Economics of The Fintech Industry in Small Open Transition Economies: A New Competitive Advantage?

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Abstract

There are three immediate constraints to the recent rise in financial technology (fintech) in the small open economies of Eastern Europe and former Soviet Union. First, much of the continued growth and local implementation of fintech-driven innovation is constrained by the structure and conduct of the domestic financial sectors. Second, central banks, currently enjoying broader macroeconomic policy mandates than peers elsewhere, may be caught off-guard balancing further financial deepening, as domestic financial credit swells, and sustaining challenges to foreign exchange markets balance. Finally, the third constraint to fintech's growth is technological, implied in the limited ability of the firms in the local high-tech sectors to source from domestic innovation and talent pool, further limiting sector's solidification domestically and minimizing sustained global presence. As such, despite recent attention from the global business community, the scalability of fintech's innovative potential for transition economies remains uncertain with lessons for smaller emerging markets prioritizing financial technology growth.

Introduction

Along with the recent pivot towards innovative economy, fintech – financial technology – has become a critical element in the financial markets development across the post-socialist economies of Central-Eastern Europe and former Soviet Union (CEE/FSU). Leveraging traditions of strong technical education and capable labor force, there is much potential in the fintech's contribution to the macroeconomy. Yet, while recent successes in the IT sector should be celebrated it is equally important to understand this progress within the context of "transition economy" to objectively chart possible future directions.

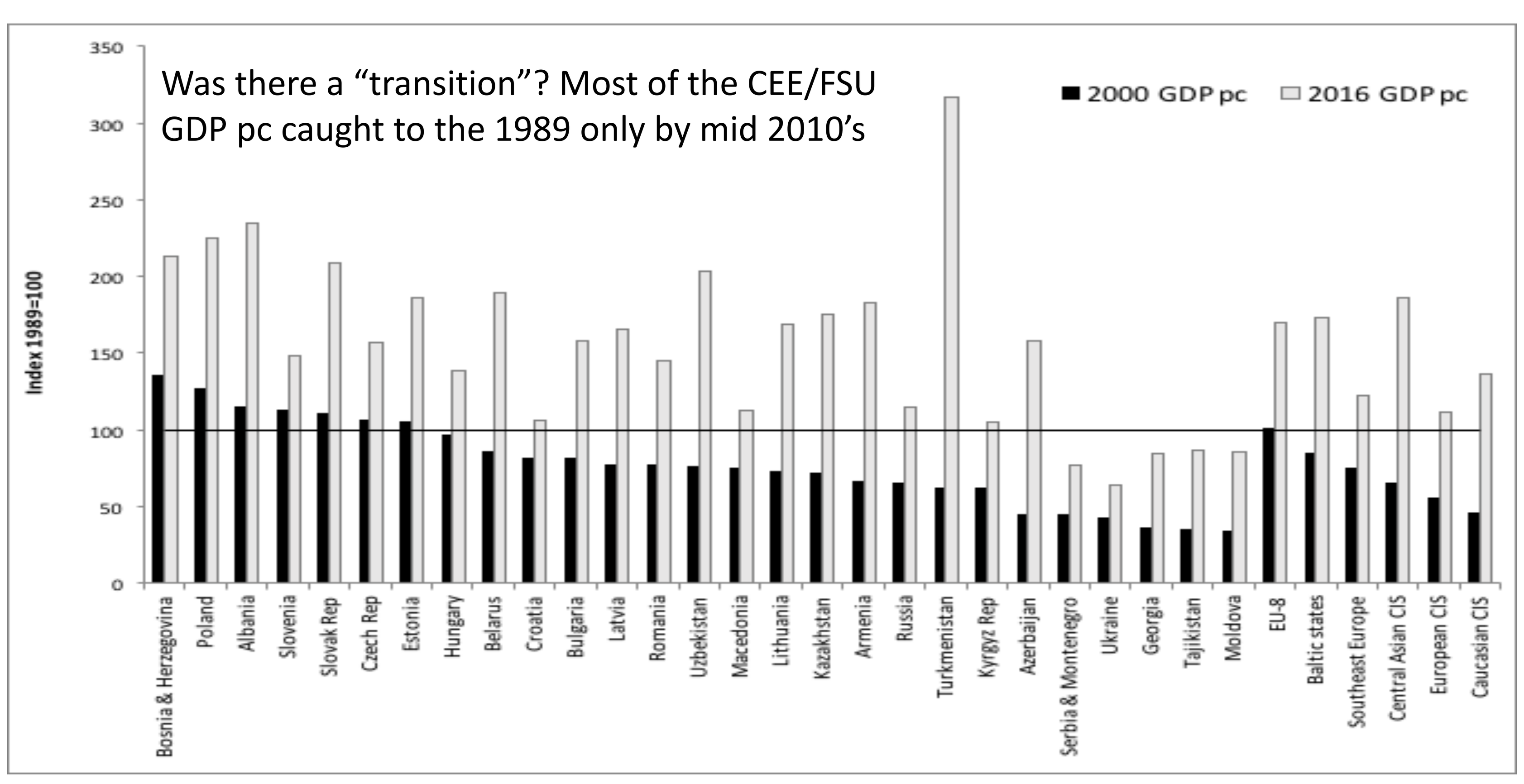

Chart 1. Real 2000 and 2016 GDP per capita by country (1989 = 100).
Source: Gevorkyan (2018)

Stylized facts of 'transition' in banking

- The banking system's evolution was drastic for the majority of countries (with couple exceptions in CEE) moving from a largely monobank (state-owned) to the two-tiered system with private banking emerging as the key driver in the 1990s privatization.
- Following rapid growth up until 2008, with significant foreign ownership across commercial banking (Fig. 1) there was a period of consolidation immediately after the Global Financial Crisis. Central banks emerged as the market makers with some decline in the foreign banks activity (e.g. Deuber, 2018).
- In the CEE/FSU the role of Vienna initiative 1 and 2 (Vienna Initiative, 2019) was important as crisis resolution mechanism and later a system of banking reforms ensuring cross-border stability. Much of this was driven by the EU manufacturing and trade interests in the CEE and drive towards regulatory consistency.
- Private domestic credit growth (households) has outpaced GDP pc growth (largely concentrated in the consumer credit and housing markets) and local currency debt across the financial and non-financial institutions has been on the rise.
- Technological advancements have been helping push greater financial access.
- Yet, access to credit and affordability remain challenging for the smaller innovative economies.

Fintech

It is often tempting to confuse fintech with growth in cryptocurrency related activities. On the latter, Republic of Georgia seems to be one of the leading smaller economies (with Russia being the largest) with up to five percent of households estimated to be engaged in the cryptomining activities (WB, 2018). At the same time, much of the fintech activity is supported by the overall growth in the information and communications technology sector (Gevorkyan and Sharpe, 2019), where small countries (e.g. Armenia) are leading in export-led ICT growth (Fig.2). Across the board the governments tend to be at the forefront in seeking ways to simplify routine payments (e.g. pensions) processes, hence encouraging growth in digital financial transactions (Chart 2). In the CEE, Poland is the leader with up to EUR1bln invested in the fintech related projects (Deloitte, 2019).
CEE and FSU are solid innovators with such offerings as Skype, Prezi, PicsArt and other innovations crossing between fintech and general use, leading governments to emphasize innovative economy (ICT) as a new national development strategy.

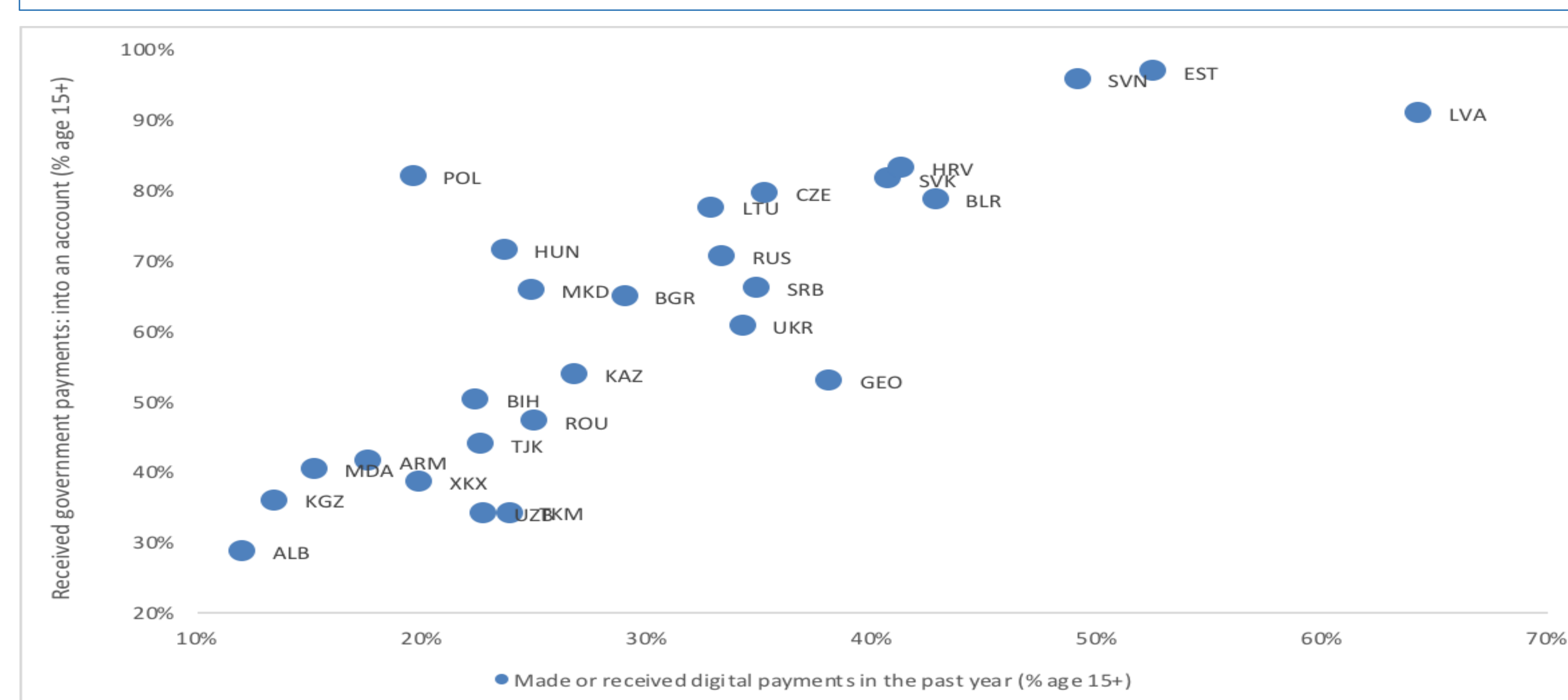

Chart 2. Proliferation of digital financial services is state-led (WB 2017, Global Findex Database).

Discussion

Despite its promise, fintech does not claim a significant share of the economy. Limiting are the problems of competitive scalability in financial services provisions. Domestic consumer markets are relatively small as access to new technology and needed infrastructure is limited. There is room for state-led uninterrupted R&D funding before high-tech inventions may be brought into the domestic market as opposed to the current model of the ICT sector's export driven growth. But any large-scale state support is limited by available funding and other public policy priorities and support to other significant employment sectors.

The regulatory constraint and any limitations on fintech activities imposed my monetary authority is a multilayered combination of tight, yet changing, regulations over digitizing financial services (including payment, credit and other uses of technology for financial needs), foreign exchange market, cross-border transactions and evolving systems of intellectual property and copyright protection.

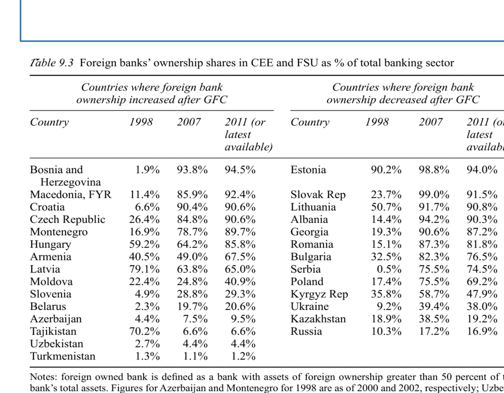

Figure 1. Foreign banks in CEE/FSU (Gevorkyan, 2018).

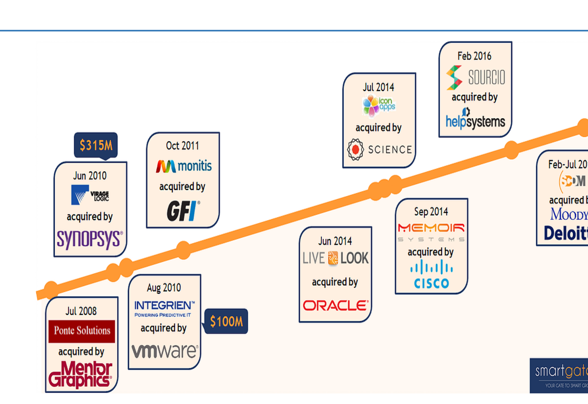

Figure 2. Global ICT in Armenia (Arzumanyan, 2019).

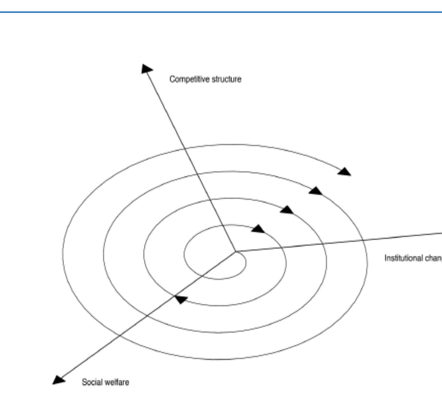

Figure 3. The transformation model in CEE/FSU (Gevorkyan, 2018).

Conclusions

The small open economy development rests on three pivots (Fig. 3). The freedoms offered by fintech will require a pronounced intervention by the central banks for macroeconomic stability. This could avoid concentration of gains solely in the banking sector. As financial sector pushes towards greater integration with the global economy, it is reasonable to suggest gradual improvements along the institutional and social welfare pivots, with advancements in the macroeconomic competitiveness as new financial credit is directed towards productive use, subject to the constraints above, before fintech can become a new competitive advantage.

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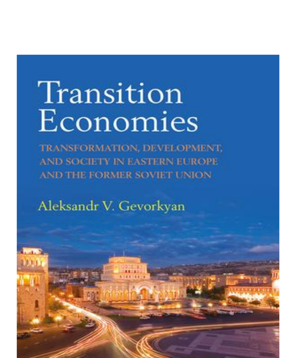

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