# Harnessing Natural Resource Wealth for Inclusive Growth and Economic Development

## Session 4

## Promoting Diversification:
## Financial Sector Development

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# The Terrain

- Resources are a natural endowment that provide an enormous window of opportunity for rapid development
- Historically, these opportunities have not so much been squandered but mismanaged.
- For a developing economy, with a very low non-resources bases, resources can come to dominate other sectors and make an economy more exposed to volatile price and demand swings
- With this in mind, does financial sector development become a risk nullifier or a risk multiplier for the resources blessing or curse?
- The key strength of the financial sector is in improving the intermediation of economic rents and matching asymmetric information between borrowers and lenders
- We note that the most successful industrialisation periods in Emerging Asia have been accompanied by significant financial deepening.
    - Historically industrial revolutions have required financial revolutions and Asia's industrialisation episodes have been a compression of this
- The key role of financial sector development is to speed up the process of diversification, perhaps assisted by the visible hand of the State.

## **Triple Trouble.**
## Stage of Development, Commodities and Finance

1. Developing countries suffer much more from volatility in output growth than developed countries
2. Countries with poorly developed financial systems are much more volatile.
3. Countries that depend a lot on national resources are much more volatile than those that are not resource based

- These are strongly correlated sources of macroeconomic volatility. Those economies with the poorest growth performance and highest volatility tend to lack a sophisticated financial system, are natural resource dependent and are also land-locked.
- A more developed financial system suggest that the economy is better able to withstand liquidity shocks that may be driven by either commodity price or demand shocks
- The probability of innovation is also higher with deeper financial markets
- Finally, with complete capital markets, longer-term investment is counter-cyclical and mitigates volatility. In contrast, with incomplete markets, investment is based on resource revenue and pro-cylical.

# Financial Sector: Blessing or Curse?

- A deep financial sector will reduce dependence on foreign capital
  - For instance, if resource extraction were to be financed by a foreign entity or government the risks is resources were extracted and transferred at below market-clearing prices, therefore transferring sovereign wealth to the financial sponsor
- An unregulated financial sector can also exacerbate volatility
  - Financial development can therefore also exacerbate the commodity price cycles and increase leverage – and therefore vulnerabilities – in the banking system
  - Credit fuelled consumption booms may shift demand and production structure further towards services, so magnifying the Dutch Disease symptoms
- Financial sector development will help make resource wealth "sticky"
  - *Global Financial Integrity estimates that illicit financial outflows from resource rich developing economies was $5.9trn over the decade to 2010, compared to donor aid inflows of $667bn*
- An autonomous and strong financial sector would be a countervailing influence to a multinational sector that can also funnel capital outflows via price manipulation and exploitation of tax loopholes and regulatory weakness

# Guidelines for Financial Sector Development

- Financial Development must go hand in hand with the resources blessing, particularly financial deepening
- A relatively deep financial sector could help ameliorate some of the volatility in the resources cycle
- Financial sector has a high propensity to develop skills-based employment
- The financial sector should be aligned with broad strategic goals of reducing volatility and managing and hedging risk rather than "punting" or pursuing a proprietary trading model
- The Financial Sector as a Stabiliser of the cycle (as opposed to being a driver of it in non-resource developed economies and arguably an amplifier of volatility will be a novel innovation for resource rich economies to pursue.

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