Financial Stability - A Regional Perspective

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OUTLINE OF PRESENTATION

I. Financial Stability – Background Issues

i. Concept and Definition

ii. Linkages to the macroeconomy

II. Recent Economic Developments and Financial Spillovers

i. Global Developments – evidence from 2017 GFSR

ii. Regional Developments – evidence from 2017 Africa Regional Economic Outlook

III. West Africa Financial Stability- Regional Financial Stability Framework

i. State of Play

ii. Financial Stability Indicators – Banking Sector

iii. Financial Stability Indicators – Non-bank Financial Institutions(evidence from WAMZ Financial Stability Report

IV. Financial Stability Challenges in the Region: Policy Focus Going Forward

V. Conclusion

PART I
FINANCIAL STABILITY – BACKGROUND ISSUES

i. Concept and definition
ii. Linkages to the macroeconomy

FINANCIAL STABILITY: CONCEPT AND DEFINITION

"A financial system is in a range of stability whenever it is capable of facilitating (rather than impeding) the performance of an economy, and of dissipating financial imbalances that arise endogenously or as a result of significant adverse and unanticipated events" (Schinasi, 2004)

"Financial stability is a condition, in which an economy's mechanisms for pricing, allocating, and managing financial risks are functioning well enough to contribute to the performance of the economy." (Schinasi, 2005)

FINANCIAL STABILITY CONCEPT AND DEFINITION

The first definition implies that a financial system is stable when there is confidence in the ability of the system to manage and absorb potential macroeconomic shocks with minimal disruption of economic and financial activity. The second definition states out the key roles of the financial system:

- **Efficient and smooth allocation of economic resources**: A stable financial system facilitates efficient and smooth allocation of resources inter-temporally and spatially between savers and investors.

- **Identification and management of potential risks**: In a stable financial system, potential risks are continuously identified, reasonably priced and effectively managed.

- **Absorption and containment of financial and economic shocks**: A stable financial system is able to absorb and contain shocks to the financial and real sectors with minimal disruption to financial and economic activity.

FINANCIAL STABILITY AND MACROECONOMIC LINKAGES

- In the absence of financial stability, the capacity of financial markets to facilitate trade, production, capital accumulation economic growth and social welfare is hampered.

- The consequences of financial instability are manifested in:

    - ***Decline in national output and incomes – real GDP growth***
    - ***Increased fiscal expenditures – fiscal deficit***
    - ***Balance of payments deficits – external balances and reserves accumulation***
    - ***Exchange rate instability – prices and competitiveness***

- A stable financial system is necessary for sustainable GDP growth and low inflation. Similarly, sustainable growth in the economy with stable prices will also make the economy less prone to financial instability.

GLOBAL LINKAGES

In an interdependent world, global financial stability maters

- The global financial crisis of 2007-2009 showed that financial stability can be jeopardized even in an environment of price stability and macroeconomic stability.
- Any disruption in the financial system anywhere in the world has the potential of affecting the real economy not only in that country but also elsewhere. The extent of transmission of disruptions through different channels, namely finance, trade and confidence channels was strong.
- Domestic financial stability cannot be a sufficient goal in the absence of a conducive global environment.

PART II
RECENT ECONOMIC DEVELOPMENTS AND FINANCIAL SPILLOVERS

i. **Global Developments – evidence from 2017 Global Financial Stability Report**
ii. **Regional Developments – evidence from 2017 Africa Regional Economic Outlook**

GLOBAL FINANCIAL STABILITY - EVIDENCE FROM 2017 GFSR

The financial crisis of 2007-09 and its aftermath emphasized the need for a global approach when assessing financial stability risks. In this context, IMF's biannual Global Financial Stability report, GFSR assesses global financial stability, identifying potential sources of risks and vulnerabilities.

According to the 2017 edition:

- **Global financial conditions are broadly stable:** Financial stability continued to improve since October 2016.
- **Economic activities and interest rates are increasing**: Economic activity has gained momentum and longer-term interest rates have risen, helping to boost the earnings of banks and insurance companies.
- **Political and policy uncertainties have heightened:** Threats to financial stability are emerging from elevated political and policy uncertainty around the globe. Policy developments in advanced economies that cause unanticipated changes in growth and debt could result in rising risk premiums and volatility in financial markets.
- **Shifts towards protectionism**: A shift toward protectionism in advanced economies could reduce global growth and trade, impede capital flows, and dampen market sentiment.

GFSR 2017 (CONTD)

The macro environment has important effects on the financial stability:

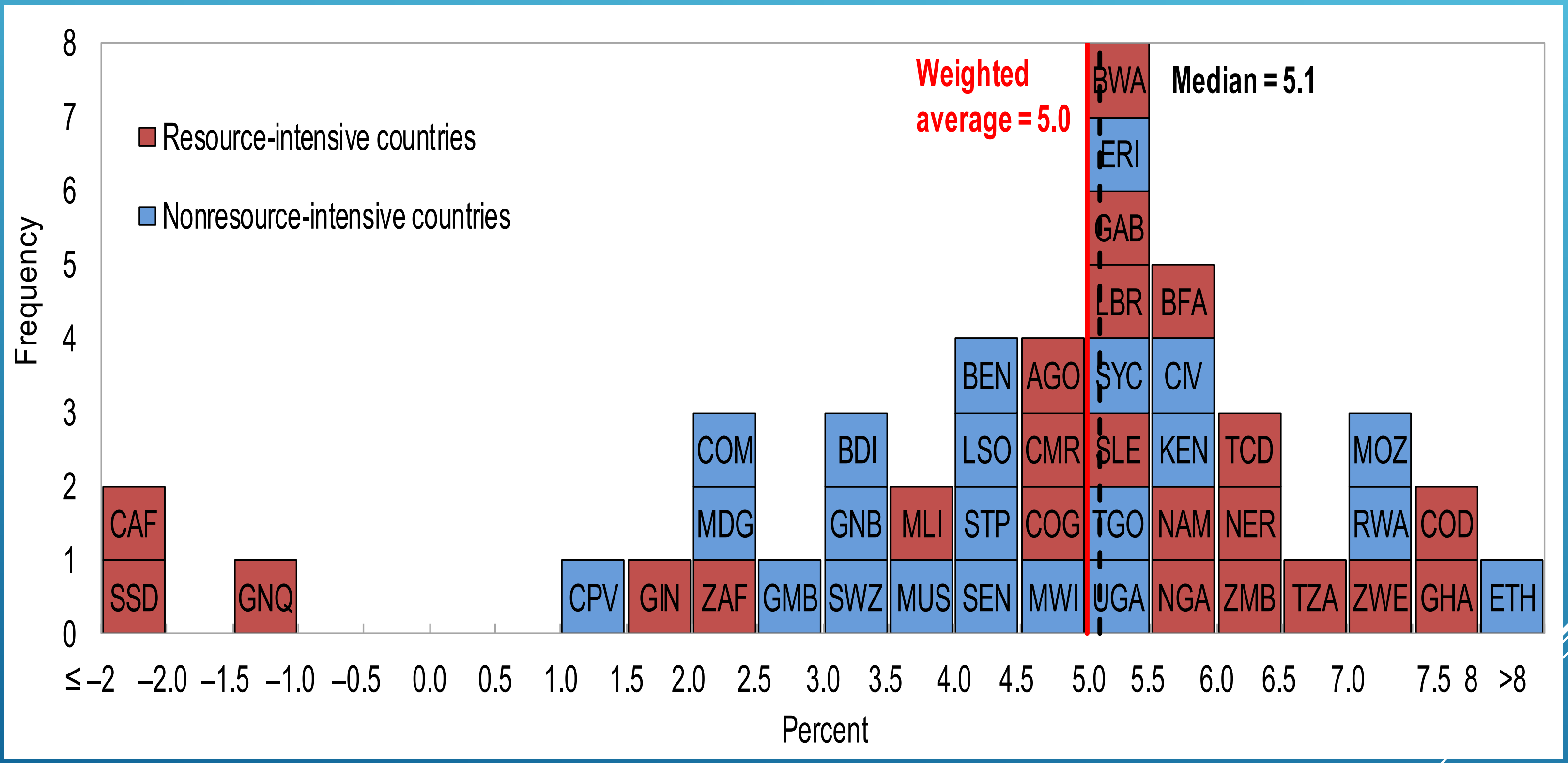
- **Low growth / low interest rate environment:** A prolonged low-growth, low-interest rate environment can fundamentally change the nature of financial intermediation. In such an environment, yield curves would likely flatten.
- **Bank earnings:** Combined with low credit demand, this would lower bank earnings, particularly for smaller, deposit-funded, and less diversified institutions.
- **Impact on non bank financial institutions**: Prolonged low interest rate also presents long-lasting challenges for life insurers and defined-benefit pension funds.
- **Achieving domestic policy objectives**: Though global shocks have significant impact on domestic financial conditions, countries retain influence to achieve domestic objectives—specifically, through monetary policy.

GFSR (2017) RECOMMENDATIONS

- **US policy mix**: In the United States, policymakers should provide incentives for economic risk taking while guarding against excessive financial risk taking.
- **Emerging market** economies should address domestic imbalances to enhance their resilience to external shocks.
- **Developing economies** should continue to strengthen supervisory frameworks.
- There should be no rollback of the post-crisis reforms that have strengthened oversight of the financial system in other regions.

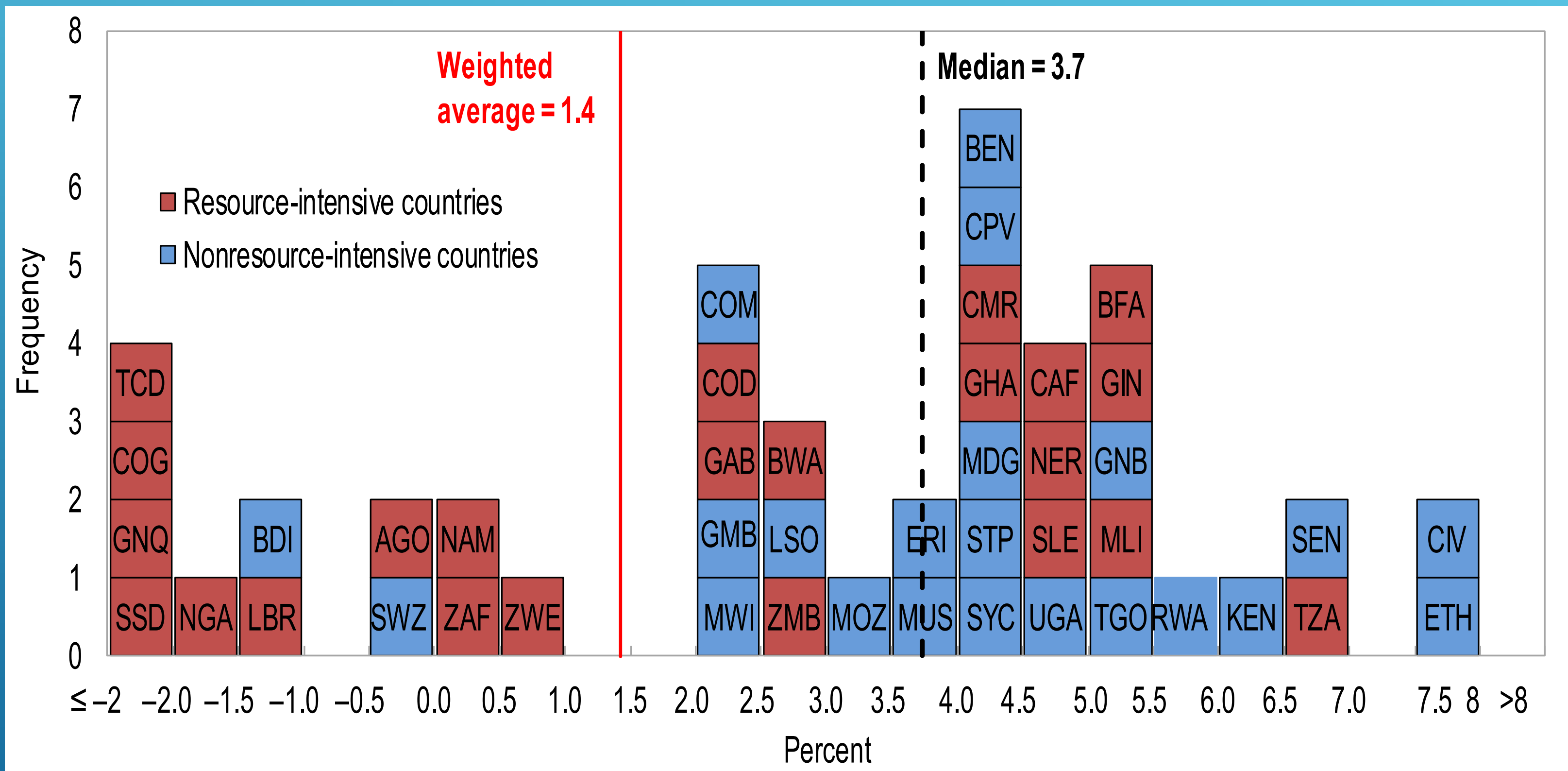
REGIONAL MACRO DEVELOPMENTS - EVIDENCE FROM AREO (2017)

Prior to 2015, African countries experienced high rates of economic growth, improvements in macroeconomic fundamentals, resulting in significant transformation and growth of their financial systems.



REGIONAL MACRO DEVELOPMENTS - EVIDENCE FROM 2017 AREO

Since 2016, SSA economic growth slowed sharply, averaging 1.4 percent, the lowest in two decades.



Real GDP Growth, 2016

REGIONAL MACRO DEVELOPMENTS - EVIDENCE FROM 2017 AREO

Drivers of the slowdown

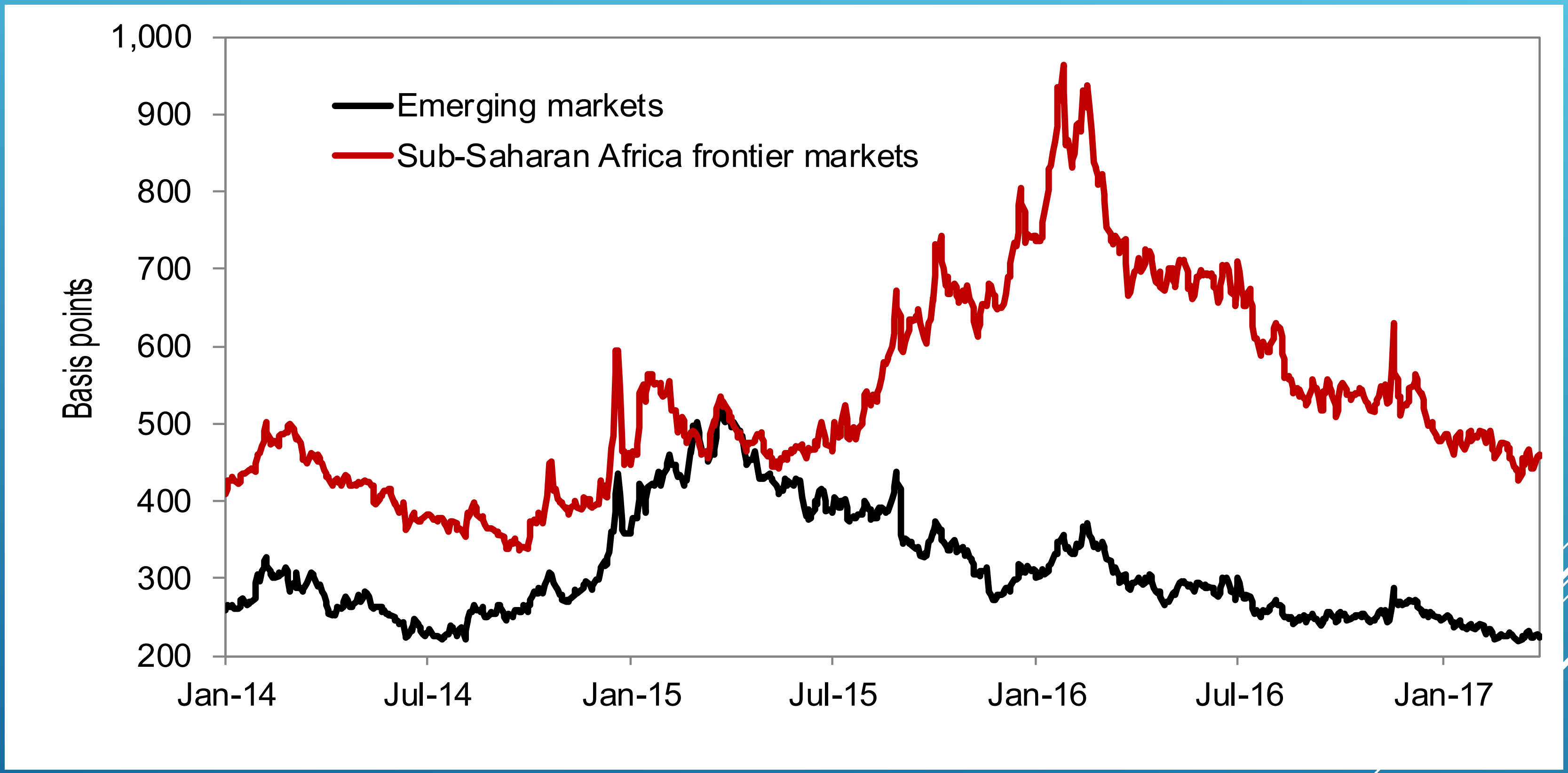
- **Exogenous** : global commodity price decline, compounded by problems with security and food shortage in several countries.

- **Policy drivers**: lack of flexibility in exchange rate policy and recourse to excessive domestic financing as external financing dried up.

- **Inadequate policy response** which *magnified the adverse outcomes in many countries.*

EVIDENCE FROM 2017 AREO CONTD.

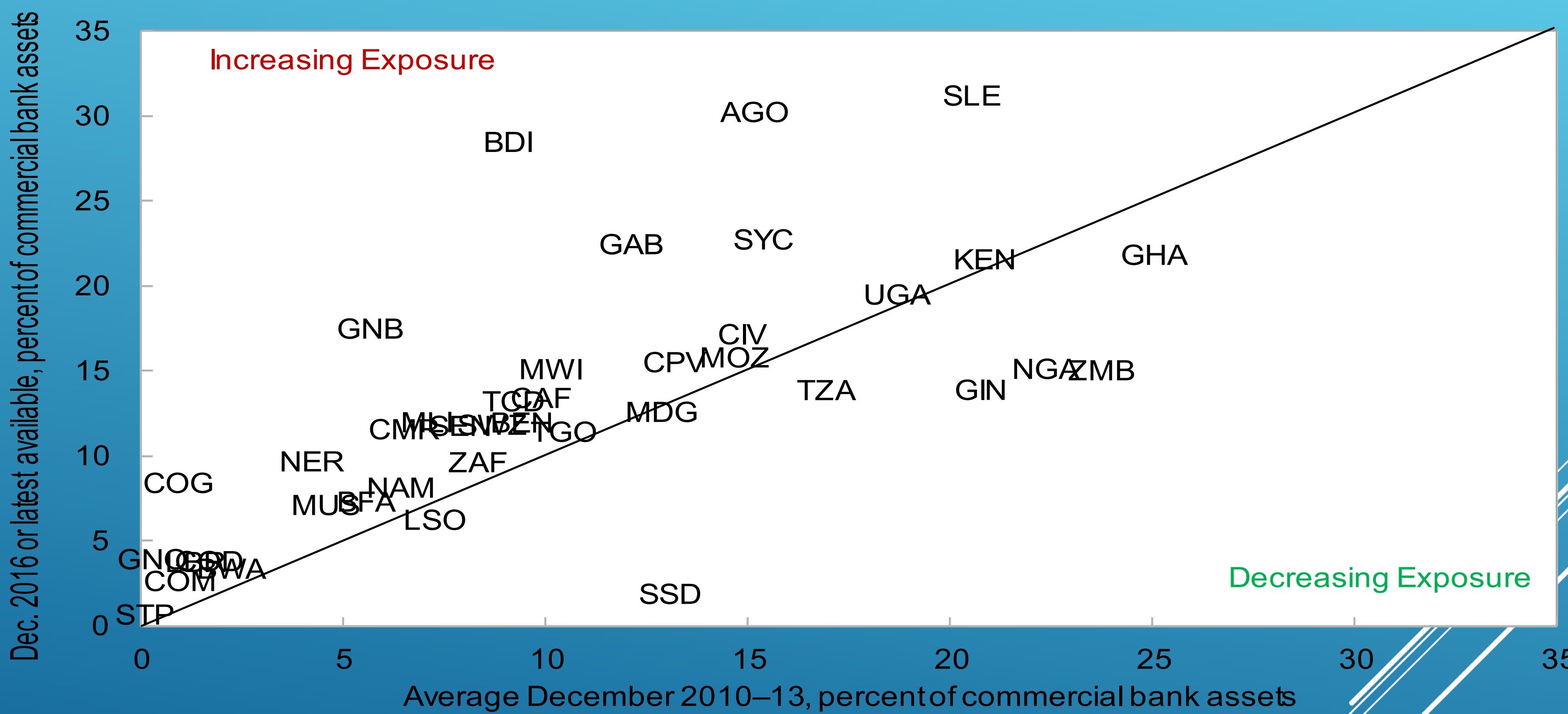
The impact of the slow down is pronounced. Borrowing cost has risen sharply, making external market financing less attractive.



Frontier and Emerging Market Spreads, 2014-17

EVIDENCE FROM 2017 AREO CONTD.

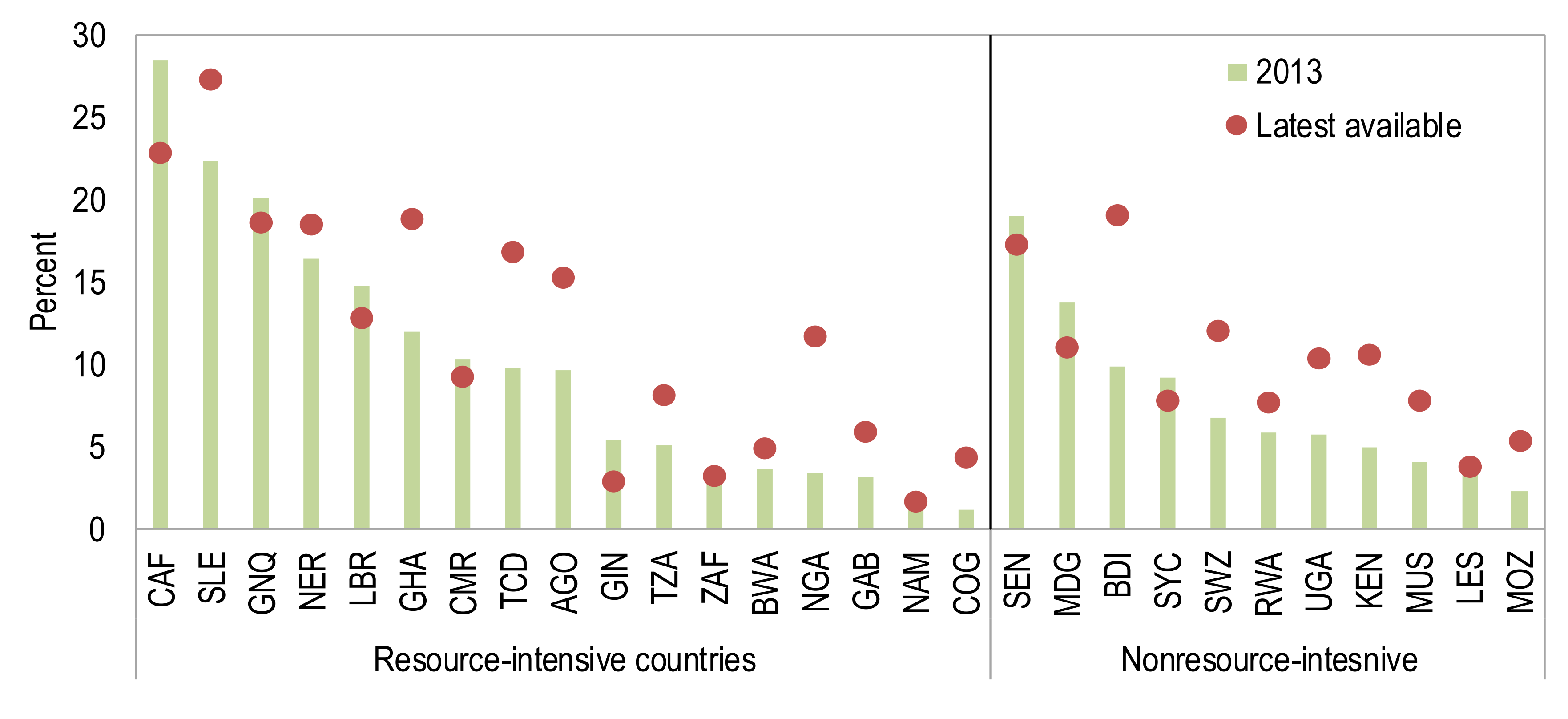
As a result, domestic financing is being accumulated at a high pace.



Exposure of Commercial Banks to the Government

EVIDENCE FROM 2017 AREO CONTD.

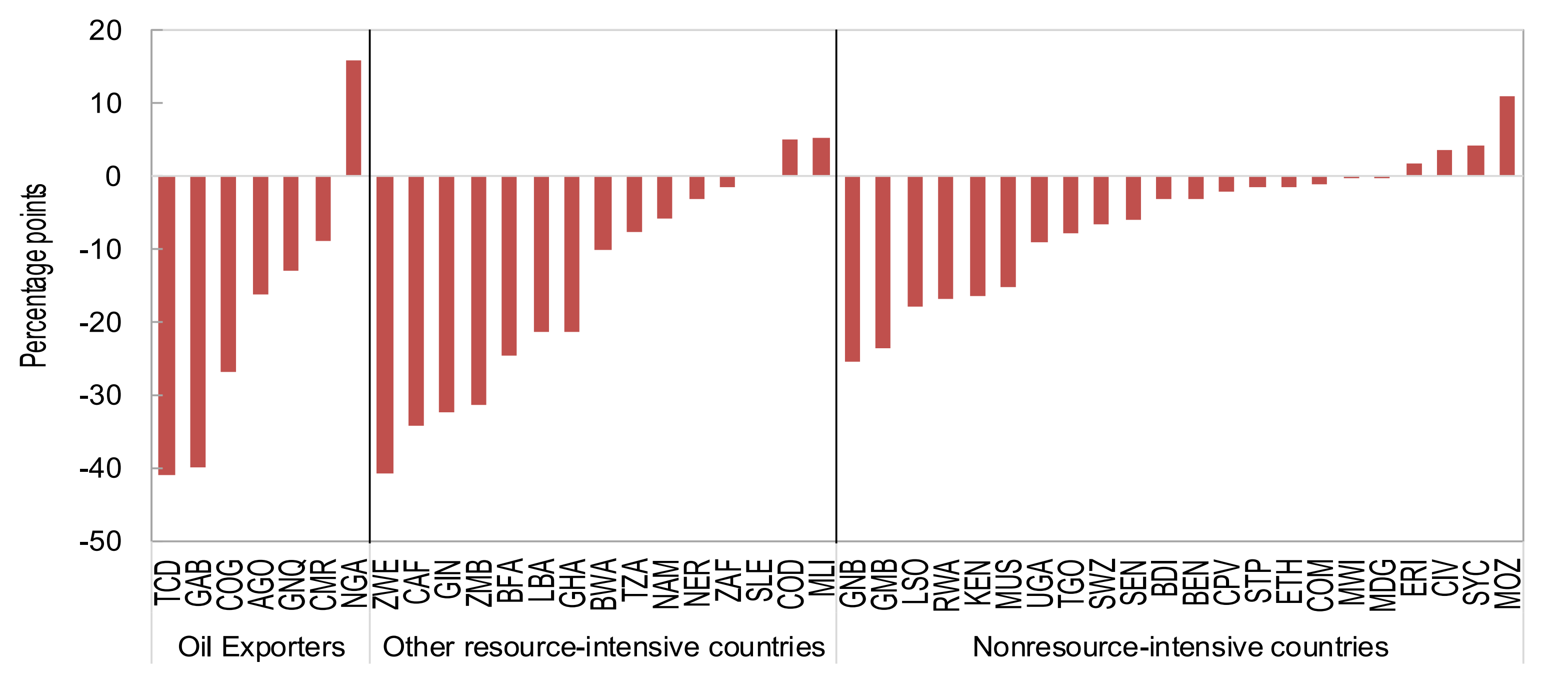
Financial sector asset quality is declining.



Nonperforming Loans to Total Loans

EVIDENCE FROM 2017 AREO CONTD.

As governments ramp up domestic borrowing amid declining economic activities, credit to the private sector is declining.



Change in Credit Growth to the Private Sector, Average 2011–13 vs. 2016

PART III
WEST AFRICA FINANCIAL STABILITY

i. **Regional Financial Stability Framework**

ii. **Financial Stability Indicators – Banking Sector**

iii. **Financial Stability Indicators – Non-bank Financial Institutions - evidence from WAMZ Financial Stability Report**

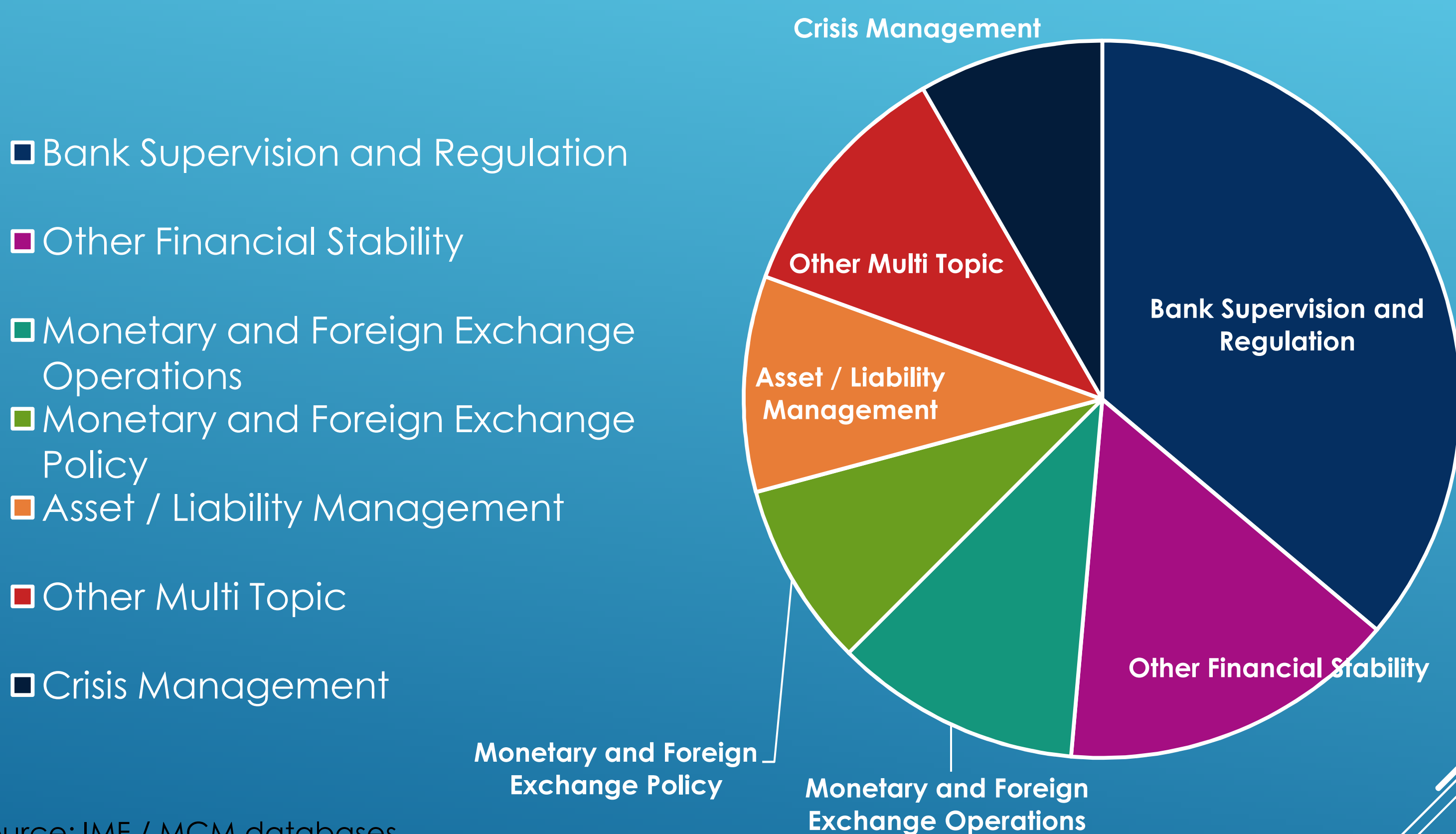
REGIONAL FINANCIAL STABILITY FRAMEWORK

Regional financial stability framework is based on international best practice and in the recent past, considerable efforts have been made to strengthen the legal and regulatory frameworks of the financial sector in the region.

- **Technical Assistance**: IMF and other international organizations provide technical assistance to improve the legal and regulatory framework and enforcement capabilities of the national authorities.
- **Training:** Supervisory staff from SSA countries have participated in training seminars offered by the IMF Institute in Washington as well as regional training centers.
- **FSAPS:** Joint IMF-World Bank Financial Sector Assessment Program, FSAPs have helped to identify weaknesses and proposed corrective measures, many of which have been implemented by the countries concerned.
- **WAMZ:** The West African Monetary Zone has a College of Supervisors that provides a platform for supervisory cooperation and strengthening of regional financial stability.
- **Non bank FSI:** Developing and compiling FSIs for non-banks, life and non-life insurance companies, credit unions and pension funds is however limited.

IMF Technical Assistance Field Delivery by Topic

Financial stability related TA represent the highest proportion of IMF MCM TA missions in FY2016.



Source: IMF / MCM databases.

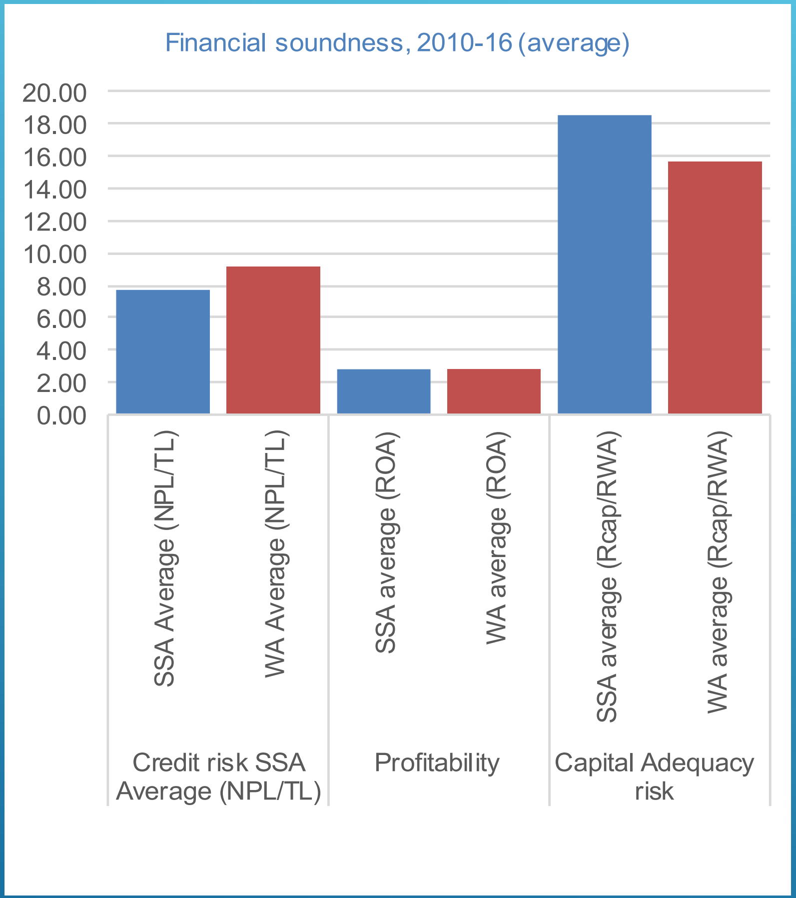
FINANCIAL STABILITY INDICATORS: STATE OF PLAY - BANKING SECTOR

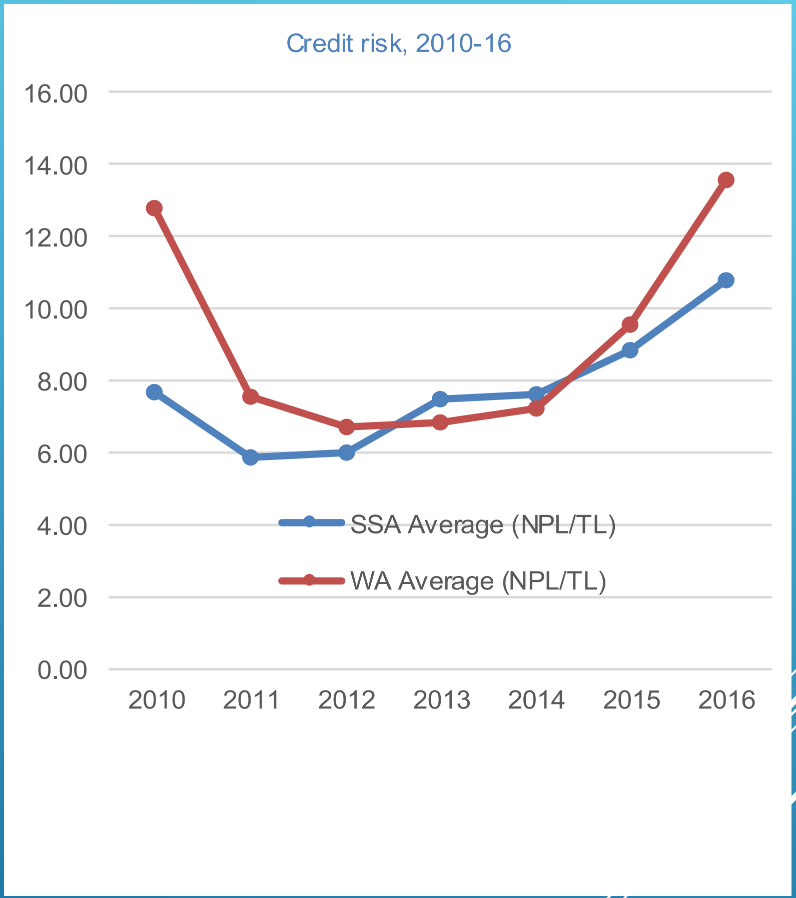
Sub Saharan Africa Banking Risk Analysis, 2016

Banking risks	Metric	SSA Average[1]	West Africa Average[2]
Credit risk	NPL/TL	10.8	13.5
Profitability risk	ROA	2.2	2.4
Capital adequacy risk	Rcap/RWA	18.8	11.9

Source: IMF Global Financial Soundness Indicators; http://data.imf.org/?sk=51B096FA-2CD2-40C2-
1. 21 countries reporting.
2. Chad, Ghana, Guinea, Nigeria reporting.
NPL, TL, ROA RCAP and RWA refer to Nonperforming loan, total loan, return on asset, bank regulatory capital and risk weighted asset respectively.

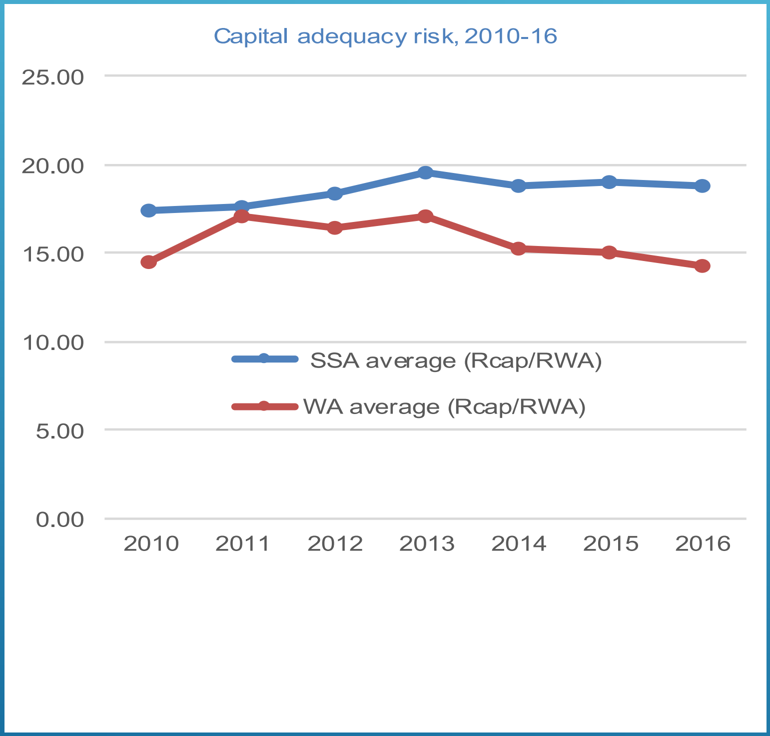
FINANCIAL STABILITY INDICATORS: STATE OF PLAY - BANKING SECTOR

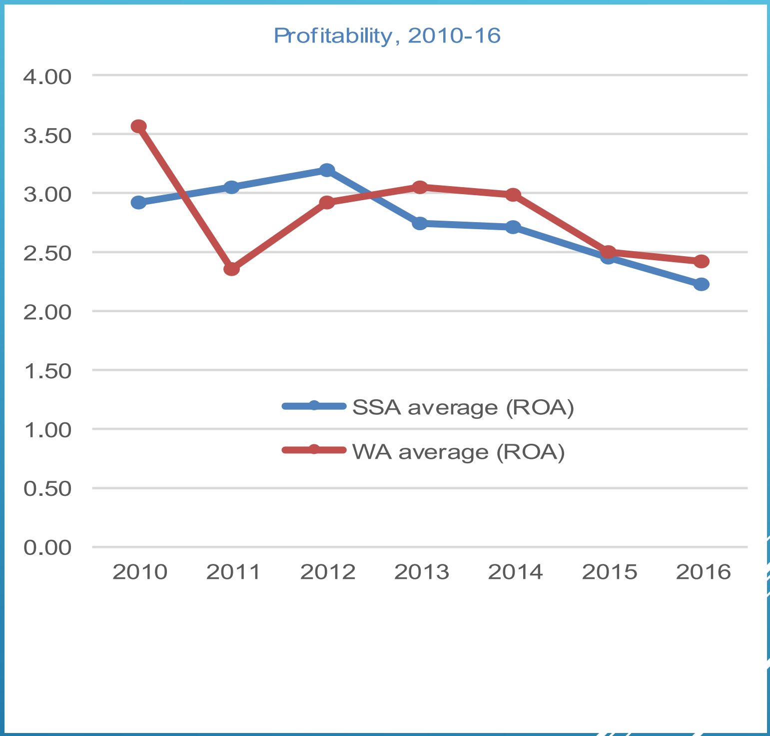




Data source: IMF Financial Soundness Indicators database

FINANCIAL STABILITY INDICATORS: STATE OF PLAY - BANKING SECTOR





Data source: IMF Financial Soundness Indicators database

FINANCIAL STABILITY INDICATORS: NON BANK FINANCIAL INSTITUTIONS (NBFI)

- NBFIs in the region comprise insurance companies, pension administration; primary mortgage companies, rural and community banks and finance companies.

- They play important role in promoting financial inclusion and risk sharing in the region. However, their size is very small.

- They remain largely unregulated, though some countries notably Nigeria and Ghana are now improving regulatory oversight.

PART IV
FINANCIAL STABILITY CHALLENGES IN THE REGION: POLICY FOCUS

KEY FINANCIAL STABILITY MATTERS FOR POLICY FOCUS

- Development and enforcement of micro prudential regulations
- Establishment of robust crisis management framework
- Improvement of cross border supervisory oversight
- Improvement of efforts to build FSIs for non-banks, insurance, credit unions and securities firms that operate in the regional economy.
- Adoption of IFRS methodology in financial reporting
- Undertake risked based supervision
- Mitigate macroeconomic risks from fiscal dominance.

THANK YOU!!!

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