Financial Systems and Development

More efficient financial systems are necessary for long-term development.

The experiences of the 1980s have led many developing countries to reconsider their approach to development. Though 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 trade risk. Trade, the efficient use of resources, saving, and risk-taking are the cornerstones of a growing economy.

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 have come under further stress when, as a result of the shocks of the 1980s, many borrowers were unable to service their loans. This has led many developing country governments to intervene to restructure insolvent financial intermediaries. Such restructuring provides governments with an opportunity to rethink and reshape their financial systems (see following article by Millard Long and Eirik Evenhouse).

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 information disclosure, and levying taxes that do not fall excessively on finance, governments can lay the foundations of well-functioning financial systems. The World Development Report 1989 reviews the lessons of past experience in both high-income and developing countries, and tries to identify the measures that will enable the developing countries' domestic financial systems to provide the services needed in the 1990s.

Future growth in the developing countries will depend in part on the policies of high-income countries and their impact on the global economy. But far more important will be the policies pursued by the developing countries themselves. They can improve their growth prospects by continuing to focus on fiscal balance and trade reform. The recent fall in foreign capital flows underlines the need for policies that encourage domestic saving and investment and that direct the flow of resources to profitable activities, in other words, for policies that will improve the performance of domestic financial systems.

Origins of financial distress

When developing countries set out to modernize their economies in the 1950s and 1960s, their financial systems comprised mainly foreign-owned commercial banks providing short-term commercial and trade credit. Governments decided to remodel financial systems to ensure that resources were allocated in accordance with their development strategies. Toward this end, they created new financial institutions, or directed existing ones to provide money at low interest rates to the sectors that were to be at the forefront of industrial development. 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 rural smallholders.

During the 1960s, many developing countries grew rapidly. But economic performance during the 1970s was more mixed. Despite favorable terms of trade in most countries and an ample supply of cheap foreign financing, growth in some countries began to slow. In the 1980s, except in Asia,
only a few developing countries grew rapidly.

The interventionist approach was less successful in promoting financial development. Under government pressure, banks did lend to state enterprises and priority sectors at below-market interest rates, but the spreads between their borrowings and loans were often too small to cover their costs. Many of these directed loans were not repaid. Interest rate controls discouraged savers from holding domestic financial assets and discouraged institutions from lending for the long term or to riskier borrowers. In some countries, public borrowing from commercial banks crowded out lending to the private sector; in others, public borrowing financed by printing money led to rapid inflation. Many countries developed a market for short-term debt, but today 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 have remained small and undeveloped.

In recent years, the inability or unwillingness of borrowers to repay their loans has created a serious problem for financial institutions. Its roots lie in the shocks of the early 1980s and in the industrial and financial policies pursued over the past 30 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 the ability of countries to pay for imports. Many were forced to reduce their trade deficits. To promote exports, they devalued their currencies and lowered tariffs and other trade barriers, exposing domestic firms to abrupt changes in relative prices. Recession at home, coupled with these external pressures, left many firms unprofitable and unable to service their loans, foreign or domestic. In many countries, mismanagement of this situation by governments and banks exacerbated the banks’ difficulties.

Financial institutions in many developing countries have suffered large losses, many are insolvent, and some have actually failed. The scale of the problem—the number of insolvent institutions, the size of their losses, and the number of countries affected—is without precedent. Many countries have attempted to deal only with the largest or most seriously affected institutions, leaving others severely impaired. Restructuring banks is politically difficult, particularly when the banks are public or the major defaulters public enterprises, but experience shows that delay is costly and that losses mount with time. Financial restructuring gives countries a chance to make their financial systems a spur to economic development, and in conjunction with structural reforms, it will lead to a more productive use of resources.

Financial development

The review of experience conducted by the World Bank staff team that produced the World Development Report 1989 shows that 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 are open to international capital movements.

The same applies to credit allocation. In the past, governments 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. Making credit available according to needs is better than subsidizing interest rates, which undermines 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 need to be updated to support modern financial processes. Laws concerning collateral and foreclosure are poorly enforced. Because collecting debts can be difficult, and because borrowers are hard to monitor and control, lenders are unwilling to enter into certain types of financial contracts. To increase the supply of long-term loans and other types of financing, governments need to reduce the risks to lenders—for instance, by requiring fuller disclosure of financial information, and by defining and enforcing the lenders’ rights. To ensure the stability of the financial system and to discourage lenders from fraud, it is equally important for governments to supervise financial markets and institutions. In the past, supervisors spent too much time ensuring that banks were obeying directives on credit allocation, and too little inspecting the quality of their loans and the adequacy of their capital.

Institutions and markets

The need to restructure insolvent institutions offers countries an opportunity to reshape their financial systems. Commercial banks are likely to remain the dominant institutions for some time, but they can be made more efficient by improving their management systems and by increasing the competition they face. Better management requires new lending policies, better loan recovery procedures, more sophisticated information systems, and improved staff training. 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 banks, 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 of the work of development banks should build on the experience of their staffs and on their existing client relationships. As more of the population seeks to provide for retirement, permitting pension funds and insurance companies to invest in other than low-interest government bonds could 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 a means for flexible liquidity management, competition for banks, 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, which caters to the household, agricultural, and small business sectors. Though family and friends are usually the most important source of credit, pawnbrokers provide a substantial amount of credit to those with marketable collateral, and money lenders 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.

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 lessons of successful programs are: take advantage of rather than suppress indigenous systems; encourage deposit mobilization as well as lending; gather the information that formal lenders need to assess small borrowers’ creditworthiness; 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, while efficient at mobilizing and allocating funds and managing risk, can make mistakes—witness the United States’ present savings-and-loan crisis, and the excessive lending to developing countries in the 1970s. 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 exercising control to limit fraud and instability.

The path to reform

Many developing countries have taken steps toward financial liberalization during the past decade. Interest rate control has become more flexible and directed credit programs have been curtailed. 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 through extensive restructuring of 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 interest rate controls, directed credit programs, and exchange controls. A number of Asian countries have also moved toward deregulation, but reforms were introduced more gradually and were less comprehensive. Financial liberalization has sometimes proved difficult. In the Southern Cone countries of Latin America, the end of the 1980s has brought major problems—such as the collapse of the Argentine banking system.

Experience suggests that financial liberalization needs to be undertaken alongside macroeconomic reform (see "Sequencing the Liberalization of Financial Markets" by Mario Blejer and Silvia Sagari, and "Issues in Financial Sector Reform" by Delano Villanueva, Finance & Development, March 1989). Countries that attempted financial liberalization before undertaking other reforms suffered destabilizing capital flows, high interest rates, and corporate distress. Financial liberalization cannot succeed unless it is accompanied by the restructuring of insolvent banks and firms, and by adequate regulation and supervision.

The change in many countries’ approach to development implies important changes in their financial sectors. Greater reliance upon voluntary decisionmaking requires measures to increase lenders’ confidence that the value of financial contracts will not be eroded by inflation and that contracts will be honored. Appropriate interest rates are important for financial development, but complementary policies are also needed. Countries need to create appropriate financial institutions, develop better systems of prudential regulation and supervision, improve the flow of financial information, develop people’s skills for managing complex financial operations, and promote good “financial habits.” None of these changes will be easy or quickly accomplished. Yet, all are needed to lay the foundation for financial systems that can contribute more to long-term development.