MIDDLE EAST
AND CENTRAL ASIA
DEPARTMENT

Strengthening Growth through Financial Development

Chapter 3 of October 2024 Regional Economic Outlook for the Middle East and Central Asia

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Will Abel, Apostolos Apostolou, Vizhdan Boranova, Vahid Hassani, Troy Matheson (co-lead), Hela Mrabet, Salem Nechi, Thomas Piontek (co-lead), Bilal Tabti, and Subi Suvetha Velkumar.

Motivation and Outline

- A well-developed, inclusive, and stable financial system is needed to help countries navigate economic transformation and fund the new economy.

- This chapter examines financial development in the MENA & CCA regions and assesses the factors holding it back, and how financial reforms can boost development and growth.

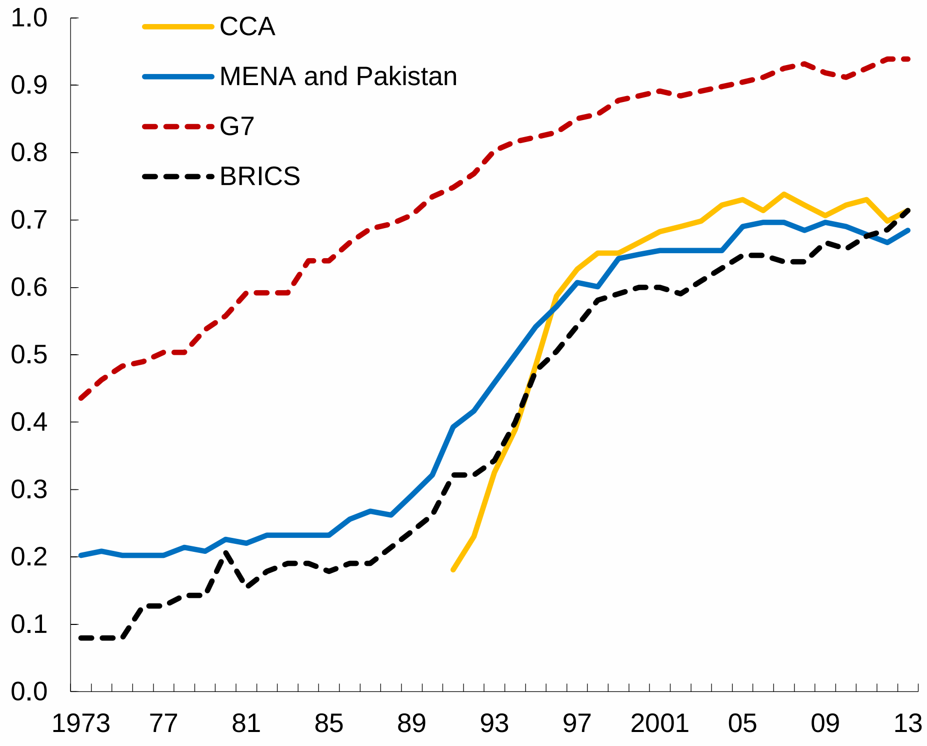
- Three key analyses:
  - *Financial development across subregions and sources of nonbank financing*
  - *Factors that can help lift financial development*
  - *Financial reforms and economic growth*

Financial Development Remains Incomplete

Progress on Financial Development Varies Across the Region

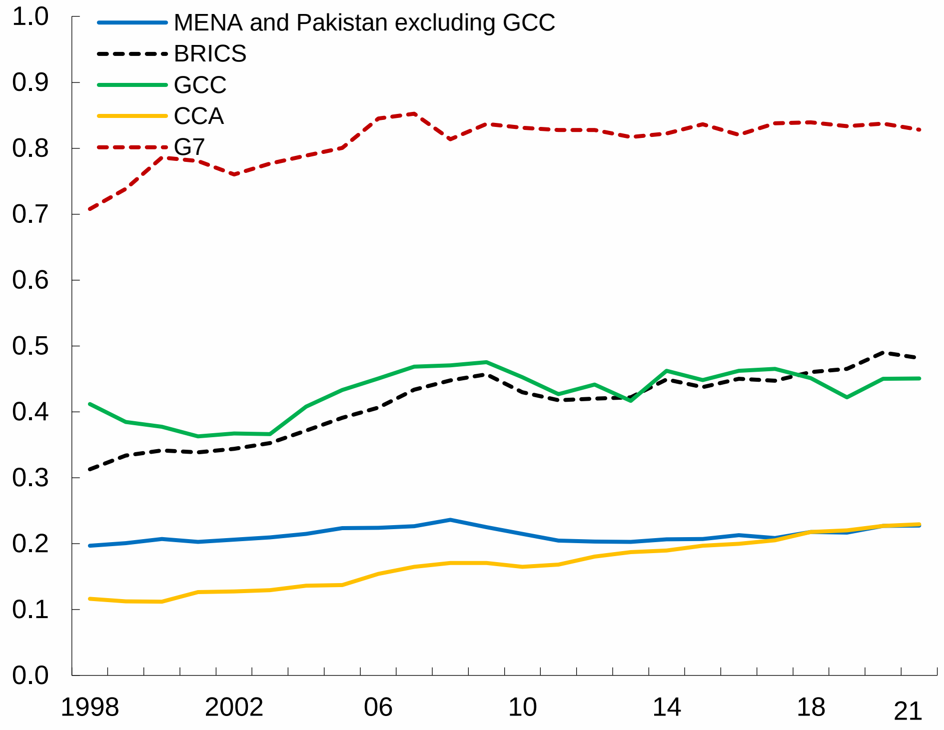
The region has seen a notable increase in financial reforms that has been broadly in line with large emerging markets…

Financial Reforms Index
(Index level, 0 to 1)



… while progress on financial development has varied across the region and slowed in some cases

Financial Development Index
(Index level, simple averages)



Sources: IMF, Financial Development Index; Financial Reforms Database (Omori 2022); and IMF staff calculations

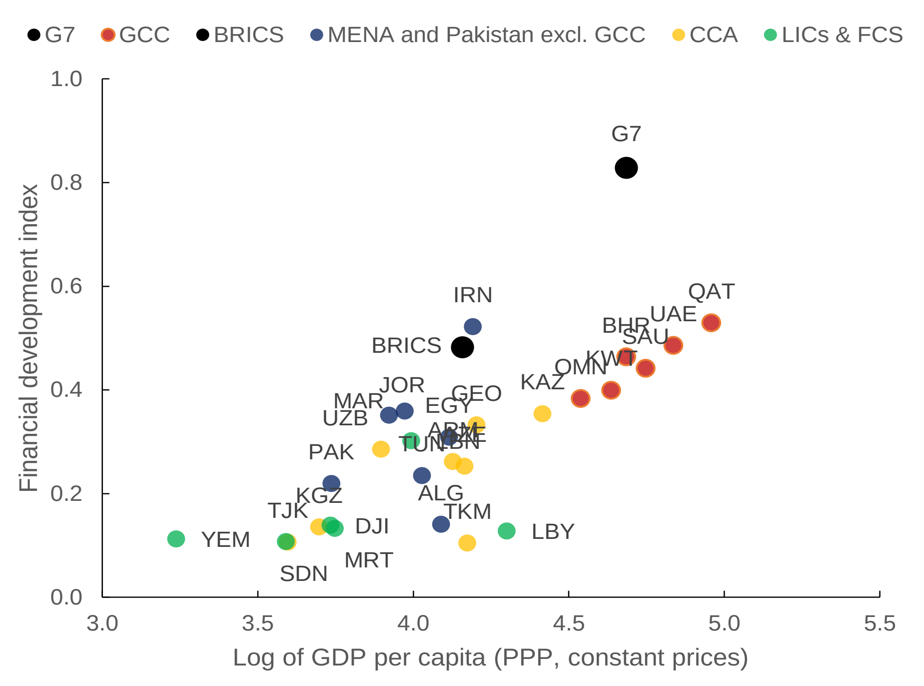
Note: For the left chart, only two GCC countries (Saudi Arabia and the United Arab Emirates) are covered in the financial reforms database and are included in the MENA and Pakistan aggregate. BRICS = Brazil, Russia, India, China, South Africa; CCA = Caucasus and Central Asia; G7 = Group of Seven; GCC = Gulf Cooperation Council; MENA = Middle East and North Africa.

Financial Systems Are Mostly Bank-Based With Scope For Further Development

The level of financial development in most MENA and CCA countries lags economies with similar per capita GDP…

MENA and CCA Country-Level Financial Development and GDP-per-Capita

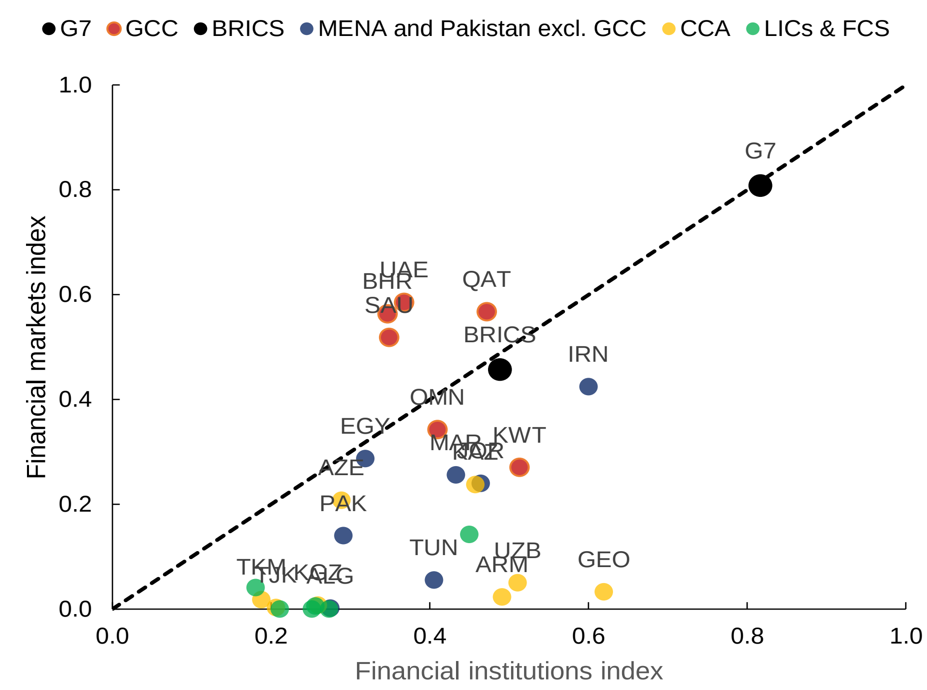
(Index level and Ratio, as of 2021)



… alongside differences in the level of financial institutions versus markets development

MENA and CCA Country-Level Financial Institutions and Markets Development

(Index level, as of 2021)



Sources: IMF Financial Development Database and IMF staff calculations.

Notes: BRICS and G7 averages are used. The data used to measure financial development was developed by Sahay and others (2015) and consists of two sub-components, financial institutions and financial markets. Financial institutions include banks, insurance companies, pension funds, mutual funds, and other nonbank financial institutions. Financial markets include stock and bond markets. Each sub-component is composed of three sub-indices covering depth, access, and efficiency of institutions and markets.

Roadblocks to Financial Development

Key Factors Underpinning Financial Development in MENA and CCA

Groups	Monetary Stability	Rule of Law	Share of Public Sector Credit	Exposure of Economy to Natural Resources	Role of State-Owned Banking
CCA					
GCC					
MENA excl. GCC					
Advanced economy					
Emerging market					
Direction of significant impact on financial development	+	+	–	–	–

Sources: Fraser Human Freedom Index; World Bank Development Indicators; IMF International Financial Statistics; and IMF staff calculations.

POLICY MESSAGES

CCA | Low scores on monetary stability and rule of law

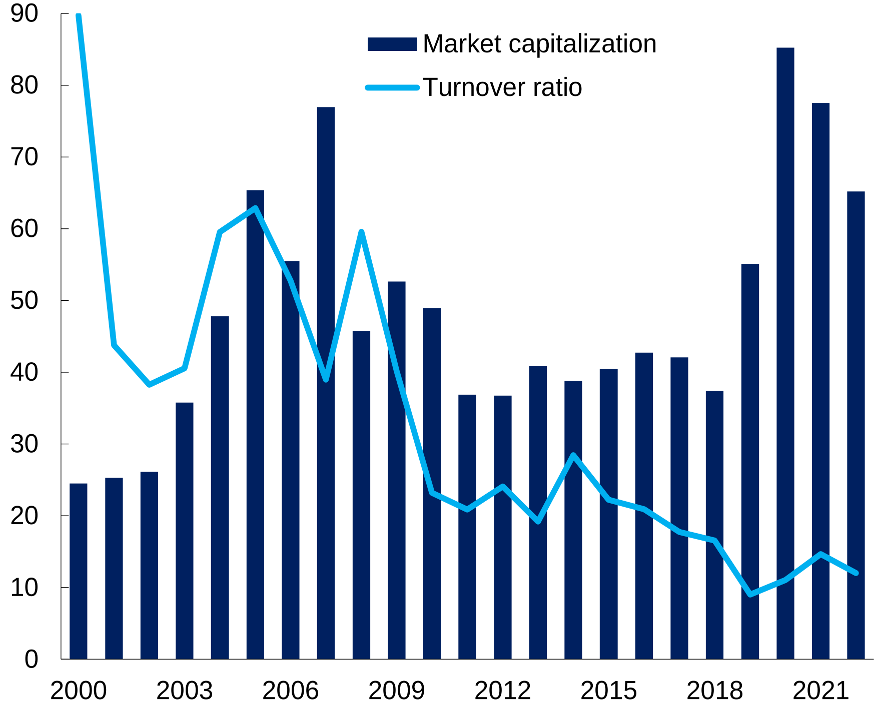
MENA excl. GCC | Similar to CCA but also has significant public sector footprint

GCC | Good on fundamentals but high on public sector footprint and dependence on natural resources

Sources of Nonbank Financing Remain Broadly Nascent

The size of equity markets has grown but liquidity has deteriorated

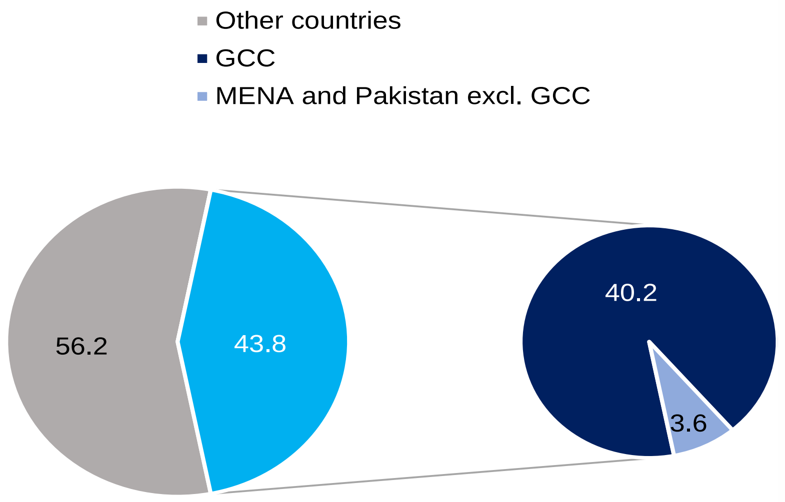
MENAP & CCA: Equity Market Capitalization and Turnover
(Simple Averages, Percent of GDP and Ratio)



Sources: Bloomberg, L.P., IMF WEO database; World Bank World Development Indicators; and IMF staff calculations

Islamic finance is a significant source of funding in some countries but issuance of sukuk (Islamic bonds) is sporadic

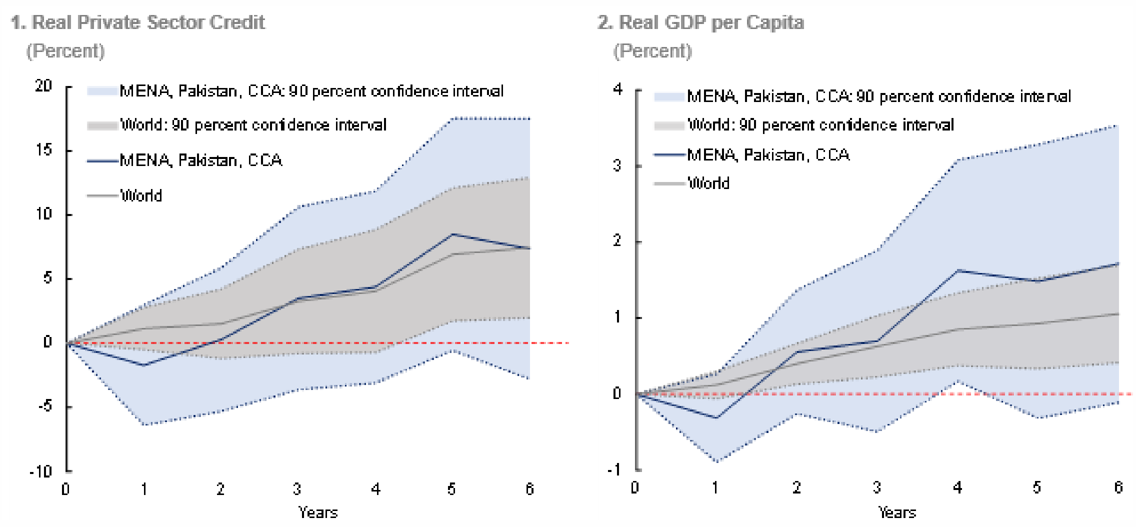
Islamic Government Bonds
(Outstanding amounts, percent of total)



Impact of Financial Reforms

Financial reforms are associated with a lasting impact on both private sector credit and output per capita in the MENA and CCA regions

Impact of Financial Sector Reform Package

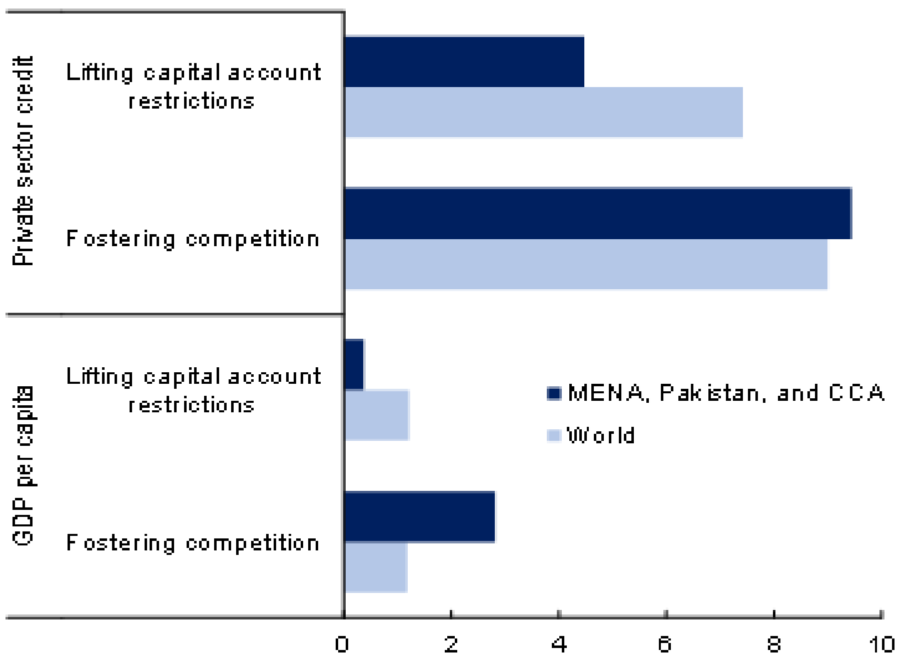


Sources: Financial Reforms database (Omori 2022); Brookings, External Wealth of Nations database (Lane and Milesi-Ferretti 2018); Banking Crisis database (Laeven and Valencia 2020); IMF, World Economic Outlook database; IMF, International Financial Statistics database; and IMF staff calculations.

Notes: A local projections approach is used to assess the impact of financial reforms. It is assumed that a financial reform package is introduced in year 1. This reform package is defined as the sum of financial sector policy changes between two years along the following dimensions: (1) privatization of banks, (2) banking sector entry, and (3) financial account transactions, based on the Financial Reforms database

Reforms aimed at fostering competition are associated with the most significant positive impacts

Five-Year Impact of Specific Financial Sector Reforms (Percent)



Notes: "Lifting capital account restrictions" is proxied by the annual change in the financial account transactions index, whereas "Fostering competition" is captured by the sum of changes between two years in the privatization and banking sector entry indices based on the Financial Reforms database (see Online Annex). The five-year impact of financial sector reforms worldwide is statistically significant at the 10 percent level. For the MENA and CCA regions, the five-year impact of the reform package and competition reforms is significant at the 25 percent level.

Policy Recommendations

- Promote higher **private sector ownership** in banking systems:
  - Banking sector reforms, such as reducing barriers to entry and gradually strengthening prudential norms, would assist in efforts to enlarge private sector footprint in the banking sectors.

- The policy response to **mitigate risks from the sovereign-bank nexus** must be tailored to country-specific circumstances and should include:
  - Conducting bank stress tests to account for the nexus; examining options to weaken the nexus (capital surcharges); and fostering a deeper and more diversified investor base.

- Successful **financial market development** requires sequencing:
  - Developing local government bond markets should be a priority to establish a yield curve for pricing of riskier assets; harmonizing capital market regulations with international standards to attract foreign investment; and modernizing infrastructure to facilitate efficient trading liquidity.

- Across all countries, **regulatory and supervisory frameworks** will need to be updated in line with the authorities' financial market development goals:
  - The use of macroprudential policy tools will need to keep pace with financial market development to mitigate potential systemic risks.

Thank You