Financing the Middle-Income Transition

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Is booming credit the best way to finance the middle-income transition?

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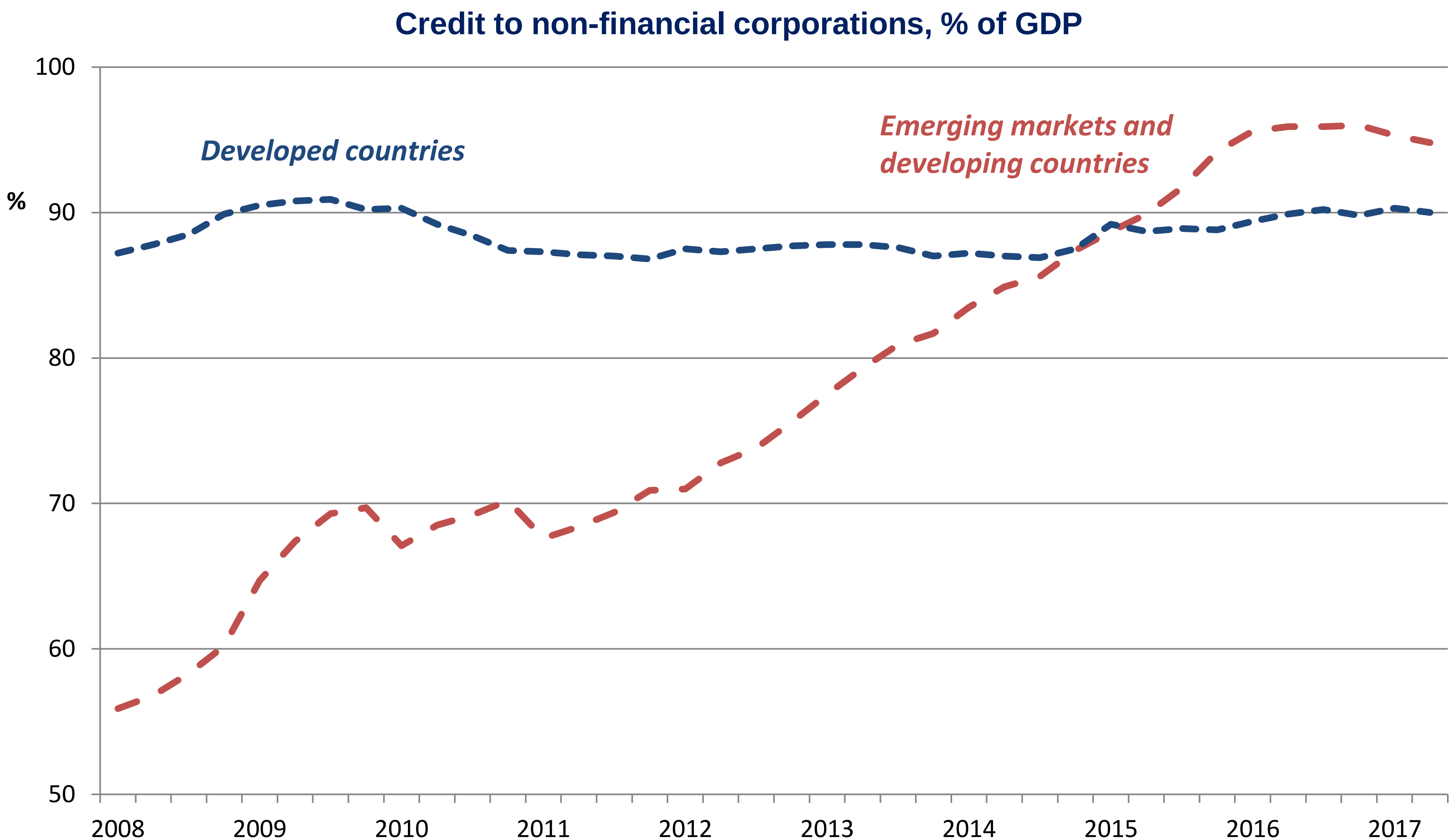

Source: BIS and authors' calculations.

Academic literature: “Probably not”...

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- Conventional wisdom: “More finance causes more growth and financial structure is irrelevant” (King and Levine, 1993; Beck and Levine, 2004; etc)

- Recent research frontier provides a more nuanced view:
  - Relationship between finance and growth is non-monotonic
  - Finance starts to have a zero or negative impact on growth above X% of GDP (Manganelli and Popov (2013): x=75; Beck, Georgadis and Straub (2014): x=109; Arcand, Berkes and Panizza (2015): x= 100)

- Why?
  1. Gradual move from productive (corporate) to unproductive (consumer) credit
  2. Worsening trade off between growth and macro risk
  3. Financial sector ‘steals’ too much talent from the real economy

Academic literature: “Probably not”…

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- Moreover, financial structure *does* matter:
  - Banks become less important and stock markets more important for growth when economies develop (Demirguc-Kunt, Feyen and Levine, 2013; Gambacorta, Yang and Tsatsaronis, 2014)
  - High-tech industries innovate more (less) in countries with deeper stock (credit) markets (Hsu, Tiang and Xu, 2014). Stock but not credit market development boosts R&D (Brown, Fazzari and Petersen, 2009)

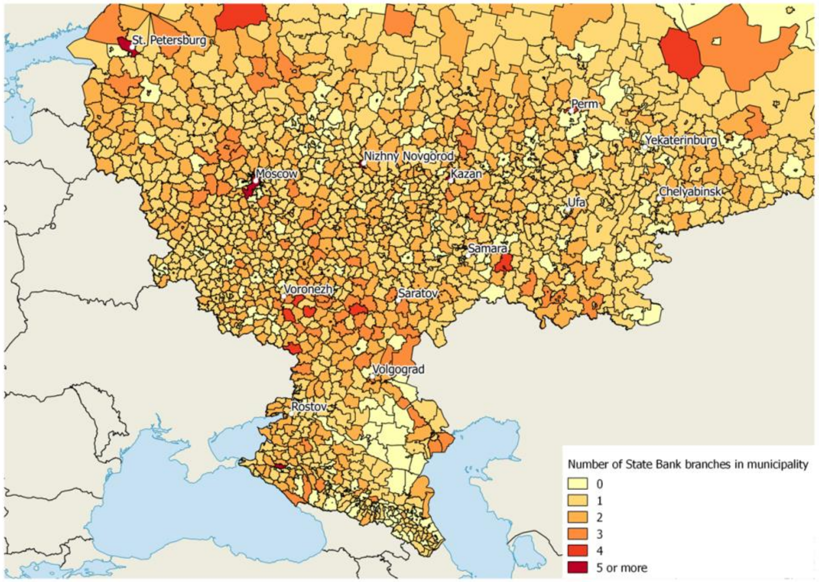
Historical data on “growth miracles”: “Probably not”...

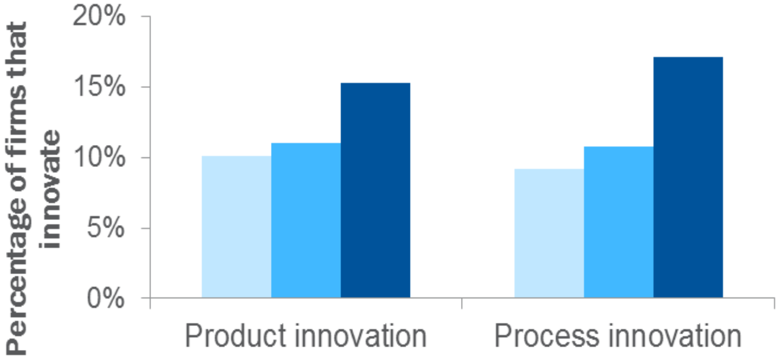
Correlates of growth outperformance episodes, a summary view

Factor	Increases likelihood of outperformance	Reduces chance of underperformance	*More important post-2008*		Makes episodes last longer	Helps ensure "soft landing"
			Supporting outperf.	Preventing underperf.		
Investment	++	+	+		++	++
Democratic institutions	+	+	–	+?		
Economic institutions	+	++		–?	+?	+
Openness to trade		+?			+	
Openness to finance		+	–	+	–	
Debt finance	––	–				
Equity finance	++	+		+		
Domestic savings	++	++				+
Infrastructure	+	+				

Source: Plekhanov and Stostad (2017)

Firm-level data from Russia: "Probably not"...

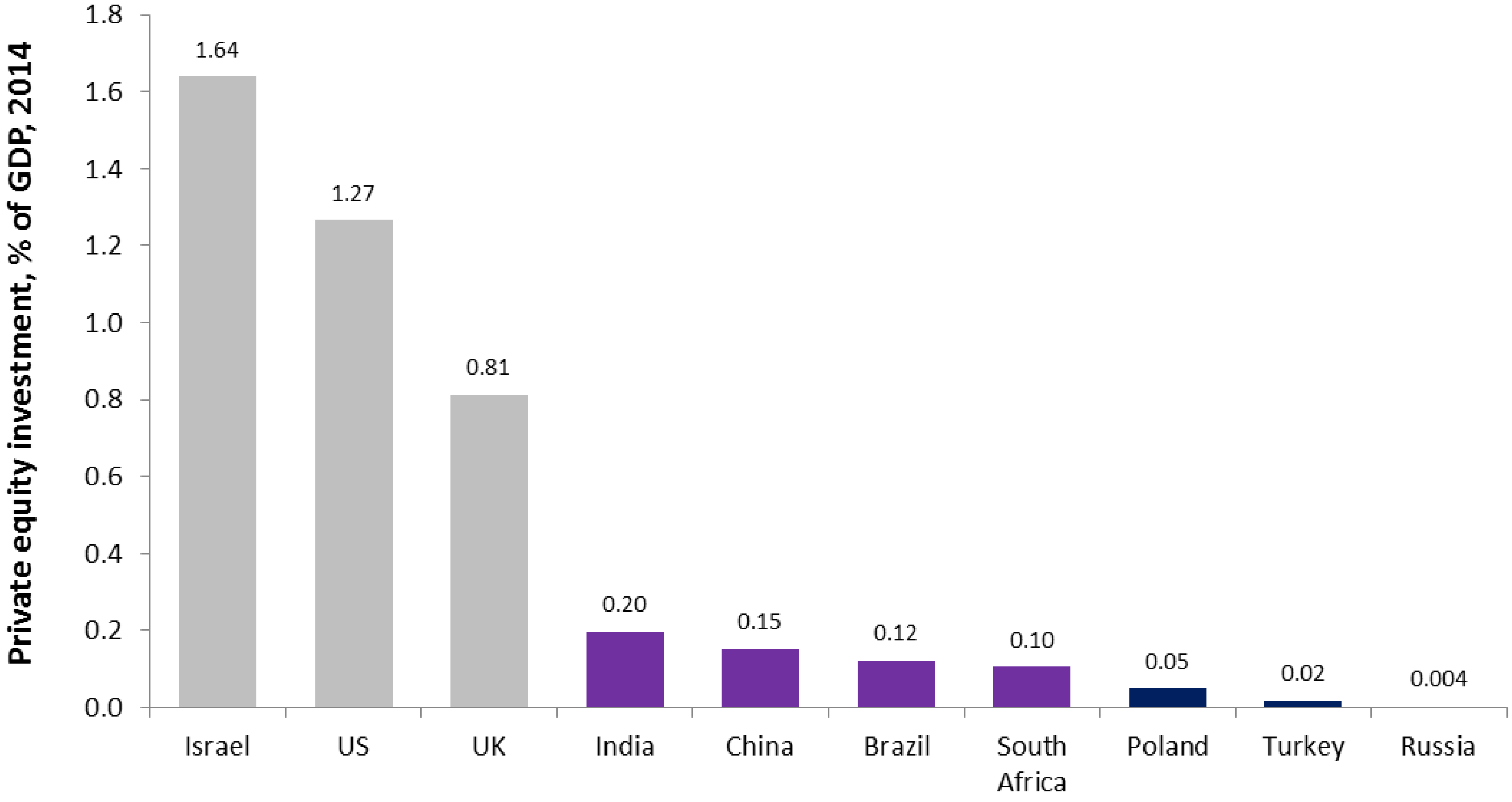




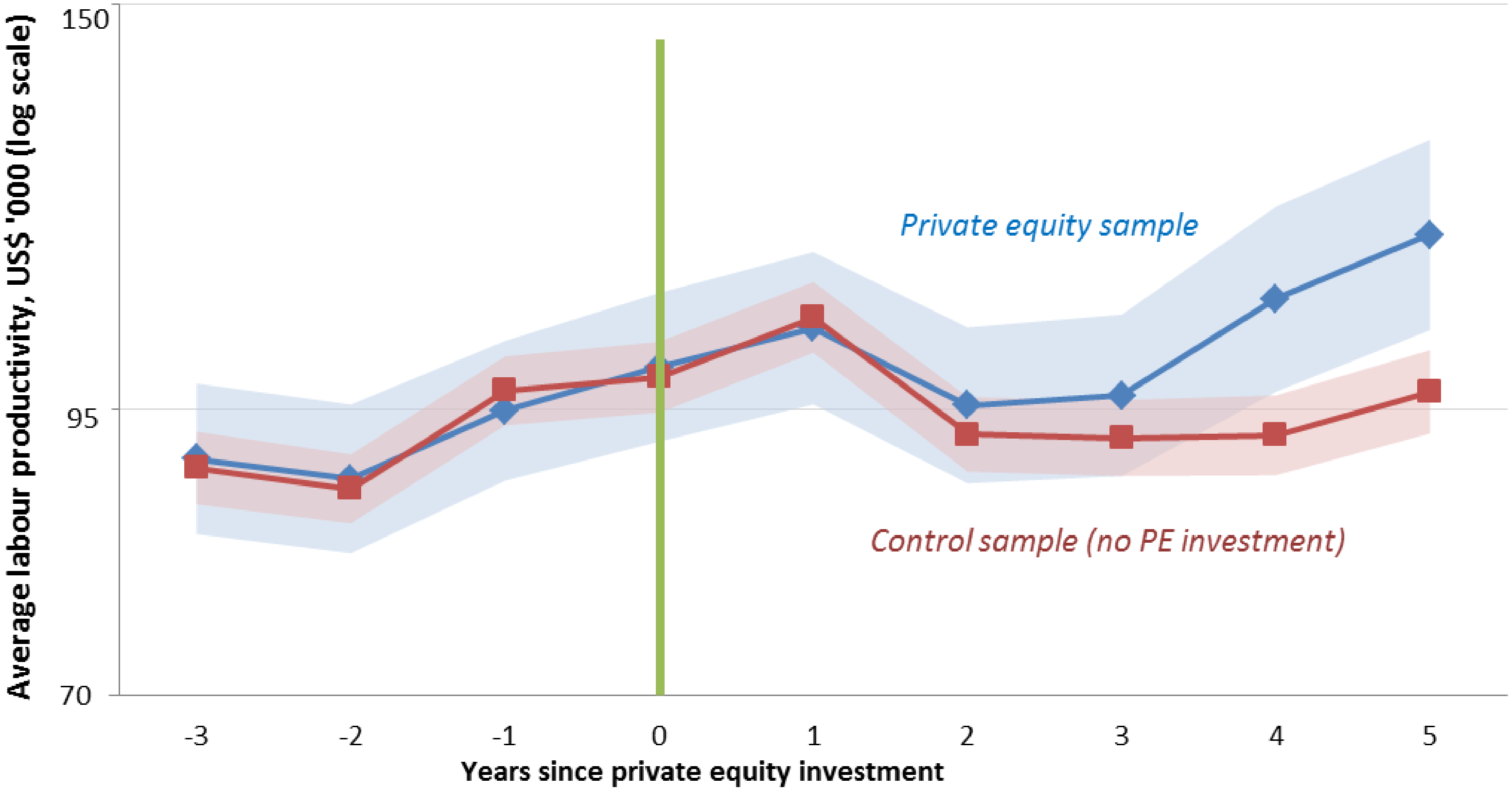
- Access to bank credit helps SMEs to reap the low-hanging fruits of imitative and adaptive innovation, but...
- ...does typically not result in successful frontier innovation and new patent applications

Source: Bircan and De Haas (2018)

Private equity presence remains tiny relative to the size of middle-income economies…



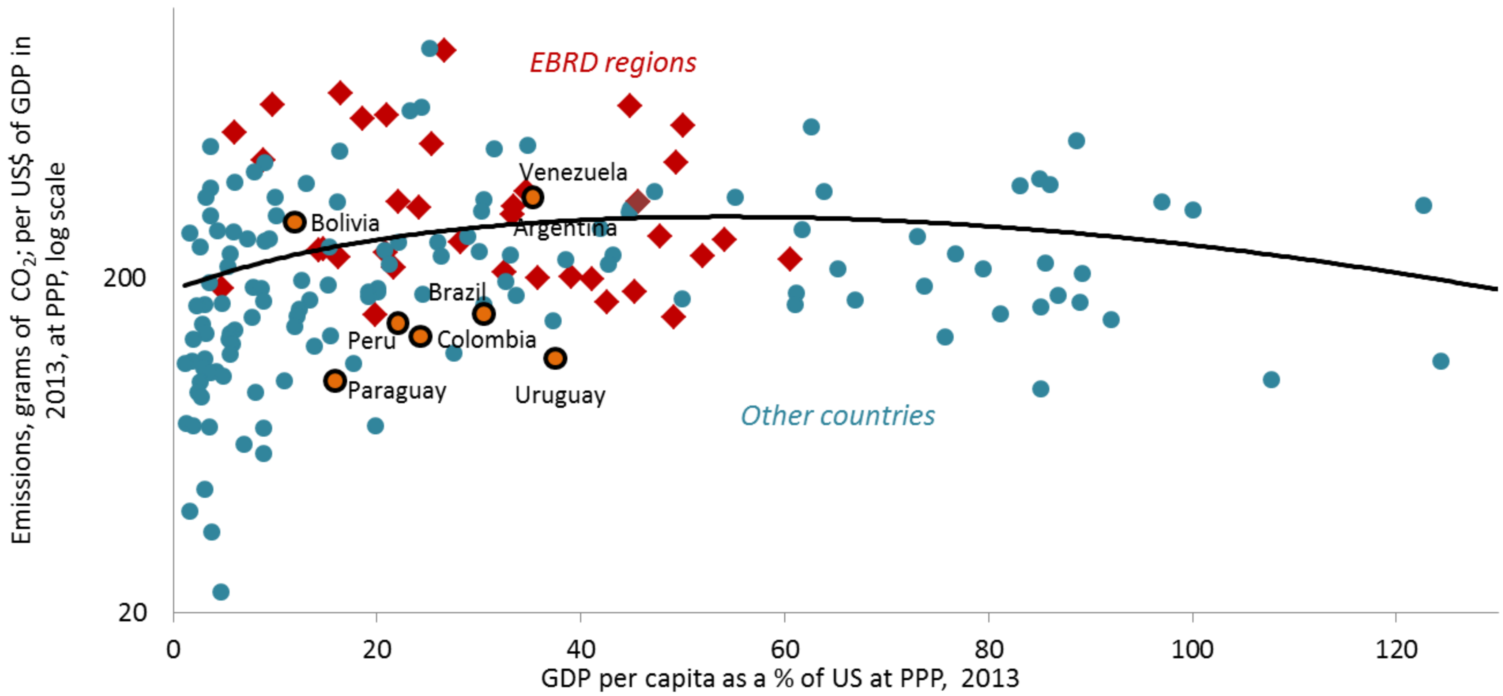
High impact: PE investment on average adds 30 jobs within 5 years. Increases labour productivity and profitability



Sources: EBRD, Orbis and authors' calculations

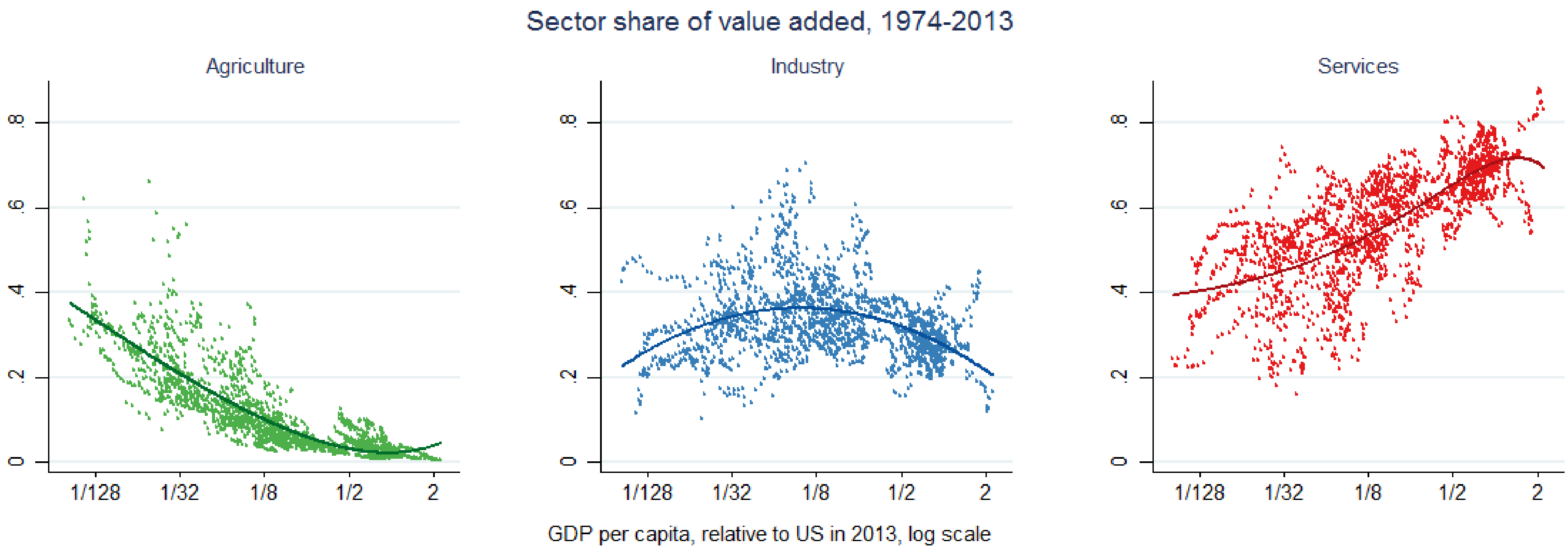
Equity: A green collateral benefit?

GDP per capita and emissions per unit of GDP in 2013



Sources: World Resources Institute, IMF and authors' calculation. The trend line is based on a polynomial fit.

Equity: A green collateral benefit?



Strong but opposite effects of credit and stock markets on industrial pollution:

1. CO_2 emissions increase with credit market, and decline with stock market, development
2. Credit-market effect is driven by cross-sectoral reallocation
3. Stock-market effect is driven by an improvement in within-sectoral energy efficiency

Source: De Haas and Popov (2018)

To wrap up

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For sustained *and* sustainable growth in middle-income countries, financial systems may need to rebalance: less credit and more equity