FRONTIER AND DEVELOPING ASIA: FINANCIAL SECTOR TRANSFORMATION

Well-managed financial deepening in Frontier and Developing Asia (FD Asia) can enhance macroeconomic stability by increasing resilience to external shocks and help promote and sustain inclusive economic growth. At the same time, the process of deepening itself can create new risks which need to be effectively managed. Countries in the region have implemented significant financial reforms over the past decades, including financial-market liberalization, bank privatization, and efforts to build the capacity of central banks and financial authorities to conduct prudential regulation and supervision of the financial system. The challenge now is for countries in FD Asia to balance the benefits and risks of further financial deepening.

Financial deepening refers to the process of enhancing and broadening financial systems by increasing the depth, liquidity, efficiency, and volumes of financial institutions and markets, diversifying domestic sources of finance, and extending access to banking and other financial services.

I. WHY FINANCIAL DEEPENING?

Limited financial system depth and breadth can pose challenges for maintaining macroeconomic stability and promoting growth and reducing poverty and inequality, issues of concern to policymakers in FD Asia. Financial deepening enables larger investments, included in much-needed infrastructure, and more productive allocation of capital, leading to higher economic growth. But the benefits extend beyond financing investment and include better and cheaper services for saving money and making payments, and financing for enterprises. These allow firms and households to reduce transactions costs, and provide the opportunity to accumulate assets and smooth income, thus reducing poverty and inequality.

Deeper and more diversified financial systems can help increase resilience to shocks and help countries mitigate macroeconomic volatility through different channels. This is of particular concern as many countries in frontier and developing Asia and the Pacific are vulnerable to external shocks, such as sharp swings in the terms-of-trade and fluctuations in external demand.

IMF research shows that shallow financial systems can limit fiscal, monetary, and exchange rate policy choices, hamper macroeconomic policy transmission, and impede opportunities for hedging or diversifying risk. For instance, limited development of financial markets constrains the use of market-based instruments (OMO, FX operations, REPO, FX swaps). FD Asia countries tend to rely on direct instruments and rules-based instruments (RR, statutory liquidity requirements) than emerging Asia countries. Shallow financial markets may lead to more procyclical fiscal policy, and larger crowding out effects. Similarly, the lack of forward exchange rate markets in some FD Asia countries can constrain exchange rate flexibility.

FD Asia countries have become substantially more financially integrated internationally over the past two decades. A high degree of financial integration can confer significant benefits in terms of economic growth and risk sharing, and even help develop the financial sector and deepen capital markets. However, the volatility of capital inflows can create challenges for macroeconomic and prudential policy. These issues are likely to become more pressing in FD Asia as countries further liberalize their capital accounts.

II. Stylized Facts

Financial systems in FD Asia remain bank-based but have deepened significantly, as proxied by the growth in banking system intermediation and deposits in recent decades, albeit with considerable heterogeneity across countries. In line with the rapid growth in credit to the private sector, intermediation efficiency (as proxied by the loan-to-deposit ratio) has increased in recent years, and net interest margins have declined to levels observed in emerging market countries. FD Asia countries have sizable presence of state-owned banks (even in comparison to other low-income countries), mostly with lower capitalization and asset quality.

However, financial systems are relatively undiversified as compared to emerging markets in the region. While equity markets have grown in size in recent years, turnover is low and markets are vulnerable to large corrections. Bond markets remain nascent, with secondary market activity a fraction of what is observed in emerging market countries in the region.

Financial inclusion has broadened, but the use of formal financial services remains limited in comparison to emerging Asia, with implications for poverty reduction and the inclusiveness of growth. For instance, use of banking services by households, as measured by the number of deposit and loan accounts and mobile phone usage for payment services, trails emerging markets in the region. Similarly, lending to domestic investors continues to be focused overwhelmingly on larger borrowers, with small and medium-sized enterprises continuing to have inadequate recourse to formal financial lending.

Some countries in the region have financial systems that are smaller than predicted by their structural characteristics (such as level of economic development, population density, demographic characteristics). Some other countries in the region such as Vietnam and Nepal, however, have witnessed a rapid increase in deepening, which poses risks to financial stability. As evidenced from the experience of emerging markets during the Asian crisis, and the experience of advanced economies during the global financial crisis, rapid deepening can fuel credit and asset price booms and can have destabilizing macro-economic effects, particularly in the absence of appropriate financial oversight and policies.

III. How to Spur Financial Deepening?

The previous slides highlighted stylized facts about financial deepening in FD Asia, showing how these countries have made progress over time, but still lag far behind emerging Asia countries. The question then arises: how far can (and should) FD Asia countries deepen their financial systems? What factors are holding back financial deepening?

The first step is to define how financial deepening comes about, as interplay between factors that limit the provision (supply) of financial services and those that affect demand for these services. On the demand side, lack of financial literacy, high macroeconomic instability or high degree of informality can be factors, while on the supply side, the costs of providing services, limited investor base, lack of reliable creditor information and weak collateral regimes, for example—are key barriers.

Country experiences from successful efforts to deepen and broaden financial systems and increase access to financial services suggests a number of policies matter for financial development:

- Macro-stability (as a pre-condition to increase demand for and supply of financial services
- Structural and institutional reforms aimed at fostering deepening (such as addressing scale barriers through competition and regional arrangements; strengthening informational and contractual frameworks (collateral development); and removing distortions (directed credit and barriers to entry))
- Policies to ensure oversight and risk management to reap the benefits of deepening (widening regulatory parameter to encompass non-bank entities; calibrating financial liberalization with oversight capacity; ensuring cross-border risk management; and consumer protection).

Questions:

- What factors constrain financial sector deepening?
- What types of policies are needed to build a sound and vibrant financial sector that avoids excessive risk taking?
- What challenges do you face in implementing these policies?