

# Financial systems and financial policy

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# Purpose of this sequence 1/2

Financial systems  
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Introduction

The role of  
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Finance and  
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Finance and  
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Banks and  
markets

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Conclusion

- Take a step back on the role of finance in development
  - finance  $\implies$  growth
  - finance  $\implies$  redistribution
  - banks vs. markets
- Assess several dimensions of a financial system
  - stability of the banking sector / stock market
  - private sector financing (efficiency / procyclicality)
  - systemic vulnerabilities
- Discuss the relevance of the financial policy

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# Purpose of this sequence 2/2

## Example of Brazil

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In the Selected Indicators: credit to the private sector only, but

■ joint IMF - WB Financial Sector Assessment Program (FSAP)

	2005	2006	2007	2008	2009	2010	2011
Capital adequacy							
Regulatory capital to risk-weighted assets	18.1	19.0	18.8	18.3	19.0	17.7	17.3
Regulatory Tier I capital to risk-weighted assets	14.9	14.9	14.3	14.6	15.3	13.7	13.2
Asset composition and quality							
Sectoral distribution of loans to total loans							
Loans to households	43.6	44.5	45.0	46.8	43.8	46.5	43.5
Loans to non-financial corporations	47.8	47.5	47.5	45.4	48.5	45.6	48.0
NPLs to gross loans	3.5	3.5	3.0	3.1	4.2	3.1	3.5
Earnings and profitability							
Return on average assets (before tax)	3.2	3.1	3.5	1.6	2.4	3.2	1.5
Return on average equity (before tax)	29.4	28.7	32.0	14.3	22.0	28.9	14.0
Liquidity							
Liquid assets to total assets	40.1	37.1	38.2	35.2	34.7	32.0	32.1
Liquid assets to total short-term liabilities	125.7	111.2	114.1	114.2	118.0	102.4	110.8
Sensitivity to market risk							
Net open positions in FX to capital	1.6	-3.6	-5.8	-7.6	-6.8	-6.4	-8.0

# Financial institutions in DCs

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Conclusion

- The Central Bank / Regulatory entities
- Commercial banks
  - intermediation
  - monetary creation
- Stock markets
- Financial intermediaries
- Investment funds

# Course outline

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## 1 Introduction

## 2 The role of finance

- Finance and growth
- Finance and redistribution
- Banks and markets

## 3 Measuring financial development

## 4 Ex: Financial development in Africa

## 5 Financial policy

## 6 Conclusion

# Several aspects of the role of finance to discuss

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- Political, legal and regulatory effects on growth and development likely to dwarf the effects of the nature / shape of the financial system
- Finance may affect poverty and redistribution as well as growth
- Causality and reverse causality between finance and growth
- The nature of the financial system (banks vs. markets)

# Finance $\implies$ Growth?

## Should we even speak of finance?

- When corporations need it, finance follows (Nobel Prize Lucas)
- Finance may in fact play a lead role (Nobel Prize Miller)
  - 1 it helps produce information
  - 2 it facilitates transactions
  - 3 it diversifies risks
    - cross-sectional risk
    - intertemporal risk
    - liquidity risk
  - 4 it mobilises savings
  - 5 it monitors firms and exerts corporate governance

# What does the data say?

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- better functioning of markets  $\implies$  faster growth
- banks vs. markets does not seem to make any difference
- reverse causality doubtful (insufficiently taken care of)
- an essential mechanism seems to be that a domestic financial system raises the external financial constraint, which impedes firm and industrial expansion



# Finance, income distribution and poverty

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- An important question to
  - understand the process of economic development
  - secondary impact on growth through redistribution
- The possible mechanisms go both ways
  - financial intermediation should disproportionately benefit the poor (Galor Zeira 1993)
  - non-linear relationship between finance and income distribution



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Conclusion

- Gini coefficients fall more rapidly in countries with higher levels of FD
- income of the lowest quintile grows faster than the national average when FD is higher
- poverty falls more rapidly in countries with higher FD
- The previous results are robust to endogeneity tests

# Banks vs. markets

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Conclusion

- Different incentives for information gathering (Stiglitz 1985)
- Information centralization changes the negotiation position of finance vs. the firm (issue of the banker's interest)
- Flexibility with unconventional or original projects
- Corporate governance:
  - financial worth vs. economic growth – innovation and risk-taking
  - minority shareholders and the issue of control
- Banks may face management issues of their own

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- Richer countries: more developed financial systems – bigger and more active stock markets
- Developed financial sectors: market-based systems outperform bank-based ones, and conversely
- Overall: neither banks nor markets are better at
  - fostering growth
  - financing financially-dependent industries
  - increasing firm's financial access

- WB's Financial Development and Structure Database
- Size, activity, efficiency and stability of banks, nonbanks, equity and bond markets
- Main stylized facts
  - financial systems have deepened over the last decade
  - deepening concentrated in high-income countries (increase in international lending and bond issues)
  - global financial integration also deepened

- Size of the financial sector
  - liquid liabilities of the financial depth / GDP
  - currency outside the banking sector / base money
  - financial deposits / GDP
  - private bond market cap / GDP
- Credit allocation
  - private credit / GDP



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# Financial development

DCs vs. higher-income countries

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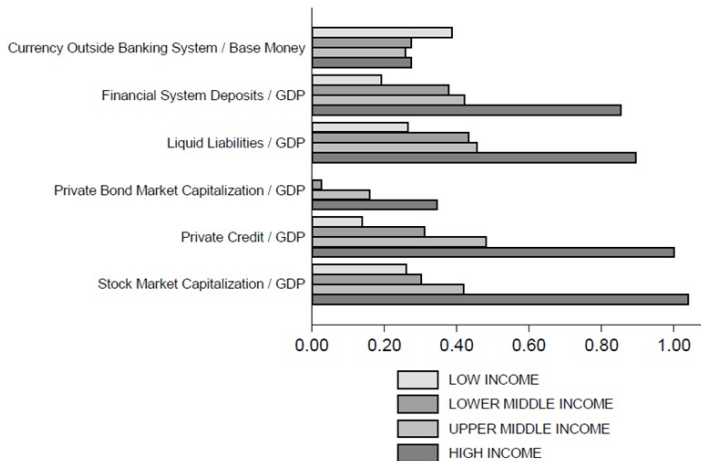
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# Financial development

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- Size, structure, efficiency of the banking sector
  - the banking sector is the largest part of the financial sectors in most countries, esp. developing and emerging markets countries
  - size: central bank assets to GDP, deposit money banks to GDP, other FI's assets to GDP
  - intermediation efficiency: bank credit to bank deposits
  - credit quality: NPL to total credit
  - structure: concentration
- Capital markets: market cap to GDP and turnover ratio





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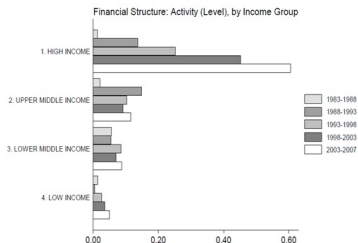
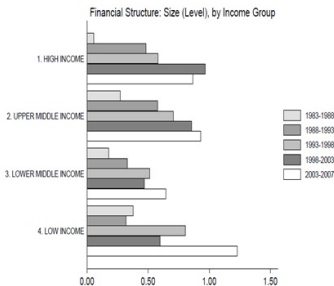
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- structure-size: stock market cap to bank credit
- structure-activity: stock market value traded to bank credit



# Small financial sectors, both in relative and absolute terms

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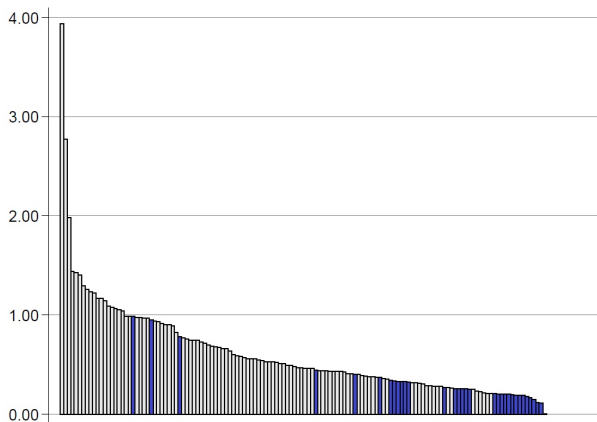
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Liquid liabilities to GDP, world, 2007. African countries are in blue



# Expensive financial sectors

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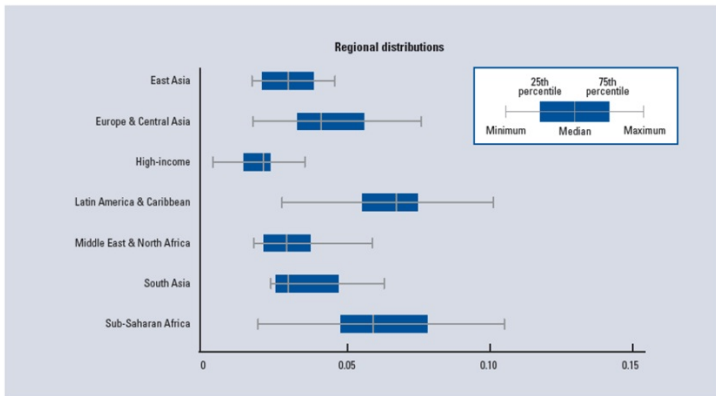
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Source: Beck and Demirgüç-Kunt, 2009.

Note: Sample size is 133 countries; data are for 2007. Net interest margins are calculated as net interest revenue divided by total earning assets.

# No stock market turnover

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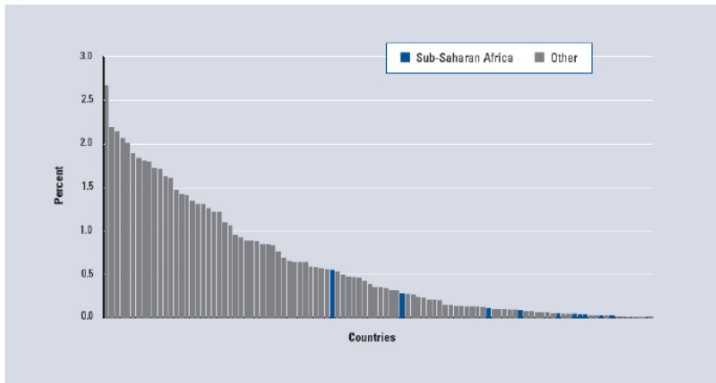
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Source: Beck and Demirgüç-Kunt, 2006.

Note: Sample size is 101 countries; data are for 2007 and indicate value traded relative to market capitalization. Countries in sub-Saharan Africa are marked with blue.

# Favourable trend / financial deepening

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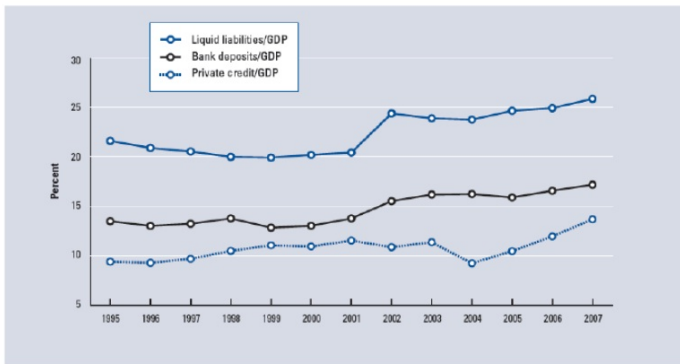
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Source: Beck and Demirgüç-Kunt, 2009.

Notes: This graph shows the median of liquid liabilities to GDP, bank deposits to GDP, and private credit to GDP across sub-Saharan Africa for each year.

# Bank ownership

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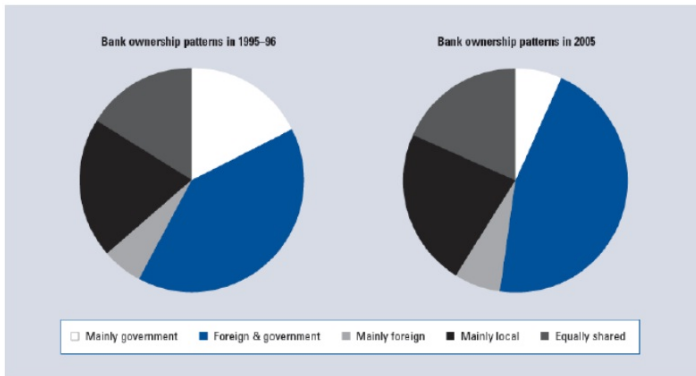
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Source: Honohan and Beck, 2007; authors' calculations.

Note: *Mainly government* (foreign, private) means more than 60 percent of total assets of the banking system are of this ownership form; *Foreign & government* means these two together hold more than 70 percent; *Equally shared* is a residual category.

# The effect of the foreign ownership of banks

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- What are the expected effects of foreign banks entry
  - can upgrade the general level of financial governance
  - can help transfer technology and experience
  - can help take advantage of economies of scale in DCs
- Cross-country evidence
  - better efficiency of foreign-owned banks in DCs
  - increased competitive pressure on the domestic banking sector
  - stabilizing effect, but risk of contagion

# The tools of financial policy

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## Possible tools include

- IR restrictions
- Forced credit allocation
- Minimum reserve requirements
- Full control through SO commercial banks
- statutory liquidity requirements





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# Usual suspects

## drivers of financial repression

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- force savings to drive industrialization
- political economy of the fiscal policy
- political economy of incumbent firms and banks

# The classical case against FR

McKinnon 1973 and Shaw 1973

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- credit rationing (government created, artificial)
- real IR depressing  $\implies$ 
  - reduces savings
  - hinders financial deepening
- investment suffers in quality and in quantity

# The initial experience of financial liberalization

Diaz-Alejandro (1985) "Good-bye financial repression, hello financial crash"

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The Latin American experience of financial liberalization after 1973:

- too high real IR (endogenous credit rationing)
- macroeconomic instability
- asset price bubbles
- deterioration of banks balance sheets
- systemic instability

Despite this, the Washington consensus. . .



# Today's consensus

World Bank 2005, "Financial liberalization: what went right, what went wrong"

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## Lessons of the 1990s

- Finance depends upon institutions
- Importance of macroeconomic stability
- Delays in policy implementation are costly
- Financial liberalization increases financial resources



# Financial policy in a liberalized context

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- monetary channels – in combination with fiscal policy
- credit channels
- wealth effect
- modifying uncertainty

# Operational conclusion

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Part 1 of the “supplementary document to the action fiche and payment dossier” organizes ‘key indicators’

- Credit to the private sector (GFSR)
  - recent evolutions / international comparison
  - CAR, NPL, provisions, RoA, RoE, systemic indicators
- Stock market depth / liquidity

Part 2 should mention financial policy

- Institutional quality
- Discuss financial liberalization / regulation
- Does policy address the financial system’s main vulnerabilities?