Economic Transformation and Inclusive Growth Frontier Asia: The Role of Financial Deepening

Remark made by Dr. Yuba Raj Khatiwada as a Panelist in the Conference organized by IMF-JICA in Bangkok, 27-28 January 2013

Economic Transformation

1. In conventional sense, economic transformation may be known as changing the structure, path and speed of economic growth. In several low income countries which have been in political transition or moving from state controlled to market economies, economic transformation might mean a shift in the whole production relations and choice of techniques for production. In a country where growth has been jobless or exacerbating inequality, then economic transformation might mean reorientation in the key drivers and agencies of economic growth and (re)distribution. In essence, the concept of economic transformation needs to be redefined so as not limiting to transformation from low-growth to high-growth path or from labor-intensive to capital or technology-intensive production process.

2. Economic transformation is characterized by at least three key features. First, the structure of the economy changes depicting an increase in the share of manufacturing coupled with a sustained decline in the share of agriculture. Second, the share of agriculture employment falls while the share of total labor force in other sectors of the economy increases. Third, economic activity shifts from rural areas to the cities, leading to an increase in the degree of urbanization. Therefore, economic transformation is a comprehensive change that encompasses the modernization of a country's economy, society and institutions. In countries where economic transformation has taken place, the middle class has become larger, priority has been accorded to market-friendly policies and government has become more effective. Experience shows that transformation processes are not uniform. In all cases where economic transformation has succeeded, human capital has accumulated and the articulation of a national vision to motivate the people has been crucial.

3. In addition to the key imperatives such as quality education, improving efficiency and productivity, infrastructure development and regional integration, ensuring that economic transformation is inclusive is equally important. However, economic transformation is a process and not a goal in itself. The goal is for a more egalitarian, equitable and inclusive economy and a just society. Even though the prime objective of development is to share fruits of growth among more people, the economic transformation process of most Asian economies has been associated with uneven growth and growing income inequality. Transition from a state led to a market led economy has also resulted in higher inequality. This leads policymakers to rethink on the transformation process.

4. Moving from low income to middle-income status requires developing countries to diversify the sources of economic growth, improving technology and human capital, and channeling financial resources more effectively toward productive investment. Though the key is sustained economic growth and boosting people's welfare, each economy may have different priorities in the transformation process depending on its specific characteristics and the stage of development. For example, in Nepal's case, priorities for the transformation include better access to productive resources (namely, land, capital and technology), boosting productivity also with higher labor skills, moving to higher value production, and overcoming geographical constraints through greater and efficient connectivity. These, however, may not necessarily be on the high-priority list of other countries.

5. The role of agriculture must be emphasized for the economic transformation of the least developed countries like ours, as unstable performance of the agriculture sector creates hindrances for a nation to sustain accelerated growth. Since many developing countries including Nepal are agriculture-based, only successful agricultural transformation can lead to economic transformation. For this, the government can play an instrumental role by making sufficient public investment in agriculture and rural infrastructure, channeling financial resources to this sector and mobilizing cooperatives and users groups for supplying input, marketing output, and providing extension services. Together with this, the growing role of service sector, greater trade and financial integration, strengthening of institutions and improving governance are also important issues in the economic transformation process.

Inclusive Growth

6. Like economic transformation, inclusive growth also requires proper definition. Inclusion does not necessarily transform the economy, neither does it ensure equity. Economic transformation, if it is market based may exclude a large section of the society from the growth process. Obviously, a market led economic transformation process which runs on efficiency path has often been exclusionary and that is the reason why we are now talking about inclusive growth. And it appears that there can be a trade-off between market-led economic transformation that survives on efficiency and inclusive growth that may need state interventions. In such a case, it is a crucial question as to how we can optimize between efficiency and inclusion.

7. One important aspect which we cannot ignore while talking about economic transformation and inclusive growth is about the actors of development. So far we have been discussing on the two actors of growth – the state and the market. Obviously, for the kind of the transformation and growth we are talking about, two players are not enough. Exclusion is pervasive in the areas where state is absent and private sector (the market force) does not want to be – obviously for profit reason. In such a situation, people who have no access to resources, opportunities and power are mostly deprived of development benefits and the challenge is how to bring these people in the development process. For this, the third actor which mobilizes the people through community approach is necessary. The non-government organizations, community organizations, and cooperative organizations are the ones which have to be mobilized for empowering this section of people and enhancing their access to resources, opportunities and development benefits. Even in this case, due care should be given that elites do not capture the community mobilization and empowerment activities and leadership.

8. Rapid pace of economic growth is a pre-requisite for substantial poverty reduction, but for this growth to be sustainable in the long run, it needs to be broad-based across sectors, and inclusive of the large part of the country's labor force. The major instrument for a sustainable and inclusive growth is assumed to be productive employment. Employment growth creates new jobs and income for the individual while productivity growth has the potential to lift the wages of those employed and the returns to the self-employed. The ability of individuals to be productively employed depends on the opportunities to fully exploit available resources as the economy evolves over time. Substantial poverty reduction occurs as employment opportunities increase, along with the transformation of the productive base of the economy.

9. Agriculture constitutes the backbone of the economies of most developing countries. It also employs more people than any other activity – as much as 60 per cent in most cases – supplies the bulk of basic food, and provides subsistence and income to more than half of the developing countries population. For developing countries, transforming agrarian and traditional economy and improving agricultural productivity is a critical component of an inclusive growth strategy; and post-harvest activities emphasizing on the transformation, preservation and preparation of agricultural products for intermediate or final consumption. Developing the productive capacity of developing countries in the area of services, particularly tourism and infrastructure-related ones, such as energy, communications, transport, and financial services, will be an essential mechanism to both improve and diversify their production of goods and services. It will also contribute to building their resilience to external shocks and limit their dependence on commodities.

10. Ensuring that the financial system plays its due role in promoting inclusive growth is one of the biggest challenges facing developing countries. Financial development creates enabling conditions for growth when access to safe, easy and affordable credit and other financial services by the poor and vulnerable groups, disadvantaged areas and lagging sectors is recognized as a pre-condition for accelerating growth and reducing income disparities and poverty. Access to a well-functioning financial system, by creating equal opportunities, enables economically and socially excluded people to integrate better into the economy and protects themselves against economic shocks. The recent financial crisis has highlighted the damaging impacts on living standards that can result from macroeconomic instability. Large swings in economic activity, high inflation, unsustainable debt levels and volatility in exchange rates and financial markets can all contribute to job losses and increasing poverty, endangering progress towards achieving the MDGs. Maintaining macroeconomic stability therefore is a prerequisite for sustained and inclusive development.

11. The primary goal of macroeconomic stabilization policies should be to achieve stable economic growth. This key policy objective is complemented by the need to stabilize intermediate variables that can have a strong impact on growth. Price stability and external balances in particular, play an important role through their impact on investment decisions. To achieve these intermediate goals, countries need policy space to use macroeconomic tools flexibly, including counter-cyclical fiscal and/or monetary policies, appropriate investment and exchange rate regimes, and strong financial sector regulation and supervision. Successful countries have coherent macroeconomic, employment, trade, industrial, environmental and social policies. Only when these policies mutually reinforce each other can they bring about sustained economic growth. Policy coherence at the national level has to be complemented by policy coherence at the international level, providing countries with the policy space to implement their national development strategies.

12. Economic growth does not automatically translate into widely shared gains**.** Policy choices matter: abject poverty has persisted despite rapid growth in several economies, while some poorer and slower-growing economies have been remarkably successful in alleviating extreme poverty and social deprivation. Policy makers will have to pay particular attention to the agricultural sector, public investments in the social sectors, and, most importantly, the employment content of growth in order to achieve inclusive development paths. A prerequisite for the achievement of the MDGs is that benefits cannot persistently and disproportionately accrue to one or more groups in society. For this reason, it is crucial that growth is inclusive—that it provides broadly shared opportunities to accumulate productive assets like education, that it allows people to utilize these assets in growth-enhancing activities and to benefit from such activities, and that it provisions for those that do not benefit directly from growth.

13. A critical component of inclusive growth is the creation of decent jobs. Full, productive and decent employment is the most important source of income security and it paves the way for broader social and economic advancement, strengthening individuals, their families and communities. In order to succeed at this task, sustainable development strategies need a strong employment component which aims at raising the productivity of the poorest workers, and at ensuring that they get to keep most of their increased earning power by progressively strengthening labor market institutions. The components of an employment-focused development strategy include macroeconomic, environmental and industrial policies that foster structural change, investment and job creation, as well as sound social and labor market policies.

14. But there are several constraints towards creating almost close to full employment jobs. First, production generated through market driven choice of technology does not ensure enough jobs, the case of jobless growth we have seen all over the world. Second, the kind of jobs created through the market forces of production do not necessarily match with the existing surplus labor force in the country. This is particularly the case when educated people aspiring for white collar jobs are not interested to engage in the blue collarr labor activities. Third, even if people are interested to work in the areas of labor market opportunity, they have skill mismatch and require extensive training to transform the skills, particularly when it comes to urban centric development, rural labor force which is uneducated, unskilled and perhaps also immobile cannot enjoy the opportunity leaving the labor market in imperfection.

Financial Deepening

15. A high level of financial deepening is a necessary condition for accelerating growth in an economy due to the central role of the financial system in mobilizing savings and allocating the same for the development process. The financial system serves as a catalyst to economic development through various institutional structures.

16. The most classic and conventional indicator of financial deepening is the ratio of M2 to GDP. However, this traditional measure of financial depth cannot be considered as a best measure of financial depth or intermediation, as it is only a very broad indicator of monetization. Thus, it is more relevant to focus on private credit to GDP as it reflects the main function of the financial system by measuring the degree to which financial institutions channel society's savings into the loans of the private sector. Moreover, rather than the aggregate value of credit to the private sector, its composition is more important for inclusive growth. Likewise, the breadth of the financial services, which implies its outreach, needs to be given top priority.

17. Financial deepening *per se*, without taking into account the quality of the deepening, would not make much sense so far as the process of economic transformation is concerned. Developing countries need to focus more on the composition of the credit flows rather than on its volume. This is because inefficiencies in the financial system of developing countries may channel the financial resources towards unproductive sectors or sectors with less comparative advantage or less concentration on productive sectors. For instance, though agriculture sector in Nepal accounts for about 35 percent of GDP, the credit allocation to this sector is below 5 percent of total credit volume.

18. A crucial question that arises is: has commensurate financial deepening been taking place at the micro-level? There is adequate anecdotal evidence to suggest that the poor or less well-off people find it difficult to open a bank account in any area—rural, urban or semi-urban. Hence, not only is the common individual deprived of access to banks for generating savings or availing credit, but so is the financial system of resources commensurate with the rapid growth of incomes all over the country. IMF studies have demonstrated that countries that were able to deepen the most over time—reduce their private credit gaps—appeared to exhibit one or more macroeconomic and financial sector characteristics: they avoided financial crises and have lower overall political and economic risk; permitted greater entry into banking activities; had limited direct government ownership of banks; did not place too many restrictions on bank lending; and possessed stronger regulatory and supervisory frameworks in place.

19. Nowadays, a growing interest has emerged around the developing world in the promotion of rural financial deepening which refers to an expansion in financial transactions of all kinds in the rural areas, to reach broader clienteles, provide wider kinds of services, and offer additional contract terms and conditions. There has also been a growing interest in the formulation and implementation of cost-effective and sustainable mechanisms to overcome the obstacles frequently encountered in the development of rural financial markets in these countries. Rural financial deepening generally depends on innovations in financial technologies that make it possible to reach broader clienteles. Innovation, however, demands investments in experimentation, development, transfer, adoption, adaptation, and learning of the new technologies.

20. Attention has gradually shifted, from the earlier exclusive emphasis on credit, towards a growing recognition of the importance of different types of financial services, including deposit facilities and similar means to accumulate liquid reserves and hold stores of value, payment instruments and opportunities to send and receive remittances, to exchange currencies and, in general, mechanisms to manage liquidity and cope with risk. Financial deepening has a positive effect on growth if not done to excess. Rapid and excessive deepening, as manifested in a credit boom, can be problematic even in the most developed markets because it can both weaken the banking system and bring inflationary pressures. If there is excessive credit expansion, a number of macroprudential instruments can be deployed: a) time-varying capital requirements (e.g., risk weights), b) dynamic provisions, c) ceilings on credit or credit growth; d) caps, possibly time-varying, on loan-to-value (LTV) ratio; e) caps, possibly time-varying, on debt service-to-income (DTI) ratio; f) minimum, possibly time varying, margin requirements; and g) reserve requirements.

21. For financial institutions, there are two dimensions along which deepening can occur. One dimension is reach, which measures the number of new customers that are being added. The larger the number of customers, the greater is the likelihood that previously unbanked customers will receive benefits the financial system has to offer. This dimension of deepening has caught the imagination of our policy makers in the form of financial inclusion. The other dimension is penetration which measures the average number of products and services per customer. Many public sector banks, in their pursuit of inclusivity, seem to have prioritized reach over penetration. On the other hand, many foreign and private banks, with their exclusive pursuit of high net worth clients, seem to have prioritized penetration over reach. Clearly, for holistic and sustainable progress, financial institutions must aspire to deepen along both dimensions.

22. Standard financial sector indicators focus on the aggregate value of credit to the private sector by deposit money banks, but do not distinguish between lending to households and lending to firms. Understanding the consequences of credit composition can have important repercussions for theory. If household credit has an independent impact on growth, this has implications for how theory should model the link between financial sector development and economic growth. Likewise, decomposing overall bank lending into its components might help us to understand why the effect of financial development on growth varies across countries at different levels of economic development and to provide insights into the channels through which financial systems foster economic development.

What can we do as governments, central bankers, and development partners?

23. Economic transformation requires concerted efforts of all the actors of development - the government and its agencies, private sector, community organization, and external development partners. Besides, there is a clear role of the financial institutions which help the transformation process through formalization of economic activities, corporatization of them, development of entrepreneurship, and management of risks associated with business. Here the role of regulatory authorities of the financial system, including the central bank, becomes crucial.

24. Government is obviously not the major provider of jobs, nor can it ensure unlimited unemployment benefit to those who do not get jobs. Still for public works, it can be as labor intensive as it can be, despite technological and efficiency constraints in choosing such labor intensive technology. This is far better than providing unemployment benefits. Public works programs which create more jobs could be prioritized in planning, programming and budgeting. Often times, the government might have to optimize between more jobs and efficiency or between macro stability and unemployment. Public policy discourse must then put jobs at the centre stage and understand that getting people engaged in the production process is the necessary step for inclusive growth.

25. The primary role of the central bank is to ensure macroeconomic and particularly financial stability. For this, the central bank must focus on its primary role on price and financial system stability. But when there are supply side shocks in the economy and if the latter is suffering from financial market distortions also because of adverse selection problems, the central bank has a key role to address the problem and avert the impending crisis. It has also the role to boost up economic growth and promote financial inclusion. In this context, the role of the central bank in designing monetary, credit and financial outreach policies is important. Some might see it as a developmental role of the central bank; but if the same could be done without compromising the primary objectives, then the supplementary role should not be overlooked as evidently financial services are very powerful instruments for economic transformation and inclusive growth.

26. The role of development partners in public policy making and programming is important in developing countries like ours. Resource availability, allocation priorities, and promotion of economic activities in donor dependent economies like ours are guided by the aid strategy, policy and programme supports of the donors. It is not necessary that the policy reforms suggested by the donors are always inclusive, mostly when the supports are only focused on market oriented institutions and economic activities. Also inclusive growth cannot be achieved if the donor funded programs do not create jobs or include people in the development process. Thus care must be given to ensure that donor support is seriously working towards inclusive growth and particularly towards creation of more jobs. Also as one size does not fit all, we need to be ensured that donors have country specific support strategy for sustainable development of the frontier economies like ours. No doubt that the polices also need to be consistent over time as frequent shift of donor priorities and supports derails the inclusive growth initiatives.

27. Private sector is the creator of jobs, but without incentive mechanism of tax and subsidies, private sector does not necessarily go for labor intensive choice of technology. Industrial and business policies which drive the private sector require encompassing the incentive mechanism which promotes labor intensive industrial and business activities. This also requires a lot of reforms in the labor market in terms of trade unionism, skill development, and labor productivity.

28. Empirical evidence illustrates that financial deepening contributes to economic growth and, thereby to economic transformation. It creates the enabling environment by contributing to the sources of economic transformation—productivity growth and capital accumulation, among others. Entrepreneurship development, for instance, occurs through adequate financial support. Moreover, rapid capital accumulation is possible through the efficient and deepened financial system.

29. Though financial deepening is increasing at varying rates across developing countries, the increase in the breadth and coverage of formal finance has not taken place as desired. Thus, concrete policy initiatives need to be undertaken by the developing countries to deepen their financial system and widen the outreach, thereby contributing more to the process of economic transformation.

30. Making growth more inclusive and addressing widespread poverty requires reorientation of production and distribution policies and programmes. Without addressing the root cause of growing inequality, economic transformation and inclusive growth do not carry much sense. Ensuring access to productive resources, enhancing productive capacity of the people, and introducing social protection schemes for the ones who are left out of the development process are some of the policy measures necessary for the kind of development we have been looking for.