RESEARCH INSIGHTS

How to Increase Credit Penetration in Latin America and the Caribbean? Improve Government Capacity and Reduce the Role of Interest Groups

There is a largely neglected political economy dimension to promoting financial development (the depth of credit markets) in the region, which includes the role of interest groups and government capabilities.

The combination of the degree of opposition to financial development from incumbent industries and differences in government capabilities explains much of the variation in financial development across countries.

To increase financial development, reforms are needed that affect the long-term incentives of political actors to invest in their capabilities, combined with policies that can influence the incentives and the power structure of interest groups.

CONTEXT

The region's financial systems are small and fragmented between formal institutions such as commercial banks and a variety of informal institutions. Even before the COVID-19 pandemic, bank credit to the private sector represented a relatively low share of GDP.

The pandemic will have negative impacts on the region's credit markets and in turn weaken economic recovery. Financial systems are likewise expected to weaken and become more fragmented. The policy implications of this paper, originally published in the aftermath of the global financial crisis, can be useful for policymakers in addressing the perennial problem of financial underdevelopment in the region.

THE PROJECT

Access to credit is fundamental for economic growth. But not all firms benefit equally, and some may prefer to limit access to maintain control of markets. Also, extensive government borrowing may limit credit to the private sector. What is needed for financial development is the combination of low opposition from incumbents and high government capabilities; one without the other may not be enough.

Key Concept

FINANCIAL DEVELOPMENT

In countries with developed financial markets—for example, the United States—households and firms have plentiful access to credit in normal circumstances.

RESULTS

The combination of low opposition to financial development from industries and heterogeneity in government capabilities explains part of the variance in financial development across countries. For the median country, increasing the degree of credit dependence of its firms (i.e., reducing opposition to financial development) would increase the share of domestic credit in the economy by about 10 percentage points of GDP. For the median country in terms of the credit dependence, increasing government capabilities would likewise increase the credit to GDP ratio by about 10 percentage points. In countries with very high credit dependence that impact could reach 40 percentage points.

What do these numbers mean in economic terms? An increase in a country's average credit dependency roughly equal to the difference in this measure between Ecuador and Belgium would imply an average increase in financial development between 0 and 25 percent of GDP, depending on the level of government capabilities. Similarly, an increase in government capabilities roughly equal to the difference between Chile and Japan would imply an average increase in financial development between 0 and 29 percent of GDP, depending on the country's level of credit dependency.

Key Concept

CREDIT TO THE PRIVATE SECTOR

Typically exceeds 100 percent of GDP in countries with high financial development. For the typical country in the region, it is less than 50 percent.

Key Concept

CREDIT DEPENDENCY

For technological reasons, some industries depend more on external finance than others (e.g, plastics and machinery manufacturing versus the tobacco or leather products industries).

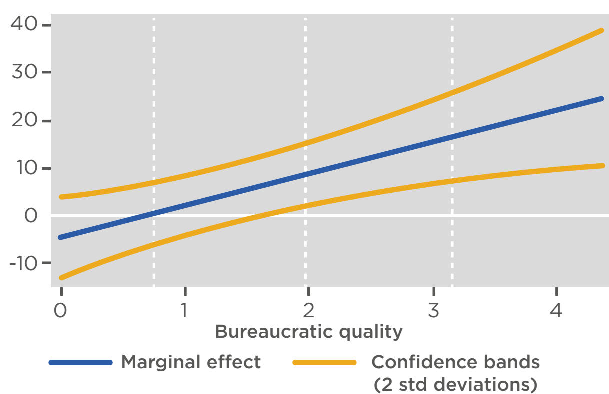
POLICY IMPLICATIONS

Both interest groups politics and government policymaking capabilities are necessary conditions for financial development. Those capabilities explain differences in financial development across countries and also provide evidence on how government capabilities matter for economic growth. In order to promote financial development, the consensus from the so-called "legal origins" literature prescribes changes to legal codes, while the consensus from "political institutions" literature prescribes far-reaching institutional reforms designed to limit the authority of public officials. The results in our study indicate that it is not enough to tinker with certain specific rules; a broader approach may be warranted.

1. First, reforms should affect the long-term incentives of political actors to invest in their capabilities. Evidence that politicians would be more eager to invest in the capabilities of government when the conditions are helpful for intertemporal cooperation – basically, when the basic institutional structure of a country provides actors with long-term horizons, open and transparent policy arenas, and enforcement mechanisms. On the contrary, institutions such as electoral systems that reward short-term political gains will not be conducive to long-term investments.

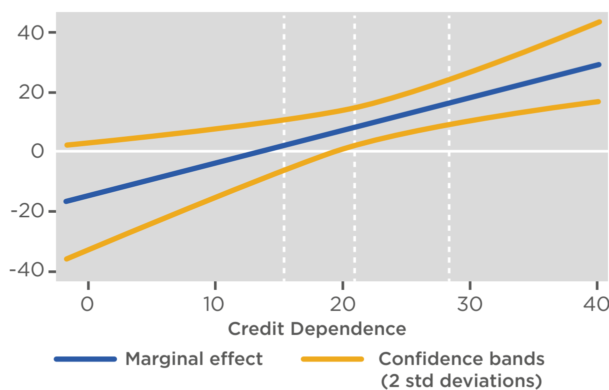
2. Second, it may also be necessary to influence the incentives and the power structure of interest groups. For instance, governments and international organizations may wish to assist in the organization of those groups that would benefit from greater financial development, doing so by helping to reduce the collective action costs for firms in sectors that are highly credit dependent. Moreover, by helping in the set-up of encompassing associations, they may achieve this objective while also moving these associations into a self-sustaining path of investing in their capabilities. On the other hand, it may make sense for countries to make strategic bets on those economic areas that would provide greater industrial complexity while weakening opposition to financial development.

Marginal Effect of Credit Dependence on Domestic Credit to Private Sector (% of GDP)



Nota: Dashed lines represent the quartiles of Bureaucratic Quality.

Marginal Effect of Bureaucratic Quality on Domestic Credit to Private Sector (% of GDP)



Nota: Dashed lines represent the quartiles of Credit Dependence.

FULL STUDY

Becerra, O., E. Cavallo, and C. Scartascini. 2010. The Politics of Financial Development: The Role of Interest Groups and Government Capabilities.

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