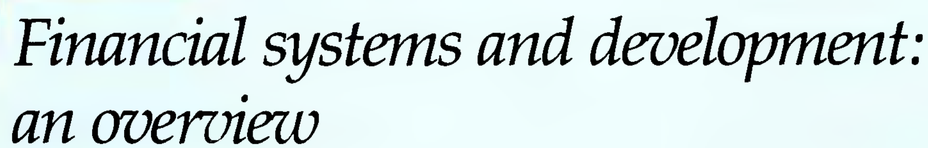

Financial systems and development: an overview

The experiences of the 1980s have led many developing countries to reconsider their approach to development. Although countries differ in the scale of government intervention and in the extent to which they have already stabilized and restructured their economies, most have decided to rely more upon the private sector and market signals to direct the allocation of resources. To obtain all the benefits of greater reliance on voluntary, market-based decisionmaking, they need efficient financial systems.

A financial system provides services that are essential in a modern economy. The use of a stable, widely accepted medium of exchange reduces the costs of transactions. It facilitates trade and, therefore, specialization in production. Financial assets with attractive yield, liquidity, and risk characteristics encourage saving in financial form. By evaluating alternative investments and monitoring the activities of borrowers, financial intermediaries increase the efficiency of resource use. Access to a variety of financial instruments enables economic agents to pool, price, and exchange risk. Trade, the efficient use of resources, saving, and risk taking are the cornerstones of a growing economy.

In the past, governments' efforts to promote economic development by controlling interest rates, directing credit to priority sectors, and securing inexpensive funding for their own activities have undermined financial development. In recent years financial systems came under further stress when, as a result of the economic shocks of the 1980s, many borrowers were unable to service their loans. In more than twenty-five developing countries, governments have been forced to assist troubled intermediaries. The restructuring of insolvent intermediaries provides governments with an opportunity to rethink and reshape their financial systems.

Conditions that support the development of a more robust and balanced financial structure will improve the ability of domestic financial systems to contribute to growth. By restoring macroeconomic stability, building better legal, accounting, and regulatory systems, specifying rules for fuller disclosure of information, and levying taxes that do not fall excessively on finance, governments can lay the foundations for smoothly functioning financial systems. This Report reviews the lessons of experience in both high-income and developing countries and tries to identify the measures that will enable domestic financial systems to provide the services needed in the 1990s.

The economic background

In 1988 conditions were generally favorable for economic growth in the developing countries. High-income countries enjoyed steady growth with low inflation for the sixth consecutive year

and grew even faster in 1988 than in 1987. Interest and exchange rates were less volatile than during earlier phases of the recovery from the worldwide recession of 1982, and prices of the principal commodities exported by developing countries rose by an average of 20 percent.

Some developing countries have taken advantage of the favorable world environment. Most countries in Asia did well; in several the gross national product (GNP) grew at an estimated annual rate of 10 percent. Some countries, however, continued to suffer from misdirected domestic policies, excessive indebtedness, and the economic shocks of the 1980s. The growth rates of many African nations remained near zero. The heavily indebted economies also continued to stagnate. The governments of creditor countries agreed at the Toronto summit to grant debt relief to the poorest and most heavily indebted countries, such as the countries of Sub-Saharan Africa, and early in 1989 took the first official steps to sanction debt relief for the middle-income countries. But despite a rise in the disbursement of funds to the highly indebted countries in 1988, net transfers to these countries continued to be negative.

Future growth in the developing countries will depend in part on the policies of high-income countries. By ensuring the success of the Uruguay Round of trade negotiations, the high-income countries can create a favorable environment for the exports of developing countries. Tighter fiscal but easier monetary policy in high-income countries would bring international interest rates down, which would ease the burden of debt. This would benefit developing and high-income countries alike. But far more important will be the policies pursued by the developing countries themselves. They can improve their growth prospects by continuing to seek fiscal balance and trade reforms. The decline in foreign capital flows has placed a premium on policies that encourage domestic saving and investment and direct the flow of resources to profitable activities—in other words, on policies that will improve the performance of domestic financial systems.

Origins of financial distress

When the developing countries set out to modernize their economies in the 1950s and 1960s, their financial systems comprised mainly foreign-owned commercial banks. These provided short-term commercial and trade credit. Governments decided to remodel their financial systems to ensure that resources were allocated in accordance with their development strategies. Toward this end, they created new financial institutions to provide funding at low interest rates to the sectors that were to be at the forefront of industrial development, or they directed existing institutions to do so. The governments themselves borrowed heavily, both from the domestic financial system and from abroad, to finance budget deficits and the needs of state-owned enterprises. In many countries banks were also directed to open rural branches in order to mobilize deposits and provide credit to widely dispersed smallholders.

During the 1960s this development strategy seemed to be working: many developing countries grew rapidly. But economic performance during the 1970s was more mixed. Despite favorable terms of trade and an ample supply of cheap foreign financing, growth in some countries began to slow. Except in Asia, only a few developing countries have grown rapidly in the 1980s.

The interventionist approach was much less successful in promoting financial development. Under government pressure, banks did lend to state enterprises and priority sectors at below-market interest rates, but spreads were often too small to cover the banks' costs. Many of the directed loans were not repaid. Interest rate controls discouraged savers from holding domestic financial assets and discouraged institutions from lending longer term or to riskier borrowers. In some countries, public borrowing from commercial banks displaced lending to the private sector; in others, public borrowing financed by money creation led to rapid inflation. Many countries developed a market for short-term debt, but only a few have more than a rudimentary system for long-term finance. In sum, the financial systems of all but a few developing countries remain small and undeveloped.

In recent years the inability or unwillingness of borrowers to repay their loans has become a serious problem. Its roots lie in the shocks of the early 1980s and in the industrial and financial policies pursued over the past thirty years. Many countries depended on commodity exports and foreign borrowing to pay for the imported inputs essential to their industrialization programs. For the highly indebted countries in particular, foreign borrowing became expensive as interest rates rose in the late 1970s; it became virtually impossible as foreign commercial banks ceased voluntary lending after 1982. Deteriorating terms of trade and international recession in the early 1980s further reduced countries' ability to pay for imports. Many countries were forced to reduce their trade deficits. To promote exports, they devalued their currencies

and lowered their tariffs and other trade barriers. Firms in developing countries therefore had to face abrupt changes in relative prices, often alongside recession at home. Many became unprofitable and thus were unable to service their loans.

Instead of foreclosing on bad debts, many bankers chose to accrue unpaid interest and roll over unpaid loans. In some cases this was because the borrowers were linked to the banks through ownership, in others because taking provisions for loan losses would have made the banks insolvent. Collateral was often inadequate, and foreclosure procedures were slow and biased in favor of debtors. So in many countries it was not thought feasible to start bankruptcy proceedings. The practice of rolling over unpaid loans and making new loans to cover unpaid interest has undermined the adjustment process: instead of financing new ventures made profitable by changed relative prices, much new lending has gone to prop up firms that are no longer viable.

Financial institutions in many developing countries have suffered large losses: many are insolvent, and some have actually failed. Bank insolvency is nothing new, but the scale of the problem—the number of insolvent institutions, the size of their losses, and the number of countries affected—is without precedent. Although more than twenty-five developing countries took action during the 1980s to restructure financial institutions, many of them dealt with only the largest or most seriously affected ones; others remain severely impaired. Restructuring banks is politically difficult, particularly when the banks are public or the principal defaulters are public enterprises, but experience shows that delay is costly and that losses mount with time.

Reform needs to go beyond recapitalizing insolvent banks. It must address the underlying causes of bank insolvency as well. Governments can strive to provide macroeconomic stability, which generally means reducing their spending. They can also undertake the structural adjustments that will lead to a more productive use of resources. Restructuring or closing insolvent firms must be part of this process; otherwise the recapitalized intermediaries that continue to lend to them will once again become insolvent.

Prerequisites for financial development

Countries with stable economies and fairly well-developed and competitive financial markets would benefit from giving market forces more influence over interest rates. Where these conditions are not satisfied, governments may choose to control interest rates, but unless that control is flexible enough to take account of inflation and market pressures, it will impede financial development. Proper alignment of interest rates is particularly important for economies that have open capital markets.

In the past, governments have allocated credit extensively. In a world of rapidly changing relative prices, complex economic structures, and increasingly sophisticated financial markets, the risk of mismanaging such controls has increased. Many countries could allocate resources better by reducing the number of directed credit programs, the proportion of total credit affected, and the degree of interest rate subsidization. Governments that continue to direct credit should specify priorities narrowly. An emphasis on credit availability is preferable to interest rate subsidies, which undermine the financial process.

Liberating financial institutions from interest rate or credit controls cannot, by itself, ensure that financial systems will develop as intended. The legal and accounting systems of most developing countries cannot adequately support modern financial processes. Legal systems are often outdated, and laws concerning collateral and foreclosure are poorly enforced. Because collecting debts can be difficult, and because borrowers are hard to monitor and control, lenders have been unwilling to enter into certain types of financial contract. If governments overcome such reluctance by directing banks to make loans that the banks consider too risky, losses can result. Governments can increase the supply of long-term loans and other types of financing by reducing the risks to lenders—for instance, by requiring fuller disclosure of financial information and defining and enforcing the lenders' rights. To ensure the stability of the financial system and discourage lenders from fraud, it is equally important for governments to supervise financial markets and institutions. In the past, supervisors have spent too much time checking banks' compliance with directives on credit allocation and too little time inspecting the quality of their loans and the adequacy of their capital.

Institutions and markets

Commercial banks are likely to remain the dominant institutions for some time. Banks can be made more efficient by improving their management systems and increasing the competition they face. Better management requires new lending policies,

better loan recovery procedures, more sophisticated information systems, and better-trained staff. The entry of new banks, domestic or foreign, can stimulate competition.

Countries also need to develop other financial institutions, whose services compete with and complement those of commercial banks. Nonbank financial intermediaries, such as development finance institutions, insurance companies, and pension funds, are potentially important sources of long-term finance. Most of the existing development banks are insolvent, however. Where they are to be restructured, rather than closed or merged with commercial banks, thought must be given to their future role and viability. Any diversification should build on the experience of their staffs and on their existing client relationships. As more of the population becomes able to and desires to make provision for retirement, contractual savings institutions will grow in size. Permitting pension funds and insurance companies to invest in financial instruments other than low-interest government bonds can greatly increase the supply of long-term finance to the private sector.

Many developing countries have benefited from the creation of money and capital markets. Money markets can provide competition for banks, a flexible means for managing liquidity, a benchmark for market-based interest rates, and an instrument of monetary policy. Capital markets can be a source of long-term finance—both debt and equity—and can help to foster sounder corporate capital structures.

Most developing countries have a long-established informal financial sector that provides services to the noncorporate sector—households, small farmers, and small businesses. Although family and friends are usually the most important source of credit, pawnbrokers provide a substantial amount of credit to those with marketable collateral, and moneylenders to those without. Merchants provide financing to their customers, and purchasing agents advance funds to their suppliers. Rotating savings and credit associations are ubiquitous in the developing world.

Financial institutions have often been weakened by being forced to channel credit to small-scale borrowers. Because such borrowers do not maintain financial accounts, formal lenders find it difficult to predict who is likely to repay. Moreover, if the borrower is in a group favored by government, formal intermediaries may find it difficult to collect. The informal sector, in contrast, has been able to serve such borrowers. Informal lending has severe drawbacks, however. The scale of lending is small, the range of services is limited, markets are fragmented, and interest rates are sometimes usurious. Nevertheless, these institutions help clients that formal institutions often find too costly or risky to serve. Some countries have recognized this and have established programs to link informal markets more closely with formal markets. The most successful formal programs for the noncorporate sector utilize rather than suppress indigenous systems, take deposits as well as lend, and levy charges that cover costs.

As the developing countries move toward more sophisticated financial systems, they can draw on the experience of the high-income countries in the design of instruments and institutions. Some of the lessons are cautionary. One lesson is that competitive financial markets, although efficient at mobilizing and allocating funds and managing risk, can still make mistakes—witness the excessive lending to developing countries that took place in the 1970s and the current savings and loan crisis in the United States. Another is that market-based financial systems can be unstable and susceptible to fraud. This underlines the importance of adequate regulation and supervision. Because finance evolves rapidly, regulators must continually strive for the right balance between stimulating competition and growth and limiting fraud and instability.

The path to reform

Many developing countries have taken steps toward financial liberalization during the past decade. In perhaps a dozen countries, interest rates have been fully liberalized; in many more, interest rates are managed more flexibly than before. Many countries have curtailed their directed credit programs, although few have eliminated them entirely. Competition among financial institutions has been promoted by opening the domestic market to foreign banks and by authorizing charters for new banks and nonbank financial intermediaries. Several centrally planned economies aim to stimulate competition by extensively restructuring their banking systems.

In a few countries financial liberalization has been quite comprehensive. Argentina, Chile, and Uruguay, for example, carried out extensive reforms in the mid-1970s, including the elimination of directed credit programs, interest rate controls, and exchange controls. Several Asian countries have also moved toward deregulation, but the reforms were introduced more gradually and were

less comprehensive. Financial liberalization has sometimes proved difficult. In the Southern Cone countries—Argentina, Chile, and Uruguay—liberalization ended in disarray: the government of Argentina had to reimpose controls, and all three governments had to deal with widespread bank failures. Turkey's government had to restore interest rate controls when real rates rose too high. But in Asia, where macroeconomic conditions were more stable and reforms were implemented more gradually, there has been no need to reintroduce controls.

Experience suggests that financial liberalization needs to be undertaken alongside macroeconomic reform. Countries that attempted financial liberalization before undertaking other reforms suffered destabilizing capital flows, high interest rates, and corporate distress. Although certain measures should be taken at an early stage, such as the alignment of interest rates with market forces, overall liberalization cannot succeed unless it is accompanied by the restructuring of insolvent banks and firms and by adequate regulation and supervision. Domestic financial markets need to be competitive to ensure that intermediaries are efficiently run. And to avoid the destabilizing capital flows that proved so difficult to manage in several countries attempting deregulation, care must be taken in opening the capital account.

The change in many countries' approach to development implies important changes in their financial sectors. Countries that wish to rely more upon private decisionmaking need financial systems that operate on a more consensual basis. For that, confidence is needed—confidence that the value of financial contracts will not be eroded by inflation and that contracts will be honored. Getting the prices—interest rates—right is important for financial development, but this must be complemented by other policies as well. Countries also need to create appropriate financial institutions, develop better systems of prudential regulation and supervision, improve the flow of financial information, develop human skills for managing complex financial operations, and promote good financial habits. None of these changes will be easily or quickly accomplished.

Outline of the Report

Chapter 1 describes the global macroeconomic environment that has confronted developing countries in recent years and discusses two scenarios for prospects to the end of the century. Even under the more optimistic of these, the developing countries face serious economic challenges.

Chapter 2 introduces the main body of the Report and examines the role of finance in development. It argues that finance matters in more ways than might be immediately apparent. Efficient financial systems help to allocate resources to their best uses and are indispensable in complex, modern economies. In many developing countries, as some of their governments have begun to realize, the financial sector is in urgent need of reform.

Reform will not be easy, but the difficulties faced by developing countries as they seek to improve their financial systems are not new. Chapter 3 charts the history of financial institutions in the industrial countries. It shows an often unsatisfactory mixture: innovation in response to the needs of growing economies, but many disruptive episodes of financial instability. Failures and fraud in their financial systems have led governments to intervene extensively.

Chapter 4 shows that for several decades after World War II, regulation of the financial systems in developing countries was designed to control the economy rather than foster the safety and soundness of banks. More than in the high-income countries, governments used the financial system to pursue their development objectives. This left their financial institutions weak, and as a result many were unable to withstand the worldwide economic shocks of the 1970s and early 1980s. Chapter 5 describes the difficulties of financial institutions in many countries and the steps taken by some governments to address the problems of their financial sectors.

This experience has led the developing countries to reassess their financial policies. A search is under way for policies that will strengthen the financial sector so that it can make its full contribution to the efficient use of resources, while keeping its tendency toward instability in check. Chapter 6 examines the legal and institutional changes that should be part of this reappraisal. Chapters 7 and 8 report in more detail on the current provision of financial services to the corporate and noncorporate sectors and explore ways in which these services might be improved. Chapter 9 discusses the lessons that can be learned from the developing countries that have already begun to liberalize their financial sectors.