Financial Development and Economic Growth: What we know and What we can do about it?

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Outline

1. Financial Development: Basic Concepts and Measures
2. Financial Development and Economic Growth and Welfare: What we know?
3. Financial Development: What we know about its Process?
4. Financial Instability and Financial Development
5. Financial Inclusion Versus Financial Development
6. Financial Crisis and Islamic Finance

1.1 Why do financial markets and intermediaries exist?

Frictionless Arrow-Debreu world of complete Market:

- Risk- fully and efficiently internalized in the price system
- Suppliers of fund would deal directly in the market with the users of funds
- Neither of them need to use financial service providers.

But in reality, Arrow-Debreu world does not exist.

1.1 Why do financial markets and intermediaries exist?

There exist two types of market frictions:

First: Agency frictions:

Asymmetric informational frictions - lead to the commonly known market failures of adverse selection, moral hazard and shirking, and false reporting.

Enforcement frictions- limit the scope for contracting because they limit pledgeability. As one party has difficulties in credibly committing to repay, financial contracts are effectively limited to those that can be effectively collateralized

1.1 Why do financial markets and intermediaries exist?

There exist two types of market frictions:

Second: Collective Frictions:

Collective frictions constrain participation.

High transaction costs and the increase in liquidity risk and no diversification

1.1 Why do financial markets and intermediaries exist?

The results:

- Individuals involved in financial contracting search for ways to cope with—and limit the costs and risks deriving from—these frictions and failures.
- Financial intermediaries and financial markets emerge

1.1 Why do financial markets and intermediaries exist?

The results:

- **Financial intermediaries and financial markets emerge and usually perform multiple functions such as:**
  1. facilitating the trading, hedging, diversification, and pooling of risk;
  2. providing insurance services;
  3. allocating savings and resources to the appropriate investment projects;
  4. monitoring managers and promoting corporate control and governance;
  5. mobilizing savings efficiently; and
  6. facilitating the exchange of goods and services.

1.2 How to measure Financial Development?

- **Instrumental approach:** the types of financial instruments and how they have risen.
- **Structural approach:** the form and organization of financial intermediaries and markets
- **Operational Approach:** how institutions actually operate, kinds of credit granted, and the types of resources granted.
- **Process Approach (a composite Approach):** the interplay of forces shaping financial system
- **Inclusion Approach:** Access, quality, usage and impact

2. Financial Development and Economic Growth and Welfare: What we know?

2.1 Five Views:

Finance promotes Growth - Schumpeter (1911), King and Levine (1993), Beck et al. (2000) and Haiss and Fink (2006)

Finance doesn't matter in growth- Lucas (1988)

Finance and growth expand simultaneously - Luintel and Khan (1999) Abu-Bader and Abu-Qarn (2008)

Finance follows growth- Robinson (1952), Gupta (1984), Demetriades and Hussein (1996)

Finance matters because financial crises hurt growth - IMF/World Bank

Part B. Financial Development and Economic Growth and Welfare

B.2 What the Theory Says?

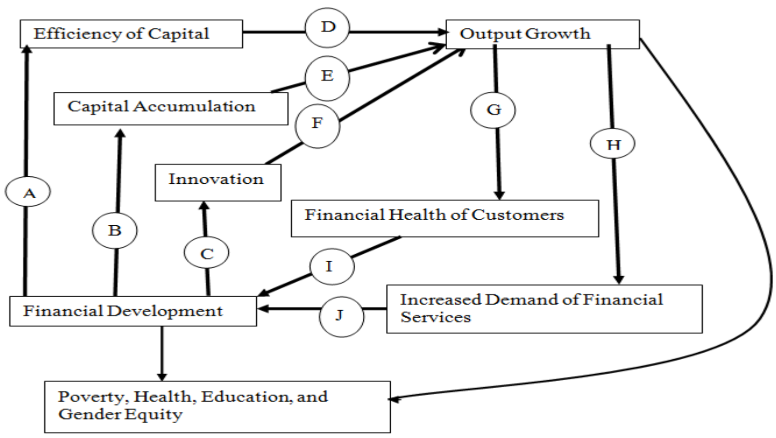
Impact of Financial Development

- improves the efficiency with which those savings are used and increasing the amount of capital and productivity.
- Better screening and monitoring of borrowers can lead to more efficient resource allocation.
- Share risk associated with high-quality investment. Improvement on risk-sharing can enhance savings rates and promote innovation, which will ultimately promote economic growth.
- Help to accommodate macroeconomic shocks
- Help to reduce poverty and undernourishment
- Better health, education and Gender Equality
- Help to mitigate a variety of risks

Part B. Financial Development and Economic Growth and Welfare

B.2 What the Theory Says?

Channels of Interrelationships between Financial Development and Economic Growth and Wealth Welfare



2. Financial Development and Economic Growth and Welfare: What we know?

2.2 What the Empirics Say?

- First empirical study: Goldsmith (1969) – Found relationship but remained uncertain of the direction of causality.
- Pure cross country Studies: King and Levine(1993a,b,c), Dregorio and Guidotti (1995) Deidda and Fattouh (2002), McCaig and Stengos (2005) and - **FD exerts a positive impact on growth and welfare**.
- Criticism of cross-country analysis: **neglects some of the more country specific effects.**
- Panel /Time Series: Levine et al. (2000), Calderon and Liu (2003), Xu (2000), Christopoulos and Tsionas (2004) and Apergis et al (2007)-**Less Clear evidence than cross-section analysis. But still supports a positive role of financial development.**

2. Financial Development and Economic Growth and Welfare: What we know?

2.2 What the Empirics Say?

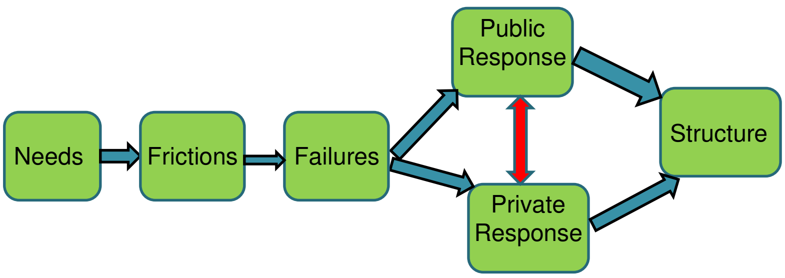
- Arestis, Demetriades, and Luintel (2001): focus on link between real growth and stock market development, **long-run relationships causality may change, the relationship show substantial variation**
- Fink, Haiss and Hristoforova (2006): focus on bond market and economic growth. **Interdependence between bond market capitalization and real output growth**.
- Rajan and Zingales (2003): **the process is diverse and complex**.

Debatable empirical results, but strong consensus for positive role of FD on growth and welfare

3. Financial Development: What we know about its Process?

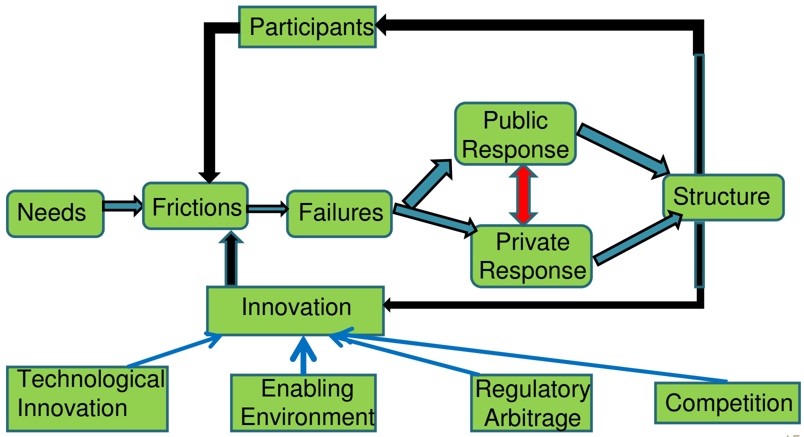
Finance pierces through the path of least resistance, which depends on the state of development, interest groups, the effectiveness of public policy, and the forces of competition, innovation and regulatory arbitrage.

Process of Financial Development: Demand Side



3. Financial Development: What we know about its Process?

Process of Financial Development: the supply side



3. Financial Development: What we know about its Process?

3.1 Financial Activities and Financial Development

	Early Finance	Intermediate Finance	Mature Finance
Information and Lending	Personal Lending Basic Accounting	Relationship Lending Advanced Accounting Credit Registries Basic Governance	Arms-length Lending Fair Value Accounting Scoring and Rating Advanced Governance
Collateral	Personal Collateral	Non-tradable Collateral	Tradable Collateral Assets Backed Securities Multilateral Clearing
Diversification and Pooling	Bank Deposits	Money Market Funds Early Portfolio Management	Mature Portfolio Management
Insurance	Non-life Insurance	Basic Insurance Bank Deposits Early Derivatives	Annuities Repo Transactions Mature Derivatives
Liquidity	Bank Assets Liquidity	Bank Liability Liquidity	Funding Liquidity Market Liquidity
Delegation	Basic Banking Basic Insurance	Intermediate Banking Intermediate Insurance Money Market Funds Personal Funds	Mature Banking Mature Insurance Mutual Funds Hedge Funds Venture Capital Private Equity and Market Makers

3. Financial Development: What we know about its Process?

3.1 A Regulatory Framework for Financial Development

1. Limit the collective failures associated with risk aversion by *absorbing and spreading out risk more evenly across individuals and over time through issuing guarantees, purchasing assets, or providing loans; and*

2. Lessen agency or collective failures by *directly providing financial services (thereby assuming a public agency role) through the use of general public infrastructure or the creation of specialized public financial institutions.*

3. Financial Development: What we know about its Process?

3.1 A Regulatory Framework for Financial Development

1. Lessen agency or collective frictions by *improving the enabling environment (normalizing contract rights and rules, providing information, enhancing* transparency requirements, standardizing instruments and activities, boosting the judiciary, etc.);

2. Limit agency or collective failures (or lessen their impact) by *protecting the uninformed, helping internalize externalities, and limiting free riding through regulation or taxes and subsidies;*

3. Limit *pure coordination failures (i.e., failures to engage in socially desirable activities or to pull out from ongoing activities in ways that are socially harmful) by engaging in catalytic support, providing lending of last resort, insuring deposits, facilitating resolution arrangements, mandating participation (e.g., in automobile insurance or pension funds), etc.;*

4. Financial Stability and Financial Development

- A financial system that is very heavily supervised and regulated may be very stable, but such a control system would hamper financial development and innovation and risk taking, and thus many reduce the opportunities for long-run growth.

- Lack of stability that tigers financial crises is also costly and inefficient. It leads to severe economic downturns and the large economic and fiscal costs of cleaning up a financial system in distress and crisis.

- Trade-off between the stability of financial system and degree of innovation and sophistication.

- Financial stability is an important component of financial development

4.1 Consequences of Financial Instability

- Developed financial system seems always prone to financial crisis.
- Financial instability and the failure of the proper working of the financial system are associated with different kinds of cost:
  - Slower economic growth and negative effects on long-term welfare.
  - Social deadweight loss due to increase in debt restructurings and increase in bankruptcies among households, corporate firms and financial institutions.
  - Fiscal costs due to government intervention

4. Financial Instability and Financial Development

4.1 Consequences of Financial Instability

Total Government cost of fiscal Bailout		
Country	Period	Total Costs of fiscal bailout as % of GDP
China	1990s	47
Korea	Late 1990s	28
Malaysia	Late 199s	16
Thailand	Late 1990s	35
Bulgaria	1995-97	13
Czech Republic	1991-1994	12
Hungary	1991-95	10
Russia	1998-99	5-7
Turkey	2000-03	30
Finland	1991-94	11
Japan	1990s	24
Spain	1990s	175
Argentina	1980-82	55
Chile	1982-86	55
Ecuador	Late 1990s	20
Jamaica	1995-20000	44
United States	1984-91	18
Venezuela	1994-95	3

Source: The financial Development Report 2008

4. Financial Instability and Financial Development

4.2 Issues of Financial Crises

- **Financial Crises:** when a significant number of financial institutions become financially distressed and need to be closed down, merged, or restructured.
- Financial crises often preceded by Asset bubble and the Credit bubbles.
  - **Asset bubble**, which go as far back as the Dutch tulip-mania of the 17th century, occur when an asset prices rises above its underlying fundamental value.
  - Asset bubbles can occur for any financial or real assets, but the recent experience shows that they are prevalent in equity markets and in housing and real estate markets.
  - Many assets bubbles have been associated with episodes of easy monetary policy and excessive credit growth.

4. Financial Instability and Financial Development

4.2 Issues of Financial Crises

- The perverse interaction between easy money, assets bubbles, credit growth, and leveraging that feeds assets bubbles has been observed in many episodes.
  - The 2007-09 crisis in the United States was preceded by easy money and easy credit that triggered the process of asset bubbles and excessive leverage of financial system.
- **Should Monetary Policy respond to restrict Asset bubbles and Credit Bubbles?**
  1. A wide range of analytical models suggests that optimal monetary policy should react to assets prices and assets bubbles above and beyond its reaction to the deviation of growth and inflation from their target.
  2. Recent experience of the UK, Australia, and New Zealand shows that monetary authorities can successfully control bubbles with monetary tightening without causing severe recession.

4. Financial Instability and Financial Development

4.2 Issues of Financial Crises

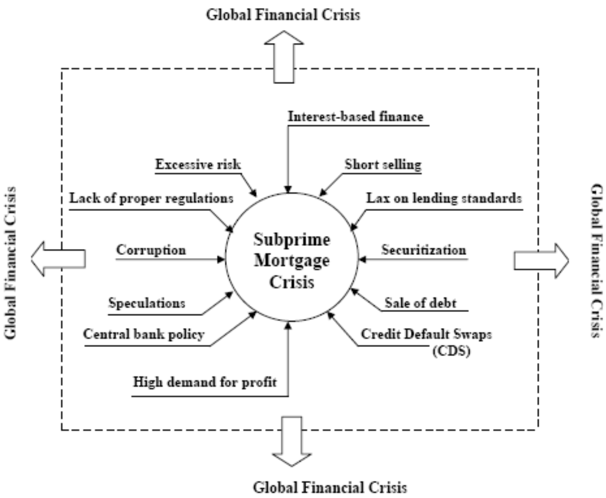
- The Use of Credit policy instruments to limit assets bubbles and Credit Bubbles
- In considering an appropriate policy response to asset bubbles and credit bubbles, one should not be limited to traditional monetary policy alone.

Chart 1: Causes and consequences of financial crisis

Causes of financial crisis	Description	Risk/Consequence
Leverage	Borrowing to finance investment	Bubble that leads to bankruptcy
Asset-liability mismatch	The disparity between a bank's deposits and its long term assets leads to the inability of banks to renew short term debt they used to finance long term investments in mortgage securities	Bank runs
Regulatory failure	Improper (insufficient/excessive) regulatory control: -Insufficient regulation: 1) Results in failure of making institutions' financial situation publicly known (lack of transparency) 2) Makes it possible for financial institutions to operate without having sufficient assets to meet their contractual obligations. -Excessive regulations that require banks to increase their capital when risks rise leading to substantial decrease in lending when capital is in short supply.	-Excessive risk-taking -Financial crisis (of 2008) Potential deterioration of financial crisis
Fraud, corruption and greed	-Enticing depositors through misleading claims about their investment strategies and manipulating information. -Creating financial assets without any real economic activity -Extreme economic greed overrides basic ethical consideration in investments	Subprime mortgage crisis
Contagion	Where the failure of one particular financial institution to meet its financial obligations (due to lack of liquidity, bad loans or a sudden withdrawal of savings) causes other financial institutions to be unable to meet their financial obligations when due. Such a failure may cause damage to many other institutions and threatens the stability of financial markets	Systemic risk
Money supply	Uncontrolled printing of paper money that is not backed by real assest/commodity (gold)	Higher inflation

Source: Derived from wikipedia, the free encyclopedia. www.en.wikipedia.org/wiki/Financial

Figure 1: Causes of the US Subprime Mortgage Crisis



SYSTEMIC RISK

- Systemic risk episodes are quite common.
- Such episodes have always existed - even before derivatives and hedge funds.
- Of the 180 IMF member countries more than 130 had experienced a banking crisis, a currency crisis or both ("Twin Crises").

BANKING & SYSTEMIC RISK

- Bankruptcy, in sectors other than banking, dos not lead to fears of contagion and meltdown.
- Bankruptcy of financial institutions, on the other hand, is uniquely threatening since the banking sector is in many ways unique. Two main reasons for this:

SYSTEMIC RISK & CONTAGION

1.) Credit is the lifeblood of the economic system. The banking system provides the plumbing that allows credit to flow smoothly from one sector to another. A problem in this sector immediately affects every other component of the economy.

2.) The money multiplier effect means that even a small decrease in credit has an outsized impact on consumption and GDP.

SUMMARY STATISTICS

CURRENCY CRISES	BANKING CRISES
1970's: 26 Currency Crises	1970's: 3 Banking Crises
1980-95: 50 Currency Crises	1980-95: 23 Banking Crises
1980-97: 158 Currency Crises	1980-97: 54 Banking Crises
Av. Output Loss: 7.1%	Av. Output Loss: 14.2%
Av. Recovery Time: 1.6 years	Av. Recovery Time: 3.1 years

THE EMPIRICS OF CURRENCY & BANKING CRISES

- Currency crises are roughly 3 times more frequent than banking crises.
- Banking crises are more virulent than currency crises in terms of economic loss.
- Banking crises cost twice as much and last twice as long as currency crises.

THE COST OF A FINANCIAL CRISIS

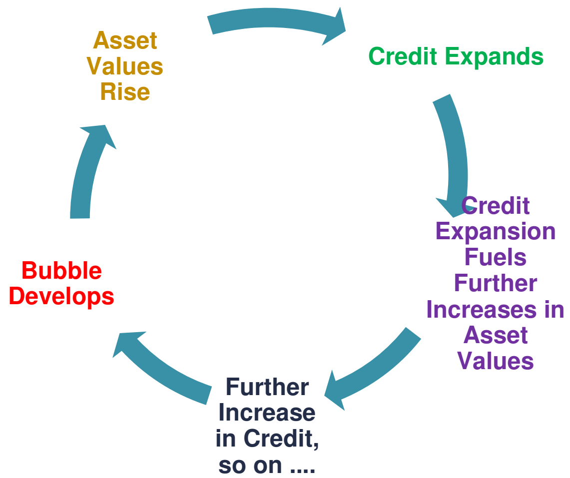
Countries (GDP Loss)	Cost of Crisis
Argentina (1980-82)	55%
Japan (1990's)	20%
Korea (1997)	60%
Indonesia (1997)	80%
U.S. TARP Program (2008)	$750 billion

How expensive is the TARP program in relation to country GDP?

SYSTEMIC RISK

- The underlying reason for the periodic recurrence of financial crises has to do with the natural operation of a capitalist system.
- Financial crises are driven by a self perpetuating, inexorable cycle of economic links.

THE SELF PERPETUATING CYCLE OF ASSET PRICE BOOMS



BANK CRISIS & CURRENCY CRISIS ("TWIN CRISES")

Irrational Exuberance or Loose Monetary Policy

↓

Asset Bubble Develops

↓

Bubble Bursts

↓

Loan Defaults, Bank Insolvency, Capital Flows Out

↓

Currency Depreciation

↓

Import Costs go up, Inflation, Central Bank loses Reserves to Defend a Fixed Exchange Rate

↓

Credit Contraction, Growth Slowdown, Currency Crisis feeds Bank Crisis

↓

Austerity Programs, Structural Reforms, IMF Loans, etc.

ASSET PRICE BOOMS AND BUSTS

- The Boom-Bust cycle is usually broken when the government steps in. Standard policy measures include:

- Using fiscal policy to stimulate aggregate demand by increasing government spending.

- Using monetary policy to increase credit.

THE GREAT DEPRESSION (1929-39)

- The Great Depression was so called because it was the longest, widest and deepest economic devastation the world had known.
- The threat of another Great Depression, and the incorrect policy choices that caused it, informed almost every major policy decision during the current crisis.

THE GREAT DEPRESSION (1929-39)

- The most obvious effect of the Great Depression was on long term stock market values.

THE GREAT DEPRESSION

- At the depth of the Depression, the stock market dropped by 90%.
- The stock market took 25 years (an entire generation!) to regain the values that were eroded at the start of the depression.

THE GREAT DEPRESSION

- For an equity driven society like the modern day United States such a debacle would have catastrophic economic consequences for tax revenues, state funds, pension funds and individual retirement values.

THE CRASH OF 2008

- The outstanding feature of the crash of 2008 was its global reach.
- Between Dec. 2007 and Dec.2008, <u>every single one</u> of the world's 40 largest stock markets had declined by significant amounts.
- The DJIA dropped from about 14,000 points in Oct. 2008 to 7000 points in March 2009.

HOW GLOBAL WAS THE CRISIS?

- The Russian and Chinese markets declined by 69%, Greece by 67%, Venezuela by 60% and Indonesia by 58%.

ECONOMIC GROWTH & FINANCIAL CRISES

- When Adam Smith wrote “The Wealth of Nations” in 1776 the richest country in the world was 4 times richer than the poorest country.
- The richest regional bloc (Europe) was about 3 times richer than the poorest (Africa).
- Thus, in 1776 income inequality was not a major issue.

POLICY, ECONOMIC GROWTH & DEVELOPMENT

- Today, the difference between countries and regional blocs are:

Qatar:	**$87,717**	
Congo:	**$334**	263
W. Europe	**$19,264**	
Africa	**$1474**	13

Source: IMF.

- Inequality between countries and regional blocs since the time of Adam Smith has increased tremendously.

GROWTH DIFFERENTIALS

- What was the difference in the growth rates of the richest and the poorest country blocs that accounts for the current level of income disparity?

WORLD GROWTH

Region	1820	2000	Annual Growth Rate
Western Europe	**$1202**	**$19,264**	**1.6%**
Africa	**$420**	**$1474**	**0.7%**

Differential Growth Rate (W. Europe vs. Africa) **0.9%**

ECONOMIC GROWTH

- Small growth divergences over long periods lead to huge differences. Financial crises matter because they slow down growth for several years.
- Effective management of financial crises is like medicine – short term discomfort for substantial long term benefits!

4. Financial Instability and Financial Development

4.3 Foundation of Sound Regulation and Supervision

- Financial crises will never be altogether eliminated, the frequency and cost of such crises can be reduced if appropriate supervision and regulation is applied.
- **Issues of reforms in supervision and regulation of financial institutions**
  - The system of compensation of bankers and agents should be fixed.
  - The current model of securitization has serious flaws.
  - Non-bank financial institutions should be brought into regulation and supervision
  - Market discipline approach of regulation should be developed.
  - Shortcomings related to capital requirements and other issues in Basel II should be overcome.
  - Role of credit rating agencies
  - Fixed inadequate regulatory regime
  - More international coordination

5. Financial Inclusion Versus Financial Development

5.1 Concepts

- **Financial inclusion**: drawing unbanked population into the formal financial system.
- **How?** – not by disregarding risks and other costs when deciding to offer services, nor by forcing everybody should make the use of financial services

  - but by policy initiatives that aim to correct market failure and to eliminate nonmarket barriers to accessing a broad range of financial services.

Benefits of financial inclusion:- Financial Stability, equity, growth and poverty elevation

Financial Inclusion: Current state

-A global survey of regulators with regards to financial access (CGAP's *Financial Access 2009)* = **2.6 billion unbanked adults in the developing world.**

- World Bank's composite access indicator (2009) = the number of financially excluded adults significantly exceeds the adult population living under the $2-1-day poverty line.

5. Financial Inclusion Versus Financial Development

5.2 Current state of financial inclusion globally

Table A.1 Composite measure of access to financial services

		Percent with access			Percent with access			Percent with access
Albania		34	Gambia, The		21	Panama		46
Algeria		31	Georgia		15	Papua New Guinea		8
Angola		25	Germany	s	97	Paraguay		30
Antigua and Barbuda		48	Ghana		16	Peru		26
Argentina		28	Greece	s	83	Philippines		26
Armenia	s	9	Grenada		37	Poland	s	66
Austria	s	96	Guatemala		32	Portugal	s	84
Azerbaijan		17	Guinea		20	Romania	s	23
Bahamas, The		53	Guyana		20	Russian Federation		69
Bangladesh		32	Haiti		15	Rwanda		23
Barbados		56	Honduras		25	Samoa		19
Belarus		16	Hungary	s	66	Saudi Arabia		62
Belgium	s	97	India	s	48	São Tomé and Principe		15
Belize		46	Indonesia		40	Senegal		27
Benin		32	Iran, Islamic Rep. of		31	Seychelles		41
Bermuda		48	Iraq		17	Sierra Leone		13
Bhutan		16	Ireland	s	88	Singapore		98
Bolivia		30	Italy	s	75	Slovak Republic	s	83
Bosnia and Herzegovina		17	Jamaica	s	59	Slovenia	s	97
Botswana	s	47	Jordan		37	Solomon Islands		15
Brazil	s	43	Kazakhstan		48	South Africa	s	46
Bulgaria	s	56	Kenya	s	10	Spain	s	95
Burkina Faso		26	Korea, Rep. of		63	Sri Lanka		59
Burundi		17	Kyrgyz Republic		14	St. Kitts and Nevis		49
Cambodia		20	Latvia	s	64	St. Lucia		40
Cameroon		24	Lesotho	s	17	St. Vincent		45
Canada	s	96	Liberia		11	Sudan		15
Cape Verde		40	Libya		27	Suriname		32

5. Financial Inclusion Versus Financial Development

5.2 Current state of financial inclusion globally

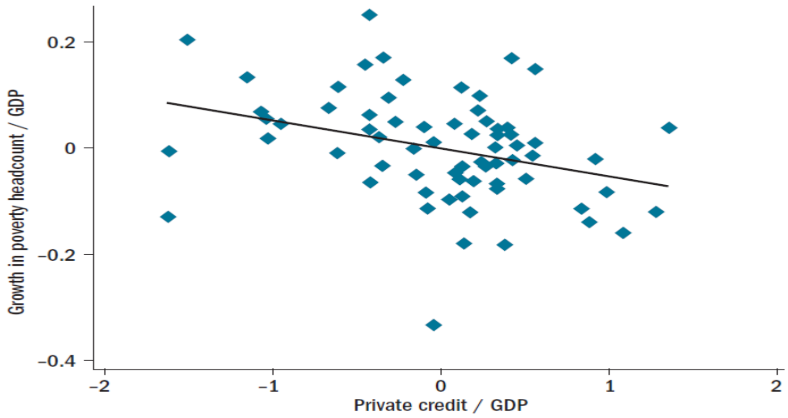
Table A.1 Composite measure of access to financial services *(continued)*

Central African Republic		19	Lithuania	s	70	Swaziland	s	35
Chile		60	Luxembourg	s	99	Sweden	s	99
China	s	42	Macedonia, FYR		20	Switzerland		88
Colombia	s	41	Madagascar		21	Syrian Arab Rep.		17
Comoros		20	Malawi		21	Tajikistan		16
Congo, Rep. Of		27	Malaysia		60	Tanzania	s	5
Costa Rica		29	Mali		22	Thailand		59
Cote d'Ivoire	s	25	Malta	s	90	Togo		28
Croatia		42	Mauritius		54	Trinidad andTobago		53
Cuba		45	Mexico	s	25	Tunisia		42
Cyprus	s	85	Moldova		13	Turkey		49
Czech Republic	s	85	Mongolia		25	Uganda		20
Denmark	s	99	Morocco		28	Ukraine		24
Dominica		66	Mozambique		12	United Kingdom	s	91
Dominican Republic		29	Myanmar		19	United States	s	91
Ecuador	s	35	Namibia	s	28	Uruguay		42
Egypt, Arab. Rep. of		41	Nepal		20	Uzbekistan		16
El Salvador		26	Netherlands		100	Venezuela, R. B. de		28
Eritrea		12	Nicaragua	s	5	Vietnam		29
Estonia	s	86	Niger		31	West Bank and Gaza		14
Ethiopia		14	Nigeria		15	Yemen, Republic of		14
Fiji		39	Norway		84	Yugoslavia, former		21
Finland	s	99	Oman		33	Zambia		15
France	s	96	Pakistan	s	12	Zimbabwe		34
Gabon		39						

Note: The composite indicator measures the percentage of the adult population with access to an account with a financial intermediary. The indicator is constructed as follows: for any country with data on access from a household survey, the surveyed percentage is given and designated by an *s*. For other countries, the percentage is constructed as a function of the estimated number and average size of bank accounts, as discussed in box 1.4 and Honohan (2007). These numbers are subject to estimation error. This is a "live" data set, and figures will be replaced as survey data become available for each country. See http://econ.worldbank.org/programs/finance for updates.

5.2 Financial inclusion and Poverty alleviation

Figure 3.1 Financial depth and poverty alleviation



Source: Beck, Demirgüç-Kunt, and Levine (2007).
Note: This figure is a partial scatter plot of growth of poverty headcount vs. private credit to GDP, controlling for the initial level of poverty headcount, with data averaged over the period 1980–2005.

5.3 Financial inclusion enhances Stability: How?

- Hannig and Jansen (2010) argues that
- Financial inclusion presents opportunities to enhance financial stability
- Financial inclusion poses risks at the institutional level, but these are hardly systemic in nature. Evidence suggests that low-income savers and borrowers tend to maintain solid financial behavior throughout financial crises, keeping deposits in a safe place and paying back their loans.
- Institutional risk profiles at the bottom end of the financial market are characterized by large numbers of vulnerable clients who own limited balances and transact small volumes. Although this profile may raise some concerns regarding reputational risks for the central bank and consumer protection, in terms of financial instability, the risk posed by inclusive policies is negligible.

5.3 Financial inclusion enhances Stability: How?

- In addition, risks prevalent at the institutional level are manageable with known prudential tools and more effective customer protection.
- The potential costs of financial inclusion are compensated for by important dynamic benefits that enhance financial stability over time through a deeper and more diversified financial system.

5.3 Financial Inclusion policies: what can a central bank do?

Center for Global Development (See Claessens et al. 2009) recommends ten policy principles for expanding financial access:

1. Promoting entry of and competition among financial firms.
2. Building legal and information institutions and hard infrastructure.
3. Stimulating informed demand.
4. Ensuring safety and soundness of financial service provides.
5. Protecting low-income and all customers against abuses by financial service providers.
6. Ensuring that usury laws, if used, are effective.
7. Enhancing cross-regulatory agency coordination.
8. Balancing government's role with market provision of financial services.
9. Using subsidies and taxes effectively and efficiently.
10. Ensuring data collection, monitoring, and evaluation.

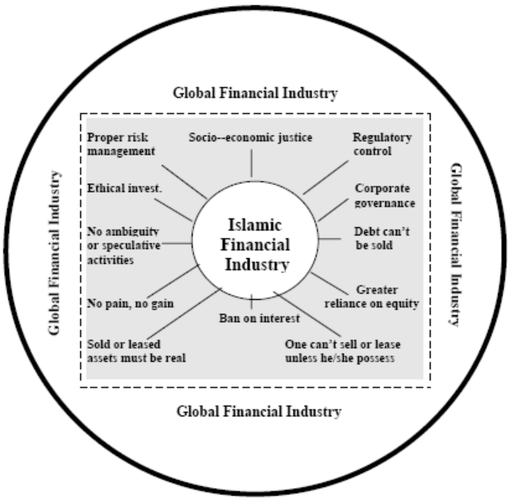
5.3 Financial Inclusion policies: what can a central bank do?

1. **Agent Banking:** policies that enable banks to contract with nonbank retail agents as outlets for financial services
2. **Formalize microsavings:** licenses for specialized institutions dedicated to taking microdeposits, licenses for nonbank financial institutions, bank licenses for successfully transforming financial NGOs
3. **State bank reforms**
4. **Consumer protection and education**
5. **Lowering documentation barriers**
6. **Mobile banking**

6. Current financial crisis would not have occurred under an Islamic financial system

- If global banking practices adhere to the principles of Islamic finance, which are based on noble ideas of entrepreneurship and transparency, global crisis would have been prevented
- Shariah principles:
  - *Not to sell a debt against a debt: one can't sell or lease unless he/she posses real assets*
  - *Islamic finance is based on equity rather than debt, and lending transactions are founded-on the concept of assets backing: mortgage loans under such system would have been backed by solid asset structure*

Figure 2: Key Intrinsic Principles of the Islamic Financial System



6. Current financial crisis would not have occurred under an Islamic financial system

- Shariah principles continued:
  - *Islam takes particular interest in fostering close relationship and trust between originators (financial institutions) of Islamic financial products and investors*
  - *Absence of an adequate and effective regulatory control system that monitors and consequently ensures the interests of investors. Potential investors are well versed about the prospects (opportunities and risks) that their investments are subject to when entering into new contracts - Risk must be explicitly communicated !*
  - *Honest implementation of Profit-and-Loss Sharing (PLS) transactions (such as* Mudarabah *and* Musharakah *contracts) in accordance with the spirit of Shariah entails full disclosure and transparency*
  - *Islam regards the relationship between the lender (financial institution) and the borrower (investor) as a partnership*

Riba prohibited

- **Intuitive description**
  - ‘Earning money from money’ or interest, is prohibited. Profit, which is created when ‘money’ is transformed into capital via effort, is allowed. However, some forms of debt are permitted where these are linked to ‘real transactions’, and where this is not used for purely speculative purposes
- **Linkage to ‘market failures’?**
  - A real return for real effort is emphasised (investments cannot be ‘too safe’), while speculation is discouraged (investments cannot be ‘too risky’). This might have productive efficiency spillover benefits (‘positive externalities’) for the economy through linking returns to real entrepreneurial effort

Fair profit sharing

- **Intuitive description**
  - Symmetric profit-sharing (eg. *Musharakah)* is the preferred contract form, providing effort incentives for the manager of the venture, while both the investor and management have a fair share in the venture’s realised profit (or loss)
- **Linkage to ‘market failures’?**
  - Aligning the management’s incentives with those of the investor may (in contrast to pure debt financing) once again have productive efficiency spillover benefits for the economy, through linking realisable returns to real entrepreneurial effort

No undue ambiguity or uncertainty

- **Intuitive description**
  - This principle aims to eliminate activities or contracts that are *gharar*, by eliminating exposure of either party to excessive risk. Thus the investor and manager must be transparent in writing the contract, must take steps to mitigate controllable risk, and avoid speculative activities with high levels of uncontrollable risk

- **Linkage to 'market failures'?**
  - This may limit the extent to which there are imperfect and asymmetric information problems as part of a profit-sharing arrangement. Informational problems might, for example, provide the conditions for opportunistic behaviour by the venture (moral hazard), undermining investment in all similar ventures in the first instance.

Halal versus *haram* sectors

- **Intuitive description**
  - Investing in certain *haram* sectors is prohibited (eg, alcohol, armaments, pork, pornography, and tobacco) since they are considered to cause individual and/or collective harm.
- **Linkage to 'market failures'?**
  - Arguably, in certain sectors, there are negative effects for society that the investor or venture might not otherwise take into account (negative externalities). Prohibiting investment in these sectors might limit these externalities

Practice of Islamic Finance

- IF regulatory environment in elementary stages and still evolving
- Excessive profit/risk-taking—difficult to impose moral order
  - Episodes of speculation observed in the Gulf states
- Innovations and Financial Instruments
  - Fixed income assets—No risk-sharing
  - *Sukuk*
    - Risk transfer through securitization
    - Do investors have control over assets?
  - Return-swap
    - Returns on assets can be swapped with return on any class of assets (including sub-prime CDOs)
    - Capital efficient solutions?

Could the Crisis Occur in IF?

Conventional

1. Banks/financial institutions engaged in sub-prime lending
2. Loans packaged as MBS/CDO
3. Rating Agencies gave positive ratings to these securities
4. Investors bought securities
5. Bought Credit Default Swaps (CDS) to hedge credit risks
6. Issuers of CDS took on the risk of default

Islamic

1. IFIs can be engaged in sub-prime financing with lax RM
2. If financing is *ijarah/Dim. Musharakah*, assets can be securitized as *sukuk*
3. Risks of Islamic instruments complex and difficult to assess
4. Investor buys securities
5. Investors can buy return-swaps that exchanges returns of *sukuk* with return on other asset class
6. Issuers of swaps take up the risk of *sukuk*

Concluding Remarks

Current financial crisis demonstrates that Islamic finance is an effectual economic authority.

Today, investments through Islamic finance systems are acceptable in a significant number of countries –both Islamic and others– such as Indonesia, Malaysia, Turkey, Japan, China, England, and the USA, and continue to expand to many other countries as an alternative or complementary to the conventional financial and banking system.

Transformation of Islamic financial paradigm into working policies and enabling institutions is a long-term evolutionary process.

Private and public sectors at country level and the cross-country coordination between member states of the Organization of Islamic Conference (OIC) undoubtedly will play a crucial role.

Future of Islamic financing looks exceptionally promising, one should not be under the illusion that such transformation would happen without shrewd vision and hard work particularly in terms of human capacity building and innovative financial engineering

Concluding Remarks

There is an urgent need for more integrated and concerted policy actions to recover from the crisis and improve the economic situation of the OIC community through, *inter alia*,

- Designing sound financial systems at national level that would prevent the adverse impacts of future global financial crises
- Promoting and encouraging financial systems based on Islamic principles such as equity-based financing and real activity-based transactions.
- In such a system, the conventional financial instruments such as collateral debt obligations (CDOs) and credit default swaps (CDSs), which stand at the heart of the current crisis, are either not allowed or regulated very tightly.
- Many researchers come to argue that the current global financial crisis could have been avoided if such a system had been in place.

Concluding Remarks

Thus, the OIC Community can make a significant contribution to the international community by presenting the financial system based on Islamic principles that would function as an effective intermediary for real sector and thus, undue financial crisis can be avoided in the future, and foster economic growth.

Collectively, we should not miss this opportunity to benefit not only our people but also all humanity.

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