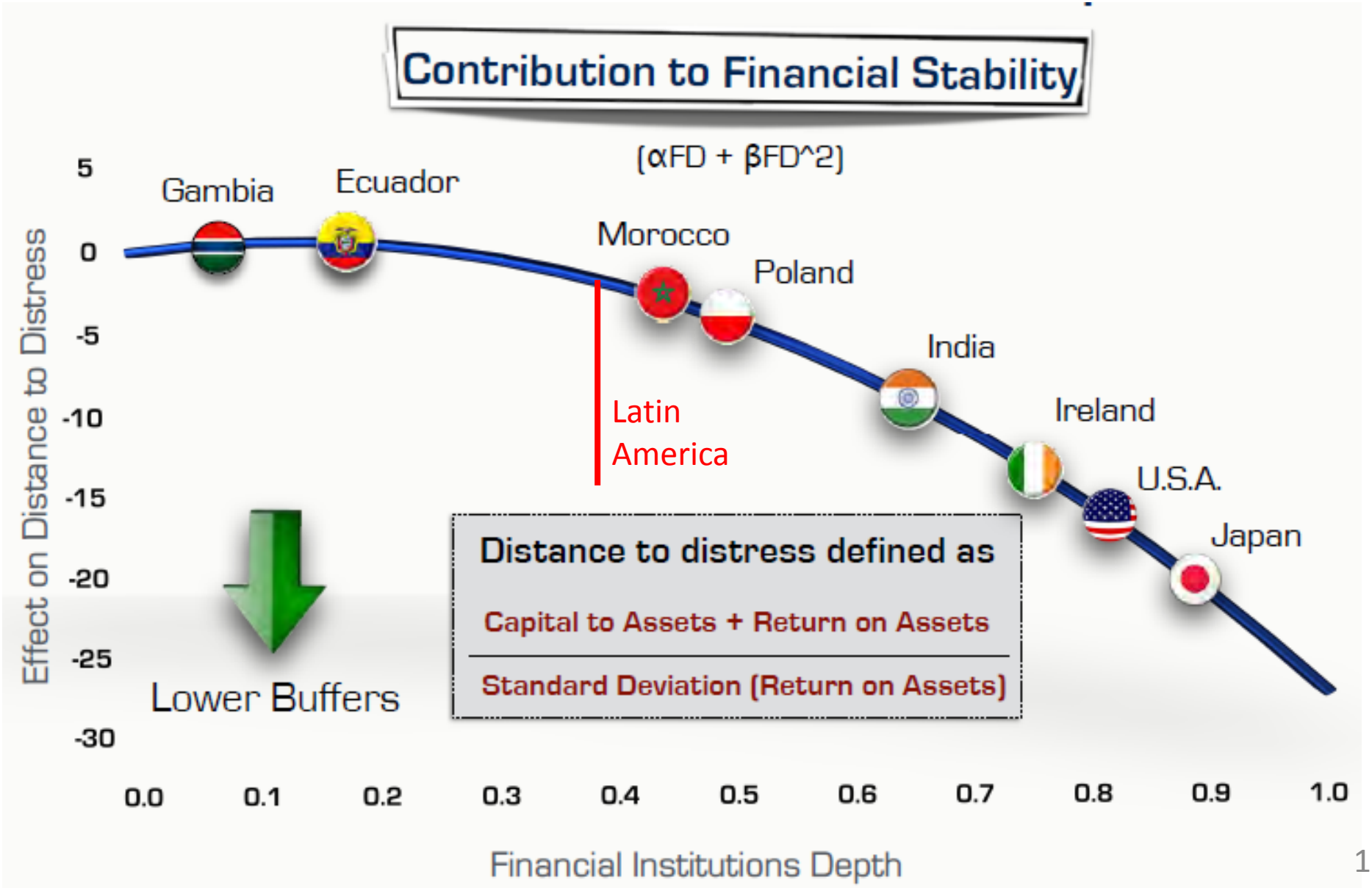
(αFD + βFD^2) evaluated at 2006-10 average FD - 128 countries

FINANCIAL DEVELOPMENT REDUCES ECONOMIC VOLATILITY

but up to a point



BANK BUFFERS DECLINE AS INSTITUTIONS DEEPEN



TAKING STOCK:

There is a growth/stability tradeoff

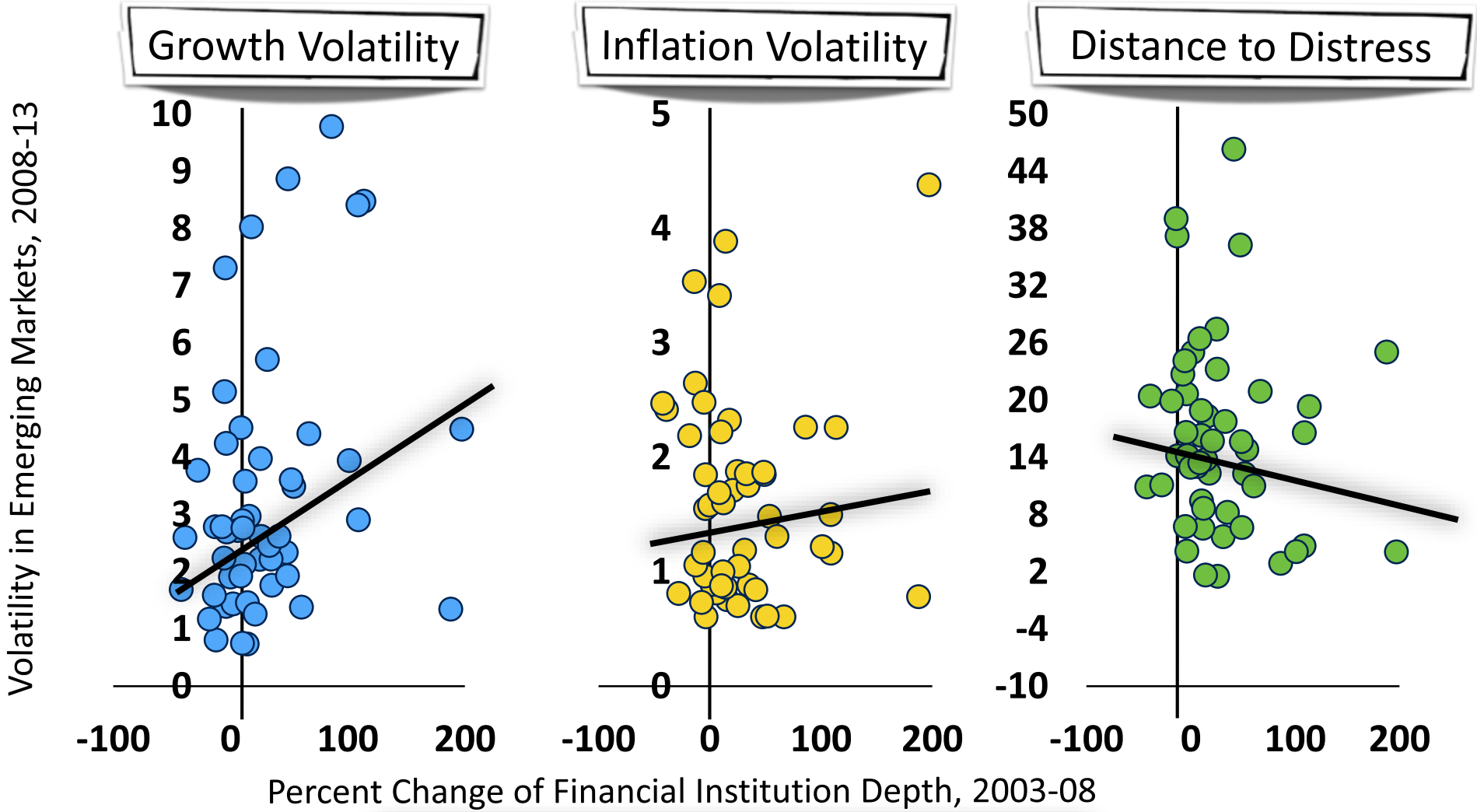
Risks & Benefits for Growth & Stability	I	II	III
	Risks < Benefits	Tradeoffs	Risks > Benefits
	Most EMs All LIDCs	Some EMs & AEs	Many AEs Few EMs
Growth:	High	High	Low
Volatility:	Low	Rising	High

0 — 0.5 — 1

Financial Development Index

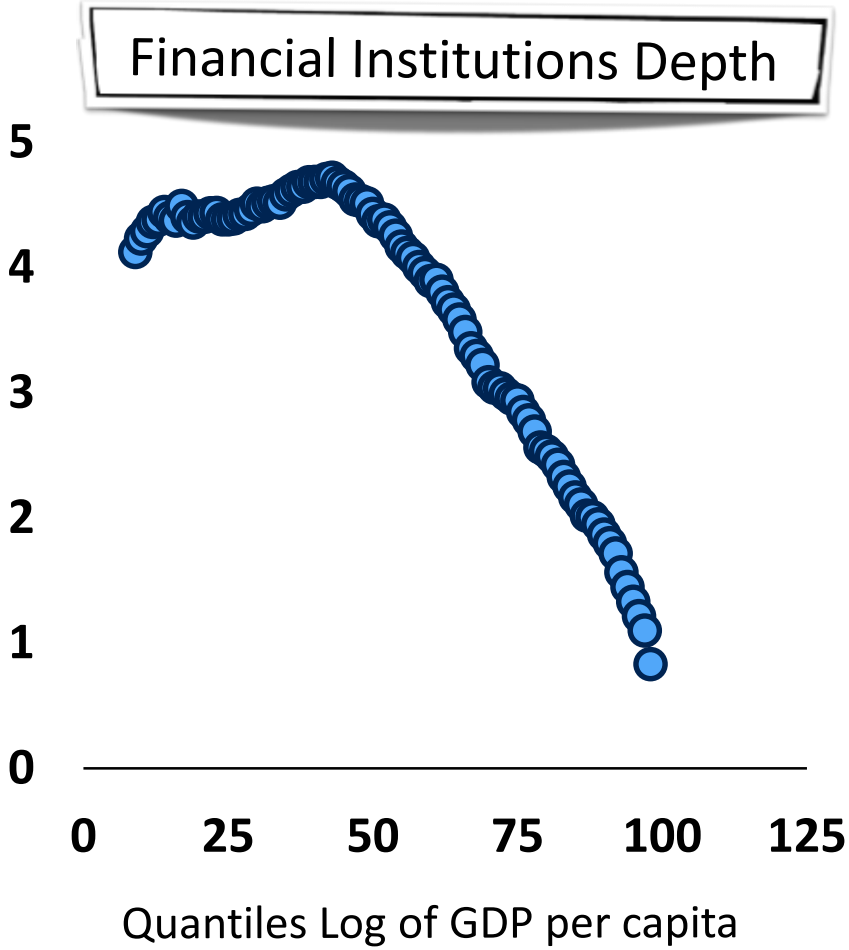
DOES PACE OF FINANCIAL DEVELOPMENT MATTER?

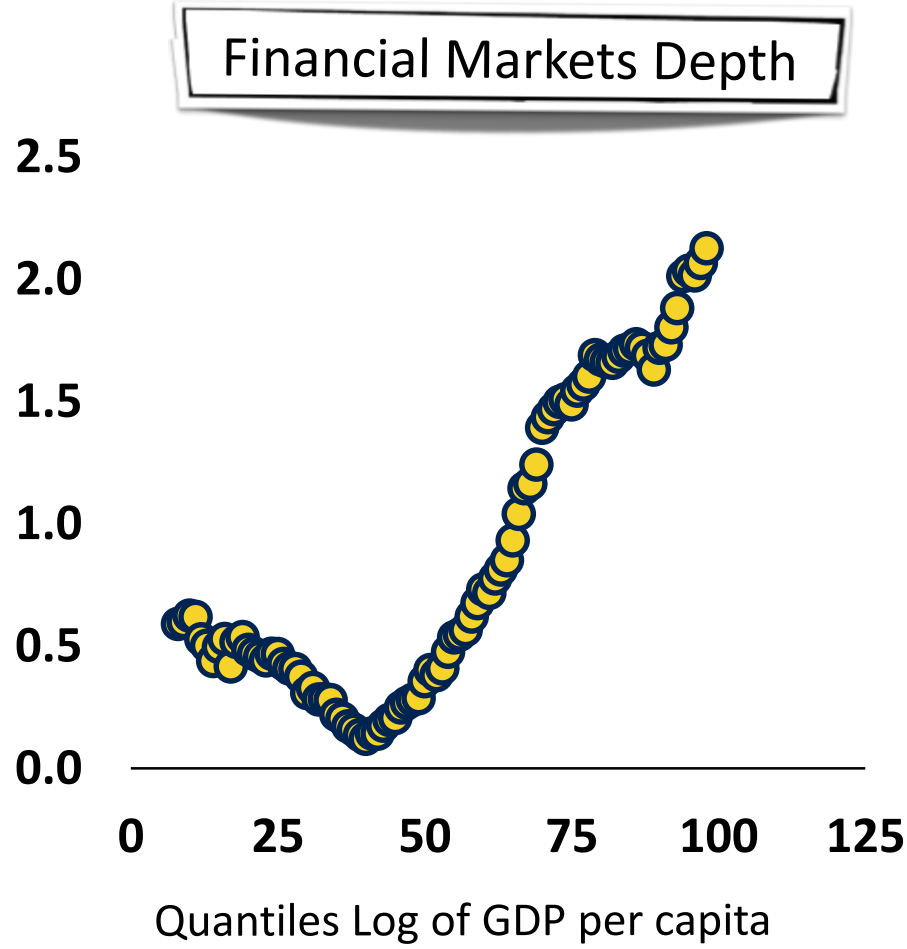
Deepening financial institutions too fast leads to instability



…consistent with boom-bust experience

WHAT DOES THE FINANCIAL DEVELOPMENT INDEX TELL ABOUT SEQUENCING?



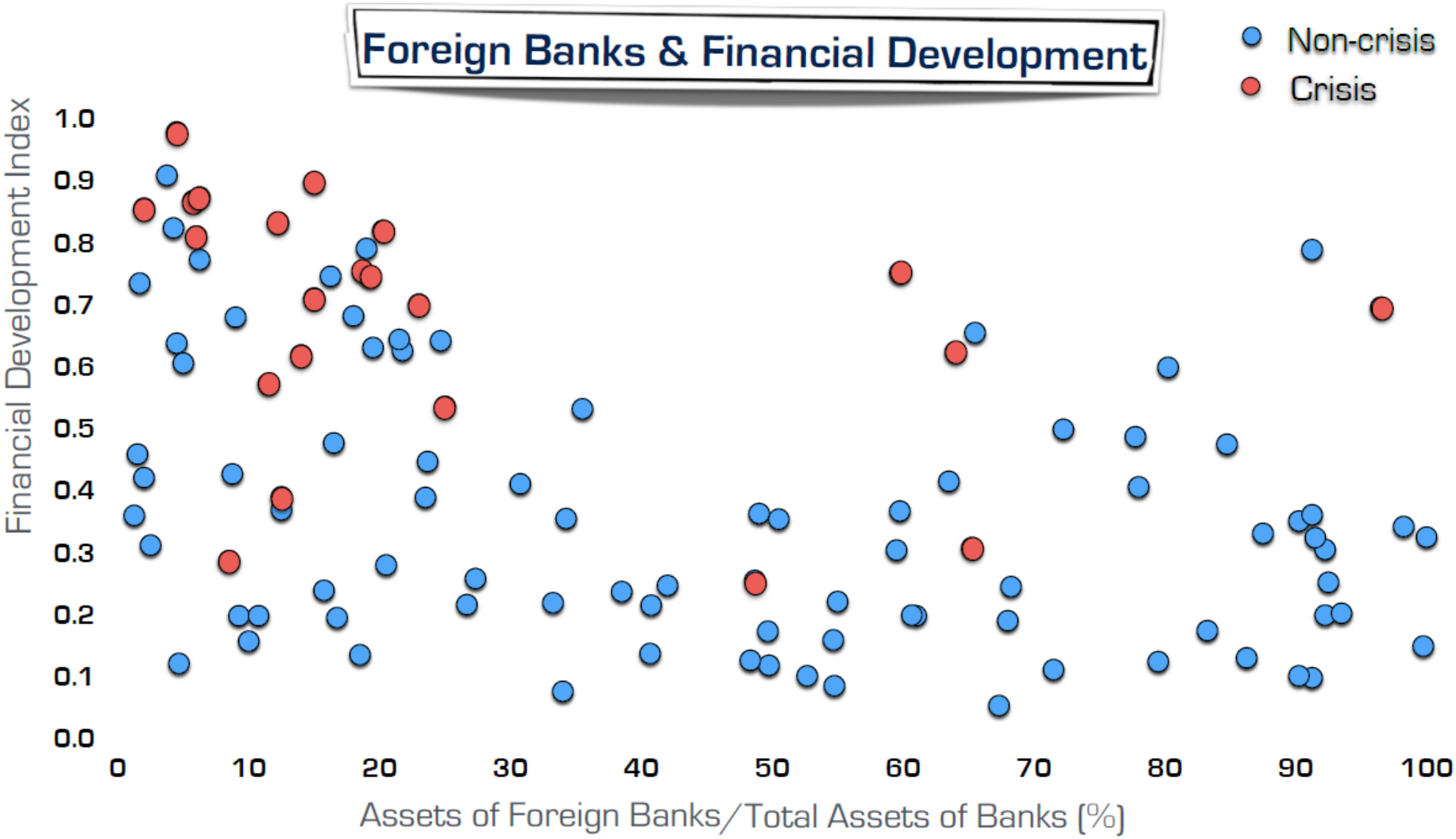


As income levels rise, marginal benefits from financial institutions decline and those from markets increase

FOREIGN BANK ENTRY

Neither a pre-requisite for financial development, nor a recipe for a crisis

(Averages 2006-10)

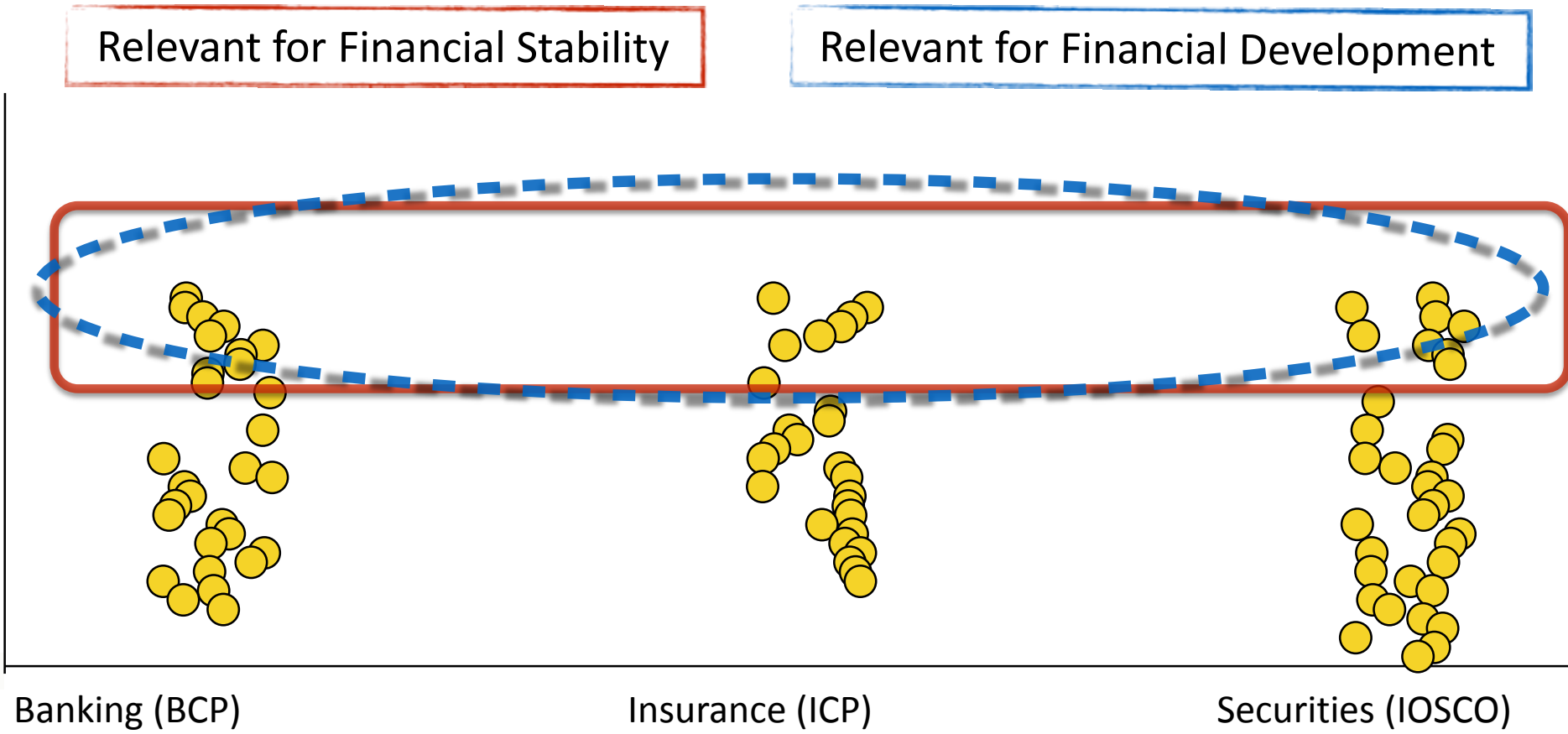


BUSINESS & REGULATORY ENVIRONMENT FOSTER FINANCIAL DEVELOPMENT

	FINANCIAL DEVELOPMENT INDEX	FINANCIAL INSTITUTIONS SUB-INDEX	FINANCIAL MARKETS SUB-INDEX
Property Rights (Heritage Foundation)	✓	✓	✓
Creditor Rights & Information (WB Doing Business)		✓	
Regulatory Quality (WB Governance)	✓	✓	✓
Rule of Law (WB Governance)	✓	✓	✓

DIGGING DEEPER

Regulatory principles that matter for financial development coincide with those that matter for financial stability



Of the 93 regulatory principles, one third are critical for both financial development & stability

- Ability of regulators to set and demand adjustments to capital, provisioning, and compensation
- Regulatory definitions of capital, nonperforming loans, loan losses
- Financial reporting and disclosures

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Zooming in on the Role of Financial Inclusion

FINANCIAL INCLUSION:

A Multifaceted Concept

Financial inclusion:
"Access to and use of formal financial services"

Financial institution access index

- **ATMs and commercial bank branches per 100,000 adults**

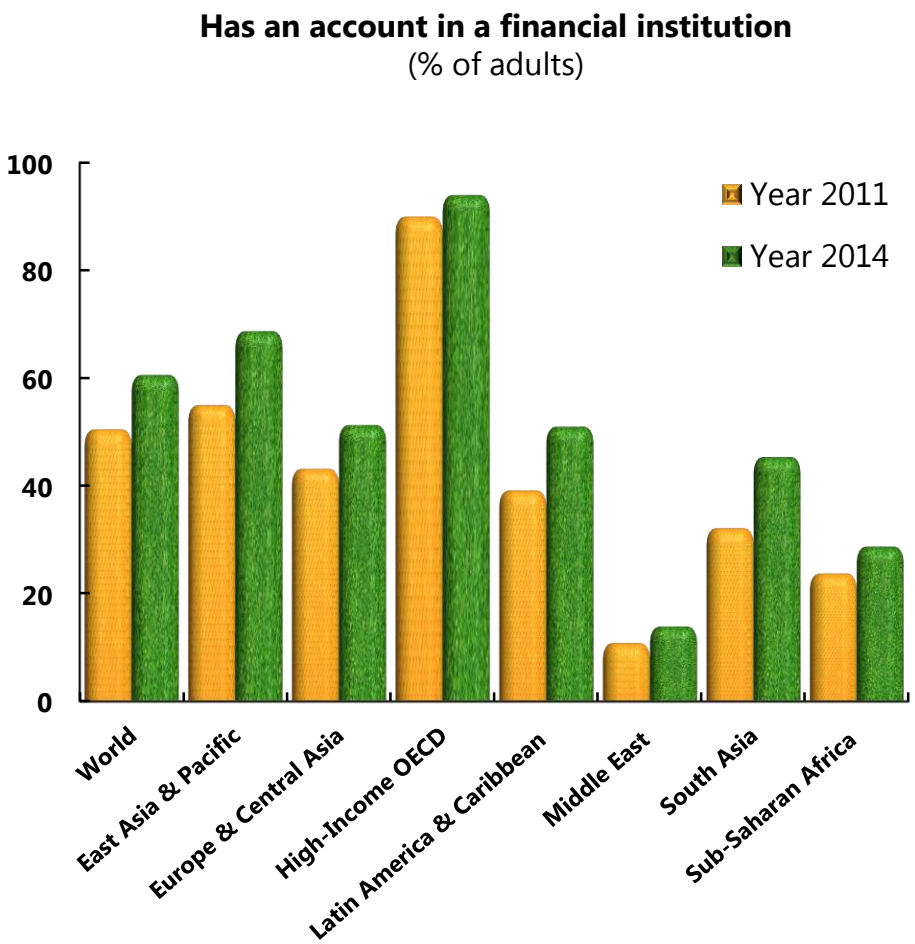
Users of financial services

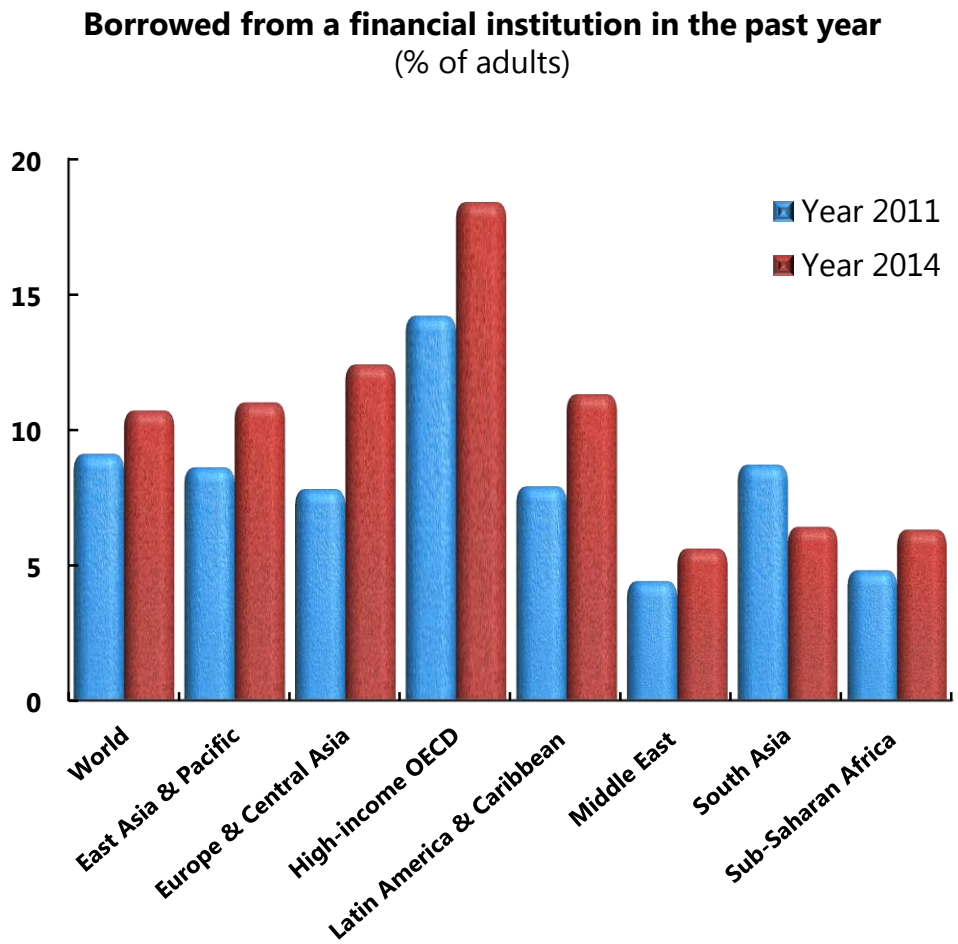
- **Accounts, including savings & mobile (adults, firms, women)**
- **Credit through financial institutions (by purposes, firms, adults, women)**
- **Wages & transfers through accounts (adults, women, income)**
- **Insurance**

Data: Sahay et al (2015), index based on Financial Access Survey (IMF) time series

Data: Financial Access Survey 2004-13 (IMF); Survey data on users for 2011 and 2014, Findex (World Bank); Enterprise Survey (World Bank) for firms for various years

IMPROVEMENTS BUT CONSIDERABLE GAPS

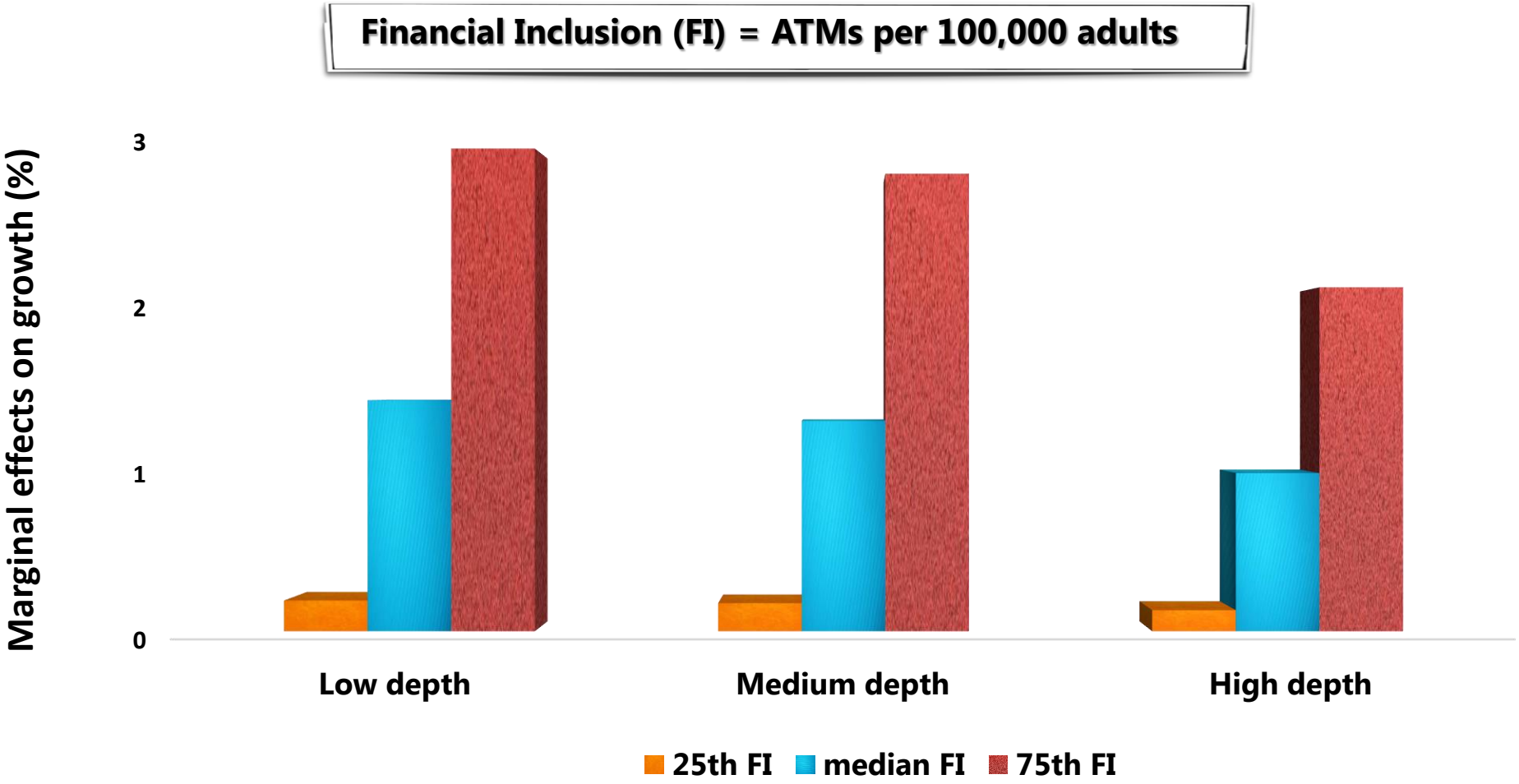




Source: Authors' calculations based on Global Findex data

FINANCIAL INCLUSION HAS CLEAR BENEFITS FOR GROWTH

although benefits decline with depth



TWO SILOS?

Financial inclusion

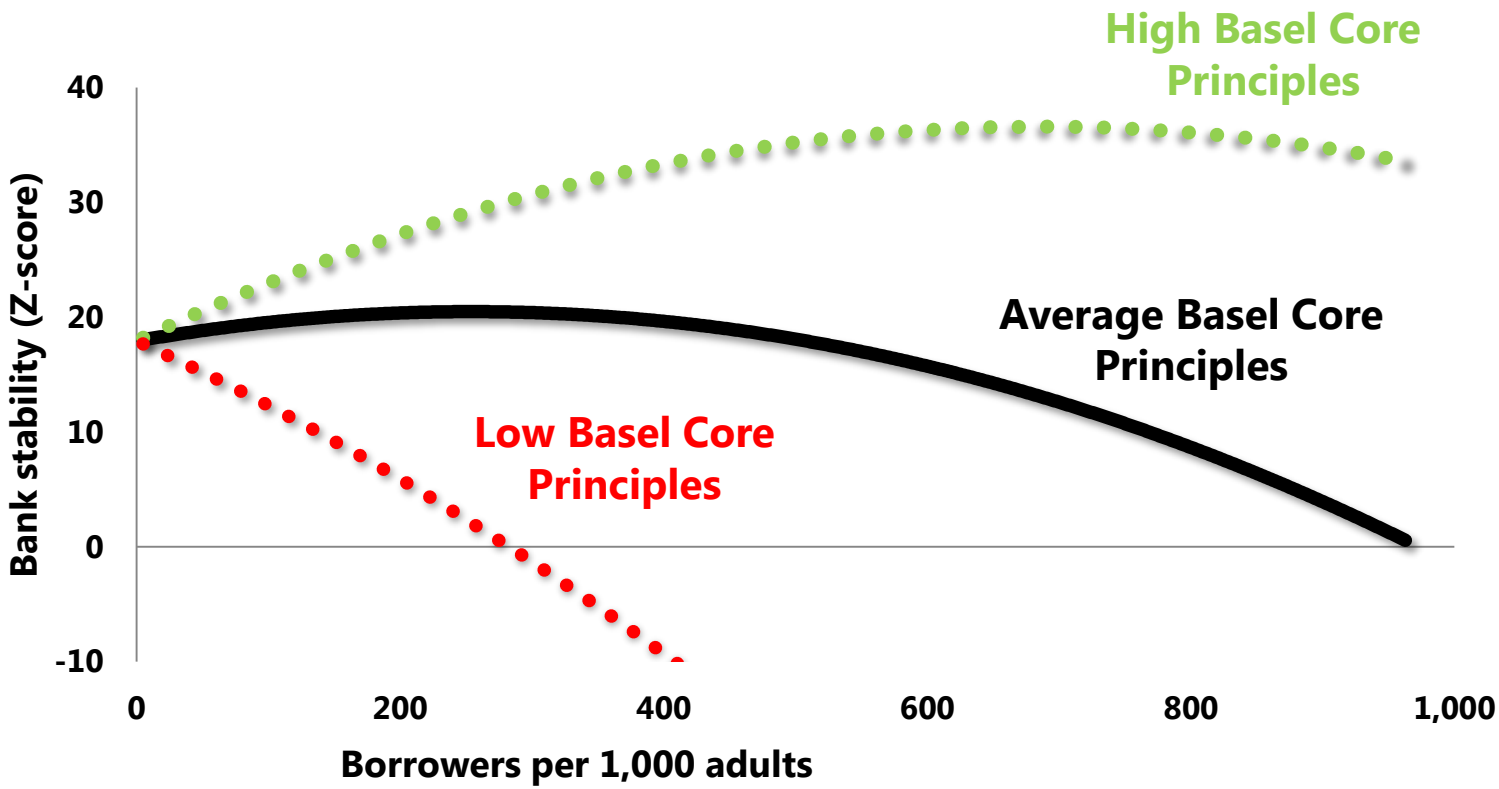
Financial stability

$$E[stable\&inclusive] = E[stable] + E[inclusive] + \boldsymbol{Cov[inclusive, stable]}$$

- The two outcomes are NOT independent -> need to address tradeoffs/synergies
- This nexus is influenced by financial openness, tax rates, education, population density, depth of credit information systems, and quality of reg. & supervision

Source: WB Working Paper WPS 7722

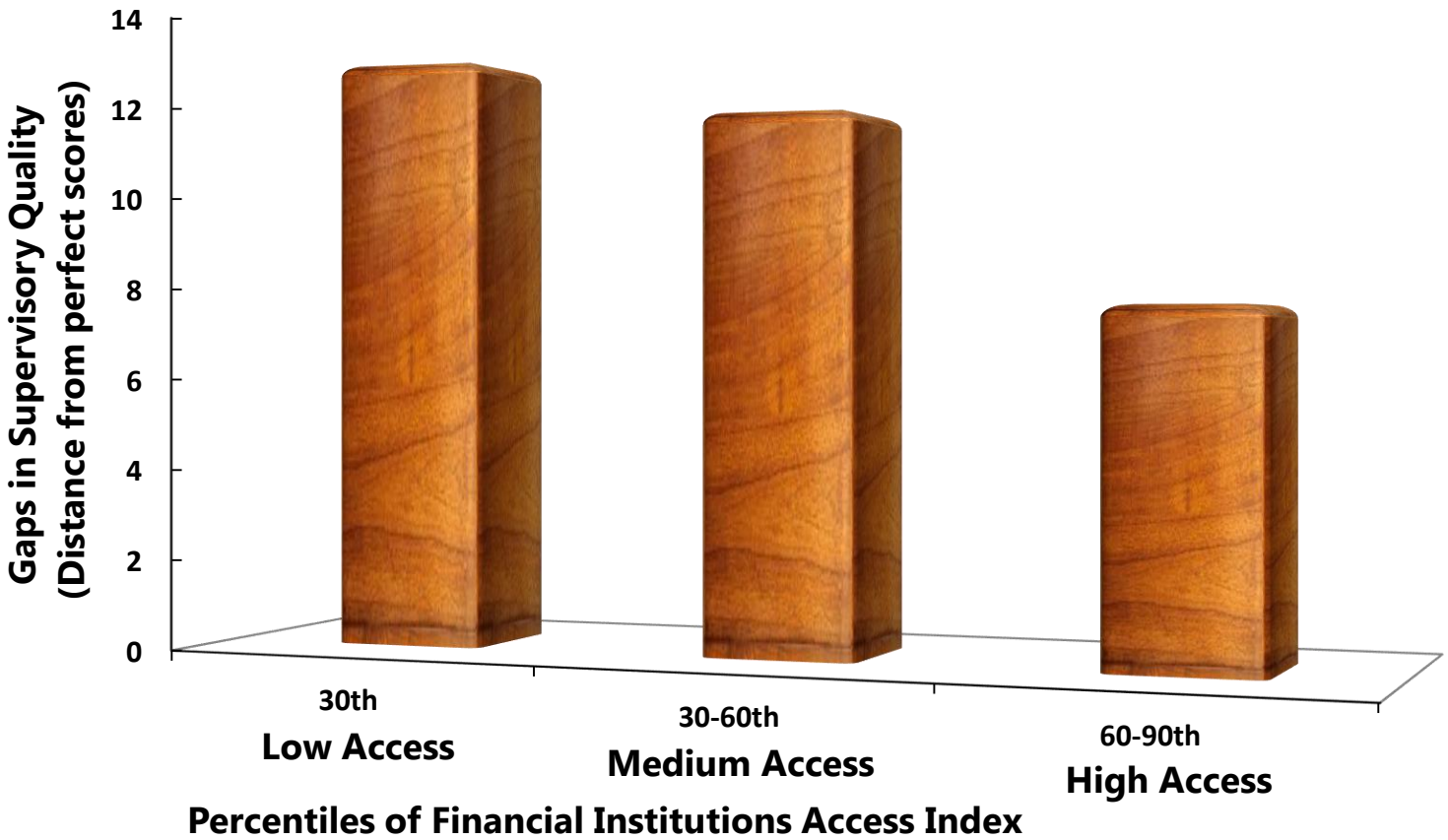
RISKS OF BROADENING CREDIT ACCESS WHEN SUPERVISORY QUALITY IS LOW



In contrast: increases in financial services other than credit do not seem to hurt stability
Key issue: proportionality in regulation and supervision of "institutions relevant to financial inclusion"
Note: Basel Committee has issued a new guidance on this issue in September 2016

Source: IMF Staff Discussion Note 15/17

SUPERVISORY QUALITY IS THE LOWEST WHERE ACCESS IS THE LOWEST



Source: Basel Core Principle (BCP) scores from the Financial Sector Assessment Program; Financial Institution Access Index from IMF SDN 15/8.
Note: BCP scores are aggregates for those relevant for financial inclusion. The bars represent the distance from perfect scores. For perfect BCP scores, the gaps are zero.

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Policy Implications and Discussion

POLICY IMPLICATIONS FOR FINANCIAL DEVELOPMENT IN LATIN AMERICA

1. Scope for further financial development for most EMs & all LIDCs (but a trade-off between stability & growth at high levels)

2. No "one-size-fits-all" in the sequencing of institutions & markets (though as economies evolve the relative benefits from institutions decline & from markets increase)

3. Foreign bank entry: neither a pre-requisite for financial development, nor a recipe for a crisis

LESSONS TO AVOID FINANCIAL CRISIS

1. Credit to GDP is not a sufficient measure of financial risks or development, a more comprehensive measure is needed

2. Financial inclusion is beneficial, but there can be "too much credit" if regulation & supervision do not keep pace with financial development

3. Of the nearly 100 regulatory principles, the same small subset are critical for both financial stability & development

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