Financial Development in Latin America

Andrew Powell
Research Department
Inter-American Development Bank
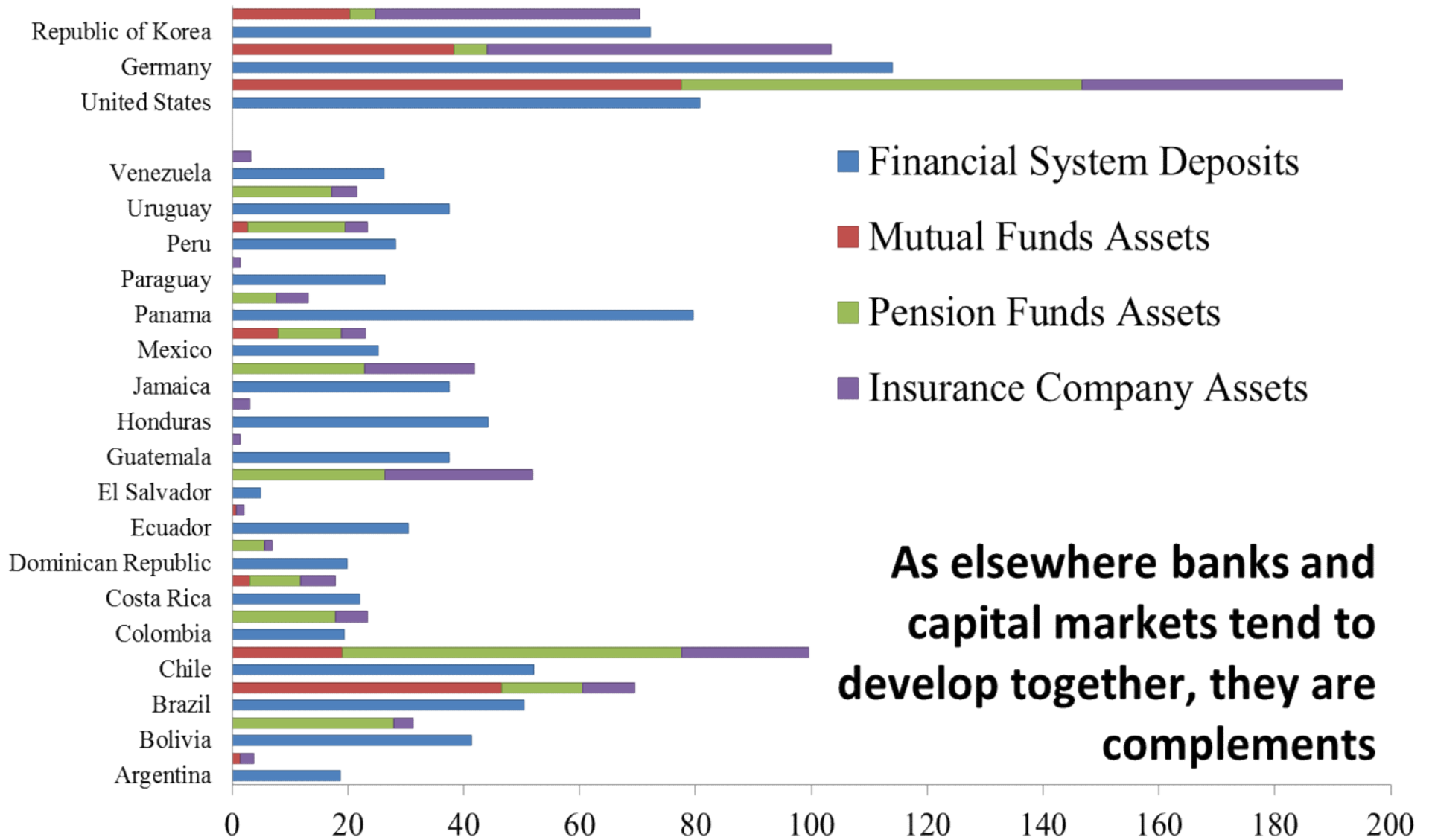
Central Bank of Argentina
Sep 20th 2016
*Strictly my own views, not those of the IDB nor its Board of Directors.

Plan of the talk

1. Data

2. Explanations

3. Policies

LAC financial systems remain small (% GDP)

Legend:
- ■ Financial System Deposits
- ■ Mutual Funds Assets
- ■ Pension Funds Assets
- ■ Insurance Company Assets

As elsewhere banks and capital markets tend to develop together, they are complements

Source: Ch 3, "Savings for Development" – IDB.

Banking systems have grown but remain small in USD terms

Median country in each region
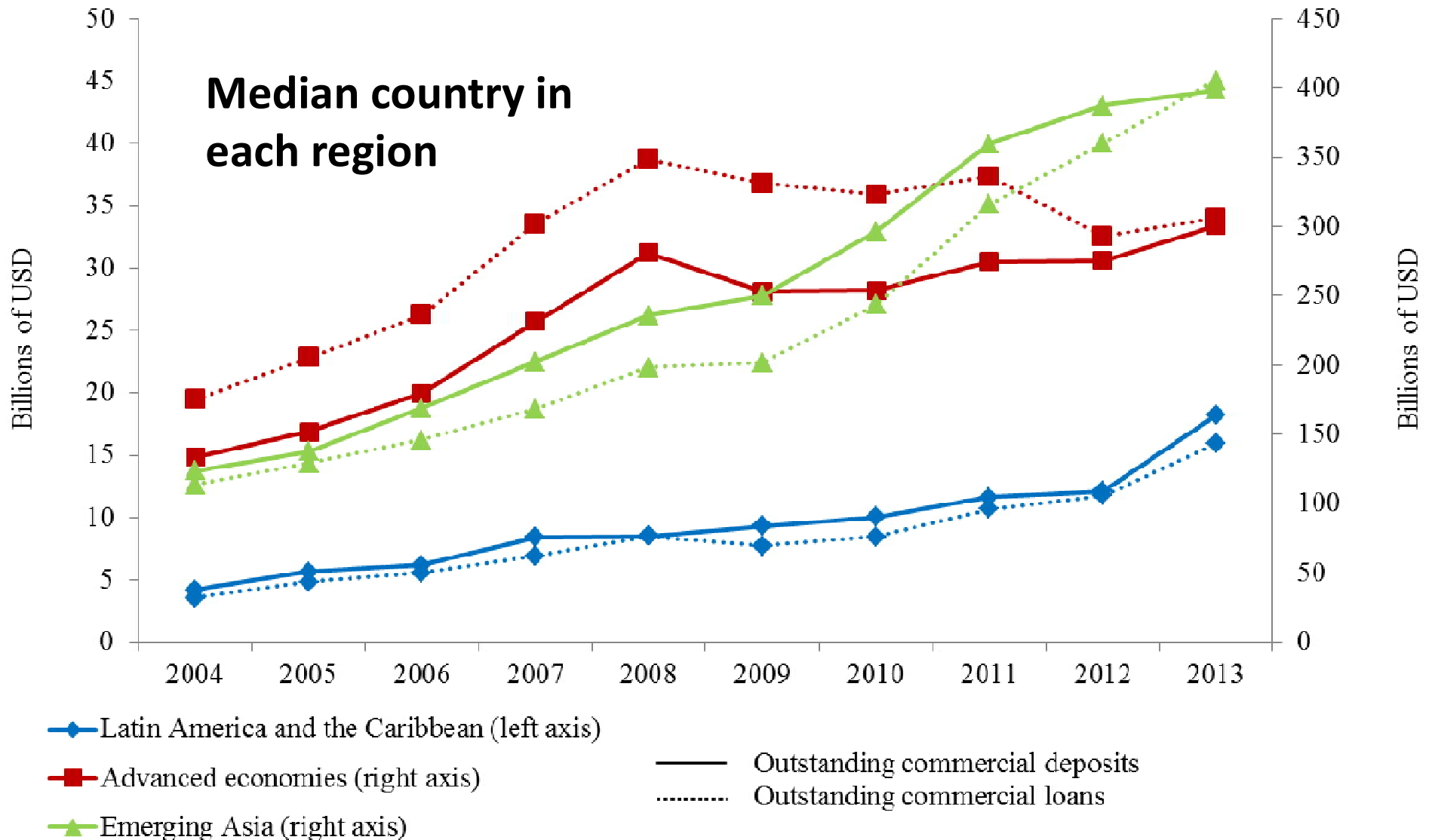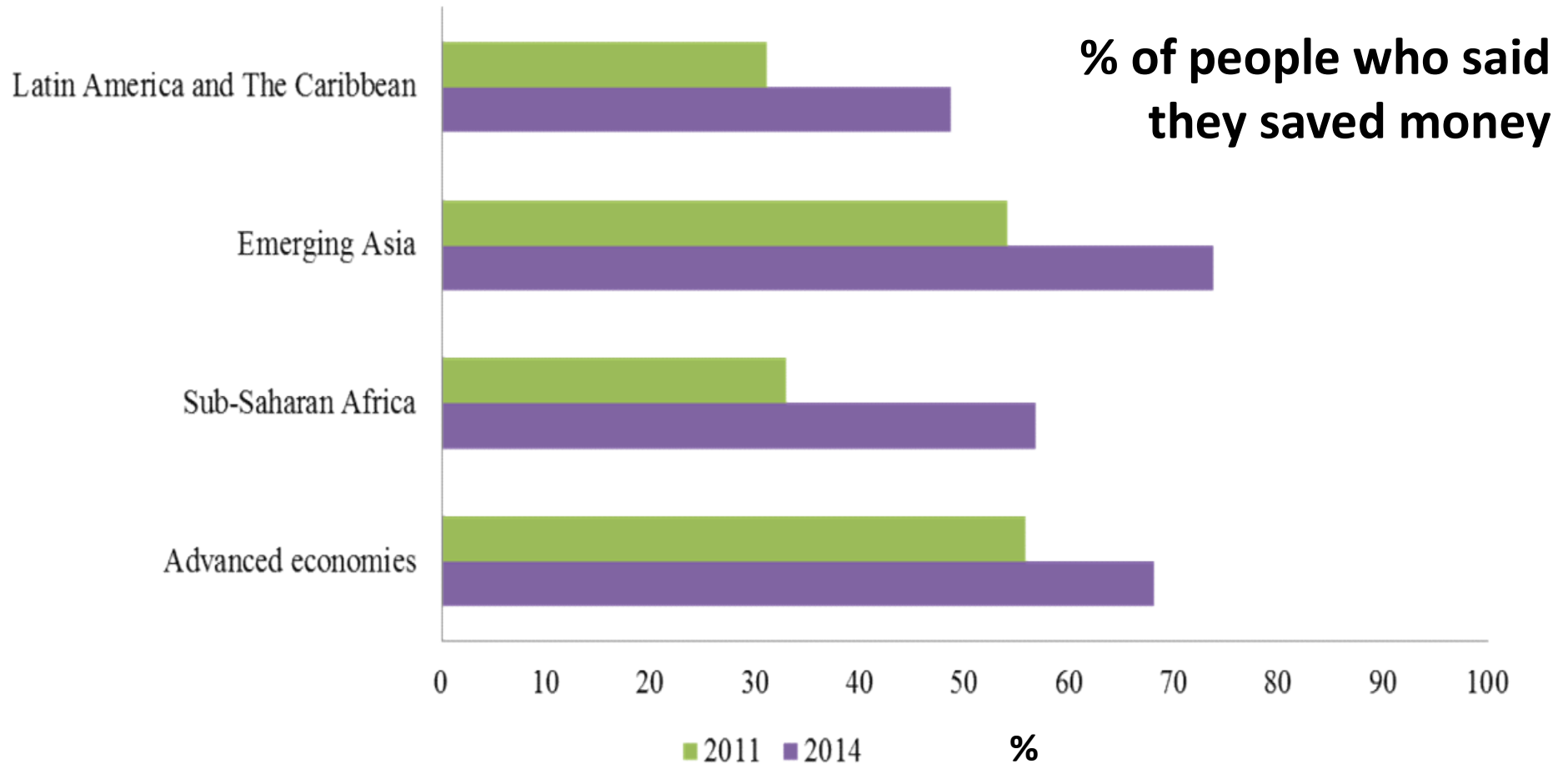
Source: Ch 3, "Savings for Development" – IDB.

Financial inclusion has Improved
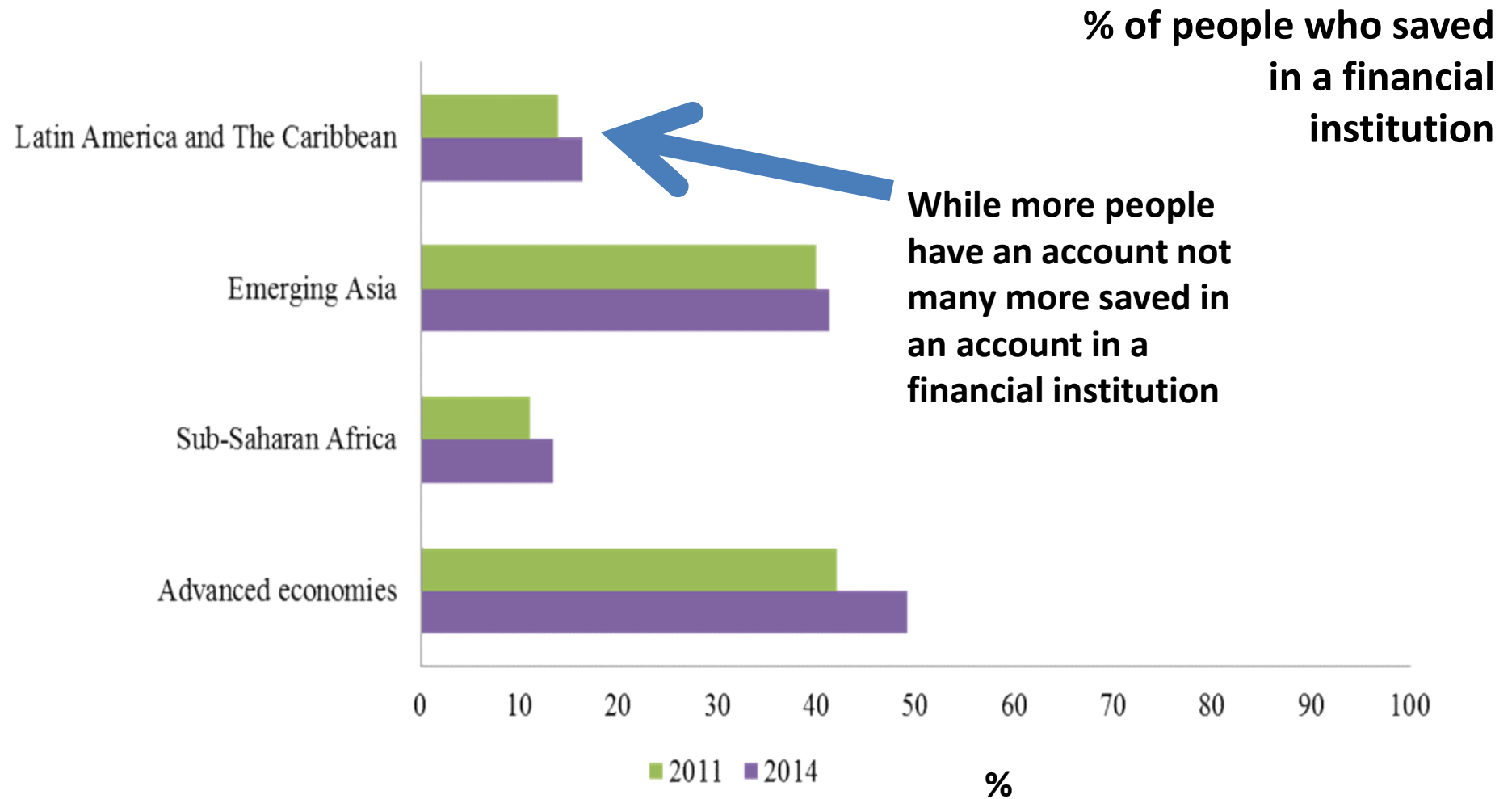## % of Individuals with an Account in a Financial Institution

Source: World Bank (FINDEX Surveys)
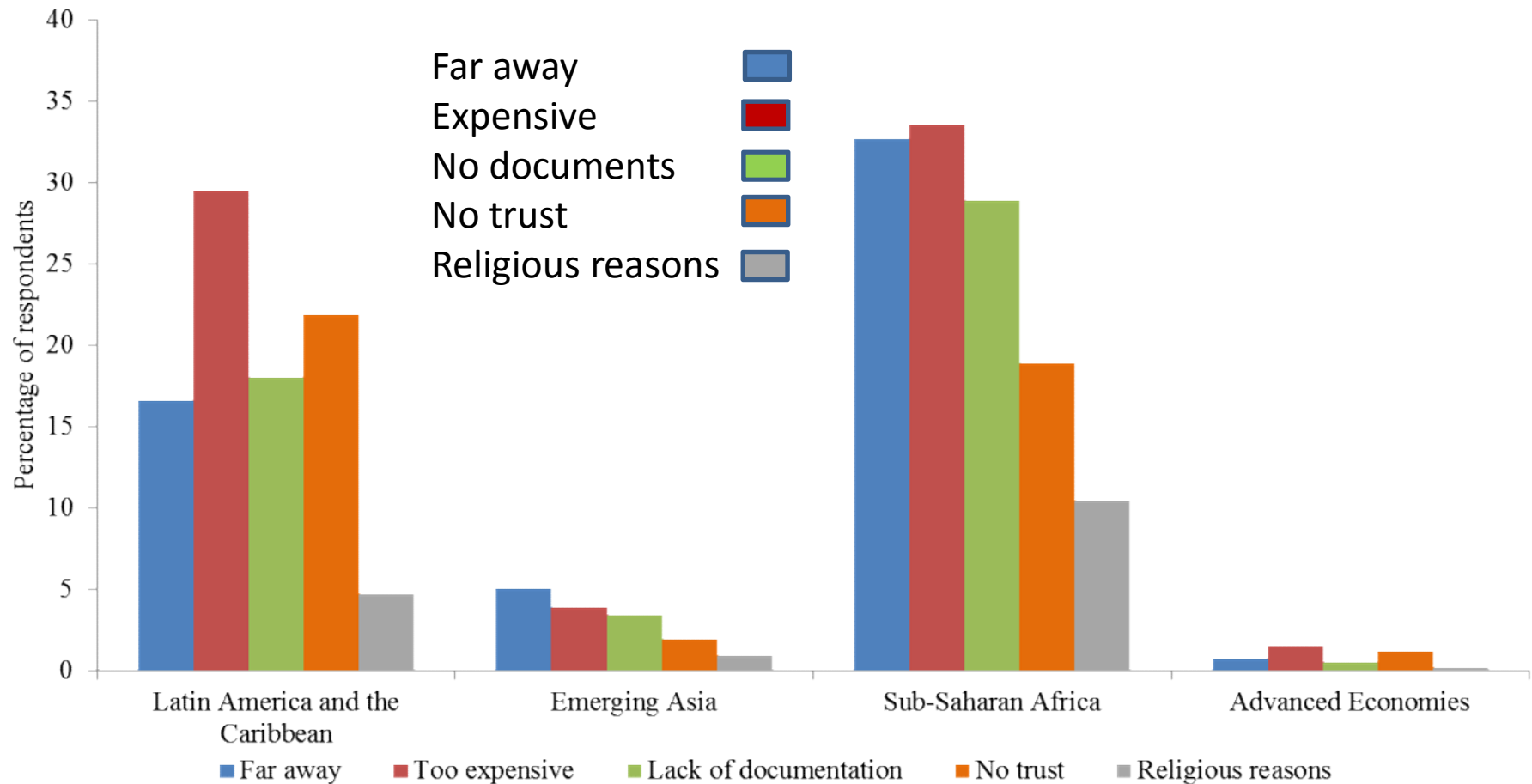
But while ≈50% of people in LAC said they saved...

% of people who said they saved money

Source: World Bank (FINDEX Surveys)

Only 15% saved in a financial institution

% of people who saved in a financial institution

While more people have an account not many more saved in an account in a financial institution

Latin America and The Caribbean

Emerging Asia

Sub-Saharan Africa

Advanced economies

0 10 20 30 40 50 60 70 80 90 100

■ 2011 ■ 2014

%

Source: World Bank (FINDEX Surveys)

Why don't people have bank accounts?

Far away ■
Expensive ■
No documents ■
No trust ■
Religious reasons ■

Percentage of respondents

Latin America and the Caribbean · Emerging Asia · Sub-Saharan Africa · Advanced Economies

■ Far away ■ Too expensive ■ Lack of documentation ■ No trust ■ Religious reasons

Note: Bars show percentage of respondents who do not have an account at a financial institution and why. Percentages add up to more than 100 percent in some regions because some respondents gave more than one reason. See endnote 3 of chapter 2 for the list of countries in each country group.
Source: Authors' calculations based on World Bank (2014b).

Source: Savings for Development (IDB) from World Bank (FINDEX)

# And firms: very reliant on own savings
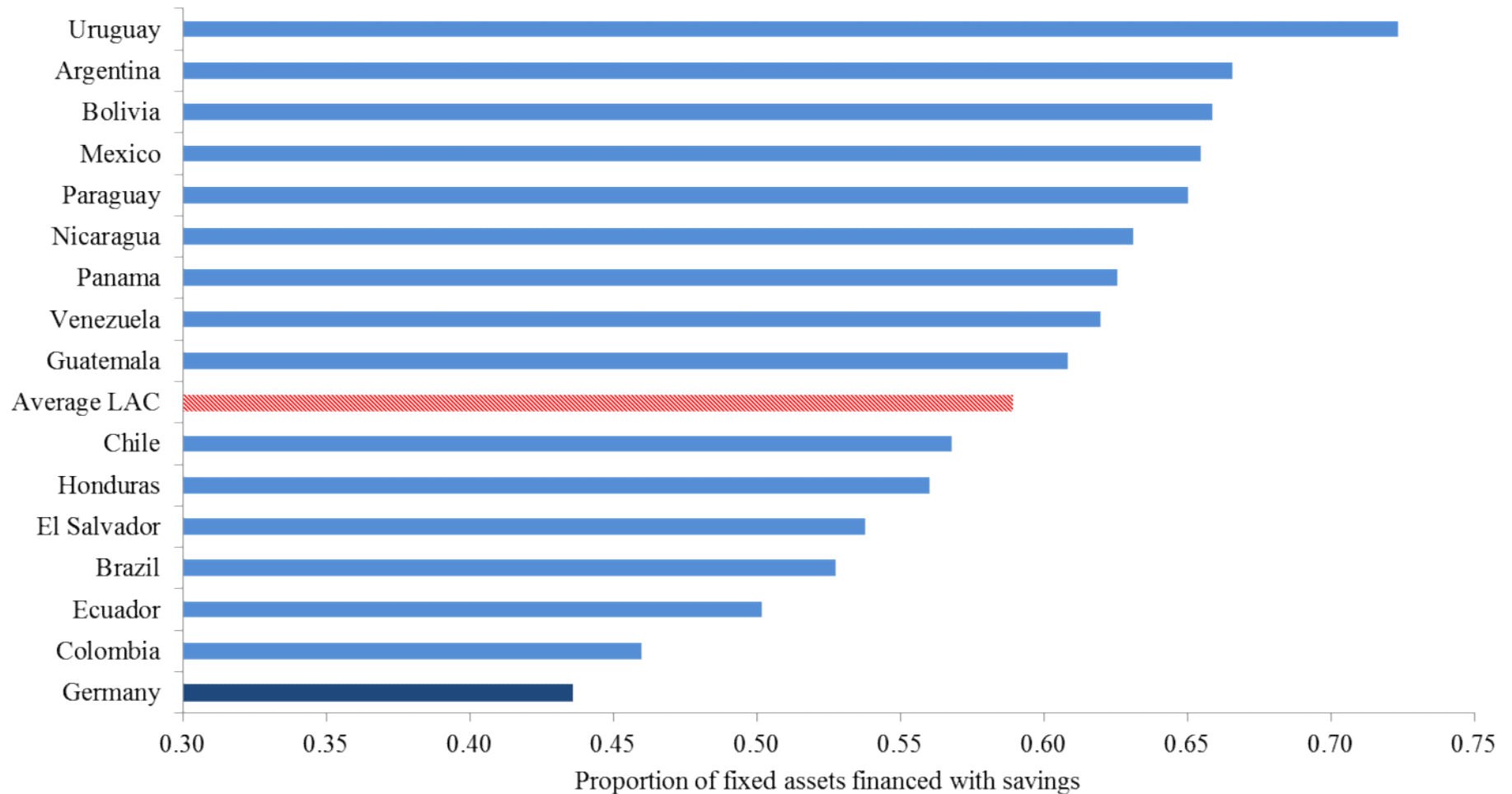
Note: Firm savings are defined as internal funds or retained earnings. LAC refers to Latin America and the Caribbean.
Source: Authors' calculations based on World Bank Enterprise Survey (WBES). See Busso, Fernández, and Tamayo (2016) for details.
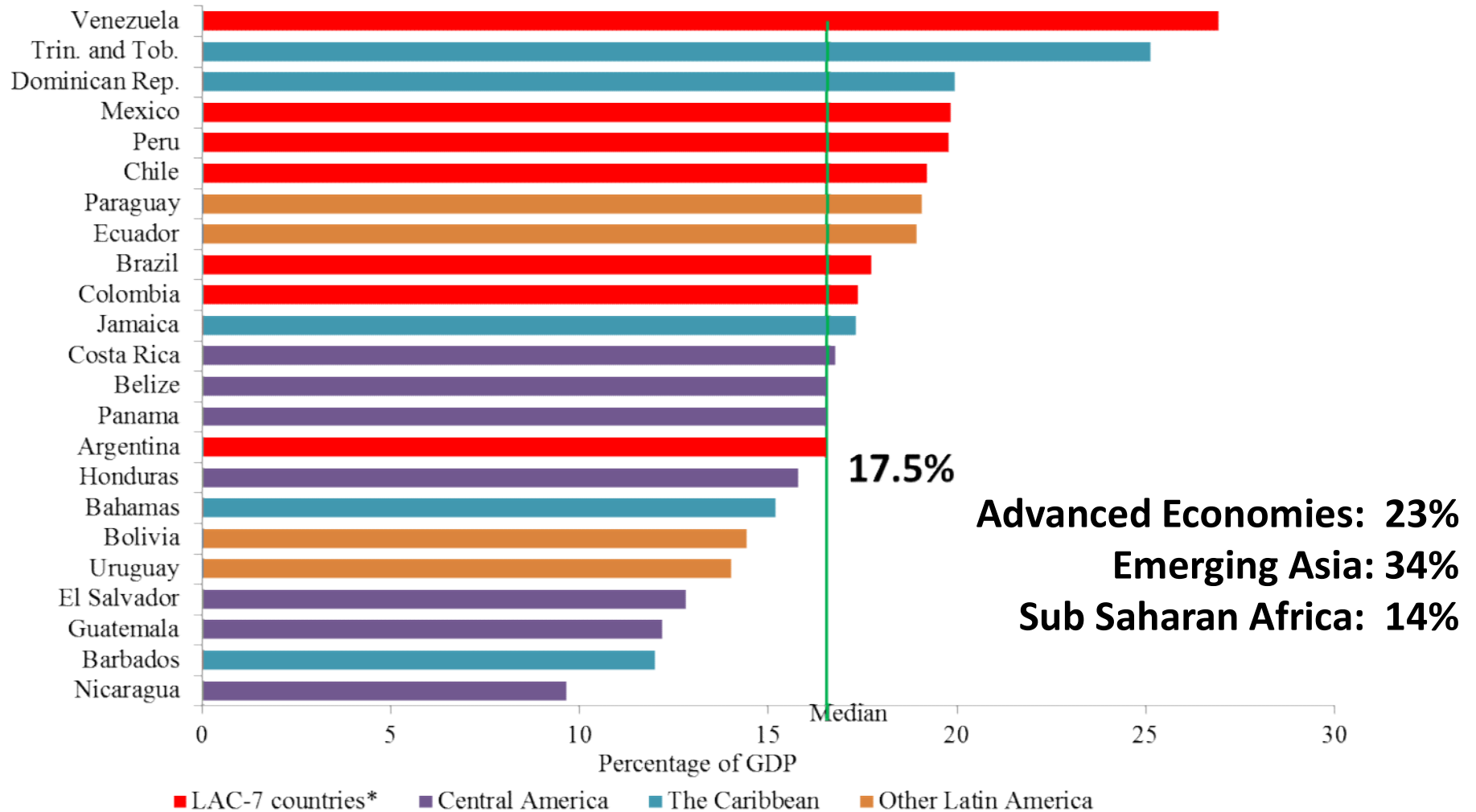
Source: Savings for Development (IDB)

And the credit that does exist biased towards consumption
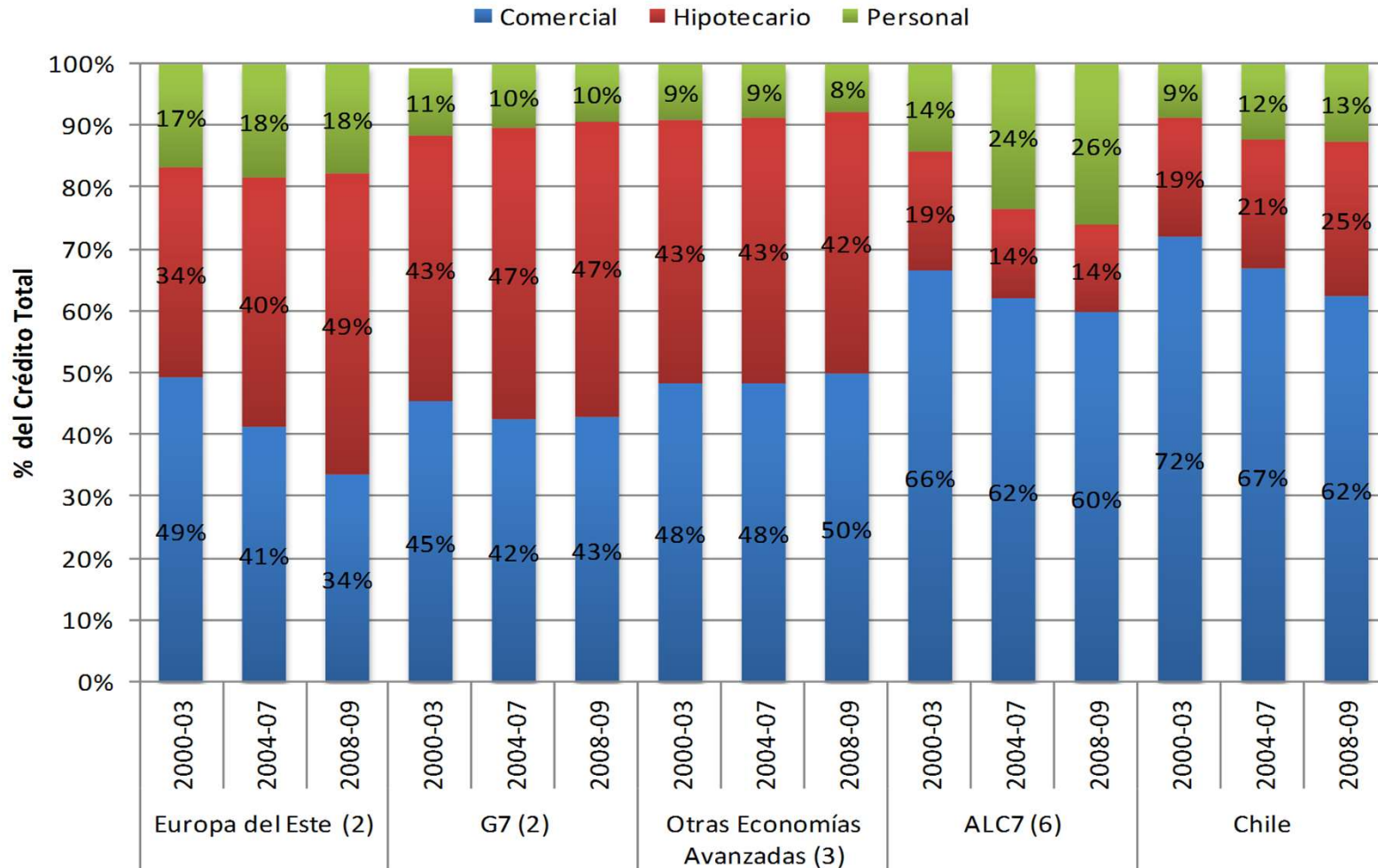
Source: Torre, Ize and Schmukler 2016

National savings rates are low…

Advanced Economies: 23%
Emerging Asia: 34%
Sub Saharan Africa: 14%

Notes: Aggregate saving rates (percent of GDP) are computed as country averages of annual saving rates over the period 1980–2014. The vertical line is the sample median.
LAC-7 includes Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela.

Source: Savings for Development (IDB)

Low savings and low savings' quality? A tale of two Systems...
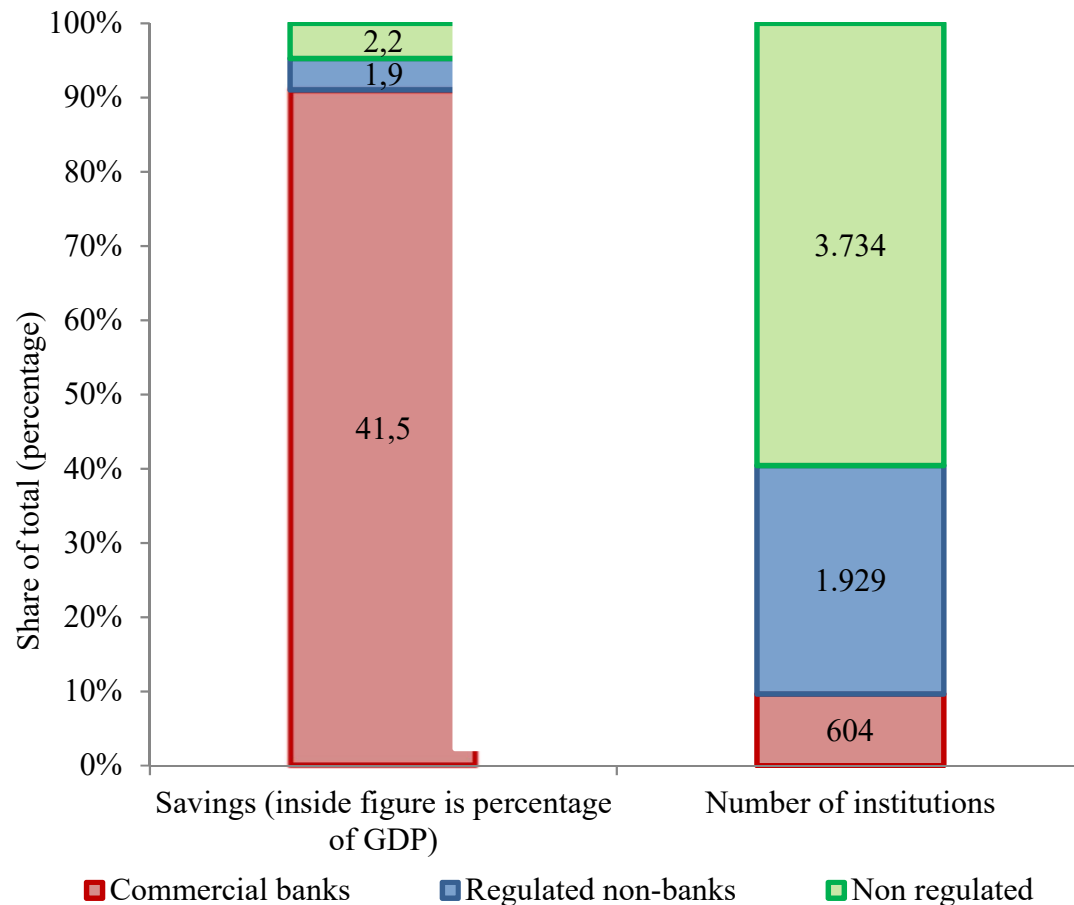
- A small number of regulated banks hold most of the savings

- But there is a large number of non-banks and non-regulated institutions

- Who hold a large number of accounts

Non regulated institutions are cooperatives, credit-unions, micro-finance institutions, NGO's and others. Source: Ch 3., Savings for Development (IDB)

Factors that seem to explain inclusion..

- Rule of law
- Inequality
- Education
- Economic instability
- Banking sector costs
- Bank Presence
- Rule of Law
- Trust

Source: Powell and Sosa (2016)
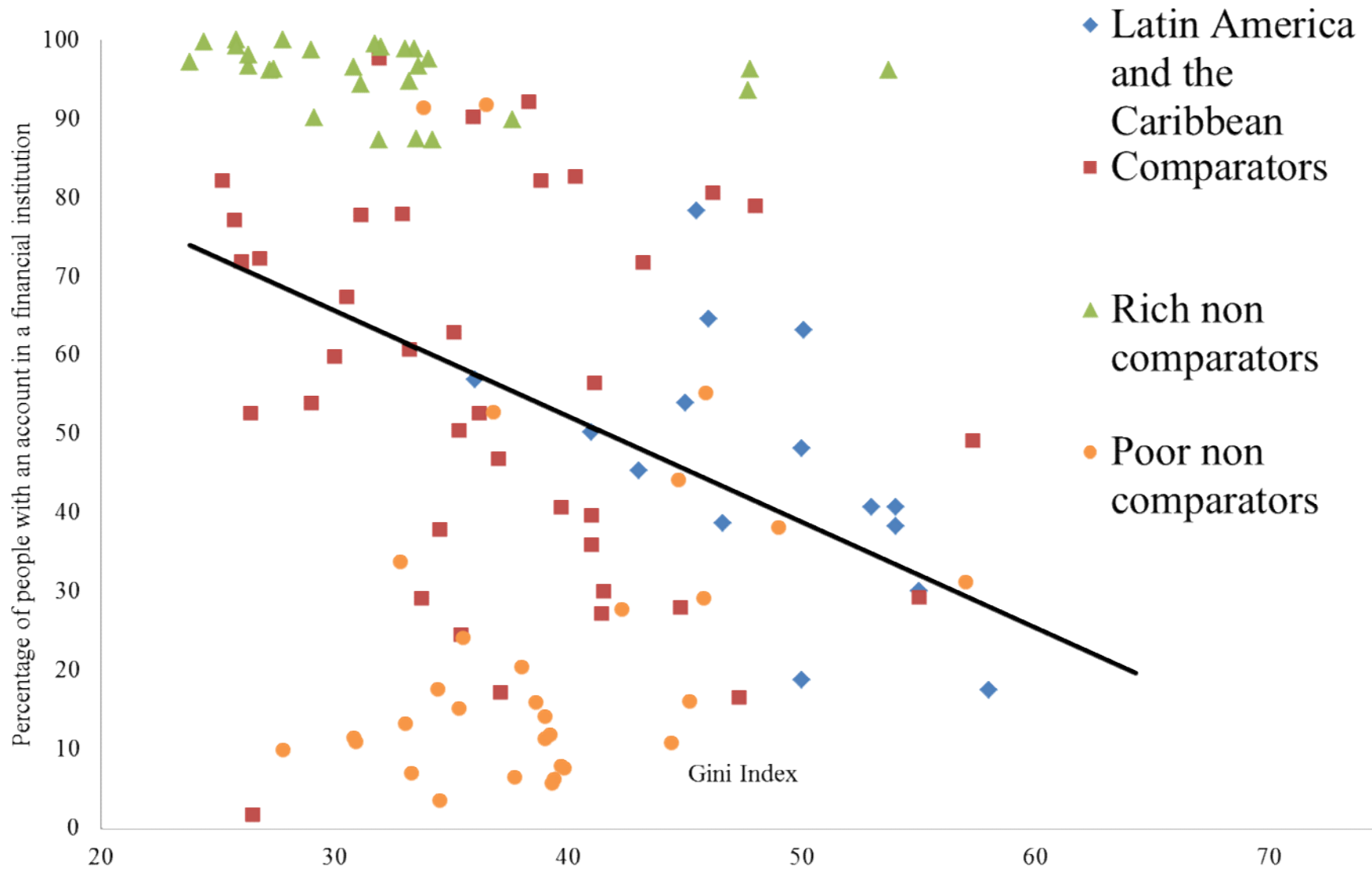
What explains LAC's lower financial inclusion?
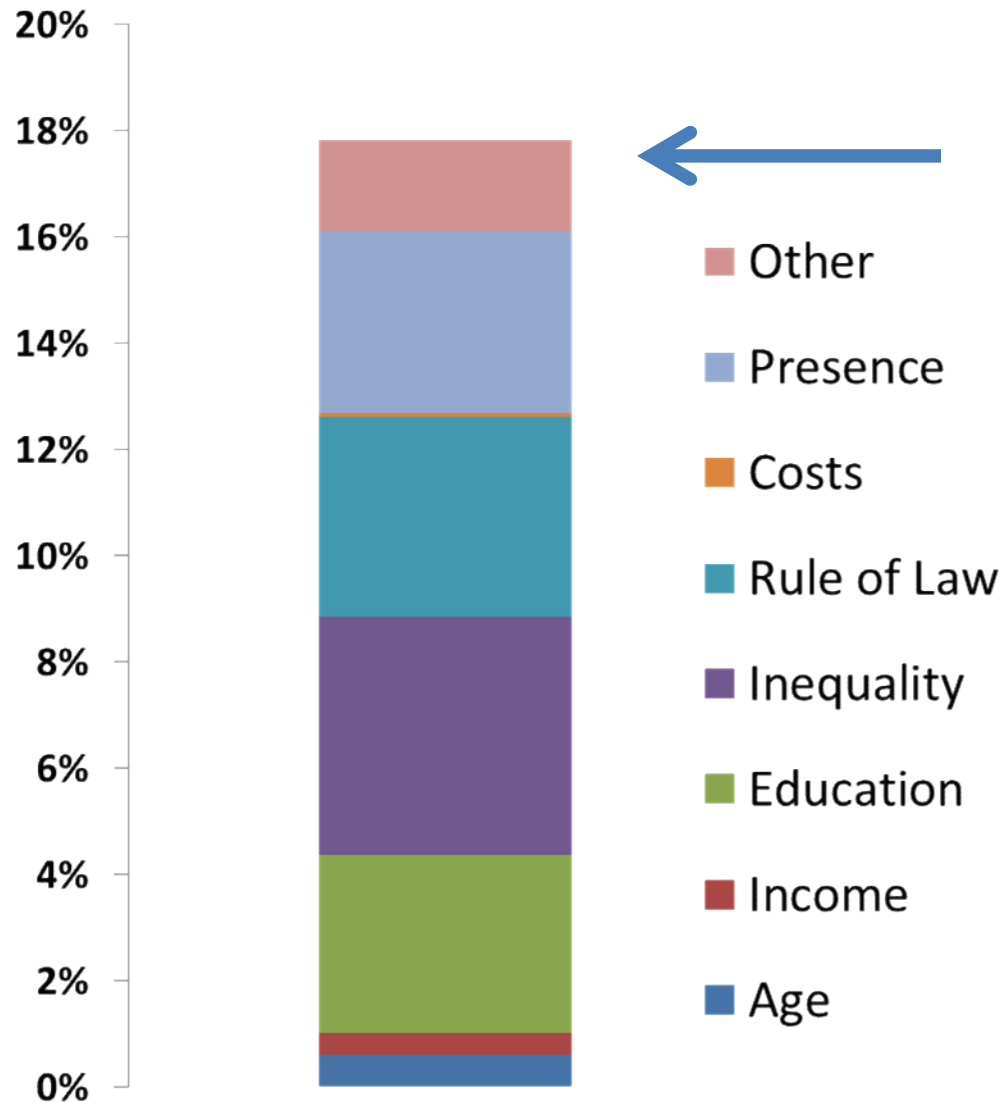
18% less people have an account in a financial institution in LAC compared to comparator countries

Legend:
- Other
- Presence
- Costs
- Rule of Law
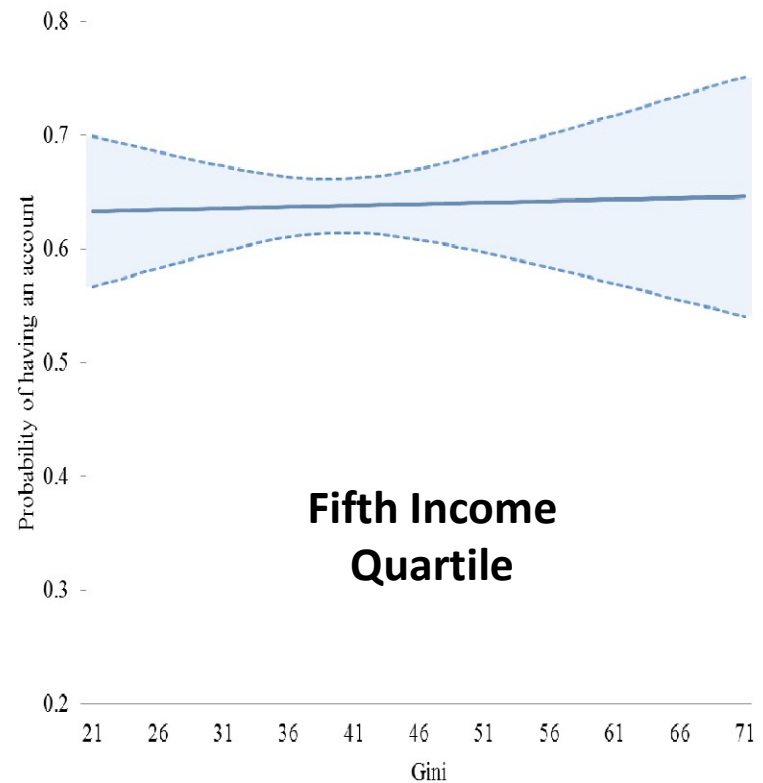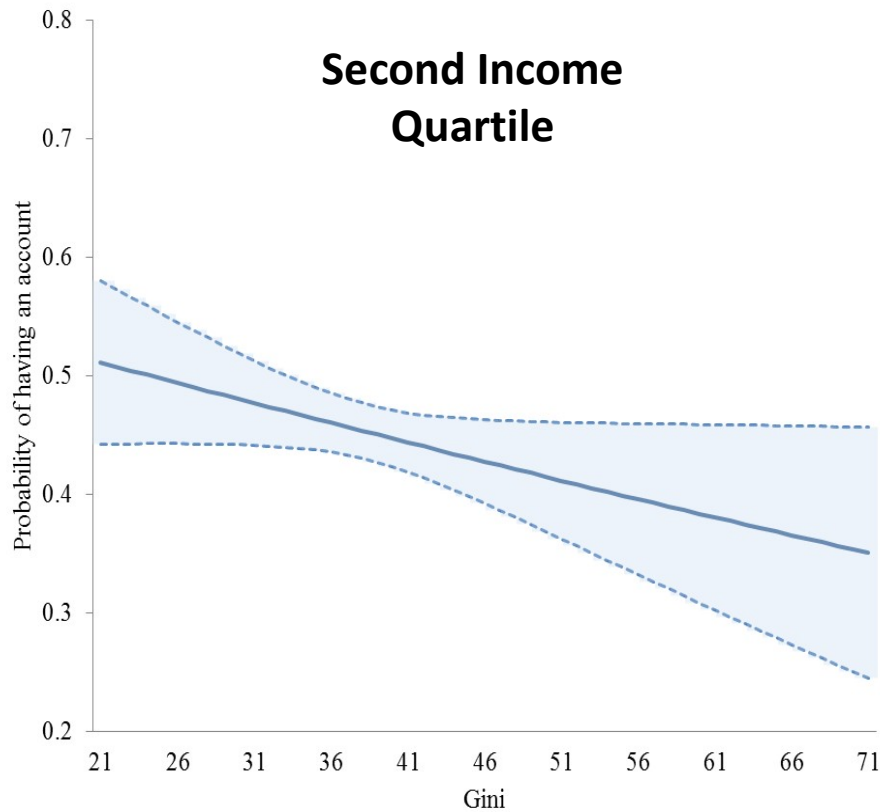- Inequality
- Education
- Income
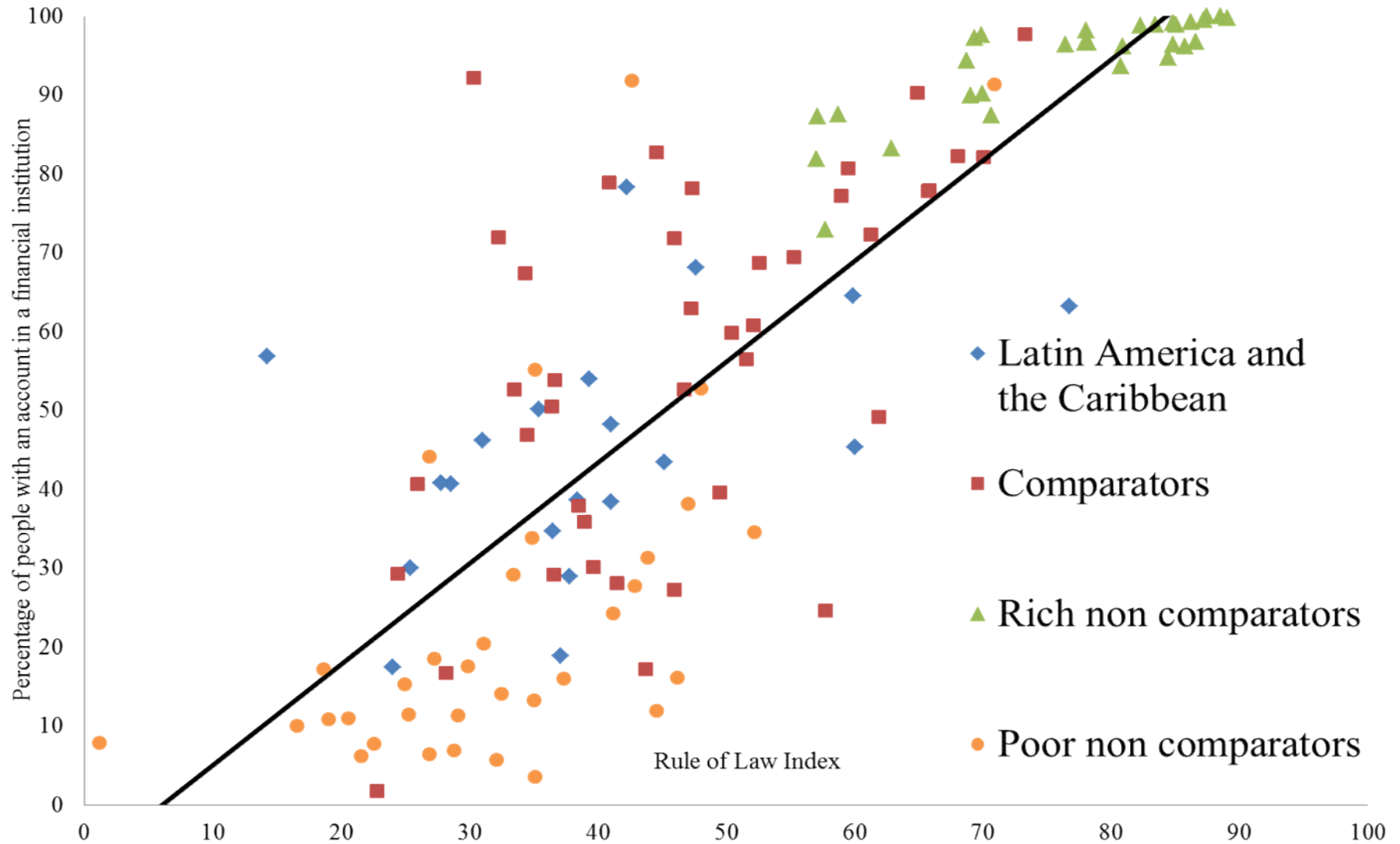- Age

Inequality
Source: Powell and Sosa (2016)

But inequality doesn't matter for everyone...

- The rich are always banked , inequality only matters for non-rich
- Comparison of the second and fifth income quartiles

Rule of Law
Source: Powell and Sosa (2016)

Plan of the talk

1. Data

2. **Explanations**

3. Policies

Why are explanations important?

- Finance matters, it's not all just endogenous
- The question is then how to improve finance - given other characteristics that we may have to take as given
- But we need a good diagnostic as to what is going on to understand how policies might work

Story 1: Show me the money!

- Banks go where the money is
- Bank entry is endogenous
- Banks compete in richer areas, other areas left unbanked
- Possible many will be banked in richer areas
- But unlikely the poor will be banked in poorer areas

Distribution of financial institutions across Mexican municipalities
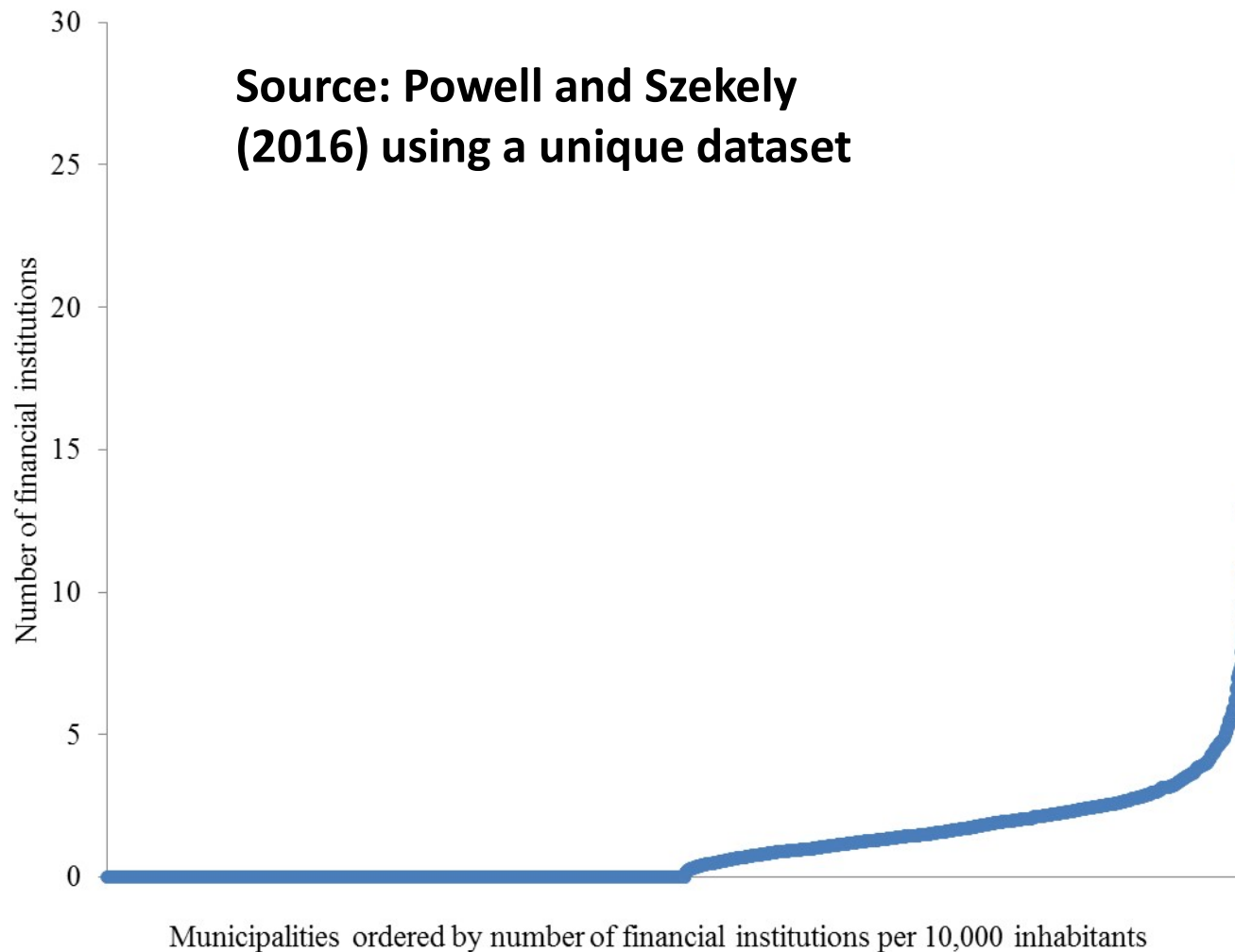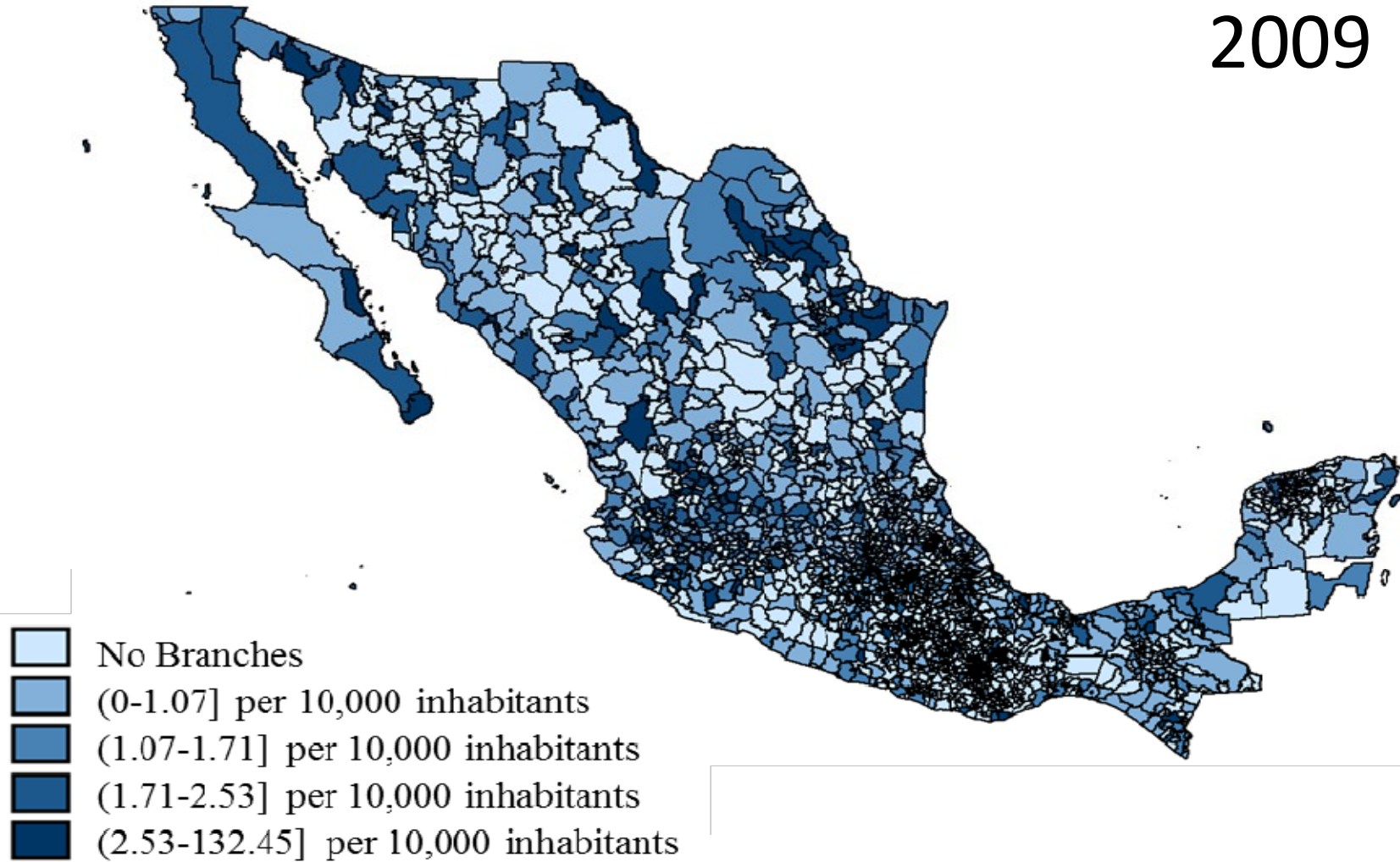
Source: Powell and Szekely
(2016) using a unique dataset

Number of financial institutions (y-axis, 0 to 30)

Municipalities ordered by number of financial institutions per 10,000 inhabitants

Source: Powell and Szekely (2015)

Distribution of financial institutions across Mexico

2009

No Branches
(0-1.07] per 10,000 inhabitants
(1.07-1.71] per 10,000 inhabitants
(1.71-2.53] per 10,000 inhabitants
(2.53-132.45] per 10,000 inhabitants

Source: Powell and Szekely (2015)

Distribution of financial institutions across Mexico

2013

Legend:
- No Branches
- (0–1.07] per 10,000 inhabitants
- (1.07–1.71] per 10,000 inhabitants
- (1.71–2.53] per 10,000 inhabitants
- (2.53–132.45] per 10,000 inhabitants
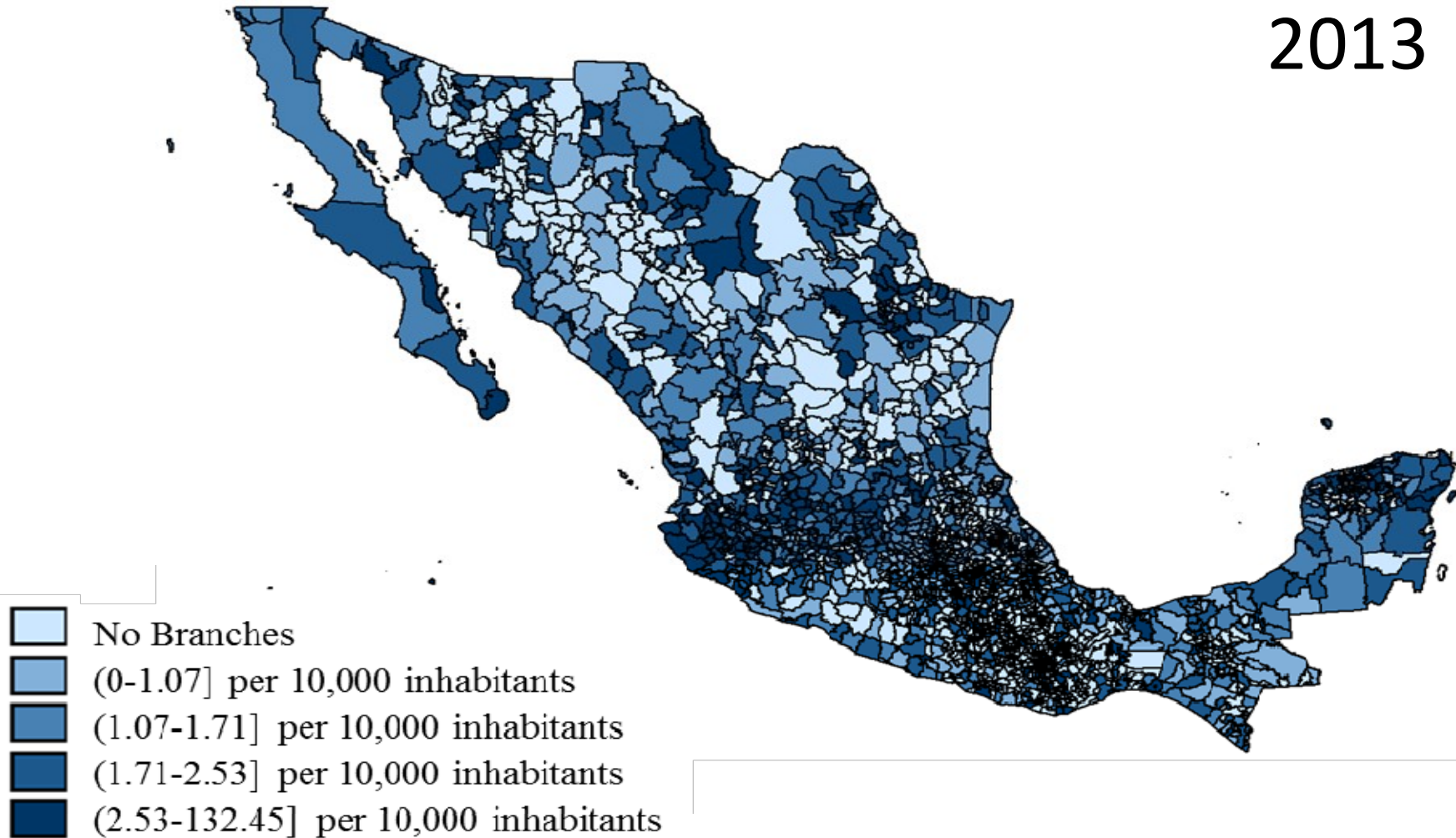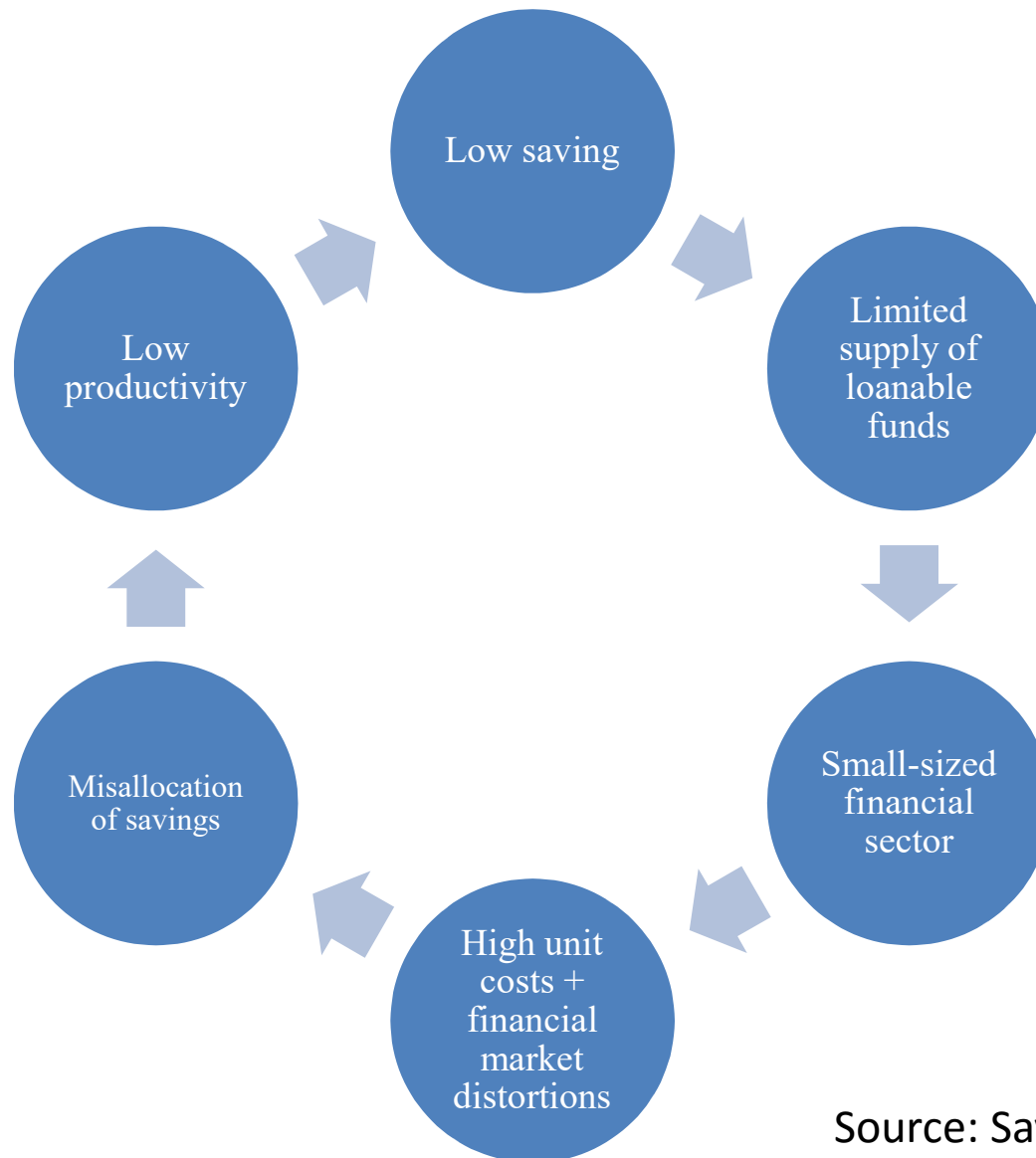
Source: Powell and Szekely (2015)

Some findings…

- Increased competition in municipalities that were already banked, not so much in those not banked
- Where financial institutions entered there was an increase in savings and in savings in financial institutions
- (IV used to control for endogeneity)
- Costs and/or trust…
- But not the whole story: relatively few households have savings in formal financial institutions, even in richer urban areas

Source: Powell and Szekely (2015)

Story 2: information comes in different flavors

- Harder vs. softer information…
- A) Hard information: on income, job status, (credit bureaus)…
  - This information may be more public
- B) Soft information: social networks
  - This information may remain private: bank-client
- In LAC perhaps latter dominates implying bank – client relations important, local monopoly power which leads to many banks, a small and high-cost banking system and an informal fringe…
- But where the former dominates this may lead to larger and more competitive banking system…

Story 3: Vicious cycle of low savings, low scale, high-costs, poor allocation & low productivity

- Low saving
- Limited supply of loanable funds
- Small-sized financial sector
- High unit costs + financial market distortions
- Misallocation of savings
- Low productivity

Source: Savings for Development (IDB)

Plan of the talk
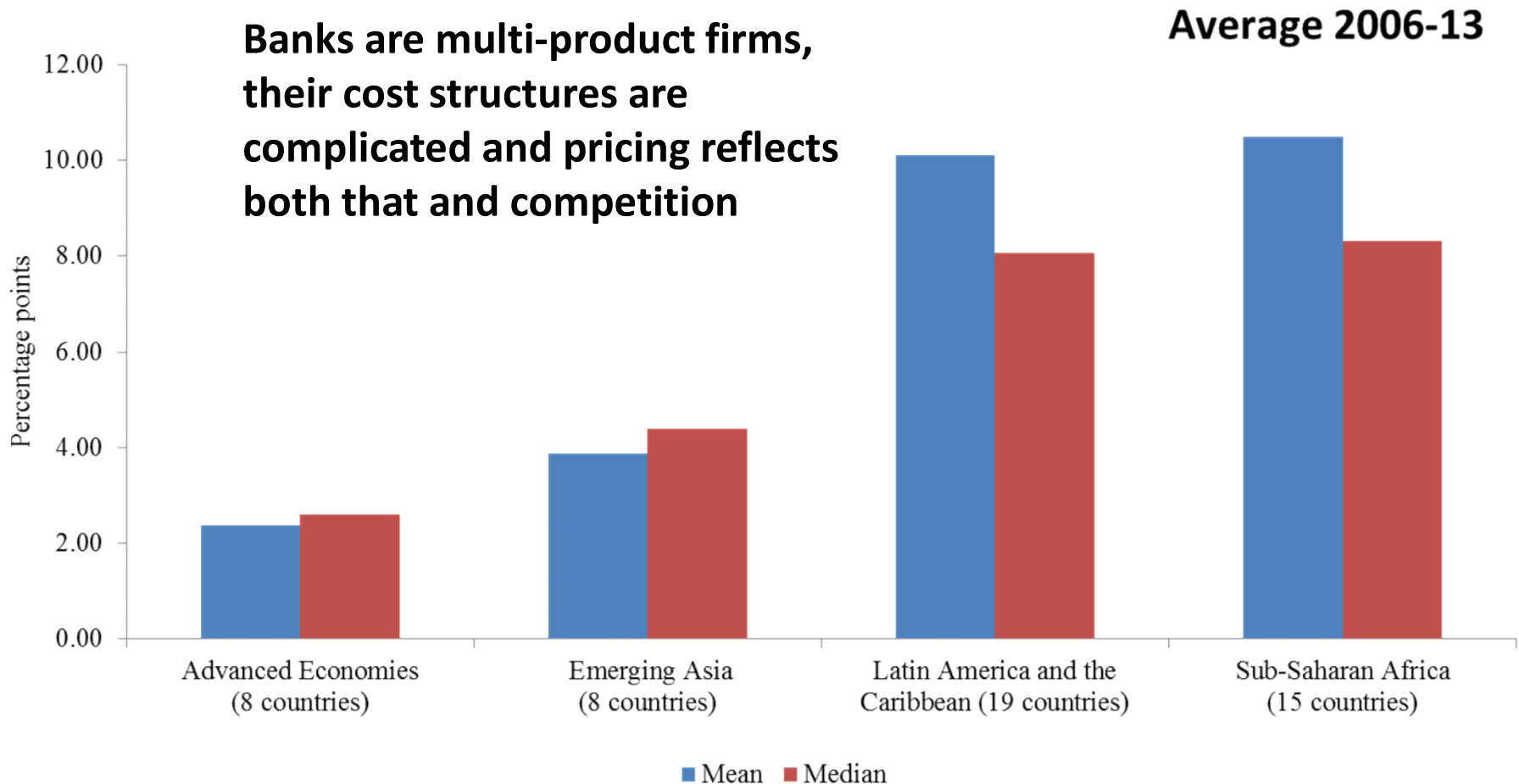
1. Data

2. Stories

3. **Policies**

How to get from A) to B):
Low Scale–High Cost ➡ High Scale-Low Cost...

- Creditor rights
- Information

Region	Depth of credit information index[a] (0-8)	Strength of legal rights index[b] (0-12)
Latin America and the Caribbean	5.8	4.4
Advanced economies	6.7	6.1
Other emerging countries	6.4	5.0

Source: Savings for Development (IDB)

Spreads (Lending – Deposit) are high...

Banks are multi-product firms, their cost structures are complicated and pricing reflects both that and competition

Average 2006-13

Note: Interest rate spread is the interest rate charged by banks on loans to private sector customers minus the interest rate paid by commercial or similar banks for demand, time, or savings deposits. The terms and conditions attached to these rates differ by country, however, limiting their comparability. See endnote 3 of chapter 2 for the list of countries in each country group.

Source: Savings for Development (IDB)

Banks are complicated multiproduct firms

- Microeconomics tells us there may be many market structures
- Can policies shift the equilibrium from
  - Low scale high cost to Larger scale lower cost?
- Policies: payment of salaries and transfers, free savings accounts
- Competition policies..
- But beware of trade-off between financial inclusion and stability
- Mobile/internet banking

# Government transfers paid thru the financial system
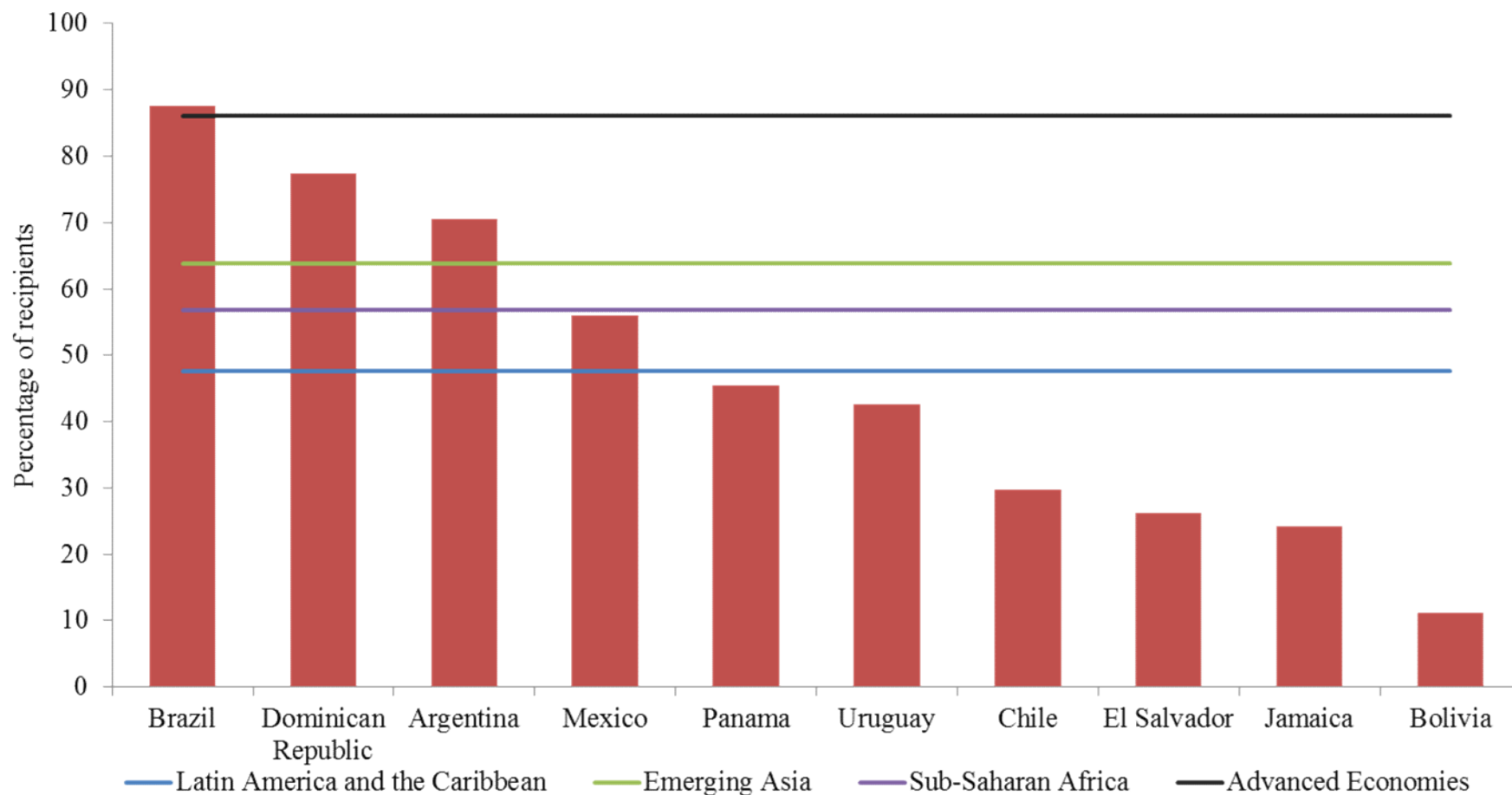
Note: Variable denotes the percentage of transfer recipients older than 15 years who received government transfers into an account at a financial institution or card in the past 12 months. See endnote 3 of chapter 2 for the list of countries in each country group.
Source: Authors' calculations based on World Bank (2014b).

Source: Savings for Development (IDB)

Mobile penetration is low
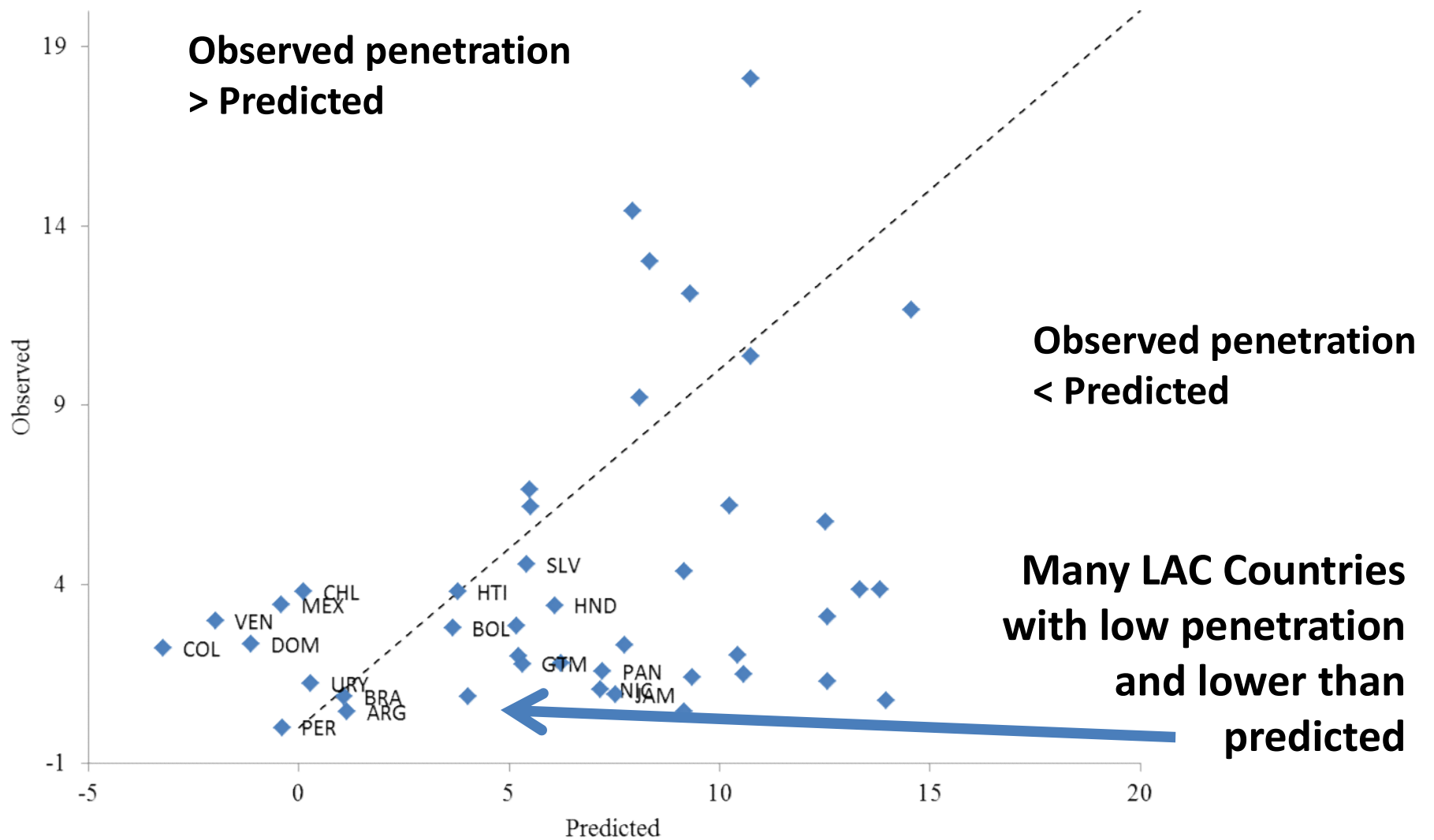
Source: Savings for Development (IDB)

How <u>NOT</u> to get from A) to B)…

- Little trade-off between regulations to enhance financial stability and financial inclusion

- High costs come largely from small scale

- Weakening regulations may lower trust, put stability at risk making the system smaller and even higher cost

- Need to manage expectations: it takes time to develop a strong, stable, large , efficient financial system, it will not happen overnight

On Basel and LAC…

- Solid capital buffers and standards are very useful
- But many aspects of Basel 1 → n are not a great "fit" for LAC:
  - Public credit bureaus - standardized IRB (Majnoni and Powell, Economia 2005)
  - we need longer maturity liabilities not that short term assets and short term liabilities match (bias to consumer lending?)
- In a January 2011 ASBA meeting in Lima, I proposed "Lima 1"
- Consistent with Basel 1→n but a better "fit" for LAC…

Conclusions

- Financial inclusion has improved in LAC but formal financial systems remain small and expensive

- Many households save more informally (informal or non-regulated institutions, or simply cash)

- Need to understand the market structure: endogenous entry, information and feedback loops

- A number of potential policy actions may be useful to push the system to greater scale and lower costs

- But no secret solution, safe, steady progress over time is key

Thank you