# Advancing Financial Development in Latin America and the Caribbean

By Anna Ivanova

November 18, 2015

In recent years, Latin America and the Caribbean countries have made significant efforts to develop their financial systems. But the region lags behind emerging market peers, especially in financial market development.

Our new study examines the current state of financial development in Latin America, as well as implications for potential growth and stability from further development. From today's vantage point, further financial development would likely convey benefits to the region, provided there is adequate regulatory oversight to prevent excesses.

**Measuring financial development**

Financial development is difficult to measure. As globalization has progressed, traditional measures such as the ratio of private credit to GDP and stock market capitalization (value of stocks outstanding at their current share price in percent of GDP) are too narrow to capture the broad spectrum of financial sector activities.

To better capture different facets of financial development, we use a new comprehensive and broad-based index developed by the IMF, with some modifications. The index contains two major components: financial institutions and financial markets, each broken down into access, depth, and efficiency sub-components.

**Where does the region stand?**

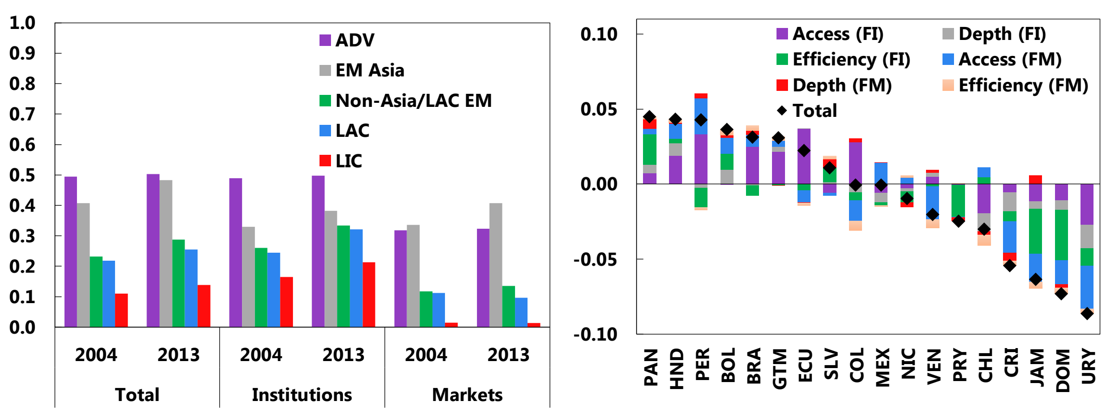
Overall, countries in Latin America lag other emerging markets with respect to financial development. But these results vary by component. Latin America scores higher on financial institutions than on markets. It excels, in particular, on access to financial institutions, reflecting strong policy efforts on inclusion, which expanded bank and ATM networks. Even so, the region fares worse on depth and efficiency of financial institutions as well as all market components when compared to other emerging market regions. Moreover, financial development varies substantially across countries. Chile and Brazil followed by Peru, Colombia, and Mexico are on top of the list. Nicaragua, the Dominican Republic, and Paraguay score low on the index.

**Remaining financial development gaps**

Financial development gaps—the deviation of the financial development index from a prediction based on economic fundamentals, such as income per capita, government size, and macroeconomic stability—can help identify potential under or overdevelopment for individual Latin American countries, compared to countries with similar fundamentals. These gaps suggest that for most Latin American countries the current stage of financial development is not fully aligned with their respective macroeconomic fundamentals (see Chart 1).

The most common negative gaps are on institutional efficiency and depth as well as market access and efficiency. These can reflect a variety of factors, for example, financial systems that experienced crises in the more recent past may still be in recovery mode (for instance, the Dominican Republic), or they can also reflect distortions such as a weak framework for obtaining or seizing collateral (for example, Peru). Positive gaps could reflect potential excesses or inefficiencies (for example, Bolivia's use of regulated interest rates and credit quotas for certain sectors or Honduras' rapid credit growth fueled by consumption).

**Chart 1. Financial Development by Region and Financial Development Gaps**




**Source: IMF staff calculations.**
**Note: ADV = advanced economies; EM Asia = emerging Asia; Non-Asia/LAC EM = emerging market economies excluding Asia and LAC; LAC = Latin America and the Caribbean; LIC = low income countries.**

**Source: IMF staff calculations.**
**Note: FI= financial institutions; FM = financial markets.**

## Potential gains

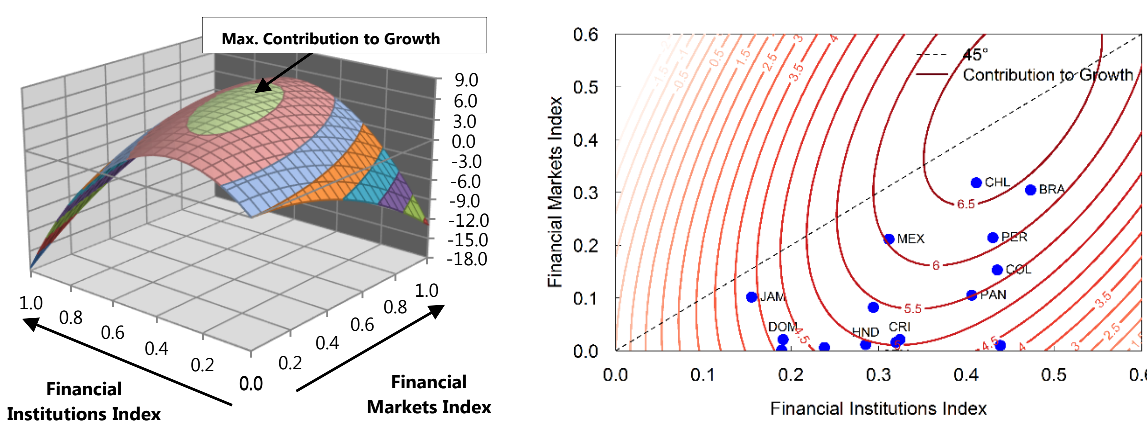
Financial development gaps, however, do not address the question of the optimal level of financial development in terms of growth and stability. To explore this question, we examine relationships between financial development and growth as well as financial development and stability. We find that these relationships are nonlinear. In other words, the benefits from financial development are rising at the early stages of development as resources are increasingly channeled into productive uses. However, there is a turning point beyond which the positive growth benefits diminish. Similarly, at the early stages, financial development can help reduce instability, for example, by providing insurance services, but these benefits also start to diminish after a certain point.

The turning points likely reflect the fact that large financial systems can divert resources from productive activities, while excessive borrowing and risk-taking by financial institutions can lead to increased instability and lower long-term growth. Indeed, the inverted U-shape relationship with growth is driven by the depth of financial institutions, or a measure of size. Access and efficiency, on the other hand, yield unambiguously increasing benefits to growth, although with potential stability costs as reduced bank profitability may encourage risk-taking.

Lastly, too much market development at the early stages of institutional development may have negative implications for stability. One reason for this could be increased market volatility, which dominates when financial institutions are not strong enough to help guard against shocks. For similar levels of development, however, institutions and markets are complementary for growth and stability.

Most Latin American and Caribbean countries have not yet reached the levels of institutional and market development that yield maximum benefits to growth and stability (see Chart 2). Brazil and Chile are closest to reaping those benefits, whereas the Dominican Republic, Paraguay, and Honduras lag behind.

**Chart 2. Financial Institutions and Market Development, and Economic Growth**




**Source: IMF staff calculations.**
**Note: surface shows the predicted effect in growth for each level of the indices, holding fixed other sets of controls.**

**Next steps**

Countries should explore policies tailored to their own circumstances and that aim to remove distortions in the short term when macroeconomic fundamentals are difficult to change.

- In this regard, identifying and addressing potential distortions behind negative financial development gaps should be a priority. For example, negative gaps could mirror weaknesses in institutional and legal frameworks for property rights and collateral or inefficiencies of courts or credit reporting systems.

- In turn, identifying and addressing potential excesses or inefficiencies behind positive gaps could also be important. If excesses are identified, steps to reinforce supervisory vigilance and/or strengthen macro-prudential policy frameworks may be in order.

In the longer term, as fundamentals continue to evolve, Latin American countries could benefit from further financial development in terms of growth and stability, provided there is adequate regulatory oversight to prevent excesses. The process, however, is likely to be gradual and iterative with income growth supporting financial development and vice versa. In the process, care should be taken not to promote excessive market development when financial institutions are underdeveloped.

********

**Anna Ivanova** is the mission chief for Guatemala in the IMF's Western Hemisphere Department. Previously she worked as a senior desk officer for Costa Rica, Germany, the Netherlands, as an economist in the Fiscal Affairs and Middle East and Central Asia departments of the IMF, and as a physicist in the Institute of Nuclear Problems in Belarus. She has published a series of papers in the areas of fiscal policy, the role of international financial institutions, and current account and growth. She obtained her Ph.D. in Economics from the University of Wisconsin-Madison (U.S.), Master's degree in Economic Development from Vanderbilt University (U.S.), and Master's degree in nuclear physics from Belarussian State University (Belarus).