

3. Strengthening Growth through Financial Development¹

Countries in the MENA and CCA regions face the pressing yet challenging task of fostering private sector investment and diversification to strengthen and sustain growth. To this effect, diversifying economies and achieving economic transformation will require robust and dynamic financial sectors to ensure the availability of adequate funding for the private sector. However, financial development remains incomplete in many of these countries. Notably, in countries outside the Gulf Cooperation Council (GCC), financial markets are underdeveloped, and financial development has been hindered by a history of monetary instability and long-standing weaknesses in legal frameworks. Among GCC member economies, financial market efficiency has declined over the past decade. Across most countries in the MENA and CCA regions, the sizable role that governments play in the financial sector stands out as a key barrier to financial development, because of the prevalence of state-owned banks and the growing share of credit used to finance public sector debt. In this respect, reforms to facilitate competition in banking systems by reducing the role of the state, lowering barriers to entry, and relaxing capital account restrictions are estimated to raise real private sector credit by more than 5 percent and real GDP per capita by almost 2 percent after five years. In addition, reforms should seek to expand the role of financial markets by encouraging stronger participation of institutional investors, establishing robust government bond markets, and increasing financial integration by fostering nonresident participation. More broadly, strengthening macroeconomic and institutional frameworks is an essential precondition for advancing financial development and growth, and financial sector policies should aim to expand financing channels available to the private sector.

3.1 Financial Development Remains Incomplete

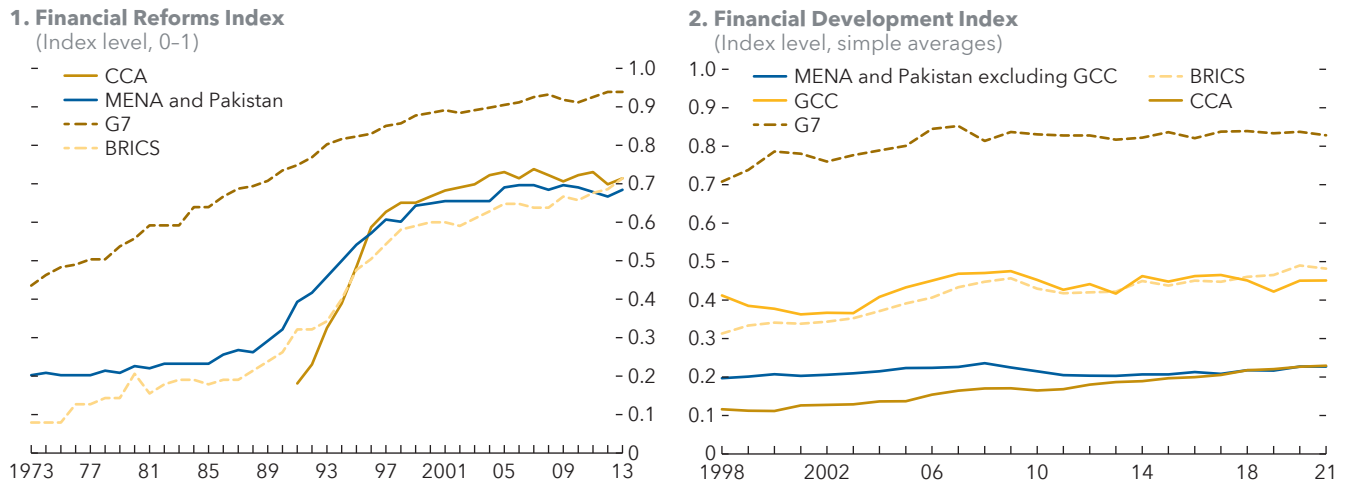
Over the past two decades, countries in the MENA and CCA regions have seen improvements in financial development.² These improvements have gone hand in hand with economic development and have played a crucial role in enhancing inclusive growth (Box 3.1). During the 1990s, there was a notable increase in the pace of financial reforms, broadly in line with progress seen in large emerging markets elsewhere (Figure 3.1, panel 1). However, progress on financial development has varied across regions, with the CCA seeing modest gains while MENA stagnated, particularly in the wake of the global financial crisis and Arab uprisings (Figure 3.1, panel 2).³ Moreover, the pace of reform has slowed, and there remains room for improvement, including in liberalizing interest rates (Egypt, Morocco, Oman, Pakistan), expanding private sector ownership in the banking sector (Algeria, Egypt, GCC countries, Morocco, Tunisia), and developing capital markets.⁴

¹ This chapter was prepared by Will Abel, Apostolos Apostolou, Vizhdan Boranova, Seyed Vahid Hassani, Troy Matheson (co-lead), Hela Mrabet, Salem Nechi, Thomas Piontek (co-lead), Bilal Tabti, and Subi Suvetha Velkumar.

² For presentational purposes, references to the Middle East and North Africa (MENA) in the main text also include Pakistan.

³ Details on the IMF's financial development indexes used in this chapter can be found at <https://data.imf.org/?sk=f8032e80-b36c-43b1-ac26-493c5b1cd33b>. Each country's overall financial development index comprises indexes relating to financial institutions and financial markets. Financial institutions include banks, insurance companies, pension funds, mutual funds, and other nonbank financial institutions. Financial markets include stock and bond markets. Each subcomponent is composed of three sub-indexes covering depth, access, and efficiency of institutions and markets.

⁴ Based on Omori (2022), the updated database covers seven dimensions of financial reforms: credit controls and reserve requirements, interest rate liberalization, banking sector entry, privatization of banks, financial account liberalization, security markets, and banking sector supervision.

Figure 3.1. MENA and CCA: Financial Reforms and Development

Note: For panel 1, only two GCC countries (Saudi Arabia, United Arab Emirates) are covered in the Financial Reforms Database and included in the MENA and Pakistan aggregate. BRICS = Brazil, Russia, India, China, South Africa; CCA = Caucasus and Central Asia; G7 = Group of Seven; GCC = Gulf Cooperation Council; MENA = Middle East and North Africa.

Looking across the MENA and CCA regions, key features that stand out are the strong presence of the state in banking systems and shallower capital markets compared to other parts of the world.⁵ The MENA region also exhibits a strong sovereign-bank and sovereign-capital markets nexus, where the public sector accounts for a relatively large share of banking sector credit, which may crowd out lending to the private sector. State-owned enterprises also account for a sizable share of market capitalization and trading in capital markets. These features partly explain the regions' relatively high scores in the efficiency of their financial institutions and low scores in capital markets (Figure 3.2, panel 4). Notably, while high levels of bank profitability contribute to the strong efficiency scores for financial institutions, this could be partly because of higher lending spreads reflecting low levels of competition across the MENA and CCA regions (Figure 3.2, panel 1). In addition, low liquidity in debt and equity markets is likely because of a lack of listing diversification and underdeveloped institutional investors. These factors have limited participation to a concentrated set of investors.⁶

Some aspects of financial development show more heterogeneity across regions:

- Financial development in GCC countries compares favorably to most other countries in the MENA and CCA regions. However, when compared to economies with similar GDP per capita levels elsewhere in the world, GCC countries often lag, especially in financial institution development (Figure 3.2, panels 2 and 3). Moreover, although GCC countries exhibit strong financial market depth and access on average, their market efficiency has declined over the past decade as lower stock market turnover and elevated bid-ask spreads have hampered secondary equity market trading in some countries (Figure 3.2, panel 4). This lower market

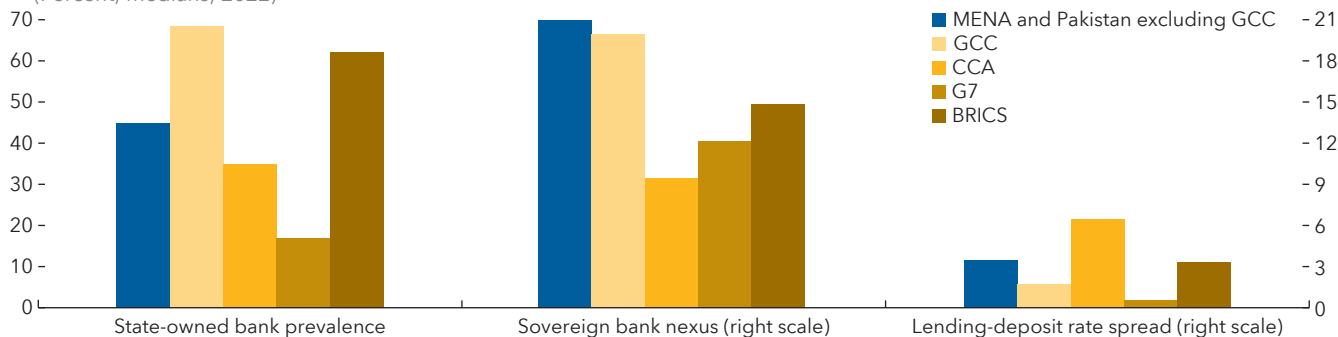
⁵ State-owned banks are particularly prevalent in MENA. State ownership is defined as a majority share (more than 50 percent) of assets held by shareholders classified as "government, including government agencies, municipalities, and Sovereign Wealth Funds" as documented by Fitch Ratings Pro dataset. Although banks owned by Sovereign Wealth Funds, particularly in the GCC, might operate with greater market-oriented principles and are subject to less political interference than those directly controlled by the central government, "the very nature of ownership structure differentiates these institutions from private companies, as they may not necessarily pursue the goal of profit maximization while the backing from government may give a unique position in the market" as noted in Box 3 of IMF (2024).

⁶ For *financial institutions*, the *depth* indicators include the size of private sector credit, pension, and mutual fund assets in relation to GDP and life and nonlife insurance premiums in relation to GDP; *access* includes bank branches and ATMs per 1,000 adults; and *efficiency* includes net interest margin, spread between lending and deposit rates, non-interest income in relation to total income, overhead costs to total assets, and measures of profitability (return on assets and return on equity). For *financial markets*, the *depth* indicators include the size of the stock market, the volume of stocks traded, the size of international debt securities of government, financial, and nonfinancial corporations relative to GDP, *access* includes percent of market capitalization outside of 10 largest companies, and total number of debt issuers; and *efficiency* includes stock market turnover (stocks traded to capitalization).

Figure 3.2. Banking Sector Structure and Financial Development

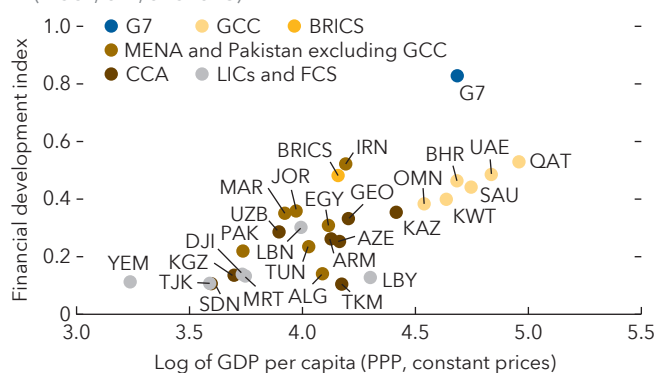
1. Banks' State Ownership Prevalence, Sovereign-Bank Nexus, and Profitability

(Percent; medians; 2022)



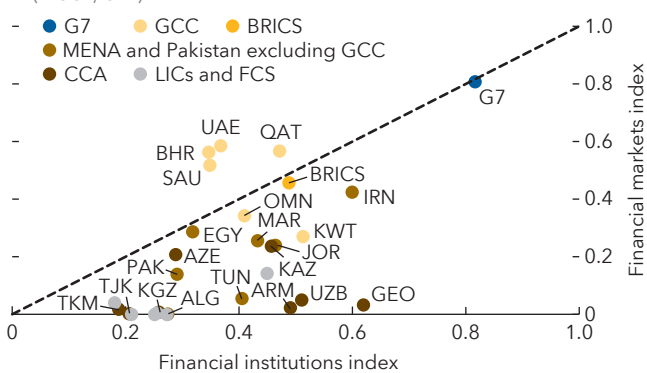
2. Financial Development and GDP per Capita, 2021

(Index, 0-1, and ratio)



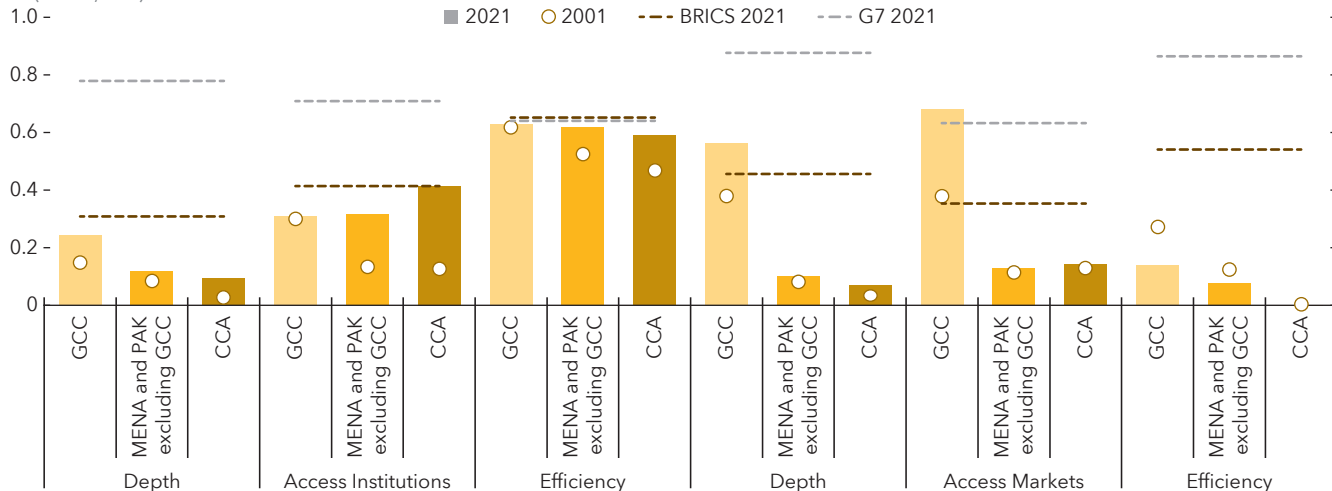
3. Financial Institutions and Markets Development, 2021

(Index, 0-1)



4. Financial Institutions and Markets Development by Region

(Index, 0-1)



Sources: Fitch Connect; IMF, Financial Development Index; IMF, World Economic Outlook database; World Bank, World Development Indicators; and IMF staff calculations.

Note: For panels 1 and 4, CCA and MENA (excluding GCC) include LICs and FCS. State-owned banks' prevalence is defined as assets held by state-owned banks as a share of total banking assets. Sovereign-bank nexus is defined as credit to the public sector (central and local governments as well as state-owned enterprises; claims on the central bank are excluded) as a share of total banking assets. The lending-deposit rate spread, used as a proxy for bank profitability, is defined as the five-year average spread between lending and deposit interest rates; for the G7, it is proxied as the spread between short-term interest rates and long-term bond yields. Data labels in the figure use International Organization for Standardization (ISO) country codes. BRICS = Brazil, Russia, India, China, South Africa; CCA = Caucasus and Central Asia; FCS = fragile and conflict-affected states; G7 = Group of Seven; GCC = Gulf Cooperation Council; LICs = low-income countries; MENA = Middle East and North Africa; PPP = purchasing power parity.

efficiency, coupled with slower progress on measures of financial institutions access, has driven a stagnation in financial development in GCC countries since the global financial crisis. Nevertheless, although not measured directly in the financial access indicators, technological advancements, including mobile payments, crowdfunding platforms, and fintech, have opened new avenues for lending and saving and boosted financial inclusion in GCC countries, particularly for women and youth.⁷

- In non-GCC MENA countries, financial systems remain heavily reliant on banks. Overall, the development of financial institutions in these countries is significantly ahead of market development, yet it remains below levels in large global emerging markets (Figure 3.2, panel 3). This aligns with the observation that relationship-based systems (that is, via financial intermediation through banks) tend to be more prevalent in the early stages of financial development.⁸ Furthermore, the depth of financial institutions in non-GCC MENA countries is relatively low, with nonbank financial institutions (pension funds, insurance companies, and mutual funds) playing a relatively small role in the region's financial systems (Figure 3.2, panel 4).
- Banking sectors in CCA countries generally exhibit a lower prevalence of state ownership, though the state's influence appears to extend beyond the direct ownership of banks.⁹ Moreover, bank profitability is generally higher (Figure 3.2, panel 1), and recently it has been supported by strong capital inflows from Russia.¹⁰ Overall, the levels of financial institution development are much higher than levels of financial market development across all CCA countries, consistent with their financial systems being largely dominated by banks (Figure 3.2, panel 3). Furthermore, over the past two decades there has been a modest yet steady improvement in financial institution development, marked by the improved availability of banking services (Figure 3.2, panel 4). Although not directly reflected by the indicators discussed here, it is important to note that the CCA region also has relatively high levels of dollarization, which is likely holding back financial development (Chakir and others 2022).

3.2 Key Structural Factors Weigh on Financial Development

A few key barriers help explain the gaps in financial development across countries in the MENA and CCA regions over the past two decades. Past research and empirical evidence suggest that although certain factors such as macroeconomic stability and effective governance can support financial development, others, including a relatively large state footprint in the financial sector and heavy reliance on commodities, can hinder progress.¹¹ To this effect, many countries in the MENA and CCA regions fall short along one or more dimensions that facilitate financial development (Table 3.1).

- Across non-GCC MENA and CCA countries, a history of monetary instability, a marked state involvement in banking sectors, and relatively weak legal systems have been key obstacles to financial development. Moreover, the lack of robust property and creditor rights limits competition, curbs investor interest, and increases financing costs (Teodoru and Akepanidaworn 2022; Gigineishvili and others 2023). At the same

⁷ The recent expansion of fintech and mobile banking operators is changing the landscape of financial development (Sahay and others 2020). However, these are relatively new developments, and the absence of sufficiently long data and cross-country availability prevents its inclusion in the financial development index (Sviridzenka 2016).

⁸ Bank-based systems can have a comparative advantage in reducing market friction associated with asymmetric information and immature legal systems (Rajan and Zingales 2001).

⁹ For example, political influence on the behavior of private financial institutions could serve as an impediment to financial development in the region. Poghosyan (2022) finds that reducing the role of the state in CCA financial systems could yield greater efficiency of financial intermediation, which in turn would enhance financial development. Another aspect of the state footprint on the sector is the prevalence of directed and subsidized lending, as noted in Box 1 of IMF (2023a).

¹⁰ See Chapter 3 of the October 2023 *Regional Economic Outlook: Middle East and Central Asia*.

¹¹ For MENA countries, Farazi, Feyen, and Rocha (2013) find that state-owned banks have lower profitability and larger nonperforming loans than private banks. Comparable results have been found for Pakistan (Bonaccorsi di Patti and Hardy 2005), Latin America (Micco, Panizza, and Yanez 2007), China (Berger, Hasan, and Zhou 2009) and South and South-East Asia (Williams and Nguyen 2005; Micco, Panizza, and Yanez 2007; Cornett and others 2010). See Online Annex 3 for a summary of the extensive literature related to financial development.

Table 3.1. Key Factors Underpinning Financial Development

(Colors represent a combination of the extent of deviation from the full sample medians [white] and the sign of the impact coefficient. Orange indicates a deviation from the sample median that is detrimental for financial development; teal shows the opposite.)

Groups	Monetary Stability	Rule of Law	Share of Credit to the Public Sector	Exposure of Economy to Natural Resources	Role of State-Owned Banking
CCA	Orange	Orange	Teal	Orange	Teal
GCC	Teal	Teal	Orange	Orange	Orange
MENA excluding GCC	Orange	Orange	Orange	White	Orange
Advanced economy	Teal	Teal	Teal	Teal	Teal
Emerging market	White	White	White	Teal	Teal
Direction of significant impact on financial development	+	+	-	-	-

Sources: Fraser Human Freedom Index; IMF, International Financial Statistics database; World Bank, Development Indicators; and IMF staff calculations.

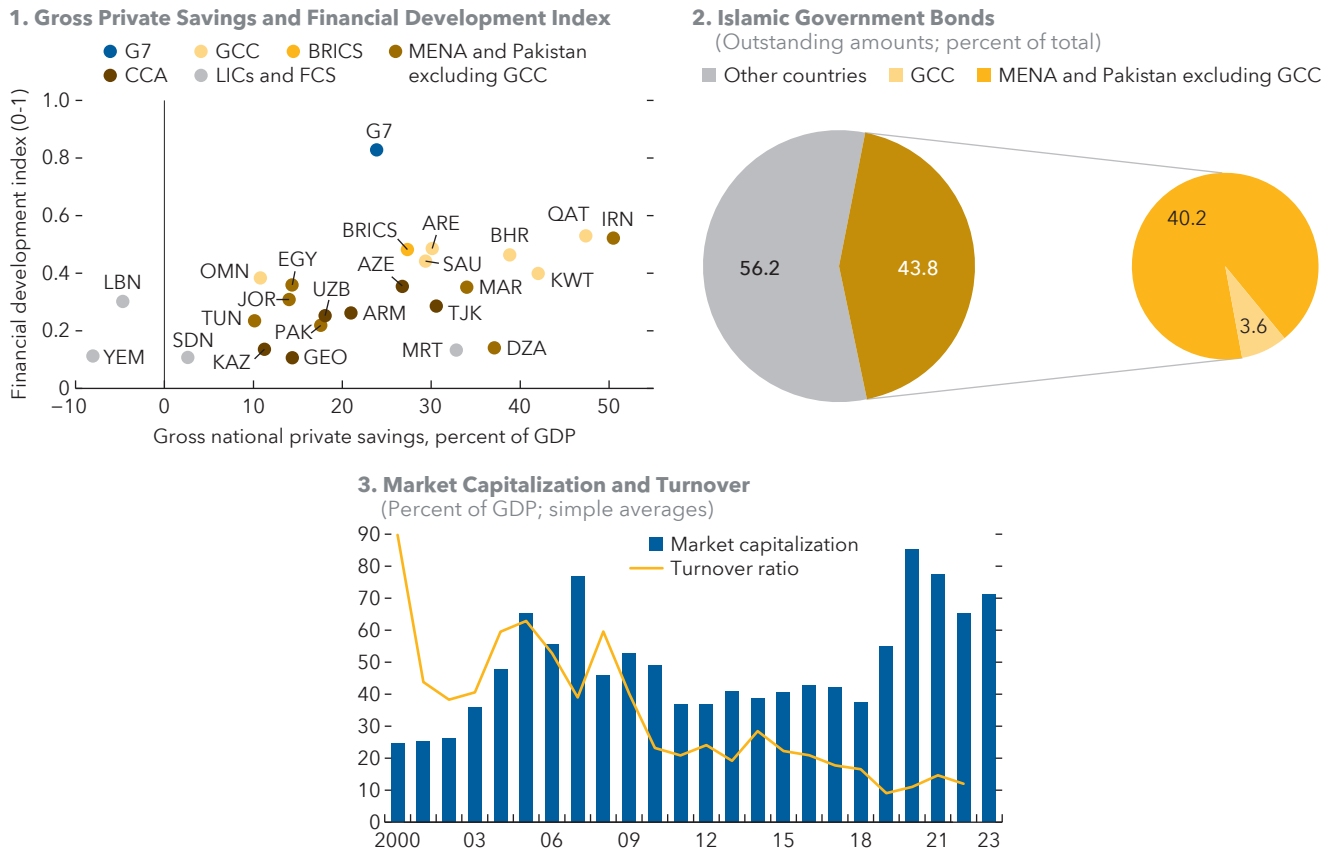
Note: The top five rows of the table show where regions stand along key factors affecting financial development. The bottom row shows the direction of impact, where significant, on financial development for each factor estimated using a panel regression with data covering 21 MENA and CCA countries and spanning 2004–21 (see Online Annex 3). CCA = Caucasus and Central Asia; GCC = Gulf Cooperation Council; MENA = Middle East and North Africa.

time, banking systems in many non-GCC MENA countries have relatively high levels of exposure to sovereign credit. This sovereign-bank nexus (where banks hold significant amounts of public sector debt) can crowd out credit to the private sector.

- In GCC countries, the public sector also strongly influences financial systems. A significant share of banking sector assets tends to be comprised of sovereign debt, although public sector debt remains relatively low in the region (except in Bahrain), and state-owned enterprises (including banks) generally have a significant presence in capital markets. In addition, a sizable share of GDP reliant on the oil sector could also undermine financial development in some countries, as profits are more likely to be invested abroad (Beck and Poelhekke 2023). Moreover, the heavy reliance on oil-related foreign exchange receipts could also increase liquidity volatility and raise risks in domestic banking sectors.

Mobilizing broader sources of savings can help unlock more financing options for private sector investment and further support financial development (Figure 3.3, panel 1). This requires emerging market economies tackling key impediments to capital market development to transition from bank-dominated financial systems toward more diversified financial systems. A critical step in this direction is establishing a local government bond market that provides a risk-free asset and a corresponding risk-free rate (Chami, Fullenkamp, and Sharma 2010). However, challenges such as irregular bond issuances, especially at longer maturities, the absence of secondary market trading, and impediments to nonresident participation have hampered the development of both local government and corporate bond markets in several MENA and CCA economies.¹² Although Islamic finance is a significant source of funding in some countries in the region, it is concentrated primarily in Islamic banking, with the issuance of sukuk (Islamic bonds) occurring sporadically (Figure 3.3, panel 2). On the positive side, equity financing has expanded over the past few years alongside growth in market capitalization and a pickup in initial

¹² In addition, institutional investors like insurance companies and pension funds can also play an important role in providing financial services for long-term savings and risk sharing and as steady investors in longer-term debt. Although assessing the involvement of these investors in the region is challenging because of limited data, there is likely significant scope for fostering and expanding these sectors (Poghosyan 2022).

Figure 3.3. MENA and CCA: Private Savings, Islamic Debt, and Equity Markets

Sources: Bloomberg Finance L.P.; IMF, Financial Development Index; IMF, World Economic Outlook database; World Bank, World Development Indicators; and IMF staff calculations.

Note: Panel 3 includes available data for MENA and CCA countries. BRICS = Brazil, Russia, India, China, South Africa; CCA = Caucasus and Central Asia; FCS = fragile and conflict-affected states; G7 = Group of Seven; GCC = Gulf Cooperation Council; LICs = low-income countries; MENA = Middle East and North Africa.

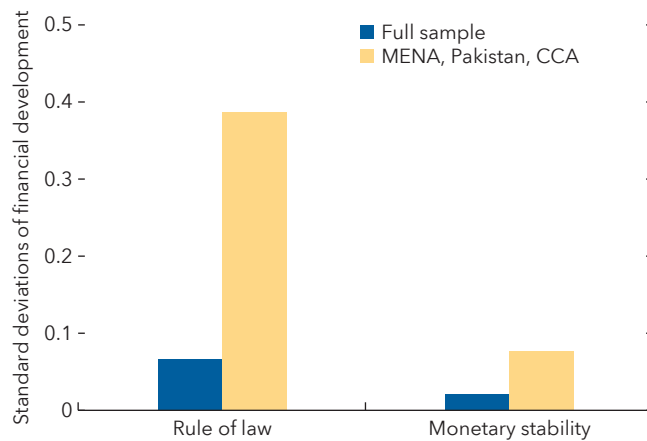
public offerings, primarily in GCC countries. That said, investor participation has been held back by persistently low liquidity and trading, which has been focused primarily on shares of financial companies and state-owned enterprises (Figure 3.3, panel 3).

3.3 Reforms Can Spur Financial Development and Growth

Financial development in most MENA and CCA countries has been limited by past monetary instability, long-standing weaknesses in legal frameworks, and a large state footprint in financial sectors. Improving macroeconomic stability and the rule of law are well established as key priorities to increase growth for MENA and CCA countries (see Chapter 2 and October 2023 *Regional Economic Outlook: Middle East and Central Asia*). Empirical estimates suggest that improving macroeconomic and legal frameworks are also critical preconditions for advancing financial development, with gains potentially more pronounced in MENA and CCA countries than elsewhere in the world (Figure 3.4). Moreover, such gains could be further amplified by the implementation of a package of financial sector reforms aimed at alleviating other key hurdles to financial development.

Figure 3.4. Impact of Rule of Law and Monetary Stability on Financial Development

(Panel coefficient estimates)



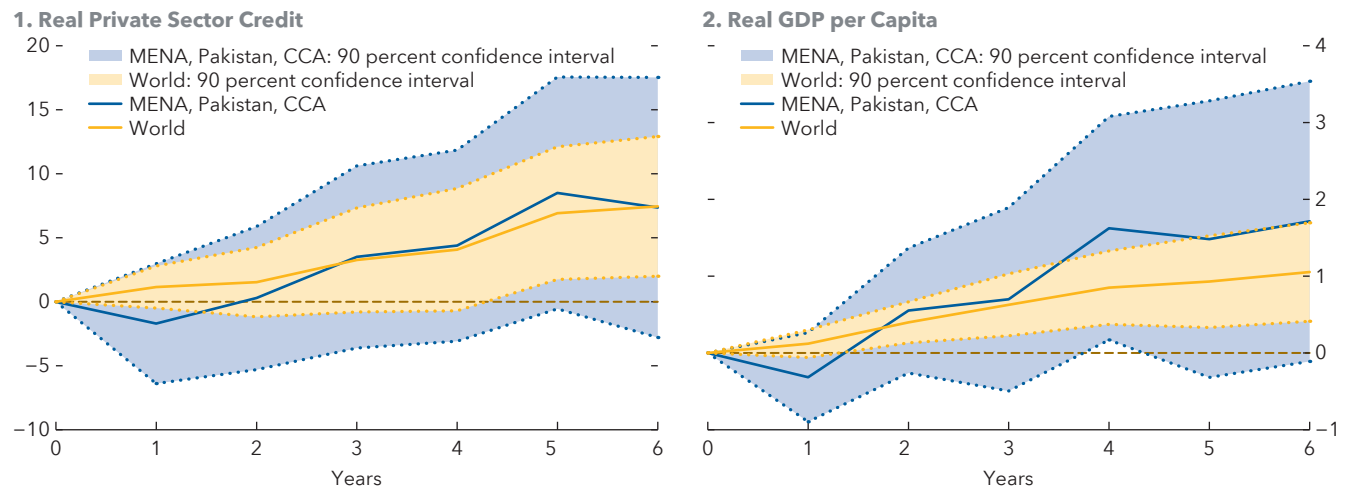
Sources: Economic Freedom Index; Fraser Institute; IMF, Financial Development Index; and World Bank, World Governance Indicators. Note: Variables are standardized prior to estimation. All coefficient estimates are statistically significant at the 1 percent level. Rule of law is from the World Bank's World Governance Indicators and measures perceptions of an agent's confidence in the rules of society. Monetary stability is a combination of the Fraser Economic Freedom Indices measuring the level and volatility of inflation. See more details in Online Annex 3. CCA = Caucasus and Central Asia; MENA = Middle East and North Africa.

The financial sector reforms examined in this chapter are designed to reduce the state's dominance in the banking sector and encourage new entrants to foster competition, alongside the removal of remaining capital account restrictions to broaden the investor base.¹³ The results show that these financial reforms are associated with a lasting impact on both private sector credit and output per capita in the MENA and CCA regions. Specifically, real private sector credit increases by more than 5 percent and GDP per capita increases by about 2 percent five years after reform implementation (Figure 3.5).

Examining individual reforms across the MENA and CCA regions, those aimed at reducing the state footprint and fostering competition are associated with the most significant positive impacts. Five years after implementation, these reforms boost real private sector credit by almost 10 percent and GDP per capita by close to 3 percent (Figure 3.6). Lifting capital account restrictions is also associated with notable

Figure 3.5. Impact of Financial Sector Reform Package

(Percent)



Sources: Banking Crisis database (Laeven and Valencia 2020); Brookings, External Wealth of Nations database (Lane and Milesi-Ferretti 2018); Financial Reforms Database (Omori 2022); IMF, International Financial Statistics database; IMF, World Economic Outlook database; and IMF staff calculations.

Note: A local projections approach is used to assess the impact of financial reforms. It is assumed that a financial reform package is introduced in year 1. This reform package is defined as the sum of financial sector policy changes between two years along the following dimensions:

(1) privatization of banks, (2) banking sector entry, and (3) financial account transactions, based on the Financial Reforms Database (see Online Annex 3). CCA = Caucasus and Central Asia; MENA = Middle East and North Africa.

¹³ The empirical estimates are based on the local projection method developed by Jordà (2005) and a financial reform database updated by Omori (2022). Capital account restrictions are prevalent in many countries in the MENA (outside the GCC) and CCA regions (see IMF 2023b). Removing capital account restrictions would support the efficient allocation of capital and foster the entry of new market players.

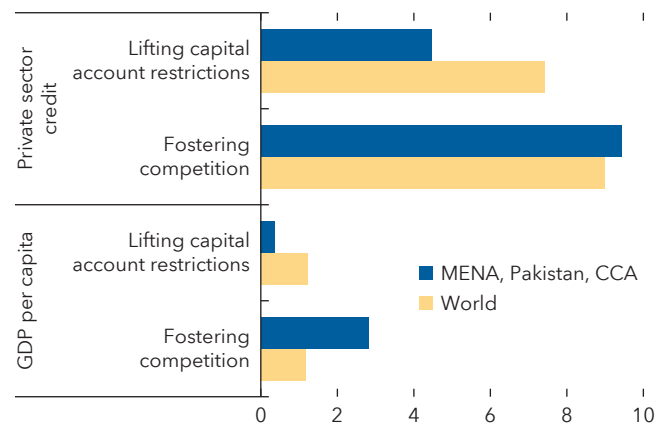
gains, with real private sector credit rising by almost 5 percent and GDP per capita by close to ½ percent.

3.4 Policies to Foster Sustainable Financial Development and Growth

Despite the expansion and diversification of financial systems in MENA and the CCA, there is still considerable scope for further improvement. A key policy objective should be to improve access to financing, particularly for underserved segments. Specific actions to enhance financial development include the following:

- Policymakers in the MENA and CCA regions are advised to address vulnerabilities associated with the sovereign-bank nexus while promoting higher private sector ownership in banking systems. Short-term measures could include (1) conducting bank stress tests to gauge nexus-related risks; (2) building buffers and providing clear and well-defined mandates to state-owned banks; and (3) tailoring supervisory tools such as stress tests to the specific risk profiles of banks to enhance resilience.¹⁴ Medium-term strategies should focus on banking sector reforms that reduce barriers to entry, strengthen prudential norms, and promote financial technology and digitalization solutions to enhance financial inclusion for firms outside the conventional banking system (Vera-Martin and others 2019).
- In GCC countries, financial sector policies should remain focused on mitigating macrofinancial risks, for example related to increased participation by nonbank financial institutions and digitalization. Actions should also aim to further develop financial markets, particularly to improve market efficiency. Notably, efficiency could be enhanced by encouraging stronger participation by institutional investors, such as pension funds and insurance companies, and increasing financial integration by attracting a broader investor base and fostering nonresident participation. Furthermore, achieving a wider mix of investors can be bolstered by strengthening corporate governance, reducing restrictions on foreign ownership in capital markets, and enhancing investor protections. In turn, these reforms would facilitate more varied sources of project financing for diversification needs (Catalan, Impavido, and Musalem 2000). However, authorities will need to weigh the trade-offs related to the participation of nonresident investors, as they could be more sensitive to global market conditions and amplify local market volatility. Financial technology (fintech), including crowdfunding, peer-to-peer business lending, and invoice lending can complement these efforts (Lukonga 2018). GCC countries have advanced on many digitalization and fintech initiatives, including establishing regulatory sandboxes, licensing digital banks (Saudi Arabia and the United Arab Emirates), and creating FinTech Hubs. GCC countries are also actively exploring central bank digital currencies. However, a cautious approach is warranted, including a careful

Figure 3.6. Five-Year Impact of Specific Financial Sector Reforms
(Percent)



Sources: Banking Crisis database (Laeven and Valencia 2020); Brookings, External Wealth of Nations database (Lane and Milesi-Ferretti 2018); Financial Reforms Database (Omori 2022); IMF, International Financial Statistics database; IMF, World Economic Outlook database; and IMF staff calculations.
Note: “Lifting capital account restrictions” is proxied by the annual change in the financial account transactions index, whereas “Fostering competition” is captured by the sum of changes between two years in the privatization and banking sector entry indices based on the Financial Reforms Database (see Online Annex 3). The five-year impact of financial sector reforms worldwide is statistically significant at the 10 percent level. For the MENA and CCA regions, the five-year impact of the reform package and competition reforms is significant at the 25 percent level. CCA = Caucasus and Central Asia; MENA = Middle East and North Africa.

¹⁴ See Adams and others (2022) for more details on policy proposals related to state-owned banks.

cost-benefit analysis and the exploration of risks related to financial stability. Finally, country authorities should continue to apply a mix of activity- and entity-based regulation proportionate to the size, complexity, and risk profile of fintech firms.

- Non-GCC MENA and CCA countries would benefit from market development to diversify their investor bases and balance their financial system. These economies largely rely on bank-centric financial systems. Hence, key strategies include developing government bond markets, aligning capital market regulations with international standards, and modernizing capital market infrastructure (October 2018 *Global Financial Stability Report*). Establishing robust government bond markets is crucial for setting a benchmark for private sector borrowing rates, facilitating effective monetary policy, and aiding in liquidity management (IMF-World Bank 2021). Aligning capital market regulations with international standards and modernizing capital market infrastructure are vital steps to attract foreign investment and facilitate efficient trading liquidity. In addition, fostering the growth of nonbank financial institutions through enhanced regulation and supervision and strengthening risk management by developing credit registries are crucial for ensuring financial sector stability (April 2023 *Global Financial Stability Report*).
- Effective management of emerging risks and challenges is crucial to ensure financial stability amid ongoing financial development. For example, to harness the benefits of growing cross-border flows while mitigating associated risks, an appropriate mix of macrofinancial policies is critical and may include foreign exchange intervention, macroprudential measures, and capital flow measures (Garcia Pascual, Singh, and Surti 2021). Regulatory and supervisory frameworks will also require updates to align with the financial development goals set by authorities (Sinha 2012; Zhu, Zhang, and Zhang 2023). In this context, several key guardrails are essential, including: (1) conducting appropriately resourced and intensive supervisory oversight; (2) incentivizing stronger risk management, especially as participation by nonbank financial institutions increase; (3) implementing adequate and comprehensive prudential regulations (such as capital and liquidity management tools); and (4) closing data gaps to facilitate appropriate and timely risk assessment by market participants and supervisory authorities. Moreover, the application of macroprudential policy tools must evolve in tandem with financial development to counter potential systemic risks.

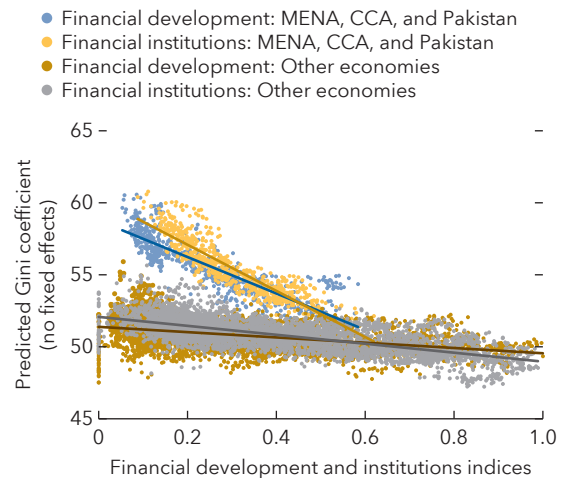
Box 3.1. Bridging the Gap: How Financial Development Mitigates Inequality¹

Financial development has the potential to address the pronounced income and wealth gaps observed across MENA and CCA countries (Blancher and others 2019). Financial development plays a crucial role in promoting growth by enhancing resource allocation, increasing investment, and fostering innovation (Sahay and others 2015). In addition, financial development influences inequality in numerous ways, mainly by improving access to finance for a broader segment of the population. For instance, microfinance institutions in Egypt, Kazakhstan, and Morocco have helped people in underserved communities start businesses, thereby reducing poverty and inequality. Digital financial services (including mobile banking) in Azerbaijan, Egypt, Georgia, and Jordan have expanded access to finance, especially in rural areas.

The impact of financial development on inequality can work in two directions. On the one hand, it can reduce inequality by providing less affluent citizens with better access to banking services, credit, and investment opportunities, enabling them to start businesses, invest in education, and improve their livelihoods, thereby narrowing the income gap (a decrease in the Gini coefficient). On the other hand, it could increase inequality if the wealthy, who often have better access to these financial services and investment opportunities, benefit more, thus widening the income gap (an increase in the Gini coefficient).

Empirical results suggest that enhancing financial development, particularly in financial institutions, reduces income inequality in MENA and CCA countries. In particular, these countries experience a more rapid decrease in inequality with advancements in financial development compared to the rest of the world (Box Figure 3.1.1), as a more developed financial sector enhances lending capacity, disproportionately boosting the income of poor households and more effectively reducing poverty and inequality, in line with existing literature that shows that countries with higher inequality benefit more from financial development (Beck, Demirguc-Kunt, and Levine 2004). These findings underscore the importance of enhancing financial development in the MENA and CCA regions.

Box Figure 3.1.1. Inequality and Financial Development



Sources: IMF, Financial Development Index; IMF, World Economic Outlook database; World Inequality database; and IMF staff calculations.

Notes: CCA = Caucasus and Central Asia; MENA = Middle East and North Africa.

The authors of this box are Apostolos Apostolou, Seyed Vahid Hassani, Salem Nechi, and Bilal Tabti.

References

- Adams, Mark, Hanife Yesim Aydin, Hee Kyong Chon, Anastasiia Morozova, and Ebru Sonbul Iskender. 2022. "Regulating, Supervising, and Handling Distress in Public Banks." IMF Departmental Paper 22/010, International Monetary Fund, Washington, DC.
- Beck, Thorsten, Asli Demirguc-Kunt, and Ross Levine. 2004. "Finance, Inequality, and Poverty: Cross-Country Evidence." Policy Research Working Paper 3338, World Bank, Washington, DC.
- Beck, Thorsten, and Steven Poelhekke. 2023. "Follow the Money: Does the Financial Sector Intermediate Natural Resource Windfalls?" *Journal of International Money and Finance* 130: 102769.
- Berger, Allen N., Iftekhar Hasan, and Mingming Zhou. 2009. "Bank Ownership and Efficiency in China: What Will Happen in the World's Largest Nation?" *Journal of Banking & Finance* 33 (1): 113–30.
- Blancher, Nicolas R., Maximiliano Appendino, Aidyn Bibolov, Armand Fouejieu, Jiawei Li, Anta Ndoye, Alexandra Panagiotakopoulou, Wei Shi, and Tetyana Sydorenko. 2019. "Financial Inclusion of Small and Medium-Sized Enterprises in the Middle East and Central Asia." IMF Departmental Paper 19/02, International Monetary Fund, Washington, DC.
- Bonaccorsi di Patti, Emilia, and Daniel C. Hardy. 2005. "Financial Sector Liberalization, Bank Privatization, and Efficiency: Evidence from Pakistan." *Journal of Banking and Finance* 29 (8-9): 2381–406.
- Catalan, Mario, Gregorio Impavido, and Alberto R. Musalem. 2000. "Contractual Savings or Stock Market Development: Which Leads?" *Journal of Contextual Economics-Schmollers Jahrbuch* 3: 445–87.
- Chakir, Selim, Maria Atamanchuk, Mazin Al Riyami, Nia Sharashidze, and Nathalie Reyes. 2022. "Reducing Dollarization in the Caucasus and Central Asia." IMF Working Paper 22/154, International Monetary Fund, Washington, DC.
- Chami, Ralph, Connel Fullenkamp, and Sunil Sharma. 2010. "A Framework for Financial Market Development." *Journal of Economic Policy Reform* 13 (2): 107–35.
- Cornett, Marcia Millon, Lin Guo, Shahriar Khaksari, and Hassan Tehranian. 2010. "The Impact of State Ownership on Performance Differences in Privately-owned versus State-owned Banks: An International Comparison." *Journal of Financial Intermediation* 19 (1): 74–94.
- Farazi, Subika, Erik Feyen, and Roberto Rocha. 2013. "Bank Ownership and Performance in the Middle East and North Africa Region." *Review of Middle East Economics and Finance* 9 (2): 159–96.
- Garcia Pascual, Antonio, Ranjit Singh, and Jay Surti. 2021. "Investment Funds and Financial Stability: Policy Considerations." IMF Departmental Paper 2021/018, International Monetary Fund, Washington, DC.
- Gigineishvili, Nikoloz, Iulia Ruxandra Teodoru, Narek Karapetyan, Yulia Ustyugova, Jean van Houtte, Jiri Jonas, Wei Shi, and others. 2023. "Paving the Way to More Resilient, Inclusive, and Greener Economies in the Caucasus and Central Asia." IMF Departmental Paper 2023/004, International Monetary Fund, Washington, DC.
- International Monetary Fund (IMF). 2023a. "Kazakhstan: 2023 Article IV Consultation—Press Release; and Staff Report." IMF Country Report 2024/046, International Monetary Fund, Washington, DC.
- International Monetary Fund (IMF). 2023b. "Annual Report on Exchange Arrangements and Exchange Restrictions 022." Monetary and Capital Markets Department, International Monetary Fund, Washington, DC.

- International Monetary Fund (IMF). 2024. "Saudi Arabia: 2024 Article IV Consultation—Press Release; and Staff Report." IMF Country Report 2024/280, International Monetary Fund, Washington, DC.
- International Monetary Fund (IMF) and World Bank. 2021. "Guidance Note for Developing Government Local Currency Bond Markets." Analytical Notes 2021/001, International Monetary Fund, Washington, DC.
- Jordà, Òscar. 2005. "Estimation and Inference of Impulse Responses by Local Projections." *American Economic Review* 95 (1): 161–82.
- Laeven, Luc, and Fabian Valencia. 2020. "Systemic Banking Crises Database II." *IMF Economic Review* 68: 307–61.
- Lane, Philip R., and Gian Maria Milesi-Ferretti. 2018. "The External Wealth of Nations Revisited: International Financial Integration in the Aftermath of the Global Financial Crisis." *IMF Economic Review* 66: 189–222.
- Lukonga, Inutu. 2018. "Fintech, Inclusive Growth and Cyber Risks: Focus on the MENAP and CCA Regions." IMF Working Paper 2018/201, International Monetary Fund, Washington, DC.
- Micco, Alejandro, Ugo Panizza, and Monica Yanez. 2007. "Bank Ownership and Performance. Does Politics Matter?" *Journal of Banking & Finance* 31 (1): 219–41.
- Omori, Sawa. 2022. "Introducing the Revised and Updated Financial Reform Database." *Journal of Financial Regulation* 8 (2): 230–40.
- Poghosyan, Tigran. 2022. "Financial Development and Growth in the Caucasus and Central Asia." IMF Working Paper 2022/134, International Monetary Fund, Washington, DC.
- Rajan, Raghuram G., and Luigi Zingales. 2001. "The Influence of the Financial Revolution on the Nature of Firms." *American Economic Review* 91 (2): 206–11.
- Sahay, Ratna, Martin Cihak, Papa N'Diaye, Adolfo Barajas, Diana Ayala Pena, Ran Bi, Yuan Gao, and others. 2015. "Rethinking Financial Deepening: Stability and Growth in Emerging Markets." IMF Staff Discussion Note 15/08, International Monetary Fund, Washington, DC.
- Sahay, Ratna, Ulric Eriksson von Allmen, Amina Lahreche, Purva Khera, Sumiko Ogawa, Majid Bazarbash, and Kimberly Beaton. 2020. "The Promise of Fintech: Financial Inclusion in the Post COVID-19 Era." IMF Departmental Paper 2020/009. International Monetary Fund, Washington, DC.
- Sinha, Anand. 2012. "Financial Sector Regulation and Implications for Growth." BIS Papers, No 62.
- Svirydzienka, Katsiaryna. 2016. "Introducing a New Broad-Based Index of Financial Development." IMF Working Paper No. 2016/005, International Monetary Fund, Washington, DC.
- Teodoru, Iulia Ruxandra, and Klakow Akepanidaworn. 2022. "Managing Financial Sector Risks from the COVID-19 Crisis in the Caucasus and Central Asia." IMF Departmental Paper 2022/005, International Monetary Fund, Washington, DC.
- Vera-Martin, Mercedes, Dominique Fayad, Rayah Al-Farah, Sergejs Saksonovs, Wei Shi, and Fang Yang. 2019. "Promoting Inclusive Growth in the Caucasus and Central Asia." IMF Departmental Paper 2019/008. International Monetary Fund, Washington, DC.
- Williams, Jonathan, and Nghia Nguyen. 2005. "Financial Liberalization, Crisis, and Restructuring: A Comparative Study of Bank Performance and Bank Governance in South East Asia." *Journal of Banking & Finance* 29 (8–9): 2119–54.
- Zhu, Chaowei, Fan Zhang, and Yuling Zhang. 2023. "Revisiting Financial Opening and Financial Development: A Regulation Heterogeneity Perspective." *Economic Analysis and Policy* 80: 181–97.