Chapter 1
The Evolving Financial Landscape in Emerging Markets and Developing Economies

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Abstract  Emerging Markets and Developing Economies (EMDEs) have been a significant driver of global growth in the twenty-first century. This paper analyses the changing contours of the financial sector and the challenges faced by EMDEs in recent years. In these countries, banks and domestic equity markets still continue to be vital as a source of financing for the corporate sector, bond markets. Amongst developing regions, South Asia had the largest equity market capitalization as a share of GDP in 2019, and the growth of corporate bond markets has been facilitated by improved macroeconomic stability, better regulation of bond markets, and protection of retail investors. Finally, the findings relating to financial inclusion (that includes digital and traditional) suggest further promoting access to and usage of formal financial services to maximize society’s overall welfare.

Keywords  Emerging markets and developing economies · Equity and bond market · Financial development · Financial inclusion

1.1 Introduction

The financial landscape of Emerging Markets and Developing Economies (EMDEs) has changed significantly since the early 2000s. This period has witnessed an increase in the depth, liquidity, and sophistication of financial markets in developing countries. While banks and domestic equity markets continue to remain important as a source of financing for the corporate sector, bond markets and foreign financing have become increasingly important. The increased integration of domestic and foreign
financial markets has benefits in the form of lower cost of financing and diversification of risk, but the increase in foreign financing (in particular, debt financing) has also brought about additional risks arising from sudden changes in foreign investors’ sentiments. In addition to improved financing for the private sector, financial inclusion has risen in the policy agenda, with ubiquitous access to mobile telephony and new financial technologies (Fintech) complementing each other in lowering the cost of transactions and increasing access to basic financial services to billions of underserved populations.

In this chapter, we document various facets of the changes in the financial sector in emerging markets and developing countries, the progress made so far, and the challenges that have arisen in recent years. The next section discusses financial development and bank lending in developing countries. This is followed by a discussion of equity and bond markets in developing countries and the benefits and risks of foreign financing. Section five analyses the changing contours of financial inclusion in emerging and lower middle-income countries and the last section concludes.

1.2 Financial Development and Bank Lending in Emerging Countries

The financial sector in developing countries has improved significantly in terms of depth, liquidity, and access. Banks in emerging market countries play an important role in intermediating credit to the private sector (Beim & Calomiris, 2001). Banks’ credit to the private sector as a share of GDP is a well-known measure of financial depth of a country (Čihák, Demirgüç-Kunt, Feyen, & Levine, 2013). The extent of legal creditor protection and information-sharing institutions (such as public and private credit registries) has been shown to be associated with higher private credit to gross domestic product (Djankov, McLiesh, & Shleifer, 2007). Protection of creditor rights is usually in the form of the ability to enforce repayment and seize collateral in the event of default.

Bank credit to the private sector in developing countries doubled from 51.2% of GDP in 2000 to 108.5% of GDP in 2019. However, there is substantial heterogeneity across the six developing regions (Fig. 1.1). For instance, the Latin America and the Caribbean started with private credit at 22% of GDP in 2000, which improved to 52% in 2019. South Asia’s share of private credit similarly improved from 27% of GDP in 2000 to 47% in 2019. Sub-Saharan Africa, however, experienced a decline in bank credit from 55 to 45% between 2000 and 2018. By contrast, developing countries in East Asia and the Pacific region had already high level of financial depth of more

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1 The variable is defined as domestic private credit to the real sector by deposit money banks as percentage of local currency GDP (Čihák et al., 2013).

2 Gopalakrishnan and Mohapatra (2020) argue that stronger insolvency frameworks that increase creditor rights are associated with improved credit discipline amongst firms. The authors find that the default risk of firms is lower in countries with stronger insolvency regimes.
Fig. 1.1 Domestic credit to private sector in developing countries. Source: World Bank. Notes: For Europe and Central Asia, the earliest available data for 2008 data has been used instead of that for 2005. For Middle East and North Africa and Sub-Saharan Africa, the latest available data for 2016 and 2018 have been used instead of that for 2019.

Domestic credit to private sector in developing countries. Source: World Bank. Notes: For Europe and Central Asia, the earliest available data for 2008 data has been used instead of that for 2005. For Middle East and North Africa and Sub-Saharan Africa, the latest available data for 2016 and 2018 have been used instead of that for 2019.

than 105% of GDP in 2000, which further increased to 153% in 2019. The relatively large weight of East Asia and the Pacific region, particularly China, in the developing countries aggregate explains the high share of credit to GDP of developing countries as a whole.

The availability of bank branches is the highest in the developing countries in Eastern Europe (24.2 per 100,000 adults in 2018), partly owing to an expansion of Western European banks to the neighbouring countries region. Sub-Saharan Africa has the lowest number of bank branches (5 per 100,000 adults in 2018), albeit an improvement from 1.5 in 2000.

Along with an increase in credit to the private sector, the reach of bank branches in developing countries has also improved (from about 5 per 100,000 adults in 2005 to about 9 in 2018), although with variation across the developing regions (Fig. 1.2).

The experience of the global financial crisis in 2008–2009 and the episodes of country-specific banking crises (Laeven & Valencia, 2018) have highlighted the need for better regulation of the banking sector. Most developing countries have adopted the Basel II regulations on bank capital adequacy, with about 40% adopting the enhanced Basel III regulations (World Bank, 2019). The higher levels of bank capital can enhance the stability of the financial system, protect depositors, and help the banking system to absorb shocks, such as that emanating from the Covid-19 pandemic, and prevent bank failures. Nevertheless, the high levels of non-performing assets (NPAs) of banks in some developing countries are a cause for concern. NPA ratios are particularly high in India (about 9% of gross advances), Russia (10.1%), Tajikistan (about 25%), Ukraine (48.4%), and several African countries (between 10 and 25% in Angola, Congo, Central African Republic, Ghana, Kenya, and Zambia).
Bank branches per 100,000 adults

Fig. 1.2 Bank branches per 100,000 adults in developing countries. Source World Bank

According to the World Bank and IMF data. High levels of banking sector NPAs impair the ability of the banks to extend credit to the corporate sector, which can translate into lower levels of investment and output.

1.3 Equity and Bond Markets in Developing Countries

Equity market financing is a traditional source of firm financing, usually through initial public offerings (IPOs). Modigliani and Perotti (2000) argue that the protection of minority shareholder rights is an important factor in equity capital raising by firms, and find some supportive evidence that in countries with weaker investor protection, equity markets tend to be smaller and the role of bank financing (relationship-based lending) is larger.

Overall market capitalization as a share of GDP of developing countries rose significantly from 40% in 2005 (prior to the global financial crisis) to 65% in 2010, but has declined in the subsequent years (Fig. 1.3). The large increase in equity market capitalization in the run-up to the global financial crisis can be attributed to high GDP growth rates in developing countries, buoyancy in international trade and capital flows, and expectations of continued earnings growth amongst emerging market firms. The subsequent decline is in line with a fall in the average GDP growth rates and a realignment of investors’ expectations. Amongst developing regions, South Asia had the largest equity market capitalization as a share of GDP in 2019, likely owing to favourable tax treatment of equities (compared to debt), growth of domestic investor base, and greater capital account openness for foreign equity investors.
Bond markets can provide longer term financing, such as for infrastructure development, in developing countries (Park, 2017). Burger, Warnock, and Warnock (2012) find that emerging market economies with higher macroeconomic stability (lower inflation volatility), and stronger creditor rights have more developed local bond markets. The authors argue that improvement in creditor (bondholders’) rights would support the further development of bond markets.

Government and corporate bond markets in developing countries have grown in recent decades, albeit from a relatively small base in many countries, particularly for corporate bond markets. For instance, the size of local currency bond markets in Asian economies has increased substantially in recent decades. Local currency bonds outstanding in China rose from 6% of GDP in 2005 to 62.9% in 2015, from 24.5 to 56.8% in India, and from 2.4 to 17.1% in Indonesia (Park, 2017; see Fig. 1.4). Governments have remained the largest issuers of local currency bonds in most Asian countries with the proceeds used to finance their fiscal expenditures. For instance, local currency government bonds accounted for 42.2% of GDP in India while corporate bonds accounted for only 14.6% in 2015. The growth of corporate bond markets has been facilitated by improved macroeconomic stability, better regulation of bond markets, and protection of retail investors. While Asia leads in terms of issuance of non-financial corporate bonds, there is wide variation in the countries in Latin America. Corporate bond issuance is high in some countries such as Bermuda (22%) and Jamaica (13%), but less than 1% in other countries such as Argentina, Dominican Republic, Guatemala, and Uruguay (Beck, 2016).

Park (2017) finds evidence that bond market development is related to macroeconomic performance and institutions, which can increase corporate debt issuance at longer maturities. Local currency bond markets can also help to stabilize economies.
During shocks, Park, Shin, and Tian (2019) find a negative association between the growth of local currency bond markets and the degree of currency depreciation in emerging economies during external shocks such as the global financial crisis and the taper tantrum in 2013.

1.4 Foreign Financing in Developing Countries: Recent Developments and Risks

In recent decades, firms in emerging market countries have relied increasingly on foreign financing in addition to domestic sources. Hale (2007) finds that domestic macroeconomic fundamentals in emerging market countries significantly affect firms’ choice of international debt instrument such as loans and bonds. Caballero, Fernández, and Park (2019) find that firms in emerging market countries experienced an increase in foreign financing since the early 2000s, with a larger role for bond issuances. According to the authors, the outstanding stock of private international debt grew from about 600 billion USD in the early 2000s to 2.4 trillion USD by 2014 in 18 smaller emerging market economies. Foreign currency syndicated loans have also played a role in financing corporations in emerging market economies. A study by Gong, Jiang, and Wu (2018) finds that loan spreads tend to be lower for syndicated loans denominated in a foreign currency compared to those in the local currency in many emerging economies, suggesting that international bank financing can reduce the cost of capital for emerging market firms.

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3 The 18 emerging economies in the study of Caballero et al. (2019) include Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Indonesia, Korea, Malaysia, Philippines, Thailand, Czech Republic, Hungary, Poland, Russia, and Turkey, South Africa, and Israel.
In the period following the global financial crisis in 2008, loose monetary policies and quantitative easing (QE) in advanced economies resulted in increased foreign financing for firms in emerging markets and developing countries. Such effects were more pronounced for portfolio debt and equity flows to emerging economies compared to foreign direct investment (Lim & Mohapatra, 2016). Fratzscher, Lo Duca, and Straub (2018) find that the second and third quantitative easing (QE2 and QE3) measures by the US Federal Reserve led to an acceleration in portfolio flows in emerging market economies. Turner (2014) documents how a low or negative term premium in the yield curve since 2010 owing to extraordinary monetary easing in advanced economies increased international investment in local bond markets in emerging economies. According to the author, the low interest rates also encouraged foreign currency borrowing through issuance of international bond market by emerging market firms, particularly through overseas affiliates.

Increased reliance on debt financing and higher leverage ratios also bring with them additional risks. Studies using firm-level data in both advanced and developing economies have examined the effects of such changes in debt financing on firm performance. For example, in a study on 11 advanced economies, Duval, Hong, and Timmer (2020) find that more leveraged firms (firms with higher debt-to-assets ratio) prior to the global financial crisis (GFC) experienced larger fall in total factor productivity (TFP). Similar effects of leverage are likely to hold during crisis events in developing countries. Reliance on international debt financing exposes emerging market firms to global volatility. For instance, the testimony of the US Federal Reserve Chairman Ben Bernanke in the US Congress on 22 May 2013 about a “tapering” of US quantitative easing resulted in a sudden increase in capital flows out of emerging market economies and large exchange rate depreciations (Eichengreen & Gupta, 2015). Such depreciations can increase balance sheet risks for firms in emerging market countries and raise the cost of foreign debt financing in local currency terms.

1.5 Financial Inclusion

Financial inclusion (FI), in the broadest terms, refers to access to financial services. It is seen as one of the foremost steps towards inclusive growth and development of a nation. As defined by the United Nations Capital Development Fund (UNCDF), financial inclusion refers to the access and use of a range of appropriate and responsibly provided financial services offered in a regulated environment to individuals and enterprises. According to the World Bank (2018), financial inclusion refers to “having access to affordable and useful financial products and services to meet the needs of transactions, payments, savings, credits, and insurance delivered in a sustainable and responsible manner”. Thus, the first step towards achieving total financial inclusion is to connect the adult population to the financial institutions through the bank account.

In recent years, a large strand of the literature has started exploring the subject area to attain higher financial inclusion citing the greater benefits achieved. These benefits,
as mentioned by different researchers in their study, vary from providing an economic rationale to providing political rationale behind framing policies targeting financial inclusion (Karlan & Morduch, 2010). Other researches show that formal account ownership impacts saving pattern (Aportela, 1999; Zins & Weill, 2016), investments, and consumption pattern (Dupas & Robinson, 2009) and helps in attaining financial stability (Han & Melecky, 2013). A very recent study by Omar and Inaba (2020) investigates the impact of financial inclusion on reducing poverty and income inequality, and the determinants and conditional effects thereof in 116 developing countries. Results show that per capita income, ratio of Internet users, age dependency ratio, inflation, and income inequality significantly influence the level of financial inclusion in developing countries. Furthermore, the results provide robust evidence that financial inclusion significantly reduces poverty rates and income inequality in developing countries. Needless to mention, most of the developing countries in the recent decades are witnessing a sharp rise in income or wealth inequality (Mishra & Parmar, 2017; Mishra, 2018; Mishra & Kumar, 2018; Mishra, Kumar, & Sinha, 2019; Mishra & Bhardwaj, 2020).

A recent World Bank report on financial inclusion (based on Global Findex data) states that despite the various efforts taken to reach out to a different section of the society around the world, there are approximately 2 billion people who are unbanked (Demirgüç-Kunt, Klapper, Singer, Ansar, & Hess, 2018). The report further states that around half of the population above 15 years of age lacks access or does not use formal financial services. Of these, the majority dwells under the poverty line in developing nations. According to the number of researches done in the field of financial inclusion, bringing this set of the population under the umbrella of formal financial services can help reduce the poverty level and increase living standards. The World Bank’s “The Little Data Book on Financial Inclusion” (2018) figures out that in the world around 68.5% of adults (age 15+) had an account in a financial institution while this number is only while for lower middle-income countries this number decreases drastically to 56.1%. This data reveals that lower middle-income countries are struggling even to make the basic infrastructure available to all of its adult population. Figure 1.5 gives us the percentage of adults (age 15+) who have an account in a financial institution in the considered lower middle-income emerging economies.

Figure 1.5 shows stark differences in the considered lower middle-income countries. On the one hand, we have countries like India and Sri Lanka, where based on the global Findex database, around 80t and 74% of the adult population, respectively, have an account at a financial institution. On the other hand, there are countries like Pakistan and Cambodia, where only 18% of the adult population have an account in a financial institution. This shows that amongst the emerging lower middle-income countries, there is a widespread disparity in terms of progress towards financial inclusion.

Having an account at a financial institution does not necessarily mean that an individual is financially included as the account itself does not ensure that the individual’s demands of transaction, savings, and credit are met through the financial institutions. While looking at the data of inactive accounts (no deposit or withdrawal done in the
past one year), we observe that at the global level, 20% of adults holding an account in the financial institution have made no deposit or withdrawal in the past one year whereas this figure is 39.2% for lower middle-income countries. Figure 1.6 gives details about the inactive accounts amongst account holders in financial institutions for the considered emerging lower middle-income countries.

We observe from Fig. 1.6 that India has the highest percentage (48%) of inactive accounts amongst the adult account holders in financial institutes, whereas Ukraine has the lowest percentage of inactive accounts. We saw from Fig. 1.6 that India also has the highest percentage of adult account holders in financial institutes, which shows that just by connecting adults to the financial infrastructure does not ensure that all the barriers in the way of accessing financial services have been removed. In the case of countries like Myanmar and the Republic of Congo, we observe (from Figs. 1.5 and 1.6) that a small proportion of the adult population has been connected to financial institutions, and amongst them, around 40% of them are inactive, which paint a much dire situation.

Similarly, while exploring the pattern of savings and credit borrowing to observe the accessibility of saving and credit products, the share of the adult population that saved or borrowed from financial institutions to the percentage of the adult population as indicators has been used. At the global level, we find that 56.25% of the adults saved in a financial institution. On the other hand, merely 23.4% of adults took credit from these institutions. For the lower middle-income countries, these figures are 32.3% and 50.9% respectively.

Figure 1.7 gives the savings pattern and we observe that there is a strong positive correlation between the share of adults saving using a financial institute to save and the share of adults having accounts in financial institutes.
Fig. 1.6 Per cent of adults (15+ age) with an account in a financial institution and those who made no deposit and withdrawal in the past one year. *Source* Global Findex database (2017)

Fig. 1.7 Savings pattern amongst the adults (15+ age) having an account at a formal institution. *Note* B* represents Bangladesh. *Source* Global Findex database (2017)
Figure 1.8 shows us the borrowing pattern in these select lower middle-income/emerging countries. We notice the correlation between the share of adults borrowing from financial institutions to the total borrowers and the share of adults having accounts in financial institutes is relatively low.

It is rather surprising as in the case of credit products, banks are very selective to ensure repayment, so borrowers are required to provide mortgages or security. The need for security acts as a barrier, especially for lower income classes. We can see that countries like Ukraine and India have connected a higher percentage of adults to financial institutions. However, the credit availability from financial institutes is still not accessible by its adult population. In contrast, Sri Lanka has done both simultaneously, has connected its adult population to the financial sector, and also made credit opportunities available to them. A very recent study by the IMF (2020) also reveals the case for digital financial inclusion which varies across countries and regions. The study combines a traditional (bank-based) and a digital financial inclusion component (such as ATM and bank branches, mobile and Internet access, account holding, and usage of financial institutions/mobile account for wage and utility payments) and covers 52 emerging market and developing economies (EMDEs) with the span period of 2014–2017 for digital financial inclusion and 2011–2017 for traditional financial inclusion.

Figure 1.9 indicates that comprehensive financial inclusion (that includes digital and traditional) increase in most countries between 2014 and 2017. Countries like Benin, Ghana, and Senegal saw greater progress in digital inclusion, while others like Mongolia, Namibia, and Peru in traditional inclusion. This implies there is an
enormous potential for progress towards digital financial inclusion for most of these EMDEs. And, Fintech service providers need to play a proactive role in this regard.

1.6 Conclusion

The changing financial landscape of emerging markets and developing economies in the context of new global scenario entails a persistent, stronger presence of governments and/or central banks in asset pricing. This paper analyses various facets of the changes in the financial sector in emerging markets and developing countries and the challenges that have arisen in recent years. In these countries, banks and domestic equity markets still continue to be vital as a source of financing for the corporate sector. Nevertheless, foreign financing has become increasingly important with the increased integration of domestic and foreign financial markets. Amongst developing regions, South Asia had the largest equity market capitalization as a share of GDP in 2019, likely owing to favourable tax treatment of equities (compared to debt), growth of domestic investor base, and greater capital account openness for foreign equity investors. Further, the growth of corporate bond markets has been facilitated by improved macroeconomic stability, better regulation of bond markets, and protection of retail investors. While Asia leads in terms of issuance of non-financial corporate bonds, there is wide variation in the countries in Latin America. The paper suggests that with prudent macroeconomic policies and additional development of analytical frameworks and policy prescriptions for financial market regulation, financial stability can be further achieved whilst balancing the goals of financial development and broader financial inclusion. The findings relating to financial inclusion (that includes digital and traditional) imply further promoting access to and usage of formal financial services in order to maximize society’s overall welfare.
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