DEVELOPING FINANCIAL SECTORS IN LOW-INCOME COUNTRIES

THORSTEN BECK
THE WORLD BANK

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Financial sector reforms

- Transition to market-based efficient and stable financial system requires an array of reforms and policies
- Focus on which area?
- Prioritizing, sequencing?
- Trade-off between development and stability?
Taxonomy of reforms (1)

- Financial Market Frontier = constrained optimum given state variables
  - Evaluate financial system according to country-level “state” variables
- Market-developing policies
  - Create conditions for efficient and stable financial markets
  - Long-term institutions building
- Market-enabling policies
  -Operate within current institutional framework and constraints
  - Push financial markets to maximize current conditions
- Market-harnessing policies
  - Policies to avoid that financial markets move beyond the frontier
  - Prevent banking crisis
Taxonomy of reforms (2)

- Market-developing policies
  - Move towards private ownership in financial and real economy
  - Stable macroeconomic environment
  - Effective contractual framework
- Market-enabling policies
  - Encourage foreign bank entry
  - Move towards market-based interest rates
  - Specific institutions (asset registries, credit registry)
- Market-harnessing policies
  - Market-based regulation and supervision
  - Incentive-compatible financial safety net
Policy conclusions from taxonomy

- What is the binding constraint?
  - Low frontier
  - Far away from frontier
  - Beyond frontier
- Design policies accordingly
- Development/stability focus depends on where the financial system stands
Interdependence of reforms – an Asian example

- Bangladesh has undertaken wide-ranging financial sector reforms
  - Allowing in private domestic banks
  - Liberalized interest rates
  - Built credit registry
  - Moving away from government-owned banking
  - ...

- But: Government still intervenes strongly in banking system
  - Corrupt licensing process
  - Implicit guarantee for depositors and owners
  - “Strong” (interventionist) regulatory and supervisory approach

- Constraints on financial markets
  - Excessive risk taking
  - Political interference
  - Undermines competition
  - Prevents system to move towards an open, arms-length economy
Policy conclusions

- Divestiture of SOCB necessary but not sufficient condition
- Complimentary:
  - Eliminate implicit guarantee
  - Authorities as facilitator not operator of financial system
  - Build market-based regulatory and supervisory system
- More general debate on moving from relationship-based to arms-length economic system
- Does not imply a laissez-faire approach, but a new and important role for government in enabling and creating markets