European Investment Bank

ECONOMIC REPORT ON PARTNER COUNTRIES

2006

A report by the

Development Economics Advisory Service (DEAS)

July 2006

ECONOMIC REPORT ON PARTNER COUNTRIES 2006

Table of Contents

Summary and Conclusions 3

Overview of Recent Economic Trends and Structural Issues in Partner Countries 4
by Valerie Herzberg

1. Global Developments 4

2. Mediterranean Partner Countries 6

3. Sub-Saharan Africa 8

4. Caribbean Economies 11

5. Latin America 11

6. Asia 12

Financial Sectors in Middle Income Partner Countries: Main Characteristics, Economic Relevance and Assessment 14
by Pedro de Lima and Simona Bovha Padilla

1. Introduction 14

2. Characteristics of Financial Sectors in MIPCs 14

3. Financial Development and Economic Growth 17

3.1 An Overview of the Literature 17

3.2 Finance and Growth in MIPCs 18

4. Conclusions 19

SUMMARY AND CONCLUSIONS

The 2006 Annual Economic Report on Partner Countries presents an overview of the main economic developments in countries covered by the EIB's mandates outside the EU: Africa, Caribbean and Pacific (ACP) plus South Africa, Asia and Latin America (ALA), and the Mediterranean Partner Countries (MPC), or a total of 123 countries accounting for about three quarters of the world's population and about 40 percent of the world's Gross Domestic Product.

The report first presents a review of global and regional economic developments in 2005. The world economy expanded by close to 5 percent in real terms, a rather robust performance driven by steady growth in the United States and the long-awaited economic recovery in Japan. Emerging markets put forward a very impressive performance, notably China, which transformed itself from one of the poorest countries in the world to one of its growth engines in little more than two decades. Also heartening was the fact that economic activity in sub-Saharan Africa expanded by more than 5 percent for the second year in a row. All this happened while oil prices were rocketing to all time records in nominal terms and other commodity prices were increasing rapidly as well. Unsurprisingly, oil-producers benefited from large revenue flows, while non oil-producers saw their current account balances deteriorate. However, inflationary pressures remained mostly subdued. On balance, short-term and medium-term prospects remain positive, despite the recent tightening in financial conditions, which have contributed to reawaken long-dormant volatility in world markets. In addition, the large global current account imbalances remain yet to be addressed and thus continue to threaten the stability of worldwide economic developments.

The report then turns its attention to the relationship between financial development and economic development. The widespread provision of financial services is commonly perceived as contributing to promote savings and facilitating investment decisions, and therefore enhancing long-term growth prospects. For the EIB, financial intermediaries in Partner Countries are also of strategic importance regarding the Bank's objective of promoting growth through private sector development. One of the most visible aspects of this strategy are the credit lines the EIB extends to financial intermediaries in Partner Countries as a mean to improve access to finance for small and medium size enterprises. On the basis of this experience, the report provides an empirical characterization of the main features of the financial sectors of middle-income Partner Countries. In this context, the report also reviews some theoretical and empirical evidence on the relationship between finance and growth and concludes tentatively that financial sectors need to reach some critical development level before their contribution to economic growth becomes positive. For countries in the initial stages of a reform process aimed at increasing financial intermediation levels – and ultimately economic prosperity – this result suggests that it takes some time before the seeds of financial reform bear fruit.

This report was prepared by a team of economists of the Development Economics Advisory Service (DEAS) – Simona Bovha-Padilla, Pedro de Lima and Valerie Herzberg – under the direction of Daniel Ottolenghi, Chief Development Economist and Bernard Ziller, Senior Economic Advisor. Robert Schmitz was responsible for database management and Sanja Steffgen for editorial treatment. The report was written on the basis of information available up to 31st May 2006.

OVERVIEW OF RECENT ECONOMIC TRENDS AND STRUCTURAL ISSUES IN PARTNER COUNTRIES
by Valerie Herzberg

1. Global developments

2005 was a year of robust global growth and ongoing recovery (Chart 1). World GDP grew by 4.8%. This was largely accounted for by sustained activity in the US and economic recovery in Japan. Growth in the EU remained muted. Emerging markets and developing economies experienced on the whole a good year, with growth particularly strong in Asia (7.8%) and Emerging Europe (5.1%), but African countries too approaching on the whole 4-5% rates. World trade began 2005 sluggishly, but gained momentum to end of the year registering 6% growth in merchandise goods. The rise in commodity prices propelled export growth in Africa, the Middle East, Central and South America and the Commonwealth of Independent States. Within the manufacturing sector, the largest export value increases were observed for iron, steel products and chemicals. In marked difference to the 1990s, although global demand recovered somewhat for computers and other electronic products, the trade value of these categories expanded no faster than that of manufactured goods in general.

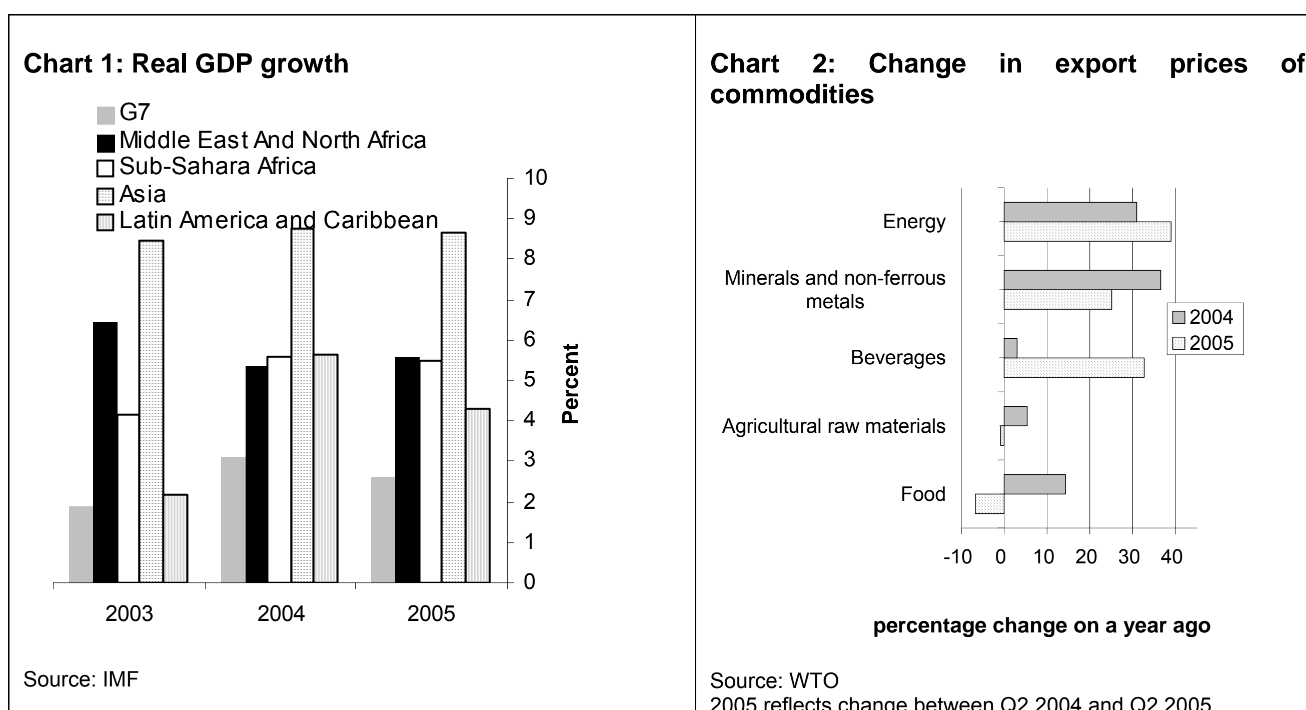


Chart 1: Real GDP growth

Source: IMF

Chart 2: Change in export prices of commodities

Source: WTO
2005 reflects change between Q2 2004 and Q2 2005.

Global activity has been supported by ongoing low real interest rates, despite the tightening of monetary policy in industrialized countries and headwinds from higher energy costs. Inflationary pressures have been contained, thanks to credible monetary frameworks, increased labour market flexibility, global competition and perhaps also a global savings-investment overhang. The US dollar has fluctuated during 2005, but with no marked trend vis à vis the euro, supported by a rising nominal short term interest rate differential in favour of the US and ongoing solid capital inflows, originating in Asia and in oil producers' surpluses in the Middle East. The latter may have reached US$ 300-450bn in 2005. Growth differentials and the rising cost of imported energy drove the US current account deficit to a record of 6.4% of GDP in 2005, raising doubts about the sustainability of current global growth patterns and increasing the risk of a disorderly unwinding. More recently, these doubts and evidence of higher global inflation have weighed on the US dollar and global equity markets.

Commodity prices rose further during 2005 (Chart 2), particularly the price of crude oil, owing to a mixture of strong demand (notably in China and the US), sticky supply and more costly extraction and political tensions surrounding some oil producers (Iran, Nigeria and Iraq). Oil prices averaged around US$ 65 per barrel in the first five months of 2006, more than twice the level three years earlier. Rubber and metal markets also benefited from strong industrial demand in China. Supply shortfalls in Vietnam, one of the biggest coffee producers, pushed up global prices. Prices of fibres and food on the other hand, key export products of many African economies, continued to stagnate. Taking the example of cotton – a major export for some Asian and African economies - prices have been on a declining trend in real terms over the past thirty years. This has reflected rising yields, due to technological progress, substantial inroads by cotton substitutes such as

synthetic fibres, and important subsidies in industrialized countries that encourage production and exports. The agreement reached in December 2005 in Hong Kong at the WTO Ministerial Conference in the context of the Doha trade round is expected to end all form of export subsidies in agriculture by 2013 with an accelerated end date of 2006 for cotton.[1] While the conference set specific deadlines for intermediate steps in the negotiations phase, including the conclusion of the round by end 2006, little progress has been made so far this year.

The global recovery has also helped enhance the creditworthiness of developing and emerging market economies. While internationally traded bond spreads have been narrowing, sovereign ratings have improved, including to a small degree in ACPs and MPC countries (Chart 3). Private capital flows to emerging markets surged in 2005. Both equity and credit flows picked up to close to US $400bn, up from a trough of around US$ 100bn in 2002, while official flows continued to decline, as repayments by major borrowers continued. While cyclical effects are important elements behind greater credit quality, strengthened external balance sheets through reductions in external debt and the build up in foreign exchange reserves have also played a role. But as reflected in the narrowing gap between local and foreign currency ratings, the improvement in public finances has been more moderate and suggests that deep rooted fiscal reforms have yet to take place in many economies (Chart 4). Moreover, it is possible that the optimism prevailing in emerging markets during 2005 reflected cheap borrowing costs in the G3 and the associated "search for yield" strategies as well as lower risk aversion. These are likely to unwind at some point in the future.[2] Indeed, in recent months, a number of emerging markets such as Turkey experienced currency turmoil and rising interest rates as foreign investors withdrew from markets amid concerns that US interest rates would rise more than previously expected.

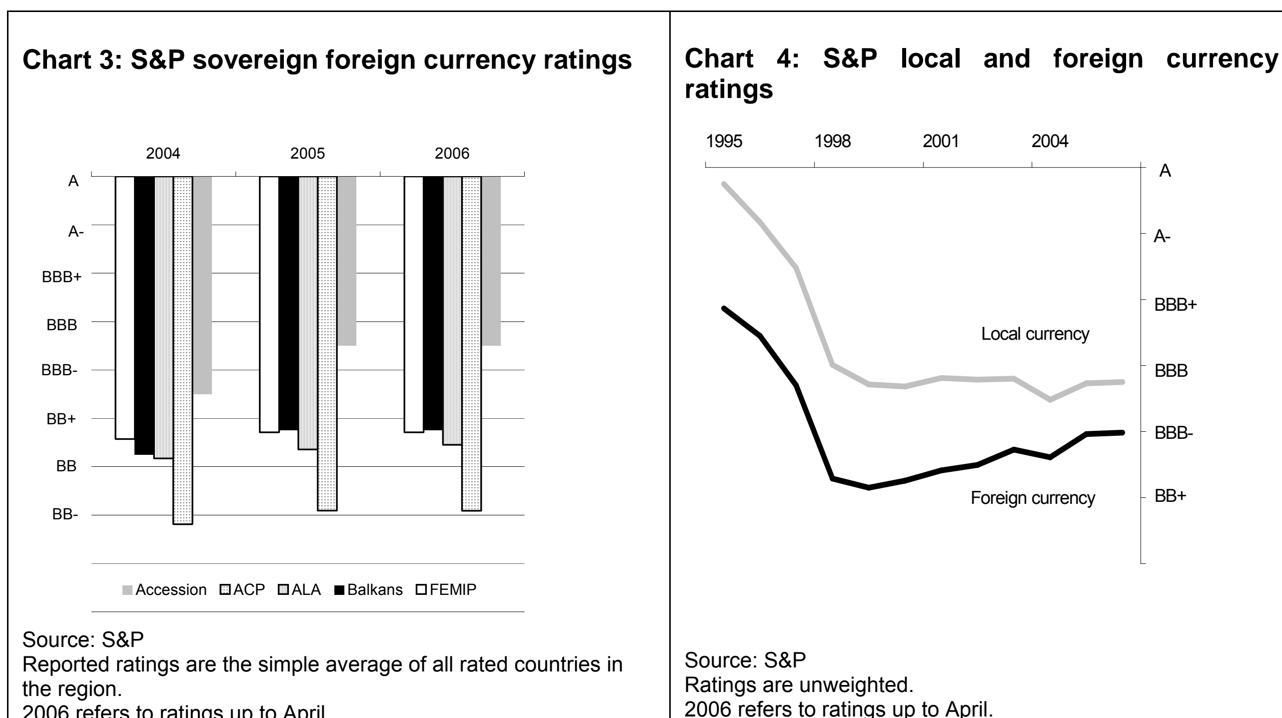


Chart 3: S&P sovereign foreign currency ratings

Source: S&P
Reported ratings are the simple average of all rated countries in the region.
2006 refers to ratings up to April.

Chart 4: S&P local and foreign currency ratings

Source: S&P
Ratings are unweighted.
2006 refers to ratings up to April.

The overall world economic outlook for 2006 and 2007 is relatively benign. While predicting further interest rate increases, the IMF expects GDP growth to hover around 4.9%, with again the US taking the lead among the G7. US activity is expected to be underpinned by strong corporate profits and hence investment and ongoing consumer demand strength, despite further rises in debt financing costs and the peaking of house prices. US demand should continue to pull activity in emerging markets, with emerging Asia again topping 7% on an annual basis and Africa and the Middle East recording 4-5% growth. Such a scenario would continue to support commodity prices, though the outlook for fibres is more uncertain and hinges partly on the implementation of the Doha trade round.

Prospects are however not without some notable downward risks: an unanticipated further tightening in global monetary conditions could change investor perception of country risk more widely, increase the cost of leverage and thus reverse capital flows from developing countries. Most affected from this would be

[1] Little progress was however achieved in facilitating market access and removing trade-distorting domestic support.
[2] See IMF Global Financial Stability Report, April 2006.

countries with large private sector based financing needs in Latin America and Emerging Europe.[3] A disorderly rebalancing of global savings-investment flows – as reflected by a rapid depreciation of the US dollar and rising US interest rates –could have even wider implications through dampening US demand and hence global activity and trade with direct effects on export driven economies in Latin America, Asia and increasingly Africa. A US dollar fall induced sudden deterioration of competitiveness of economies pegged to the euro (e.g. CFA zone) and inflationary threats in countries pegged to the US dollar (e.g. China, Lebanon, Jordan) could also endanger the stability of these monetary regimes (though for the latter the effect is likely to be attenuated thanks to increased competitiveness). Finally, a potential Avian flu pandemic could pose a risk to the working of global capital markets by disrupting operations and increasing risk aversion. In developing countries with a large rural sector, a direct depressing effect on activity could also be expected. According to the Asian Development Bank, the economic costs could be in the order of US$100-300bn, potentially bringing to a halt global economic growth for the duration of about one year.

2. Mediterranean Partner Countries

Apart from Lebanon where growth collapsed in the aftermath of the assassination of President Hariri in February 2005, economic conditions remained favourable in 2005. Growth averaged around 5% in the region (Table 1). Activity in energy exporting countries was again boosted by windfall gains associated with the rise in oil prices. But unlike previous oil-boom episodes in the 1980s, current account balances of all oil/gas exporters in the region recorded large surpluses as external balance sheets were strengthened through accumulation of reserves and repayment of external liabilities. For some oil importers, such as Jordan, Lebanon and Turkey, however, external financing needs continued to be substantial and current accounts widened. In Jordan, the current account is estimated to have reached 16% of GDP, partly also on account of a shortfall in grant money. But as elsewhere financing has been relatively easy and cheap. Increased capital inflows and liquidity have narrowed spreads and lifted stock markets across the region. According to the Morgan Stanley Capital Index the Egyptian Stock Market was the world's best performing in 2005 with a 125% overall annual return. This has raised questions about the appropriateness of market valuations, as reflected by stock market corrections throughout the region in early 2006.

Table 1: Macroeconomic indicators for MPCs

	Real GDP growth (%)				Inflation (%)				Current Account Balance (% of GDP)				Fiscal Balance (% of GDP)			
	2003	2004	2005	2006	2003	2004	2005	2006	2003	2004	2005	2006	2003	2004	2005	2006
Maghreb [a]	6.2	5.0	4.0	5.2	2.2	2.9	1.5	3.7	7.3	7.1	11.1	9.4	2.2	1.7	5.1	4.9
Mashrek & Turkey [b]	5.0	7.5	6.4	5.6	18.4	8.3	8.2	6.0	-2.2	-3.8	-5.3	-5.7	-10.6	-7.5	-4.0	-4.3
Israel	1.7	4.4	5.2	4.2	0.7	-0.4	1.3	2.4	0.7	1.6	1.9	1.0	-5.6	-3.8	-1.9	-3.0

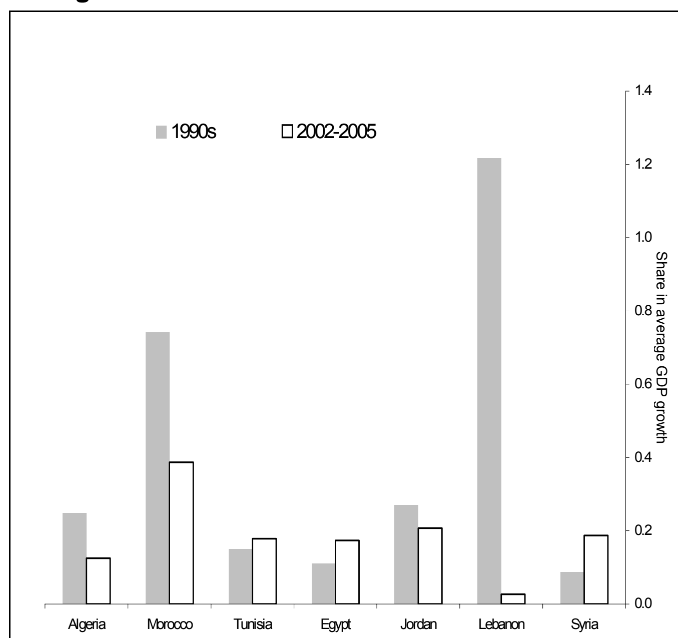
[a] Algeria, Morocco, Tunisia
[b] Egypt, Jordan, Lebanon, Syria, Gaza and West Bank
Source: IMF

[3] A number of emerging market economies however insured themselves against such event by prefinancing their 2006 issuing plans.

Government spending continued to play a key role in spurring growth, keeping fiscal deficits at high levels, notably in Lebanon, Egypt, Morocco and Jordan. Some progress appears to have been made however in curtailing public involvement in some countries, as reflected in a declining contribution of government consumption to GDP growth relative to the 1990s (Chart 5).[4]

Despite the rise in energy prices, inflation has been contained throughout most of the region. This has reflected still negative output gaps, managed or pegged exchange rate systems, the sterilization of foreign exchange reserves (e.g. Morocco, Algeria, Tunisia) and interest rate increases (Israel, Jordan, Lebanon). Inflation in Egypt has been falling since 2004, thanks to the increased credibility of the new inflation-targeting regime and an appreciating exchange rate.

Chart 5: Contribution of government consumption to GDP growth in selected MPCs



Source: IMF

Structural reform progress during 2005 has been mixed. Most countries are still – to various degrees – transitioning from centrally-planned public sector dominated economies to more market-based systems. Efforts have however accelerated in Egypt, focusing on foreign exchange reform, trade liberalization and the tax system. Privatisation is also progressing in Jordan in the telecoms and transport sectors. Large-scale privatisations and restructuring of public banks are ongoing in Egypt and Algeria. These should improve risk assessment capacities and strengthen banks' capital base, encouraging commercially-oriented lending to the private sector. In Turkey, structural changes are being spurred by the start of EU accession negotiations. In Syria and Gaza-West Bank, on the other hand, political tensions and increased uncertainty have rendered economic reform more difficult if not impossible. Research has shown that institutional reforms are positively associated with trade openness (Chart 6) and negatively with natural resources. [5] Increased pressure to liberalize trade – through the gradual implementation of association agreements with the EU to form a free trade zone by 2010 – should thus foster deep-rooted reforms, even though they might be toned down due to current windfall gains accruing from the oil price shock.

Despite the recent more favourable macroeconomic conditions, the region's weaknesses continue to be considerable. Substantial reliance on portfolio equity or banking flows in Jordan or Lebanon represents a vulnerability in the context of rising global interest rates and significant geo-political risks. A large public debt burden in some countries (public debt to GDP ratios in Israel, Egypt and Lebanon are above 100% of GDP) and potentially large contingent liabilities suggest fiscal sustainability risks – with respect to growth, interest rates and/or exchange rate shocks – and a limited degree of flexibility to cushion the effects of adverse shocks. The large share of public sector activity is also a significant drag on private sector development. Institutional frameworks remain highly distortive – as reflected by relatively low scoring in investment climate surveys, contributing to a misallocation of resources (Table 2).

[4] The sharp drop in the contribution of government consumption in Lebanon is also due to debt swaps by official creditors in 2005, reducing debt-servicing costs. Note that while in Algeria public consumption has declined relative to GDP, the role of the government in stimulating activity remains significant as reflected in a rising contribution of public investment.

[5] Regional leadership in reform was also found to be a relevant factor encouraging change, perhaps because countries compete for a regional pool of money. See September 2005 IMF World Economic Outlook

Table 2: World Bank Investment Climate indicators for MPCs[(6)]

	Delay in obtaining an electrical connection (days)	Average time to clear direct exports through customs (days)
Algeria	94.3	8.6
Egypt	80.1	4.8
Syria	51.8	5.6
Turkey	5.7	4.2
New EU Member States	12.95	2.9

Source: World Bank

Chart 6: Institutional strength and trade openness in MPCs

Doing busines score ranking, 155=worst
Egypt
Syria
Algeria
Lebanon
Jordan
Turkey
Morocco
Tunisia
Israel
155
140
120
100
80
60
40
20
0
30 50 70 90 110 130 150
Exports and imports as % of GDP

Source: World Bank, IMF

3. Sub-Saharan Africa

Economic growth on the whole persisted at a relatively high rate during 2005, with the region expected to have grown by 5.6% (Table 3). Conditions were especially favourable for oil, metal and coffee exporters. External financing needs declined in countries such as Nigeria and South Africa. Oil price rises, weather related food production shortfalls and the removal of textile quotas however put some pressure on current account deficits, inflation and activity in many other African countries (Chart 7). CPI inflation in oil-importing countries rose from 4.2% in 2004 to 6.7% in 2005.[7] Still, despite these adverse shocks and in contrast with previous decades, more-stability oriented macroeconomic policies and greater political stability in many parts of the continent supported activity. In the CFA zone, for example, economies grew on average by 4.1% in 2005, while Mozambique and Ethiopia both recorded growth in excess of 7% per annum. Zimbabwe has been one notable exception again, with the economy contracting in each of the past six years, with a cumulative shrinkage of about 34% in GDP since 1999 and inflation close to 1000% in 2005.

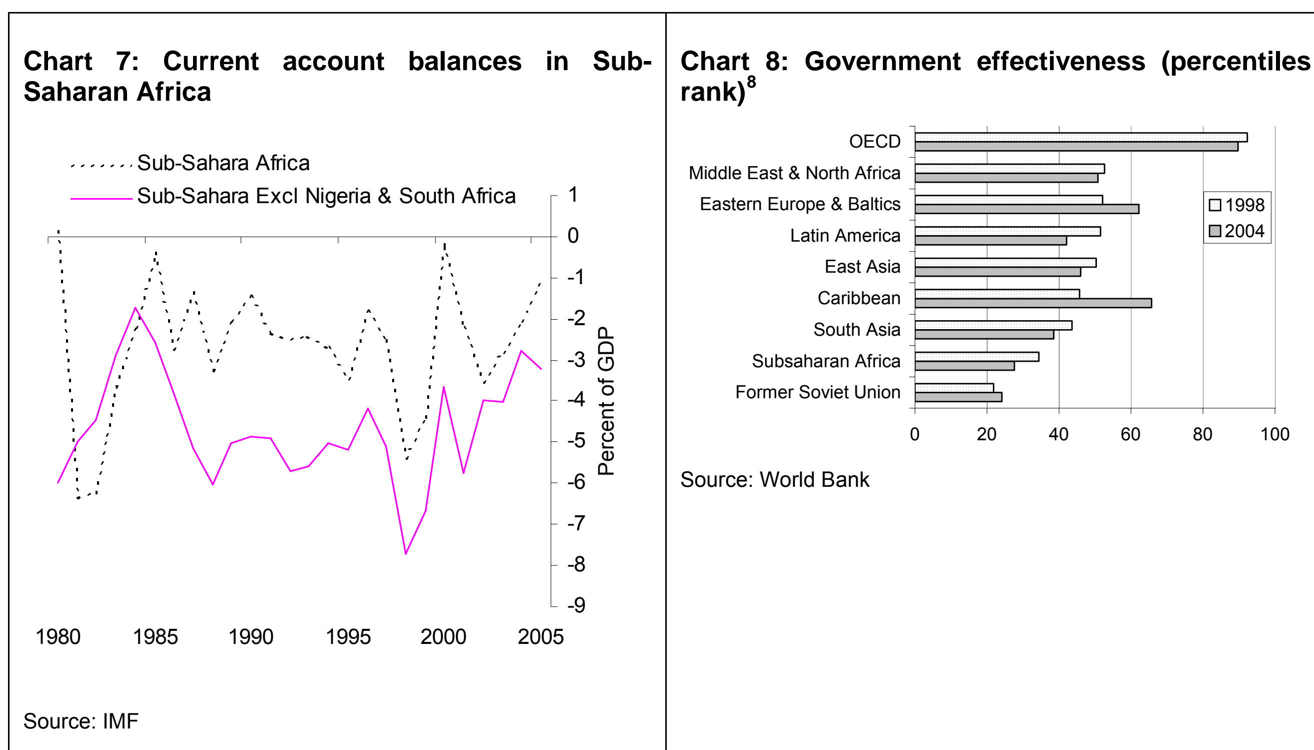
---

[6] Data for other MPC countries unavailable.
[7] This excludes Zimbabwe.

Table 3: Macroeconomic Indicators for Sub-Saharan Africa

	Real GDP growth (%)				Inflation (%)				Current Account Balance (% of GDP)				Fiscal Balance (% of GDP)			
	2003	2004	2005	2006	2003	2004	2005	2006	2003	2004	2005	2006	2003	2004	2005	2006
Sub-Saharan Africa	4.5	5.4	5.6	5.7	14.1	9.7	10.0	13.8	-3.0	-2.0	-1.5	-0.5	-2.2	-0.2	0.8	1.6
African-oil producing countries [d]	7.1	7.2	6.8	7.7	21.3	13.8	13.2	7.5	-4.3	2.4	8.1	10.1	-1.6	4.5	7.4	11.6
East Africa [e]	3.7	6.3	6.8	7.4	8.6	8.3	8.0	8.4	-3.8	-3.8	-7.2	-6.1	-2.1	-0.9	-2.5	-3.4
Central Africa [f]	5.2	8.9	4.5	3.8	3.6	1.5	5.9	3.7	-8.3	-3.6	1.1	3.0	-0.1	1.3	5.9	6.2
West Africa [g]	7.5	4.9	5.7	5.5	10.5	10.1	13.5	7.3	-3.1	0.5	4.2	5.6	-2.0	3.0	4.3	8.6
Southern Africa [h]	3.2	4.9	5.4	5.8	19.1	11.5	9.6	20.0	-1.9	-2.6	-3.3	-2.6	-2.5	-1.6	-0.8	-1.1

[d] Angola, Cameroon, Chad, Congo (Republic), Côte d'Ivoire, Equatorial Guinea, Gabon, Nigeria, São Tomé & Príncipe
[e] Djibouti, Eritrea, Ethiopia, Kenya, Sudan, Tanzania, Uganda
[f] Burundi, Cameroon, Central African Rep., Chad, Congo (Republic), Congo (DRC), Equatorial Guinea, Gabon, Rwanda, São Tomé & Príncipe
[g] Benin, Burkina Faso, Côte d'Ivoire, Gambia, Ghana, Guinea, Guinea-Bissau, Mali, Mauritania, Niger, Nigeria, Senegal, Sierra Leone, Togo
[h] Angola, Botswana, Lesotho, Madagascar, Malawi, Mozambique, Namibia, South Africa, Swaziland, Zambia, Zimbabwe
Source: IMF



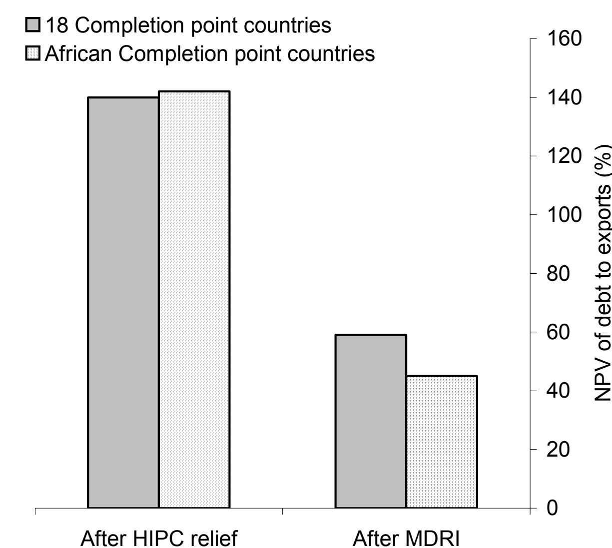
While systematic violence has indeed been limited, many countries continue to be affected by political uncertainty and/or unrest, stifling the investment climate. A bloodless coup d'état led to a change in power in Mauritania, while in Uganda long standing president Museveni managed to cling on to another mandate in elections that encountered substantial irregularities. The first democratic elections in the Democratic Republic of Congo planned for July 2006, after numerous delays, required a 16 0000 UN peacekeeping force amid ongoing violence and unrest and political uncertainty remains as high as ever in Cote d'Ivoire,

[8] The percentile rank indicates the percentage of countries worldwide that rate below the selected region.

affecting trade routes and heightening social tensions in neighbouring countries. In Nigeria too, regional unrest intensified, disrupting oil exploration with effects on global oil prices.

Some countries made progress on structural reforms. In Ghana, petrol price liberalization advanced. Nigeria increased capital requirements on the banking system to encourage consolidation and efficiency. Rwanda improved land titling and labour laws. Gabon published its first EITI report on the management of oil revenues for 2004. In Chad however, cooperation between the World Bank and the government in the financing and building of the Cameron-Chad oil pipeline broke down (though a compromise appears to have been found recently), following disagreements over management and governance of oil revenues. Overall, the region still fares among the worst on the Word Bank governance indicators and has even in certain areas regressed relative to other countries (Chart 8).

Chart 9: Impact of MDRI on external public debt to exports ratio



Source: World Bank

The most salient development for Sub-Saharan Africa in 2005 is represented by the Multilateral Debt Reduction Initiative (MDRI). At the G8 Gleneagles summit in July 2005 the heads of state agreed to double aid by 2010 - an extra $50 billion worldwide and $25 billion for Africa - and to write off immediately the IMF, World Bank and African Development Bank debts of 18 of the world's poorest countries, most of which are in Africa.[9] Average debt to export ratios are expected to fall to 45% from over 140% (Chart 9). The size of debt relief varies from country to country. Regarding IMF debts for example, Zambia will save resources worth 7.9% of GDP, while the gain for Ethiopia is worth less than 1%. Debt relief is expected to free up resources for developmental spending in priority areas such as education, health and infrastructure and to prevent unsustainable debt levels. The evidence with existing debt relief however suggests that the long-term effects on economic growth are less clear and dependent largely on strong governance and public expenditure standards and prudent post-relief borrowing policies. The Paris Club creditors also agreed to write off $17 billion of Nigeria's debt, the biggest single debt deal ever. It remains to be seen whether this systemically important country (in terms of transport links, population and size) is finally embarking on a period of increased stability and growth, with potential significant ramifications for the rest of Africa.

Against this background, the overall outlook is positive, but is not without challenges. Ongoing world trade growth and strong demand for raw materials from China should maintain the growth momentum. The IMF expects growth to rise to 5.8% in 2006, the highest in three decades. Within this, the pick up owes much to surging growth in oil producing countries as new capacity comes on line (Congo, Mauritania, Angola). Debt relief should encourage developmental and infrastructure spending and thus increase the region's growth potential while reducing vulnerabilities to external shocks. Completion of the Doha Trade Round should better the prospects of cotton exporters. However, achievement of the Millennium Development Goals by 2015 remains far off.[10] Despite the recent recovery, the region's poverty rate remains the world's highest and little changed from 1990: 44 % of the population live on less than $1 a day. On current trends, poverty is expected to only decline to 38% of the population, well above the targeted 22%. Adverse shocks could however halt even these modest gains in poverty reduction. Substantial falls in US and/or Chinese growth could weaken export demand for raw materials, particularly affecting Nigeria, Angola, Chad and Botswana. Aid budgets could be cut if industrialized countries were to face a marked slowdown or recession. A widespread breakout of Avian flu could disrupt activity in many countries of the region and reduce incomes especially of poor households.

[9] Initially, 17 HIPC countries are eligible for 100 percent debt cancellation: Benin, Bolivia, Burkina Faso, Ethiopia, Ghana, Guyana, Honduras, Madagascar, Mali, Mozambique, Nicaragua, Niger, Rwanda, Senegal, Tanzania, Uganda and Zambia. Mauritania has completed the HIPC program, but will qualify for relief after implementing key public expenditure management reforms.

[10] See the World Bank Global Monitoring Report, April 2006.

4. Caribbean economies

Economic growth bounced back in 2005, reaching close to 5.5%, up from 3.2% in the previous year (Table 4). Affected particularly harshly by hurricanes in the recent years[11], the region is transitioning away from some of the traditional industries particularly prone to damage, such as the production of sugar cane and bananas. Another traditional industry, tourism, while also negatively affected, continues to be on solid footing as a wave of post-hurricane reconstruction and even new construction demonstrates. But government balance sheets are fragile. Public debt levels are high and rising, reaching over 90% of GDP in 2005, up from 70% in the mid 1990s. The region is now home to seven of the world's ten most indebted emerging market countries. A large portion of public sector debt is being held by local banking systems, raising systemic vulnerabilities and discouraging effective intermediation of savings to the private sector. Moreover, external account positions of many of the countries have recently suffered from the high oil prices though natural gas and oil producers, such as Trinidad and Tobago have benefited from the recent highs.

But as documented by the World Bank governance indicators, countries in the region have substantially enhanced their institutional frameworks. Regulations are being put in place to reduce money laundering and related criminal activity. In addition, measures are being taken to liberalise trade. The initiated Single Market and Economy agreement (CSME) should boost regional trade and investment, but is also seen as an effective way to strengthen the region's bargaining position in trade negotiations. Inaugurated on 1 January 2006, the single market component of the CSME has been adopted by 6 member states (Jamaica, Barbados, Belize, Guyana, Suriname, Trinidad and Tobago) and 6 member states have signed their intent to join by the end of June 2006 (Antigua and Barbuda, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines).[12] The common market would encompass a population of 6 million people with a combined GDP of approximately 30 billion USD. Reflecting this potential, financial integration has been progressing: cross-listed companies in regional stock exchanges already account for around 60% of total market capitalization. But in order to mitigate the spillover risks associated with increased financial integration, regional oversight of cross-border flows will have to be enhanced.

Over the short to medium term, growth is expected to remain strong at 5.8% in 2006, supported by high tourism receipts and a construction boom ahead of the 2007 Cricket World Cup in several countries of the region. Most countries enjoy macroeconomic and political stability. With few exceptions, the region has a strong track record of social stability, as well as well functioning democratic systems. Key risks to this outlook include devastating hurricane activity and demand shocks to tourism activity, especially bearing in mind the limited fiscal flexibility of many countries in the region.

Table 4: Macroeconomic Indicators for the Caribbean economies [j]

Real GDP growth (%)				Inflation (%)				Current Account Balance (% of GDP)				Fiscal Balance (% of GDP)			
2003	**2004**	**2005**	**2006**	**2003**	**2004**	**2005**	**2006**	**2003**	**2004**	**2005**	**2006**	**2003**	**2004**	**2005**	**2006**
3.6	3.2	5.5	5.8	14.4	21.8	7.5	8.0	0.2	2.0	-1.0	-1.4	-2.4	-2.3	-0.7	-0.3

[j] Bahamas, Barbados, Belize, Dominica, Dominican Republic, Grenada, Guyana, Haiti, Jamaica, St. Lucia, Suriname, Trinidad and Tobago
Source: IMF

5. Latin America

Robust economic expansion continued in Latin America with overall growth of 4.1% recorded in 2005 (Table 5). Commodity producers benefited from windfall gains, boosting growth in Argentina, Venezuela and Chile. Improved fiscal management, effective inflation targeting and the appreciation of exchange rates contributed to contain inflationary pressures. Annual inflation remained around 5-6% on average in 2005. Only Argentina and Venezuela, experimenting with populist policies and using price controls, recorded at times double-digit inflation. Connected with this, the region experienced solid capital inflows, largely in terms of portfolio equity investments. Stock and bond markets rallied – dollar denominated equity returns ranged from 166% in Venezuela to 741% in Colombia during 2003-2005. In some countries, nominal exchange rates appreciated.

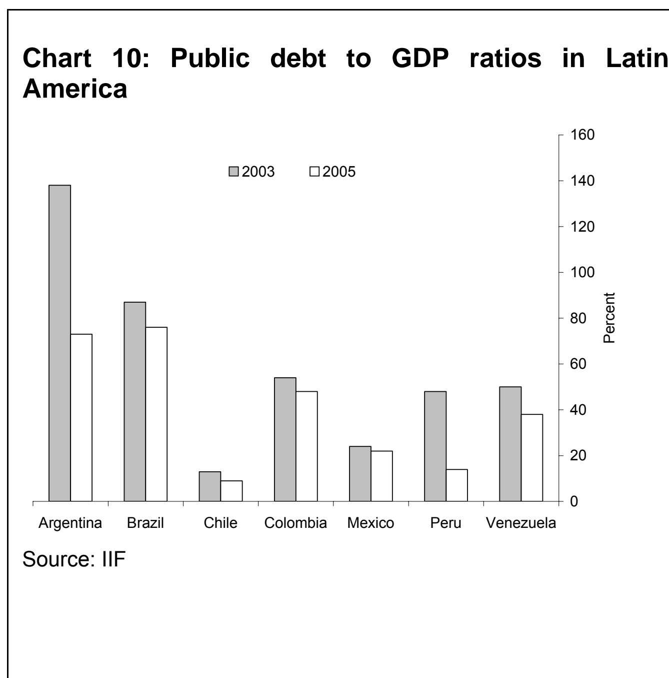
[11] In September 2004, Hurricane Ivan tore through the Caribbean leaving a trail of devastation behind it. In Grenada alone total damages are estimated at USD 900 million, or nearly double the country's GDP.
[12] An initiative of the Caribbean Community and Common Market (CARICOM) organization, the CSME is composed of two components, of which the single market component allows goods, services and skilled workers to move more easily throughout the region, while the planned single economy component provides for common currency, single stock market, and removal of other restrictions so as to create a single economic space and unify the countries' economic and trade policies.

The commodity price boom and cheap access to external capital have been strengthening external balance sheets: current account surpluses were 1.2% of GDP on average in 2005 and foreign exchange reserves accumulated. Public debt, notably the external and FX linked component – a key vulnerability across Latin America - has been reduced to an average of around 45% of GDP in 2005 (Chart 10). In mid 2005, Argentina exchanged $62.2 billion of its defaulted public debt for $35.2 billion of new bonds, lowering the net present value of its liabilities by over 60%. Brazil and Argentina also repaid all outstanding US$ 15.5bn and US$ 9.6bn IMF obligations. Brazil, Colombia and Uruguay issued global bonds in local currency thus again lowering the vulnerability with respect to exchange rate shocks.

Despite the improved cyclical conditions, the continent's potential growth rate continues however to be held back by a weak investment climate – largely due to regulatory arbitrariness, ineffective judiciaries and rigid labour markets. Structural reforms have been delayed and at times reversed in recent years as policymakers have become increasingly critical of liberal policies. By way of example, Argentina and Bolivia are both in the process of partly nationalizing foreign-owned utility sectors.

Looking ahead, in the short run favourable global developments should continue to underpin activity, though the expected tightening in global monetary conditions is likely to push up bond spreads and increase debt servicing costs. More than any other region Latin America depends on more volatile portfolio flows. A disorderly unwinding of global imbalances manifested in capital outflows and reduced demand for commodities would pose risks to economic growth in these countries.

Chart 10: Public debt to GDP ratios in Latin America



Source: IIF

Table 5: Macroeconomic Indicators for Latin America

	Real GDP growth (%)				Inflation (%)				Current Account Balance (% of GDP)				Fiscal Balance (% of GDP)			
	2003	2004	2005	2006	2003	2004	2005	2006	2003	2004	2005	2006	2003	2004	2005	2006
Latin America[i]	1.7	5.8	4.1	4.2	8.1	4.7	5.1	4.6	-0.1	0.2	0.1	-0.1	-2.3	-0.8	-1.6	-1.6
Central America[k]	3.4	3.9	3.8	3.9	5.2	6.9	8.1	7.0	-5.2	-5.7	-4.9	-4.9	-2.6	-1.8	-1.4	-1.7
Andean[l]	0.6	8.8	6.7	5.1	11.9	8.5	6.8	6.0	2.7	3.5	4.9	3.9	-3.5	-2.0	-0.8	-0.2
Argentina	8.8	9.0	9.2	7.3	13.4	4.4	9.6	12.9	6.3	2.2	1.8	1.2	-1.9	-1.6	-2.3	-2.6
Brazil	0.5	4.9	2.3	3.5	14.8	6.6	6.9	4.9	0.8	1.9	1.8	1.0	-4.0	-1.5	-3.8	-2.8
Mexico	1.4	4.2	3.0	3.5	4.5	4.7	4.0	3.5	-1.3	-1.1	-0.7	-0.6	-1.6	-0.0	-0.5	-1.1

[i] Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay, Venezuela
[k] Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, Panama
[l] Chile, Colombia, Ecuador, Peru, Venezuela
Source: IMF

6. Asia

Growth in emerging Asia continued at an unabated rate of around 7-8% in 2005 (Table 6). Most of this was accounted for by China and India, who grew respectively by close to 10% and 8%. Economic activity was largely export driven, though in some countries (India and Pakistan) strong agricultural production also played a role. Domestic investment, while strong in countries such as China, overall remained below levels seen in the mid 1990s. Positive sentiment about the region's activity was displayed in surging regional asset prices. The impact on economic activity of the December 2004 Tsunami and the Asian flu outbreak have been small. While the number of victims of the Avian flu has reached over one hundred, the impact has

been confined to the poultry sector.[13] To date, considerable subsidization of fuel costs have buffeted the highly energy dependent region from rising energy prices. But mounting fiscal liabilities (and to some degree pressure from financial markets) encouraged countries like Indonesia, Philippines and Thailand to adjust retail prices, spurring cost-push inflation.

Foreign exchange reserves rose by US$ 250bn during 2005. China's current account surplus has risen substantially since 2002 and is estimated at 7.1% of GDP in 2005 (Table 6)—now accounting for two-thirds of the regional surplus, compared to around one-quarter in 2002. Developing Asia's trade balance with the US accounted for around 38% of the US trade deficit in 2005. But current accounts in the region were also buoyed by strong remittances flows, originating notably in Middle Eastern oil producing countries. The accumulation of foreign exchange reserves reflects central bank intervention to prevent the appreciation of real exchange rates, notably in China and Malaysia, giving rise to complaints that such policies were distorting global trade flows. Elsewhere, however, real appreciation has progressed, though apart from Korea, price competitiveness in Asia is still higher than before the Asian crisis.

Reforms to financial sectors, key to stimulating a sustainable growth in private demand and investment, and thus also to a global rebalancing of savings flows, have made some progress over the past twelve months. China injected capital into three of the large state-owned banks, most recently the $15 billion injection into the Industrial and Commercial Bank of China. At the same time, strategic foreign partners have been found for several other banks. Blanket deposit guarantees are being gradually removed in Malaysia and Indonesia. In the Philippines, under proposed amendments to the central bank charter, legal protection for bank supervisors is being strengthened.

Table 6: Macroeconomic Indicators for Developing Asia

	Real GDP growth (%)				**Inflation (%)**				**Current Account Balance (% of GDP)**				**Fiscal Balance (% of GDP)**			
	2003	**2004**	**2005**	**2006**	**2003**	**2004**	**2005**	**2006**	**2003**	**2004**	**2005**	**2006**	**2003**	**2004**	**2005**	**2006**
Asia [m]	7.4	8.0	7.7	7.6	2.5	4.0	3.5	3.8	3.3	3.6	4.3	3.9	-1.8	-1.3	-1.1	-1.2
Asean4 [n]	5.4	5.9	5.2	5.1	3.9	4.3	7.1	8.4	5.5	4.4	3.2	2.8	-2.0	-1.8	-1.4	-1.2
NIA [o]	3.2	5.9	4.6	5.2	1.5	2.4	2.2	2.2	6.9	7.0	6.1	5.9	0.8	1.1	0.9	0.8
China	10.0	10.1	9.9	9.5	1.2	3.9	1.8	2.0	2.8	3.6	7.1	6.9	-2.4	-1.5	-1.3	-1.1
India	7.2	8.1	8.3	7.3	3.8	3.8	4.2	4.8	1.5	0.2	-2.5	-3.1	-5.3	-4.4	-4.1	-4.2

[m] Bangladesh, Brunei Darussalam, China, India, Indonesia, Korea, Lao People's Dem.Rep, Malaysia, Mongolia, Nepal, Pakistan, Philippines, Singapore, Sri Lanka, Thailand, Vietnam, Yemen
[n] Indonesia, Malaysia, Philippines, Thailand
[o] Newly Industrialized Asia: Hong Kong, Korea, Singapore, Taiwan
Source: IMF

Looking ahead, growing world trade should continue to support activity in South and East Asia. Moreover, increased public investments, more effective financial systems and exchange rate appreciation should gradually shift the drivers of growth from external sources to domestic demand, contributing to a measured unwinding of global unbalances. Key risks to the outlook include a financial or social crisis in China, an abrupt and sharp depreciation of the US dollar and recession in the US – largely through trade links – and a generalized avian flu outbreak. The latter would particularly damage growth in countries with large service sectors, such as Singapore, Thailand and Malaysia.

[13] The Avian flu outbreak has however increased the incidence of poverty in afflicted economies.

FINANCIAL SECTORS IN MIDDLE INCOME PARTNER COUNTRIES: MAIN CHARACTERISTICS, ECONOMIC RELEVANCE AND ASSESSMENT

by Pedro de Lima and Simona Bovha Padilla

1. Introduction

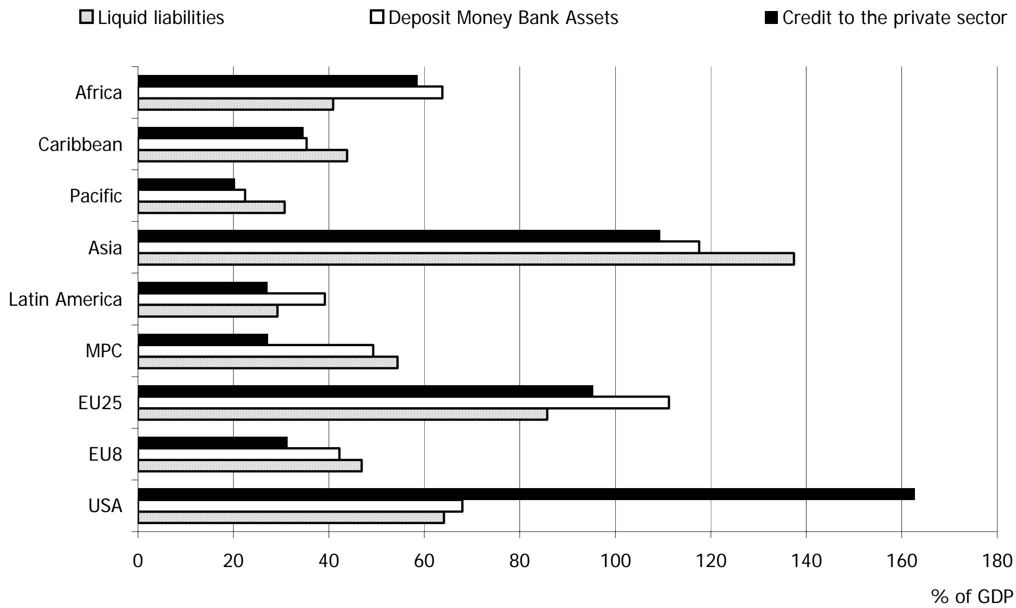
Financial sectors and their level of development, performance and efficiency are commonly seen as important contributors to the economic development of countries. The widespread provision of financial services contributes to promote savings and facilitate investment decisions and ultimately enhances long-term growth prospects. For the European Investment Bank (EIB), financial sectors in Partner Countries are also a strategic instrument to achieve its stated objective of promoting economic growth through private sector development.[14] Credit lines to financial intermediaries are one of the most important instruments used by the EIB to finance the investments placed by small and medium size enterprises (SME) in Partner countries. Given these two sets of considerations – overall economic relevance and importance for the EIB – the appraisal of such operations is carried out with particular care. On the basis of this experience, we provide here a broad characterisation of the financial sectors in 59 middle income Partner Countries, followed by an empirical investigation of the role played by financial sectors in the promotion of the economic development of these countries.

2. Characteristics of financial sectors in MIPCs

Typically, the development stage of financial sectors (financial depth) is described by a set of quantitative indicators that includes measures such as liquid liabilities, deposit money bank assets, or credit to the private sector. This set of three indicators (scaled by GDP) shown below in Chart 1 suggests that the level of financial development in MIPCs is broadly correlated with the overall level of economic development of those countries, though there is wide dispersion. Developed economies – such as those of the European Union or the United States – show high levels of financial intermediation, notably in terms of credit extended to the private sector. Among MIPCs, Asian countries – particularly China and Malaysia – have already reached levels similar to those of developed countries. At the other extreme, financial depth in Latin American countries is relatively weak, with levels of credit extended to the private sector below those registered in African MIPCs. It is however worth noting that African figures are driven almost entirely by South Africa's, whose financial sector is indeed quite developed. In fact, the indicators displayed in Chart 1 even place African MIPC's one step above the eight Central and Eastern European countries that acceded the European Union in January 2004, as far as financial development is concerned.

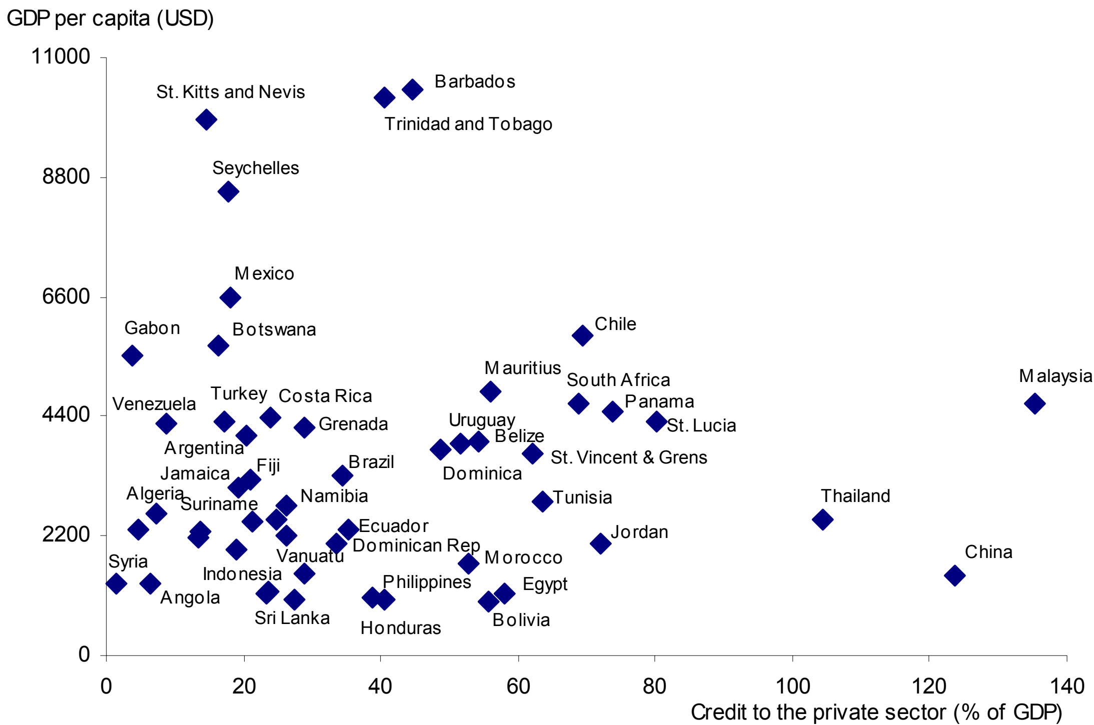
[14] For the purposes of this section, Partner Countries are defined as the set of countries considered in EIB mandates covering non-European countries: Africa, Caribbean, Pacific and Overseas countries and territories (ACP), Asia and Latin America (ALA), and Mediterranean Partner Countries (MPC). While not technically under the ACP mandate, in this section South Africa is taken as an ACP country. Moreover, middle income Partner Countries (MIPC) correspond to the ALA, ACP, and MPC countries that are defined as middle-income countries by the World Bank for which a reasonably comprehensive database on financial sector issues is available. The list of countries – hereafter labeled as Middle Income Partner Countries (MIPC) – is as follows: in ACP, Angola, Antigua and Barbuda, Barbados, Belize, Botswana, Cape Verde, Djibouti, Dominica, Dominican Republic, Equatorial Guinea, Fiji, Gabon, Grenada, Guyana, Jamaica, Mauritius, Namibia, Samoa, Seychelles, South Africa, St. Kitts and Nevis, St. Lucia, St. Vincent, Suriname, Swaziland, Tonga, Trinidad and Tobago, and Vanuatu; in ALA, Argentina, Bolivia, Brazil, Chile, China, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Honduras, Indonesia, Malaysia, Maldives, Mexico, Panama, Paraguay, Peru, Philippines, Sri Lanka, Thailand, Uruguay, and Venezuela; and in MPC, Algeria, Egypt, Jordan, Lebanon, Morocco, Syria, Tunisia, and Turkey.

Chart 1: Financial depth indicators



Source: IMF, World Bank. For each of the three indicators of financial depth, the group variables Africa, Caribbean and Pacific (ACP), Asia and Latin America (ALA) and MPC correspond to the weighted average of the individual middle income partner countries figures as defined in footnote 14. EU25 is the corresponding weighted average of the European Union countries, while EU8 is the weighted average for the 8 Central and Eastern European countries that acceded the EU in 2004.

Chart 2: Financial depth and economic development



Source: IMF, World Bank

It is also important to point out that the relationship between financial development and economic performance in MIPCs suggested by Chart 1 at an aggregate level becomes considerably weaker once the analysis is taken at an individual country level. Chart 2 above shows that the simple correlation between income per capita and credit to the private sector is quite weak and that no obvious pattern between income per capita levels – taken as a proxy for economic development – and financial development seems to exist. As discussed in further detail below, the relationship between the level of financial development and the overall economic performance of countries can be rather subtle, as the benefits of financial development might not kick in before financial sectors reach some critical mass. Evidently, what might be at stake here is the characterization of financial development provided by simple indicators of financial depth such as the ones employed so far. While each of those different measures identify specific characteristics of financial sectors and provides a comprehensive overview of the size of financial sectors, there are significant structural and institutional details on which those indicators are mute.[15, 16]

Financial sectors across MIPCs tend to be dominated by banks. As shown in Table 1 below, other market segments, notably equity and bond markets, are typically quite incipient, despite some significant progress in recent years. Particularly underdeveloped is the corporate bond market, whose capitalization levels are considerably below those of developed economies – even those of the vast majority of EU countries whose financial sectors are also bank dominated. The difference is even more striking to the US, with its highly developed capital markets – about 35 percent of the credit extended to the private sector is not bank-related.

In addition to contributing to channel savings to productive investments, the continued development of capital markets in MIPCs might also prove itself instrumental in increasing competition levels in the banking sector. Currently, even after the process of financial liberalization that has characterized most developing countries since the early 1990s – which has contributed to a progressive reduction in the share of assets held by government-owned institutions – banks in MIPCs appear to still enjoy a rather protected environment when compared with peer institutions in developed countries. This is particularly evident when US banks are set as a benchmark: there, the three largest commercial banks hold little more than 30 percent of total commercial bank assets, in sharp contrast with the 75 percent figure for corresponding African MIPC banks. Similarly, the high overhead costs in Latin American banks, and the high net interest margins in Latin American and MPC banks, suggest that competitive levels in the banking sectors of those countries remain sub-optimal (see Table 1).

This notwithstanding, banking sectors in many MIPCs tend to display modest aggregate performance indicators, reflecting difficult business conditions as well as deficient risk management practices. While capital adequacy ratios at an aggregate level are significantly above the 8 percent level set by the Basel core principles – or even above the more conservative 10 percent level usually recommended for emerging market economies – significant asset quality problems are quite common across MIPCs' banking sectors. The level of non-performing loans for Middle Eastern and Sub-Saharan African countries displayed in Table 2 below is a good illustration of this rather prevalent problem in developing countries.

[15] The quantitative indicators of financial development presented in Table 1 by no means exhaust the list of indicators used in the relevant literature to characterize financial development. In addition to the ones presented here, different money measures (narrow, broad and quasi-money), different credit measures (central bank domestic, commercial banks domestic credit), the real interest rate, or even indicators such as stock exchange liquidity, and rural population per rural bank branch have been commonly employed.

[16] See Gelbard and Leite (1999and Creane et al. (2004) , for a more comprehensive approach to a quantitative characterization of financial development. These two papers develop indices encompassing six different dimensions of financial development: development of the monetary sector and monetary policy, banking sector development, non-bank financial development, regulation and supervision, financial openness, and institutional quality. While quite informative, their approach is not easily replicable and is therefore not pursued in the current paper.

Table 1: Financial Sector Characteristics

	Africa	Asia	Latin America	MPC	EU25	EU8	USA
Life insurance penetration	13.7	1.5	0.9	0.3	5.2	1.1	4.4
Non-life insurance penetration	2.7	0.9	1.6	1.0	3.3	2.0	4.7
Stock market turnover ratio	36.1	90.4	23.7	107.4	93.3	41.7	169.1
Private bond market capitalization	9.7	11.4	6.7	n.a.	39.4	4.9	106.8
Public bond market capitalization	36.4	16.9	25.9	42.5	47.6	29.3	44.1
Concentration	75.3	63.8	51.7	54.3	60.1	58.1	31.6
Overhead Costs	7.4	1.7	7.5	4.5	3.7	4.3	3.8
Net Interest Margin	6.3	2.4	9.3	8.1	2.9	4.2	4.1

Source: IMF, World Bank.

- The first set of variables provides a characterization of the non-banking sectors. Insurance penetration variables are premium volumes as a share of GDP; Stock market turnover ratio is the ratio of the value of total shares traded to average real market capitalization; and bond market capitalization variables are (private/public) debt outstanding as a share of GDP. See Chart 1 for the definition of the regional aggregates.
- The second set of variables provides a characterization of competition conditions. Concentration corresponds to the share of assets all commercial banks held by the three largest banks; Overhead costs are the average value of a bank's overhead costs as a share of its total assets; and Net interest margin is the average value of bank's net interest revenue as a share of its interest-bearing assets.

Table 2: Soundness Indicators

	Return on Assets			Non-Performing Loans to Total Loans			Regulatory Capital to Risk-Weighted Assets		
	2002	2003	2004	2002	2003	2004	2002	2003	2004
Emerging Asia	0.8	0.9	1.3	15.5	13.1	10.8	13.8	14.3	14.3
Emerging Europe	0.9	1.5	1.5	9.8	8.7	7.6	19.1	18.7	17.5
Latin America	–1.3	1.3	1.6	12.0	9.6	6.6	13.7	14.7	16.1
Middle East	1.2	1.2	1.5	14.7	14.3	13.4	15.2	14.9	14.6
Sub-Saharan Africa	2.1	3.1	3.1	16.9	14.6	13.3	17.7	16.6	16.9

Source: IMF, Global Stability Review (2005). The regional groupings included in this table include all available (and not just MIPC) country data.

3. Financial development and economic growth

3.1 An overview of the literature

While discussions on the relationship between financial development and growth can be traced back to Schumpeter (1912), advances in computing power and the availability of economic data for a large number of countries in the late 1980s launched a large-scale empirical literature on the subject. A series of empirical articles initiated among others by King and Levine (1993), brought the discussion to the forefront of economic literature in the 1990s. The usual result from this literature is that ***financial development*** has ***a positive, monotonic effect on growth***[17].

At a theoretical level, the link between finance and growth is seen as reflecting the economy-wide reduction in transaction and information costs stemming from the increased availability of financial instruments and institutions. More precisely, the link is established through the following different channels:

[17] As mentioned previously, over the short and medium-term reverse feedback effects might take place.

1. *Supply of credits for investment*. A developed, competitive financial sector ensures relatively small deviations between lending and deposits interest rates, which in turn enlarge savings that can be transformed into credits for investment projects of the non-banking sector. A functioning financial sector ensures high private savings rates due to an attractive interest rate. High private savings facilitate investment activities of private firms and enable an economy to grow rapidly. This saving rate effect is intensified when the growth dynamics are also driven by human capital accumulation. Hence, the financial sector could raise the formation of human capital through the provision of credit to private households, which use it for private education investments.

2. *Provision of information.* A developed financial sector facilitates the channelling of savings into the most profitable investment projects because banks and insurance companies monitor investment projects and provide information about potentially innovative enterprises to their customers.

3. *Insurance of risks.* Since more profitable investment projects are usually associated with higher risks, improving insurance possibilities against these risks can significantly increase investments financed by given savings. This insurance function is the more important the more economic growth is driven by technological innovations that are linked to high sunk costs. R&D drives the technological knowledge of an economy through spillover effects, which in turn increases Total Factor Productivity (TFP).

The theoretical and empirical support in favour of the hypothesis that finance market development enhances growth is partly responsible for the agenda of financial market reform adopted by a significant number of countries and pushed for by the international community, notably the Breton Woods institutions, since the early 1980s. It is therefore important to clearly identify how financial development policies will affect growth. In fact, one of the reasons why financial sector development is interesting as a determinant of growth is that there is much a government can do to foster or restrain it.

Past experiences show that in many cases financial liberalization contributes to growth acceleration. However, in other instances, rapid expansion of financial sectors has lead to crises and lower overall growth. Often financial development policies have been subsequently reversed, as in the case of Latin America, where liberalization policies were often followed by financial crashes.[18] Furthermore, some literature has introduced some nuances on the relationship between finance and growth, with some showing that the effect of finance on growth differs across countries or time periods[19], while others point out that the effect declines as the level of financial development increases.[20]

3.2 Finance and growth in MIPCs

In what follows, the paper investigates the link between finance and growth in MIPCs. For a sample of 59 MIPCs during 1980-2005, work in progress in DEAS suggests that the *effect of finance* on *growth is not uniformly positive* and even *when positive its size depends strongly on the adopted measure of financial development.*[21] Results suggest tentatively that **financial development yields a strong positive effect on economic growth only once it has reached a certain critical threshold**. Until that point, the impact of further financial development on growth might actually be negative.

There are several possible theoretical arguments to explain the impact of finance on growth according to the stage of financial development reached by a country. For the initial stages of financial development, a number of arguments point to the importance of economies of scale effects. First, larger financial sectors allow greater opportunities for pooling and managing risk. Therefore, a large financial sector may be more efficient than a small one. Second, experiences in many countries have shown that the expansion in the financial sector produces sound results only if the regulatory and supervisory authorities have enough expertise to manage this expansion. Since financial sector “expertise” is accumulated in a learning-by-doing manner, the financial sector may have to develop to a certain size before the rules of its functioning are sophisticated and regulators are more effective. For more developed financial sectors, the theoretical literature shows that the effect of financial development on growth will decline with further improvements. This is due to diminishing returns[22]and also because in countries with highly developed financial markets

[18] See Diaz-Alejandro(1985).
[19] See Demetriades and Hussein (1996).
[20] See Levine et al (2000).
[21] These results are based on work in progress from Simona Bovha.
[22] See Greenwood and Jovanović (1990).

much of the allocation of savings occurs through non-bank channels,[23] which is not readily captured using standard measures of financial development.[24]

The results reported here were obtained using two alternative measures of financial development, namely, credit to the private sector and liquid liabilities of the financial sector (both as ratios of GDP). For each of these two variables, empirical thresholds are determined to define low, medium and high financial development.[25]The data are supportive of the hypothesis that financial development has a positive impact on growth *once countries reach a high level of financial development*. The magnitude of the results is sensitive to the measure of financial development employed, and the growth impact of finance is estimated to be stronger when financial development is measured by the credit to the private sector variable. However, the direction of the effect is unequivocal. Similarly, we also find a clear cut growth impact of financial development for countries with a low financial development level: *intensifying financial development contributes negatively to growth.* Again an increase in private credit has the strongest negative effect.

These results suggest that countries that engage in financial reforms aiming at strengthening the financial sector with the ultimate objective of boosting economic development need to take a long term view. Indeed, in the short to medium-term, i.e. until some critical value of financial development is reached, the development of financial sectors might hinder growth. Furthermore, the same result might even hold true for countries that start their reform programs after having reached a medium level of financial development. A somewhat surprising result is the fact that the negative impact from financial development on growth for countries in the middle financial development region appears to be stronger than for those in the low financial development region.

One possible explanation for the apparent complex relationship between finance and growth identified in MIPCs has to do with the shortcomings of each of the different proxies of financial sector development used in this paper. For example, liquid liabilities to GDP are a measure of size, which may not entirely reflect the effectiveness of the financial sector. In developing countries, sometimes cheap and abundant credit has been issued by state-owned banks without many questions asked about the expected productivity of the project. As many of these projects later fail, the increase in liquid liabilities may not lead to higher growth rates. On the other hand, the same qualitative results are obtained even when using the credit to the private sector variable, the preferred measure of Levine et al., op. cit, because it "isolates credit issued to the private sector" (pp. 38). This includes credit issued by banks and other financial intermediaries, and it is found to have a negative impact on growth in countries with both low and medium financial development. A possible explanation is once again that while the credit is extended to the private sector, some of it may be issued by central banks, government, development banks, or other official bodies, and thus not always based on commercial considerations. Therefore, project failure and bankruptcies could lead to lower economic growth.

As pointed out before, a significant number of MIPCs still have financial sectors that fall in the low and medium regions of financial development. In light of the results just presented, an important policy question is how a country moves to the high region where the payoff from financial development appears more certain. The threshold defining the high region is relatively low, (35 percent for the credit variable and 30 percent for the liquid liabilities one) suggesting that the effect of finance on growth kicks in fairly early. However, it is important to note that sustained improvements in financial development can be difficult to engineer especially starting from such low levels.

4. Conclusions

This section presents an empirical characterization of the financial sectors of middle-income Partner Countries based on the experience of the EIB operations in support of the financial sector in these countries. Typically, the level of financial development in MIPCs goes hand in hand with the level of overall economic development though the relationship is complex. Banking sectors dominate the financial landscape, competitive pressures remain relatively small, but economic volatility and risk management practices that still require strengthening contribute to significant asset quality problems.

[23] See De Gregorio and Guidotti (1995)

[24] In our selected sample this issue is not too relevant since we observe only middle-income countries.

[25] For the private credit to GDP ratio, low financial development corresponds to the case when the ratio falls below 14 percent; medium development if the ratio is between 14 and 35 percent, and high for any value above 35. In the sample, 14 countries out of 59 were in the low region (with 7 African and 4 Latin American countries) between 1981 and 1985, and 20 were in the high region (with 6 Latin American, 6 Caribbean, 4 Mediterranean, and 3 Asian countries). Between 2001 and 2005, the number of countries in the low region reduced to 6 (out of these 3 African countries), and the number of countries in the high region increased to 31 (10 Caribbean, 7 Latin American, 5 Mediterranean, 4 African and 3 Asian countries). Similar results are obtained when the measure of financial development is set by the liquid liabilities variable.

.

This section also reviews some theoretical and empirical evidence on the relationship between finance and growth in MIPCs. The data reviewed here appear to support tentatively the hypothesis that financial sectors need to reach some critical mass before their contribution to economic growth is positive This preliminary result is interesting because it is at variance with much of the findings of the literature and calls for further investigation.

References:

Gelbard, Enrique A., and Sergio Pereira Leite, 1999, "Measuring Financial Development in Sub-Saharan Africa," IMF Working Paper 99/105

Creane, Susan, Rishi Goyal, A. Mushfiq Mobarak, and Randa Sabfor, 2004, "Financial Sector Development in the Middle East and North Africa," IMF Working Paper 04/201

Schumpeter, Joseph A., 1912, "Theorie der wirtschaftlichen Entwicklung" (The Theory of economic Development), Leipzig: Dunker & Humblot, translated by REDVERS OPIE. Cambridge, MA: Harvard U. Press, 1934

King, Robert G. and Ross Levine, 1993, "Finance, Entrepreneurship, and Growth: Theory and Evidence", Journal of Monetary Economics, 32(12), pp.513-542

Diaz-Alejandro, Carlos, 1985, "Good-Bye Financial Repression, Hello Financial Crash," Journal of Development Economics, 19, pp. 1-24

Demetriades, Panicos and Khaled Hussein, 1996, "Does Financial Development Cause Economic Growth?" Journal of Development Economics, 51(2), pp. 385-409

Levine, Ross, Norman Loayza, and Thorsten Beck, 2000, "Financial Intermediation and Growth: Causality and Causes," Journal of Monetary Economics, 46(1), pp. 31-77

Greenwood, Jeremy and Bojan Jovanović, 1990, "Financial Development Growth, and the Distribution of Income", Journal of Political Economy, 98(5), pp. 1076-1107

De Gregorio, J. and Pablo Guidotti, 1995, "Financial Development and Economic Growth", World Development, 23(3), pp. 433-448