Growth Research Programme

Financial barriers to economic growth in low-income countries

Phyllis Papadavid, Johan Rewilak, Natalie Brighty

May 2017

Key messages:

1. Many low-income countries, particularly in sub-Saharan Africa, remain financially under-developed, which is compromising their growth prospects.

2. Even in countries where financial development has occurred, the positive effects associated with development, and with financial deepening in particular, are not being seen to the extent expected. Financial development is no longer necessarily leading to growth.

3. Deregulation and financial crises have been offered as explanations for the lack of growth, but financial fragility is also a likely, although under-researched, possibility.

This brief provides context and policy-relevant analysis of the DEGRP-funded research project *Politics, Finance, and Growth*. Led by Svetlana Andrianova of the University of Leicester, the research investigated why many developing countries are experiencing low levels of economic growth, with a focus on how politics and finance affect pro-poor growth.

Financial development and economic growth

Finance is crucially important for developing countries. A well-functioning financial system is essential for economic growth, providing financial intermediation that boosts investment, transaction services that support firms and households, and tools to mitigate risk and guard against volatility at both the individual and national level.

The healthiest financial systems are typically characterised by four key elements: high levels of financial depth, or the volume of financial transactions occurring in the system; inclusive financial market access, meaning a range of financial services are accessible to firms and households of varying sizes and income levels; high levels of banking sector efficiency, where financial institutions allocate credit to the most productive parties at the lowest cost possible; and financial stability, meaning the financial system is resilient to negative shocks.

Financial development – the combination of these elements – is important for growth and, more importantly, pro-poor growth. Countries with higher financial development experience faster reductions in income inequality (Beck, Demirgüç-Kunt and Levine, 2007).

More specifically, financial deepening can reduce growth volatility by alleviating liquidity constraints on firms and facilitating long-term investment (Aghion et al., 2010).

As for market access, availability of diverse forms of finance is positively associated with entrepreneurship and higher firm entry, as well as with growth in innovation. Greater access to finance also allows firms to exploit investment opportunities, thus boosting growth (Beck, 2013).

Despite the importance of a robust and well-rounded financial system, many developing countries, particularly in sub-Saharan Africa, remain financially under-developed. Banks continue to lend little domestically and access to commercial finance, via bank deposits, remains low in the majority of low-income sub-Saharan African economies.

Yet even countries where financial development has occurred are not seeing as much growth – and particularly inclusive growth – as might be expected. Several explanations have been put forward, including the suggestion that low growth is a result of deregulation, or of successive banking crises.

An alternative but likely explanation is that the financial systems in these countries are 'fragile' in numerous ways, and that it's this fragility that is eroding the previously observed link between finance and economic growth (Demetriades et. al, 2016).

The DEGRP research

Aims

To test this hypothesis, the project team developed the following aims:

- to identify and examine financial systems that are not performing effectively across developing economies, particularly in Africa; and
- to create measures of financial fragility at a country level that can then be used to address specific questions about the relationship between financial fragility and economic growth.

In addition, the research project also sought to contribute to existing understandings of the finance-growth relationship by analysing the consequences of banks' profit-seeking behaviour on broader financial instability, and the effect of different types of financial reforms on bank soundness.

Methods

A range of methods were used in pursuit of these aims. A cross-sectional regression analysis was carried out on data from the World Development Indicators database and other sources to assess the importance of both financial liberalisation and financial deepening on the growth rate of real per capita GDP (Demetriades and Rousseau, 2015).

Additionally, to understand where and why inclusive growth has stalled, researchers analysed data from financial institutions in 124 countries spanning over a decade, (Demetriades et al. 2015), as well as creating and testing theoretical models using household-level data on income (Bumann and Lensink, 2013).

From their analyses, the team developed a set of eight country level measures of financial fragility indicating different vulnerabilities in the financial system. Data corresponding to these indicators from their financial institutions analysis was then collated into a new financial fragility database, which was subsequently used as a tool for the investigation of questions such as:

- does financial liberalisation lead to financial fragility?; and
- does making the financial system more inclusive – in particular extending access to the poor – reduce or increase fragility?

Particular attention was paid to the question of whether fragility is a predictor of financial crises, and also whether it can negatively affect growth even in situations where crisis has been avoided.

Findings

The research has yielded several important findings, advancing understandings of financial sector development both in terms of its beneficial impacts on growth and development, and its negative impacts in the increased incidence of financial crises.

Key findings include:

- Countries with low levels of financial fragility are less susceptible to experiencing financial crisis as a result of large inflows of foreign capital.
- Financial depth is no longer a significant determinant of long-run growth: financial reforms can have sizeable growth effects, which can be positive or negative depending on how appropriately banks are regulated and supervised.
- Financial fragility is shown to have a negative impact on economic growth above and beyond the negative effect that occurs due to a financial crisis: even if a financial crisis is avoided financial fragility is harmful to economic growth.
- Greater financial inclusion, or access to affordable finance, particularly for households, is shown to reduce financial fragility, therefore promoting financial inclusion may have beneficial impacts to the safety of the financial system.
- Policies aimed at increasing the size of the financial sector should not be considered ‘one-size fits all’, particularly where the welfare of the poor is at stake. While financial development may be beneficial in raising the incomes of the poor in certain regions, it has been shown to reduce it in others.
- While a high rate of loan defaults typically reduces bank lending in Africa, once a certain level of institutional development is reached, variations in the loan default rate do not significantly impact underlying trends in bank lending.

Implications

The project has contributed to a greater understanding of how financial fragility can, in some instances, contribute to the breakdown between finance and growth in LICs. The project’s database on financial fragility for 124 countries from 1998 to 2012 contains a variety of financial indicators that allows for richer analysis and has been used to fruitfully address several issues.

In sub-Saharan Africa, though there has been limited understanding as to why financial systems have performed poorly, the project findings evidence that regional high default rates limit future credit supply thus preventing future lending and investment.

In the light of the findings pertaining to the role of financial fragility, the work of the research project has shown that strengthening institutions may be one way to overcome this issue. For example, in comparing the role of financial deepening and financial access in India, the research shows that their synthesis in rural areas contributed to poverty alleviation.

Key project outputs

Recent outputs from the project include:

- Andrianova et al. (2017) 'Ethnic Fractionalization, Governance and Loan Defaults in Africa', *Oxford Bulletin of Economic Statistics* (early online version).
- 'The changing face of financial development (2016) Panicos Demetriades and Peter L. Rousseau. *Economics Letters*, Vol. 141, pp 87–90.
- Andrianova et al. (2015) 'A New International Database on Financial Fragility' (2015), Working Paper No. 15/18, Leicester: University of Leicester.

For more, and access to the financial fragility database, visit the project website.

Wider relevance

The need for effective financial development is likely to persist, particularly for LICs, given their ongoing vulnerability to economic and financial shocks. Policy reform for financial development should therefore continue to be a priority, especially for LIC governments, although policy reform is also necessary at the international level.

Long-term policies should focus on institutional change. There is a need for institution building, and of particular importance is support for and fostering of information networks and contractual frameworks at a microeconomic level.

Additionally, there is a need to understand and facilitate growth in different segments of the financial system including banks, capital markets and contractual savings institutions, bearing in mind the changing needs for financial services in a developing economy. And, although 'long-term finance' has seen limited research, its development can be seen as critical to improving and deepening shallow financial markets in many developing countries.

Policymakers need to target the channels and mechanisms through which financial deepening, in its different forms, can influence and transform the real economy, particularly considering that these channels might vary across different levels of economic, financial and institutional development. While there are several indications that finance can contribute to structural transformation, more research in this area is needed. Such structural transformation can have important distributional consequences. Additionally, the relationship between finance and distribution of opportunities is still to be researched (Beck, 2013).

Adequate financial development matters when it comes to facing the challenges of globalisation. As developing countries liberalise and open their economies, it is important they do so in a sustainable fashion, with well-regulated and inclusive financial markets. Meeting these criteria will help ensure that the benefits of finance-led globalisation are evenly distributed, that income inequality in developing countries is reduced, and that the likelihood of financial and economic shocks as a result of liberalisation are minimised.

When accompanied by financial deepening, liberalisation measures, such as loosening of reserve requirements or of capital controls, can be associated with lower levels of income inequality (Bumann and Lensink, 2013). China, for example is likely to continue to pursue slow and steady liberalisation in order to mitigate the likelihood of crisis (Papadavid, 2016). This follows previous liberalisation successes in other large emerging economies such as India, where in 1991, such a process was embedded in a period of financial deepening that subsequently reduced poverty rates among the rural self-employed through fostering entrepreneurship (Ayyagari et al, 2013).

References

Aghion, P., Angeletos, G.-M., Banerjee, A. and Manova, K. (2010) 'Volatility and Growth: Credit Constraints and the Composition of Growth'. *Journal of Monetary Economics* 57: 246 – 265.

Ayyagari, M., Beck, T. and Hoseni, M. (2013) 'Finance and Poverty: Evidence from India'. CEPR Working Discussion Paper 9497. Available online at: https://assets.publishing.service.gov.uk/media/57a08a54e5274a27b200053f/61070_Finance_Poverty_India.pdf

Beck, T., Demirgüç-Kunt, A. and Levine, R. (2007) 'Finance, Inequality and the Poor'. *Journal of Economic Growth* 12: 27– 49.

Beck, T. (2013) 'Finance for development: A research agenda'. DEGRP Research Report. London: DFID-ESRC Growth Research Programme, Overseas Development Institute.

Bumann, S. and Lensink, R. (2013) 'Financial Liberalisation and income inequality: channels and cross country evidence'. Working paper for DFID-ESRC project 'Politics, Finance and Growth'. Available at: https://assets.publishing.service.gov.uk/media/57a08a3de5274a31e00004d2/61070_BaumannLensink.pdf

Demetriades, P., Fielding, D., and Rewilak, J. (2015) 'A new international database on financial fragility'. *Voxeu.org*. Available online: http://voxeu.org/article/new-international-database-financial-fragility.

Demetriades, P. and Rousseau, P. (2015) 'The changing face of financial development' University of Leicester Working Paper. Online: http://www.le.ac.uk/economics/research/RePEc/lec/leecon/dp15-20.pdf?uol_r=d307e306.

Demetriades, P., Rousseau, P., and Rewilak, J. (2016) 'Finance, growth and fragility', University of Leicester Working Paper. Online: https://research.aston.ac.uk/portal/files/21806804/FINANCE_GROWTH_AND_FRAGILITY_Demetriades_et_al._2017_WP.pdf

Papadavid, P. (2016) 'China's balancing act'. ODI research report. London: Overseas Development Institute. Available online at: https://www.odi.org/publications/10268-chinas-balancing-act

Authors

Phyllis Papadavid is Senior Research Fellow – Team Leader in the Overseas Development Institute's International Economic Development Group.

Johan Rewilak is Lecturer in economics at Aston Business School, and was a co-investigator for the Finance, Politics and Growth project.

Natalie Brighty is Communications Officer for the DFID-ESRC Growth Research Programme.

Research jointly supported by the ESRC and DFID