THE WORLD BANK

World Development Report 1989

An overview of
WORLD DEVELOPMENT REPORT 1989

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SUMMARY

A financial system provides services that are essential in a modern economy. Money constitutes a stable, widely accepted medium of exchange whose use reduces the costs of transactions and facilitates trade and thereby 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 efficient use of resources. 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.

Why finance is important

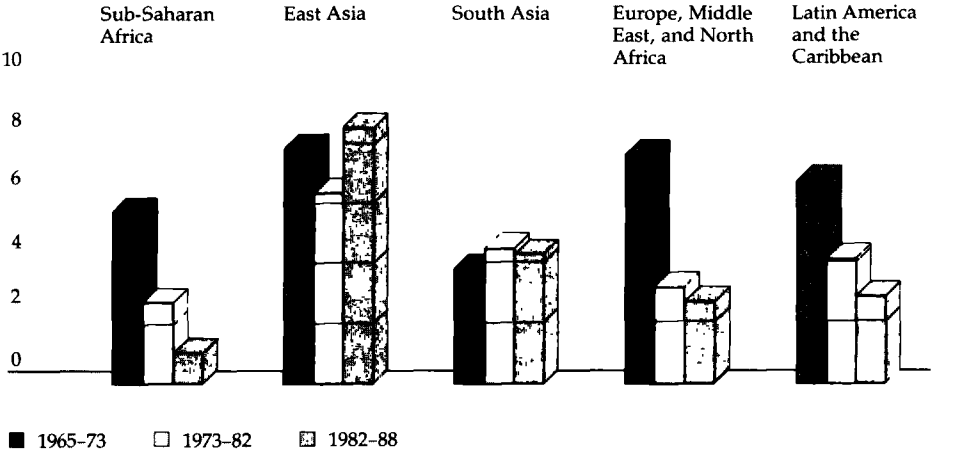
Today the financial systems of many developing countries are either inadequate or working less efficiently than they could. This has important implications for overall economic development. Two trends in particular make the reform of financial systems a priority in these countries. First, the decline in flows of foreign capital to, and economic stagnation in, many countries have placed a premium on policies that encourage domestic saving and investment and that direct the flow of resources to the most profitable activities—in other words, on policies that will improve the performance of domestic financial systems. Second, the experiences of the 1980s have led many countries to reconsider their strategies for 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, countries need efficient financial systems.

The economic environment

Financial and overall economic development are closely intertwined. In 1988 the international economic environment was favorable for growth in the developing countries. High-income countries enjoyed steady growth with low inflation for the sixth consecutive year and grew even faster 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 this favorable environment. Most countries in Asia did well; in several the gross national product grew at an estimated annual rate of 10 percent. Other 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 (Figure 1). The governments of creditor countries agreed at the Toronto summit to grant debt relief to the countries of Sub-Saharan Africa and early in 1989 took the first official steps to sanction debt relief for the middle-income countries. Despite a rise in the disbursement of funds to the highly indebted countries in 1988, however, net transfers to these countries continued to be negative.

Figure 1 Growth of real GNP in developing countries by region, 1965 to 1988
(average annual percentage change)



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 down international interest rates, a step that would ease the burden of debt and 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 own growth prospects by continuing to pursue fiscal balance and trade reform and to implement policies that will improve the performance of domestic financial systems.

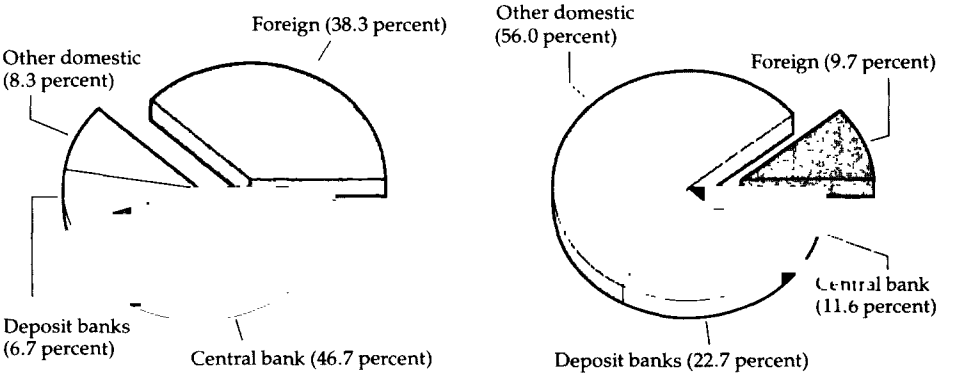
Origins of difficulties in the financial sector

The difficulties experienced today by financial systems in developing countries are in part a consequence of the economic shocks of the 1980s. But they stem also from the development strategies and financial policies of the past several decades. When the developing countries set out to modernize their economies in the 1950s and 1960s, their financial systems often 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, which emphasized rapid industrialization through protected import substitution as well as modernization of agriculture. Toward this end, they created new financial institutions or directed existing ones to provide

funding at preferential interest rates to the sectors that were to be at the forefront of development. Governments not only imposed interest rate controls on directed credit but also kept the general level of deposit and lending rates artificially low. The governments themselves borrowed heavily, both from the domestic financial system and from abroad, to finance expanding budget deficits and the needs of state-owned enterprises.

Interventionism appeared to be working in the 1960s and 1970s: in both decades developing countries grew rapidly, although in the 1970s the growth rate in some countries began to slow. But its costs became apparent in the 1980s when ample foreign funding and favorable terms of trade—which had masked domestic inadequacies in the 1970s—were no longer a reality. And whatever the effect on overall growth, the development strategy in many countries has had negative consequences for their financial sectors. Under government pressure, banks lent to state enterprises and for projects in priority sectors at below-market interest rates, but many of the directed loans were not repaid. Interest rate controls discouraged savers from holding domestic financial assets and discouraged institutions from lending for a 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 central bank credit—that is, by monetary creation—led to rapid inflation (Figure 2). As a consequence, many countries have devel-

Figure 2 Central government borrowing by source, 1975 to 1985



Note: Data are GDP-weighted averages. The developing country sample consists of Bolivia, Burkina Faso, Burma, Chile, Cyprus, Dominican Republic, Arab Republic of Egypt, Gabon, Indonesia, Republic of Korea, Liberia, Mexico, Morocco, Nepal, Nicaragua, Pakistan, Thailand, Togo, Tunisia, Uruguay, Venezuela, Yemen Arab Republic, Zaire, and Zimbabwe. The high-income sample consists of Australia, Austria, Canada, Finland, France, Federal Republic of Germany, Italy, Netherlands, Sweden, United Kingdom, and United States.

oped a market for short-term debt, but few have developed more than a rudimentary system for long-term finance, and the financial systems of all but a few developing countries remain small and undeveloped.

Distressed financial institutions

The inability or unwillingness of borrowers to repay their loans has become a serious problem in recent years. Many countries depended on commodity exports and foreign borrowing to pay for the imports 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 their ability to pay for imports. Many countries were forced to reduce their trade deficits. To promote exports, they devalued their currencies and lowered tariffs and other trade barriers. Firms in these countries therefore had to face abrupt changes in relative prices, often alongside recession at home. Many became unprofitable and were unable to service their loans.

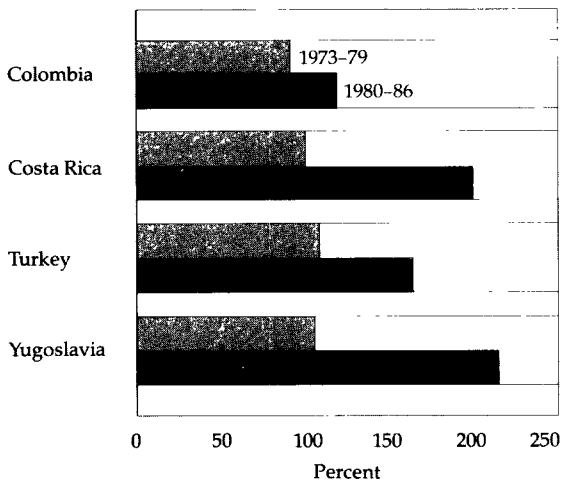
Instead of foreclosing on bad debts, many bankers chose to accrue unpaid interest and roll over unpaid loans. In some cases this occurred because the borrowers were linked to the banks through ownership; in others, because collateral was often inadequate, foreclosure procedures were slow and biased in favor of debtors, and to have recognized losses on these loans would have made the banks themselves insolvent. 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 (Figure 3).

Numerous financial institutions in 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 have taken action during the 1980s to restructure financial institutions, many of them have dealt with only the largest or most seriously affected institutions; other institutions remain severely impaired. Restructuring banks is politically difficult, particularly when the banks are public or the principal defaulters are public enterprises. Experience shows, however, that delay is costly and that losses mount with time.

Prerequisites for [illegible] financial systems

Financial restructuring can also be seen as an opportunity: it gives countries a chance to make their financial systems a spur to economic development. But reform needs to go beyond recapitalizing insolvent banks. It must also address the underlying causes of bank insolvency and shallow and uncompetitive financial systems. Governments can strive for macroeconomic stability, which generally necessitates reducing their spending. They can also undertake the adjustments that will

Figure 3 Ratio of new credit to investment in selected developing countries, 1973 to 1979 and 1980 to 1986



Note: New credit is the change in the stock of outstanding credit to the nonfinancial sector. Investment is gross fixed capital formation.
Source: IMF, *International Financial Statistics,* and World Bank data.

lead to a more productive use of resources. Restructuring or closing insolvent firms must be part of this; otherwise, the recapitalized intermediaries that continue to lend to them will once again become insolvent.

Countries with stable economies and fairly well-developed and competitive financial markets would benefit from giving market forces more influence over interest rates. In other countries, until these conditions are met, 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; otherwise, the outcome is likely to be substantial capital flight.

The allocation of credit could also benefit by being more responsive to market pressures. In the past, governments have intervened extensively to direct credit. 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 controls on interest rates or credit 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 specified. 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 contracts. 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 on the part of the borrower and defining and enforcing the rights of lenders. 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 making sure that banks are obeying government directives on credit allocation and too little time inspecting the quality of their loans and the adequacy of their capital.

Developing institutions and markets

Commercial banks are likely to remain for some time the dominant institutions in the financial systems of most developing countries. Banks can be made more efficient by improving their management systems and increasing the competition they face. Better management requires new lending policies, better procedures for loan recovery, more sophisticated information systems, revised organizational structures, and better-trained and motivated 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 finance institutions 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 a larger proportion of a country's population become able to make provisions for retirement and wish to do so, contractual savings institutions will grow in importance. 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, although the latter often remain small. Money markets can provide a flexible means for managing liquidity, 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 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 government requirements to lend to small borrowers. Because such borrowers do not maintain standardized 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, though informal lending has severe drawbacks. The scale of lending is small, the range of services is limited, markets are fragmented, and interest rates are sometimes usurious. Nevertheless, these lenders 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 ones. 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 developing countries move toward more sophisticated financial systems, they can draw on the experience of 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 still make mistakes—witness the excessive lending by commercial banks 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 seek the right balance between stimulating competition and growth and exercising control to limit fraud and instability.

Many developing countries have taken steps toward financial liberalization during the past decade. Interest rates have been fully liberalized in perhaps a dozen countries; interest rates in many more are managed more flexibly than before. Many countries have curtailed their directed credit programs, although few have eliminated them entirely. Competi-

tion 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 intend 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 interest rate controls, directed credit programs, 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 reintroduce controls, and all three governments had to deal with widespread bank failures. Turkey's government had to reintroduce controls on interest rates 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 a careful sequencing of measures directed toward financial liberalization is important to avoid destabilizing capital flows, high interest rates, and distress among firms and financial institutions. Though generalizations are hazardous, reducing fiscal deficits and establishing macroeconomic stability seems a first priority. Government should then scale down its directed credit programs and adjust the level and pattern of interest rates, bringing them in line with internal and external market forces. Financial liberalization cannot succeed unless it is accompanied by the restructuring of insolvent banks and firms. In the initial stage of reform, the government should aim also to improve the foundations of finance: accounting and legal systems, procedures for the enforcement of contracts, disclosure requirements, and prudential regulation and supervision. Measures to improve efficiency in the real goods sector—that is, more liberal policies toward trade and industry—ought also to be undertaken at an early stage.

The next stage of financial reform should include the development of a greater variety of markets and institutions and fostering of competition. Broader ranges for deposit and lending rates should be introduced. On the external side, foreign entry into domestic financial markets should be encouraged to increase competition and efficiency—with restrictions, perhaps, until domestic institutions are able to compete fully. Until such reforms are well under way, it will probably be necessary to maintain controls on capital movement. After substantial progress has been made toward reform, the government can move to the final stage: full liberalization of interest rates, the elimination of its remaining directed credit programs, the relaxation of capital controls, and the removal of restrictions on foreign institutions.

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