Financial development and economic diversity: is there a link?

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OUTLINE OF PRESENTATION

- Introduction and Motivation for Study
- Literature Review
- Lack of Diversification in the T&T Economy
- Finance and Diversification in T&T
- Some Preliminary Econometric Analysis
- Conclusion and Recommendations

INTRODUCTION

- Economic Diversification has been like the "holy grail" for many small open economies.
- Diversification is seen as key for the long term survival of small, single commodity dependent states.
- Traditionally, the focus has been on finance and economic growth.
- Given the dominant role of finance in recent economic events, some literature, however, has begun to explore the link between the financial sector and diversification
- The aim here is to examine this relationship in the T&T context.
- We review the relevant literature an present some initial findings.

LITERATURE REVIEW

- Overall, there seems to be evidence of a positive relationship between financial sector development and economic growth.
- Ongoing debate as to the direction of the relationship.
- However, very little literature exists on the relationship between the financial sector and diversification.
- There are few theoretical and empirical papers.

Financial sector development and diversification	1-Acemoglu and Zilbotti(1997), Saint Paul(1992) 2-Schclarek(2007) 3-Ramcharan(2010)	-two-way relationship(theoretical) -economies that are more diversified tend to be more financially developed. -causality can run in both directions. A robust role for diversification in shaping financial sector development.
Financial sector development and growth(Caribbean)	1-Watson and Ramlal(2005) 2-Birchwood and Nicholls (1999) 3-Iyare and Moore(2011)	1-causality in both directions. 2-LR-demand following SR-bi-directional 3-positive relationship
Financial sector development and growth(Int'l)	1-Levine, Loayza, & Beck(2000); King & Levine (1993) 2-Demetriades and Hussein (1996), and Luintel and Khan (1999)	1-financial development positively related to growth. 2-bi-directional

Sectoral composition of GDP(%)
(Source: Central Bank (AES), various years)

Sector	1970	1980	1990	2000	2005	2010	2011
Agriculture	5.9	2.3	2.2	1.4	0.5	0.7	0.6
Petroleum	22.3	42.1	30.5	31.3	45.9	43.9	45.3
Manufacturing	9.4	5.6	8.7	7.1	5.5	4.3	4.6
Electricity and water	2	1	1.6	1.7	0.9	1.4	1.3
Construction	5.9	11.3	7.7	7.5	7.4	7.1	6.1
Transport ,storage and communication	0	10.7	8.7	8.6	5.6	5.3	5.2
Distribution	15.6	9	13.4	16.4	11.9	13.5	12.4
Finance, insurance and real estate	8.5	6.1	10	14.2	11.6	11.1	11.1
Govt	8.4	7.4	11.1	7.6	6.6	8.4	9.2
Other services	22	4.5	5.4	4.7	4.1	4.4	4.2

FINANCE AND DIVERSIFICATION IN T&T

FINANCIAL SECTOR AS ENABLER OF DIVERSIFICATION

- Palacin (2008)-Greater financial development is associated with more rapid adoption of new technologies and capital reallocation among industries.
- Gelb(2011)-importance of well developed financial system to help diversify the economy.
- Birchwood(2003)-knowledge and expertise is important to identifying productive opportunities and directing credit towards those activities.

BANKING SECTOR OF T&T

- Dominates the financial sector in terms of financial assets.
- For 2011, the financial, insurance and real estate sector accounts for 11.1% of GOVTT) and 9.1% of employment in June 2011.(CB)
- Birchwood(2003) notes the banking sector's conservative behaviour in terms of lending to certain borrowers.
- Studies have shown that lending is often skewed to more established enterprises, with small and micro enterprises encountering difficulties in accessing finance.(CSO finding in 2011 that 11% of SME start-up funding comes from the banking fraternity with 70% coming from personal savings.)

BANKING SECTOR CONT'D

- Financial services–The Budget Statement for 2012/2013 noted Scotia Bank entered a Memorandum of Understanding with the IFC Management Company in the financial services sector which will result in an investment of $100 million and the employment of 200 persons.
- If the financial sector is a driver of diversification, its loan portfolio is supposed to be dominated by sectors of strategic importance.
- Let's examine this…

YEARS	TOP 3 SECTORS RECEIVING LOANS(BANKS)	% OF LOANS	TOP 3 SECTORS RECEIVNG LOANS(FIN AND MERCHANT BANKS)	% OF LOANS
1990	Consumer(24.3%) Manufacturing FIR	53.5%	Manufacturing(20.9%) Consumer Petroleum	38.9%
2000	Consumer (41.1%) FIR_1 Manufacturing	66.1%	FIR_2 (19.9%) Consumers Manufacturing	50.6%
2005	Consumer (29.9%) FIR_1 Distributive trades	54%	FIR_2 (31%) Petroleum Consumers	54.4%
2007	Consumer(30.3%) FIR_1 Distributive trades	59.3%	FIR_2 (36.9%) Consumers Manufacturing	68.3%
2009	Consumer(24.5%) FIR_1 Construction	52.9%	Consumers(35%) FIR_2 Manufacturing	62.7%
2010	Consumer(25.8%) FIR_1 Construction	53.2%	Consumers(34.3%) FIR_2 Hotels and Guest Houses	65.4%

YEARS	AGRICULTURAL SECTOR		MANUFACTURING SECTOR	
	% OF GDP	% OF LOANS	% OF GDP	% OF LOANS
1980	2.3	2.8	5.6	15.2
1990	2.6	3.8	8.9	16.4
2000	1.4	0.9	7.1	12.
2005	0.5	0.3	5.5	7.
2006	0.6	0.2	5.6	7.7
2007	0.4	0.2	5.7	6
2008	0.4	0.3	4.7	7.3
2009	0.6	0.3	4.8	7
2010	0.7	0.2	4.3	6.8

OTHER FINANCIAL INSTITUTIONS

- Credit Unions–seen as a source of finance for small and medium enterprises.
- Insurance firms–CLICO involvement in down-stream energy industry
- Merchant Banks and Finance Companies
- Stock Market

FINANCING KEY SECTORS IDENTIFIED FOR DIVERSIFICATION THRUST

- SECTORS: Tourism, ICT, Maritime, Agriculture, Manufacturing, Financial Services, Creative Arts, Renewable Energy
- Traditionally financed by government initiatives, international development organizations…
- Supported by: BDC,NEDCO,EX-IM Bank, ADB, Development Finance Ltd.
- Lack of involvement by private sector and minimal involvement of banks.

SOME PRELIMINARY ECONOMETRIC ANALYSIS

- VECM:1975-2009(annual)
- Dependent variable: non-oil sector GDP as proxy for economic diversification
- Financial sector development indicators(correlation): M2/GDP(83%) and private credit/GDP(46%).
- Cointegrating equation:
  - $LDIV_{t-1} = 1.96LM2_{t-1} - 11.15LB_{t-1} + 45.65 + U_{t-1}$
- LR relationship, adjustment coefficient negative and significant.
- However, no Granger Causality between the variables??(SR coefficients insignificant)
- Suggestions are welcomed…

RECOMMENDATIONS AND CONCLUSION

- Some evidence of long-run relationship, implies that policies should be geared towards deepening the financial sector.
- Greater incentives for bank lending to SME's.
- Bennett(2006) need for change in attitudes, government incentives and human resources.
- Based on the literature, the development of the financial sector can play an important role in the diversification of the economy.
- If the financial sector improves its credit allocation to the SME's and the non-energy, it could play a pivotal role in transforming the economy.