

## Financial Deepening

### Definition

‘Financial Deepening’ is economically referred of the case of

1. The increase in provision of financial services.
2. It can refer both a wider choice of services and better access for different socioeconomic groups

Financial deepening can have an effect on both individuals' and societies' economic situations.

One of the key features of financial deepening is that it accelerates economic growth through the expansion of access to those who do not have adequate finance themselves.

Typically, in an underdeveloped financial system, it is the incumbents who have better access to financial services through relationship banking. Moreover, incumbents also finance their growth through *internal resource generation*. **Thus, in an underdeveloped financial system, growth is constrained to the expansion potential of incumbents.**

In mature financial systems on the other hand, financial institutions develop appraisal techniques, and information gathering and sharing mechanisms, which then enable banks to even finance those activities or firms that are at the margin, thereby leading to their growth-inducing productive activities in addition to the incumbents.

The assumption is that the availability of *external finance* to budding entrepreneurs and small firms enables new entrepreneurship, while also providing competition to incumbents and consequently **encouraging entrepreneurship and productivity**. However, research indicates that widely available formal finance can produce informal intermediation, an unintended form of entrepreneurship. Hence, maintaining a skeptical approach when researching the effectiveness of initiatives is advisable.

### Examples of ‘Financial deepening’

1. Provision of the underbanked and unbanked society (those who do not have bank account or sufficient access to mainstream financial services) mostly associated with disadvantage poor.
2. Development of financial markets or Development of financial institutions and increasing the diversity in financial instruments which could cause the larger gap in the society.

## **The reasons why there are higher limitations of access to financial services**

1. Dispersed demand for financial services due to low levels of economic activity and population density.
2. High information and transaction costs linked to poor infrastructure and lack of client information.
3. Weak institutional capacity of rural finance providers related to the limited availability of educated and well-trained people in smaller rural communities.
4. Crowding-out effect of subsidised and/or directed credit from state-owned banks or donor projects.
5. Seasonality of many agricultural activities and long maturation periods for others, resulting in variable demand for savings and credit, uneven cash flow and lags between loan disbursement and repayments.
6. Risks linked specifically to farming, such as variable rainfall, pests and diseases, price fluctuations, and small farmers' poor access to inputs, advice, and markets.
7. Lack of usable collateral due to ill-defined property and land-use rights, costly or lengthy registration procedures, and poorly functioning judicial systems.

## **Financial Deepening for Macroeconomic Stability and Sustained Growth (Case of Low-income countries)**

Financial deepening and macro-stability has been identified as a priority area in the years ahead for the Fund

### 1. Managing volatility and supporting low-income country growth.

Managing Volatility and Supporting Low-income Country Growth Enhancing macro-economic policy effectiveness Shallow financial systems limit fiscal, monetary, and exchange rate policy choices; hamper macroeconomic policy transmission; and impede opportunities for hedging or diversifying risk. This is of particular concern because LICs are vulnerable to external shocks, such as sharp swings in commodity prices and fluctuations in external financing. Limited policy space and instruments to mitigate the ensuing macroeconomic volatility often translate into large growth and welfare costs for these countries.

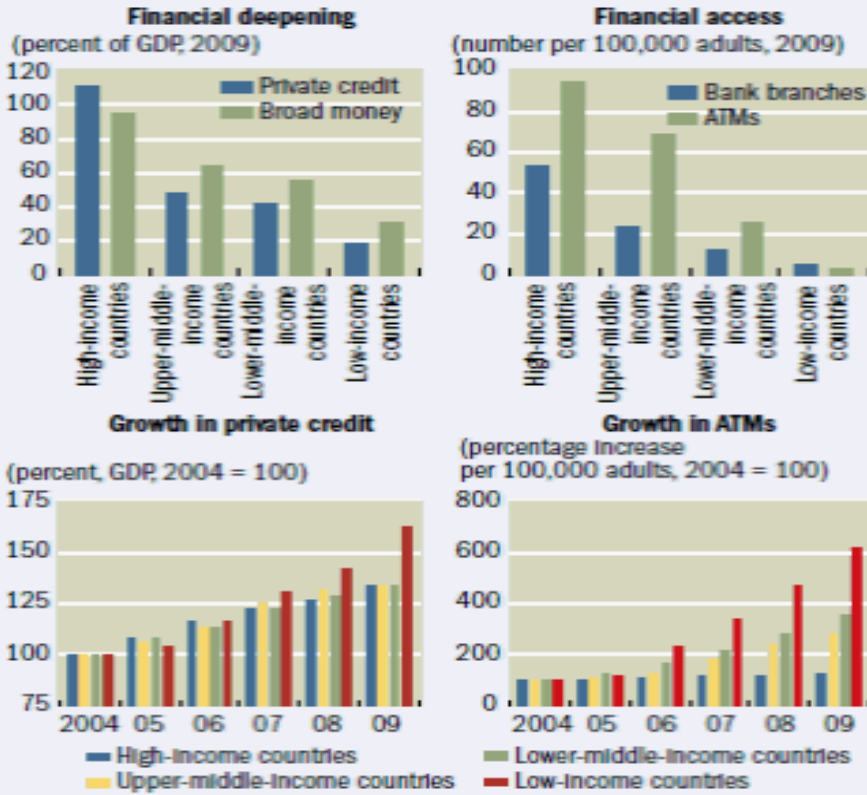
### 2. Current state of play

Financial systems in LICs have grown and become more inclusive over the past two decades, but they still remain relatively small and undiversified (as Chart 1 shown). Encouragingly, although they have much lower levels of financial depth than high- and middle-income countries, low-income countries are experiencing financial deepening at rates far faster than higher income countries. But financial deepening will be of low quality if financial services are available to only a few firms or households. Access to finance is as pivotal as the depth of the financial system. Here again, there are encouraging signs, but more could be done.

Chart 1

## Steady gains

By a variety of measures, low-income countries are making consistent progress in financial development.



Sources: IMF, *International Financial Statistics*; IMF, *Financial Access Survey*; and IMF staff calculations.

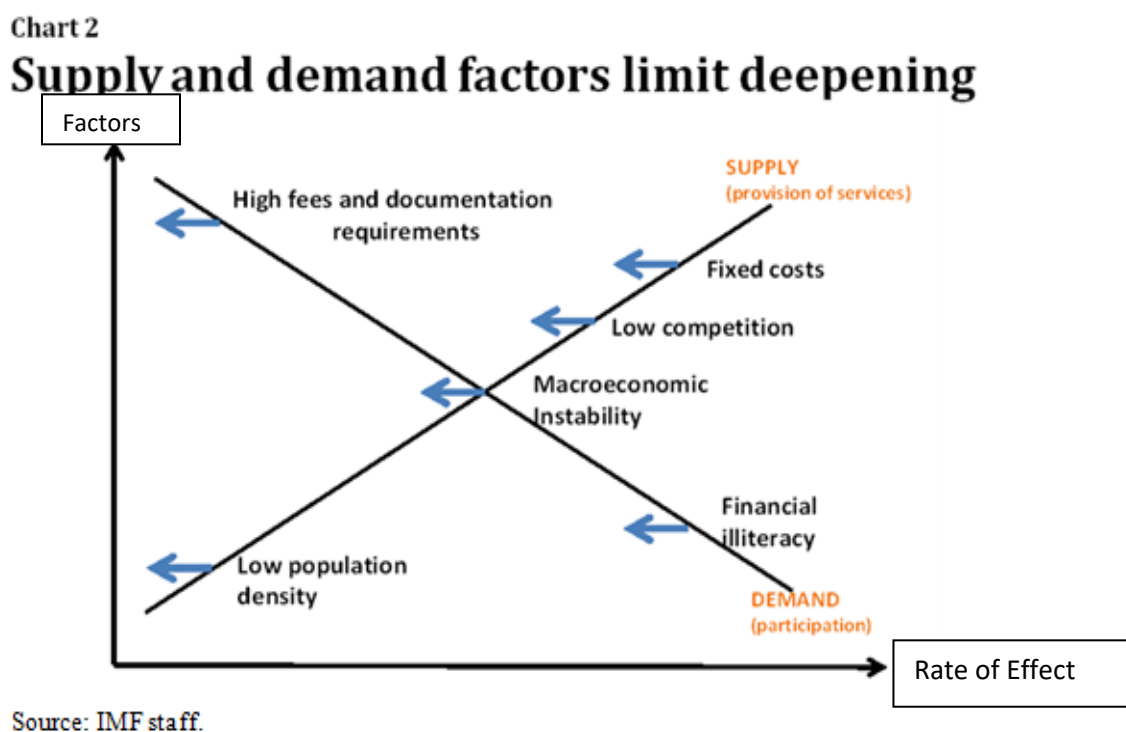
Note: Broad money (top left) is checking accounts and most savings accounts. ATMs (top right, bottom right) are automated teller machines. In the bottom right panel, the number of ATMs is measured annually as a percentage increase from the base year, 2004.

### 3. Challenges for deepening

Structural characteristics of countries, policy factors, and exogenous influences (e.g., the technology available, sociopolitical conditions) determine the environment within which financial deepening may either flourish or stagnate.

- High fixed costs in financial provision explain why larger low-income country economies can sustain more diversified financial systems and why, for instance, small island economies tend to have shallow systems. Similarly, low national incomes, a high degree of informality, and low population density are factors that increase the costs and risks for financial institutions. These structural factors work to exclude large segments of the population from formal financial services and explain why many LICs have underdeveloped financial systems.

- A confluence of demand and supply factors constrains financial deepening in LICs (Chart 2). For example, low mobilization of deposits, financial illiteracy, and high fees and documentation requirements can limit financial intermediation. Similarly, for a wide variety of LICs persistent macroeconomic instability, weak collateral regimes, limited completion, and regulatory restrictions often act as barriers to the deepening and diversifying of their financial systems.



These impediments not only affect macro-financial stability but also reduce the growth dividends from deepening. At the same time, unsustainable expansion of financial systems can pose risks for stability. Weak and limited supervisory and regulatory frameworks and capacity, deficient early warning and resolution systems, and governance problems in LICs increase the risks of such fragility.

The considerable heterogeneity among LICs, however, suggests that there is no "one-size-fits-all" solution. Different areas and approaches may be needed to promote financial deepening generally.

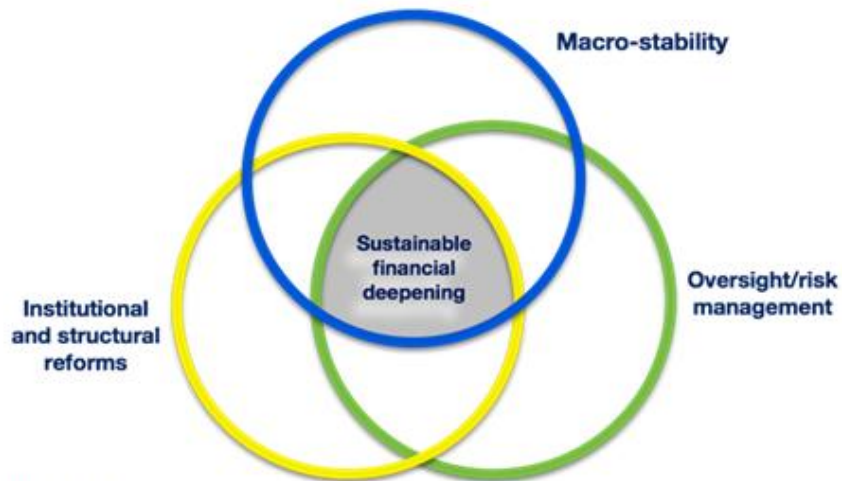
#### 4. Policies matter

Cross-country experiences in emerging market and low-income countries suggest that targeted and balanced initiatives to encourage competition, put in place information and market infrastructure, address collateral issues, limit excessively intrusive public sector interventions and dominance, maintain macroeconomic stability, and exercise appropriate macro-prudential oversight to avoid creating new sources of instability can help overcome

specific impediments to increasing the depth, breadth, and inclusion of financial systems (**Chart 3**).

Chart 3

## Finding the right balance: policies fostering sustainable financial deepening



Source: IMF staff.

### Financial deepening in developing countries

Financial deepening in developing countries such as in Sub-Saharan African countries is that the lack of or stagnant growth of output of any country is often caused by "shallow - finance". A shallow financial depth (FD) means that the range of financial assets for that country is narrow. It is a scenario that goes far in explaining why most SSA countries have low or negative per capita growth rates. From the slow growth of output (even negative growth in some years) that characterizes the economies of most SSA countries, it is evident that these countries are greatly affected by "shallow finance" or "financial repression". Throughout the study of John E. Udo Ndebbio suggested that SSA countries should strive hard to make real money balances grow, and that these countries should also come up with policies to improve financial development/intermediation. Given such factors as price stabilization, elimination of fiscal deficit and removal of various restrictions on financial institutions, real money balances could be made to grow. Financial intermediation/ development could positively affect output growth if, among other suggested ways, the volume of investment is raised.

Another example of the financial deepening case in Mexico from the study by Alexander Herman and Alexander Klemm shows that The Mexican economy has been marked by low growth by emerging market standards over the last decades. Credit depth is also very low in

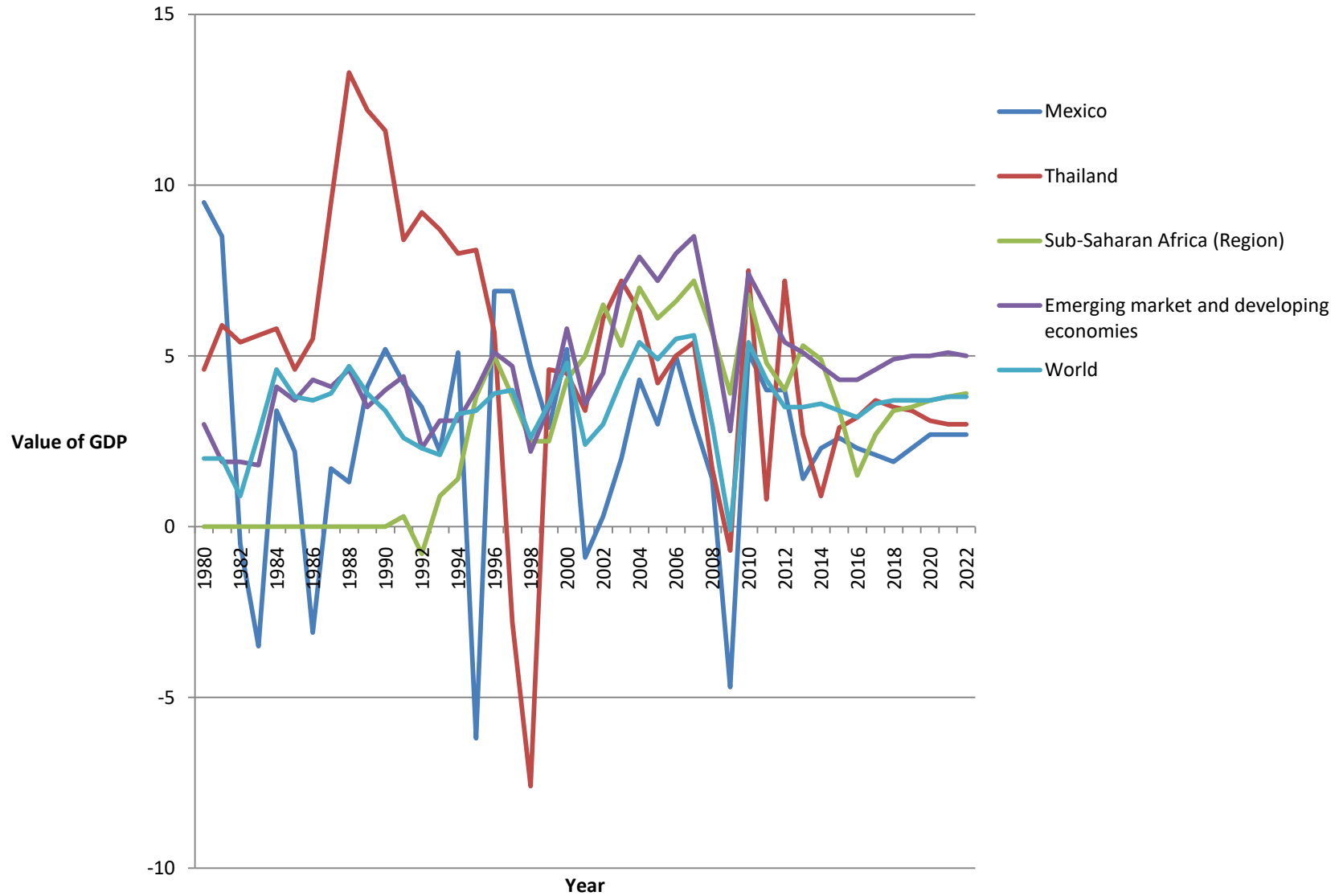
Mexico, not only in comparison to advanced economies, but also emerging markets. The economic benefits of deepening financial integration need to be weighed against the risks to financial stability. Excessive credit growth can lead to financial risks and has been shown to be one of the most robust predictors of banking and currency crises (the other predictor being real appreciation can be seen from the paper of Gourinchas and Obstfeld (2012) retrieved from the site [voxeu.org](http://voxeu.org), which has a key precursor of twentieth-century financial crises in emerging and advanced economies alike was the rapid buildup of leverage. Those emerging economies that avoided leverage booms during the 2000s also were most likely to avoid the worst effects of the twenty-first century's first global crisis.) A discrete-choice panel analysis using 1973-2010 data suggests that domestic credit expansion and real currency appreciation have been the most robust and significant predictors of financial crises, regardless of whether a country is emerging or advanced. For emerging economies, however, higher foreign exchange reserves predict a sharply reduced probability of a subsequent crisis.). This is particularly important in an environment of rising interest rates. This would immediately affect the affordability of variable interest rate loans, but ultimately also the cost of rolling over fixed-term debt, and it could entail risks for financial institutions with maturity mismatches. Credit growth can be both cyclical and structural, but empirically it can be difficult to disentangle both. The recent financial reforms could boost credit structurally, but the improvement in the economy can also be expected to lead to a cyclical rise in credit, given that credit cycles tend to lag growth cycles in Mexico.

However, there are the limitations of the financial deepening in developing countries that policy and exogenous influences determine whether financial deepening achieves optimum results.

### **Comparison on GDP per capita growth rate**

The chart below shows the comparison between the countries which have the financial deepening such as Sub-Saharan African countries and Mexico by comparing these countries with Thailand in terms of their GDP per capita growth rate. After 2010, all countries have the downtrend on their GDP per capita growth rate. In the most recent year of 2017, Sub-Saharan African and Mexico have very low GDP per capita comparing to Thailand, other developing economies and the world. This implies us that those countries who are suffering with the shallow finance problem have higher rate of difficulties in reaching GDP as high as other emerging markets due to the fact that they have so many limitations. However, why the developing countries are stuck in negative growth might not just only come from the shallow finance, but there are many other factors that can affect too.

# Real GDP growth (Annual percent change)



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