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Politics, Finance and Growth

Svetlana Andrianova
University of Leicester

Summary of the Project

Linkages between politics, finance and growth with a special emphasis on Sub-Saharan Africa

1. Analyse causes of financial under-development (theoretical models and empirical evidence)
2. Re-examine key aspects of finance-growth nexus with special focus on bank distress and financial fragility in LICs
3. Explore relationship between financial development and poverty in LICs using different approaches and data

“Why Do African Banks Lend so Little?”

- An explanation of African banking sector under-development
- A modified IO model of banking with unchecked moral hazard (strategic loan default) & adverse selection (lack of good projects)
- Empirical test applied to a large sample of African banks
    - Dynamic panel estimator
    - Results:
        - Loan defaults are a major factor inhibiting bank lending when institutional quality is low
        - Once at or above the threshold of institutional quality, improvements in institutional quality or in the default rate do not matter

"Ethnic Fractionalization & Loan Default in Africa"

- Why are there loan defaults in Africa? Theory model of AS and MH with
  - varying level of contract enforcement (related to the quality of governance)
  - different degrees of market segmentation (ethnic fractionalization)
  - Prediction: a specific form of non-linearity in the effects of these variables on the loan default rate
- Empirical analysis:
  - uses African panel data for 111 individual banks in 29 countries over 2000-2008
  - supports the theoretical prediction
- Improvements in the quality of contract enforcement will reduce loan default rates only in certain circumstances

New Dataset of Financial Fragility

- Coverage: **124 countries** over 1998-2012 (including **48 African** countries)
- Total asset value in our dataset is nearly 5 times as large as that in the previous datasets
    - Dataset includes commercial banks, cooperative banks, investment banks, islamic banks, real estate and mortgage banks, savings banks
- **8 different measures** of financial fragility: different aspects of vulnerability in the financial system

Financial Fragility Measures:
what they are

Table 4: Core measures related to financial fragility

CAMEL Measure	Variable	Bankscope Code	Definition of Variable	Proprtional/Inverse
Capitalisation 1	$\frac{\text{Equity}}{\text{Total Assets}}$	$\frac{2055}{2060}$	$\frac{\text{Equity}}{\text{Total Liabilities} + \text{Equity}}$	(–)
Asset Quality	$\frac{\text{Impaired Loans}}{\text{Gross Loans}}$	$\frac{2170}{2000+2070}$	$\frac{\text{Impiared Loans}}{\text{Loans} + \text{Loan Loss Reserves}}$	(+)
Managerial Efficiency	$\frac{\text{Cost}}{\text{Income}}$	$\frac{2090}{2080+2085}$	$\frac{\text{Overhead Costs}}{\text{Net Interest Revenue} + \text{Other Operating Income}}$	(+)
Earnings	$\frac{\text{Net Income}}{\text{Average Total Assets}}$	$\frac{2115}{\text{Average } 2025}$	$\frac{\text{Net Income}}{\text{Total Assets}}$	(–)
Liquidity I	$\frac{\text{Net Loans}}{\text{Total Assets}}$	$\frac{2000}{2025}$	$\frac{\text{Loans}}{\text{Total Assets}}$	(+)
Liquidity II	$\frac{\text{Liquid Assets}}{\text{Total Assets}}$	$\frac{2075}{2025}$	$\frac{\text{Liquid Assets}}{\text{Total Assets}}$	(–)
Risk exposure	$\frac{\text{Net Charge Offs}}{\text{Average Gross Loans}}$	$\frac{2150}{2000+2070}$	$\frac{\text{Net Charge Offs}}{\text{Loans} + \text{Loan Loss Reserves}}$	(+)

Financial Fragility Measures:
how different they are

Table 24: Correlations between the financial fragility indicators

	Equity	Impaired Loans	Cost to Income	Return on Av. Assets	Net Loans	Liquid Assets	Net Charge Offs	Z-Score
Equity	1							
Impaired Loans	-0.07	1						
Cost to Income	-0.04	0.16	1					
Return on Av. Assts	0.32	-0.18	-0.28	1				
Net Loans	-0.01	-0.18	-0.10	-0.08	1			
Liquid Assets	0.02	0.17	0.01	0.11	-0.71	1		
Net Charge Offs	0.01	0.12	0.19	-0.09	-0.17	0.10	1	
Z-Score	0.24	-0.13	-0.17	0.10	0.16	-0.15	-0.12	1