Rethinking Financial Deepening: Stability and Growth in Emerging Markets

Ratna Sahay, Martin Čihák, Papa N’Diaye, Adolfo Barajas, Ran Bi, Diana Ayala, Yuan Gao, Annette Kyobe, Lam Nguyen, Christian Saborowski, Katsiaryna Svirydzenka, and Seyed Reza Yousefi
EXECUTIVE SUMMARY

Financial development increases a country’s resilience and boosts economic growth. It mobilizes savings, promotes information sharing, improves resource allocation, and facilitates diversification and management of risk. It also promotes financial stability to the extent that deep and liquid financial systems with diverse instruments help dampen the impact of shocks. But is there a point beyond which the benefits of financial development begin to decline and costs start to rise, and have emerging markets (EMs) reached these limits? This paper takes stock of where EMs are on the stability-growth tradeoff that financial development entails, and considers whether there is further scope for financial development, and how EMs can secure a safe process of financial development.

The 2008 global financial crisis raised some legitimate questions about financial deepening and financial development, given that the crisis originated in advanced economies (AEs), where the financial sector had grown both very large and very complex. Are there limits to financial development for growth and stability? Is there a right pace of development? Are there tradeoffs? What is the role of institutions in promoting a safe financial system? Are there lessons for EMs from AEs’ experience to reap the benefits from financial development, while avoiding the pitfalls? In this regard, this study provides five key policy-relevant findings:

First and foremost, using a new, broad, measure of financial development, this study underscores that many benefits in terms of growth and stability can still be reaped from further financial development in most EMs. Financial development is defined as a combination of depth (size and liquidity of markets), access (ability of individuals to access financial services), and efficiency (ability of institutions to provide financial services at low cost and with sustainable revenues, and the level of activity of capital markets).

Second, the effect of financial development on economic growth is bell-shaped: it weakens at higher levels of financial development. This weakening effect stems from financial deepening, rather than from greater access or higher efficiency. The empirical evidence also suggests that this weakening effect reflects primarily the impact of financial deepening on total factor productivity growth, rather than on capital accumulation.

The third and related finding of the study is that the pace of financial development matters. When it proceeds too fast, deepening financial institutions can lead to economic and financial instability. It encourages greater risk-taking and high leverage, if poorly regulated and supervised. In other words, when it comes to financial deepening, there are speed limits. This puts a premium on developing good institutional and regulatory frameworks as financial development proceeds.

The fourth finding relates to the potential tradeoffs of financial regulation. One view is that tighter and more regulation to help safeguard financial stability can hamper financial development. This study provides a new angle. It finds that, among a large number of regulatory principles, there is a small subset that is critical for financial development as well as for financial stability. In other words, there is very little or no conflict between promoting financial stability and financial development. Better regulation is what promotes financial stability and development.

The fifth finding is that there is no “one-size-fits-all” in the sequencing of developing financial institutions versus markets, though as economies evolve the relative benefits from institutions decline and those from markets increase.