**Development Research Group**

**Knowledge in Development Note 3**

# Finance and Development

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At every turn, the role of finance in development has been mired in controversy: Can financial sector development be left to benign neglect, or is it a key driver of economic growth? Does deposit insurance encourage smooth market development, or does it encourage irresponsibility and banking failures? Should credit for the poor be subsidized? Development policy needs answers to such questions based on sound empirical research.

An efficient financial system is one of the foundations for building sustained economic growth and an open, contestable economic system. At its best, finance works quietly in the background, but when things go wrong, financial failures are painfully visible. Both success and failure have their origins largely in the policy environment. So while the widespread failures of 1997–98 have receded in memory, it is important not to relax policy vigilance.

Financial sector research at the Bank is focused on two main areas. First is understanding just how an effective financial system contributes to economic development and poverty reduction. Second is identifying which policies work best to improve the effectiveness, stability, and reach of the financial system in developing countries. Both are important to achieving the Millennium Development Goals, and the Bank's research group has taken the lead in answering them through a systematic research program.

## How financial sector research has helped improve policy recommendations[1]

### *Neglecting financial development damages growth and poverty reduction*

The Bank's research has reinforced the empirical evidence pointing to a strong and independent causal role of the sector in promoting growth.[2] More recently, we have shown that well developed financial systems are associated with faster growth in the incomes of the poor. Thus, finance helps the poor catch up with the rest of the economy as it grows. Even at the same average income, economies with deeper financial systems have fewer poor people.[3] These research findings have persuaded numerous countries to sharpen their policy focus on the sector. They have also influenced the design of the Bank and IMF's joint Financial Sector Assessment Program which increasingly—and often at the explicit request of member countries—incorporates development issues along with prudential and risk-reduction issues.

### *Avoiding financial crises: Transplanting First World practice does not work*

Research on the determinants of financial crises both before and since the 1997–98 East Asia events has highlighted the limitations of existing early warning and risk-reduction policies. Our research has not only thrown light on which institutional aspects

need strengthening to support financial development. It has also revealed evidence of several types of financial sector policy which, even though considered appropriate in advanced economies, prove ineffective or even counterproductive in weak institutional environments.

One important example relates to the design of *prudential regulation*. Our analysis of regulatory design has shown the importance of preserving and providing incentives to harness market forces to complement the inevitably limited capacity of official supervision. Having the right incentives requires ensuring the availability of accurate and timely information, making sure that large market participants have significant loss exposure, and limiting the expectation that they will be compensated for their losses.[4] These findings have influenced the Bank's policy advice to countries considering which aspects of the Basel II capital accord (designed for and by regulators in advanced economies) to adopt and over what time period.

Our research has also questioned the adoption of *deposit insurance* in developing countries by highlighting the potential costs of explicit schemes—lower market discipline, higher financial fragility, and lower financial development—in countries where complementary institutions are not strong enough to keep these costs under control.[5] Guided by this research, the Bank recommended against an early adoption of deposit insurance in Russia and China among many others and encouraged policymakers to focus on more pressing financial sector reforms instead.

***Government banks bad—foreign banks good?***

Policymakers in many countries have felt the need to retain public ownership of banks, and have often been reluctant to allow foreign ownership of any sizable fraction of the banking system. But Bank and others' research have shown that the inefficient allocation of credit by state-owned banks frequently necessitates costly recapitalizations.[6] And systems in which foreign banks are active seem to perform better.

The empirical evidence shows that the ownership of financial firms is an area where the public sector tends not to have a comparative advantage: such ownership weakens the financial system and the economy. But privatization also entails risks and needs careful design. Our work, based on detailed and quantified examination of case studies, suggests that the preferred strategy is moving slowly but deliberately with bank privatization, while preparing state banks for sale and addressing weaknesses in the overall incentive environment.

On average, bank privatization tends to improve performance over continued state ownership, and in weak institutional settings selling to a strategic investor and inviting foreign interests to participate in the process increase the benefits.[7] These findings are helping World Bank staff persuade the many governments that have been slow to divest—with Egypt, Turkey, and Tanzania among the larger recent examples.

These and other countries worry about whether allowing foreign banks to take a large ownership share in the banking system could damage financial and economic performance. Our research, drawing especially on experience in LAC and ECA, has allowed the Bank to make a clear recommendation: facilitating the entry of reputable

foreign financial firms to the local market should be welcomed, for they bring competition, improve efficiency, lift the quality of the financial infrastructure, and expand access. Although there are risks to be managed, and although local financial firms may lose business, these considerations are outweighed by the broader benefits to financial development and economywide growth.[8]

### *Mistaken targets: Setting up stock markets, eliminating concentration?*

Coherent long-term financial policy in emerging markets calls for vision on the part of national financial policymakers about the overall financial structure they wish to aim for. Research has been able to answer some long-contested questions about what type of financial system works best. For instance, the debate over whether securities markets or banks are more important for growth has been resolved by the finding that there is no empirical case for biasing financial development in either direction. Both banks and markets matter; their relative scale will respond to country conditions.[9] Likewise, it has been possible to show that high concentration in banking is not bad in itself. Instead contestability—as characterized by lower entry barriers, fewer regulatory restrictions on bank activities, greater banking freedoms, and higher overall institutional development—is what is needed to promote efficiency, stability, and greater access to finance.[10] Contestable financial systems also help to erode concentrations of power, providing hitherto marginalized segments of population with the opportunities to advance.

## Current and future research directions

### *Promoting access and an inclusive, efficient financial sector*

Current policy concerns regarding the financial sector in the process of development revolve around two rather different, albeit not fully independent dimensions, which we call here *access to finance* and *risk management*. Thus our current finance research program is also organized around these two strands. Access refers to the need to ensure that financial services essential for growth reach widely through the economy, thereby ensuring the foundations for broad-based, inclusive growth. But deepening finance and expanding access are not enough, given the fragility of finance. Most countries, even including those which have experienced rapid development success underpinned by financial deepening, have suffered from financial crises interrupting the growth process, and sometimes setting it back for a decade or more. In addition, heightened risks at the level of the individual firm and households have reinforced the role of financial instruments and markets for hedging and managing risk also at the micro level. This is why risk management, including crisis prevention, remains a central part of the financial development agenda and hence of our research program.

Areas under investigation include:

- Just how limited is financial access? How well does the financial system in different countries directly serve the poor households and small enterprises? Who has access to which financial services (e.g., deposit, credit, payments, insurance)? What are the chief obstacles and policy barriers to broader access? Recognizing the serious data gaps in this area, we are working to develop better cross-country indicators of access to financial services to illustrate the extent of financial inclusion around the world.

This effort has already attracted significant attention in the development community, and has been given a central role in the International Year of Microcredit 2005 as well as the UN Advisors Group on Building Inclusive Financial Systems, supported by the wider donor community.[11]

- What is the impact of greater access to finance on small firms and households? Another part of our work on access looks closely at conditions facing small firms, recognizing that the entry and growth of small firms is the key to ensuring contestability of the economic system and limiting the power of incumbent firms and groups. We have established that small firms benefit disproportionately from financial sector improvements generated by strengthening the legal and informational infrastructure. This reinforces the case for giving priority to such infrastructural improvements and confirms that the development of mainstream finance entails no compromise with a focus on small firms. On the contrary, financial development seems to work by relaxing the constraints on small firms the most.[12]

  Even though many of the benefits of financial sector development is likely to come indirectly to the poor through economywide effects, there is concern that the poor should be empowered through direct access to financial services, including a safe place for their savings, reliable and inexpensive payments mechanisms, and crop insurance and credit. We are also conducting evaluation studies to assess the welfare impact of pro-poor innovations introduced by microfinance institutions, to discover best practices.

- What policies work best to broaden access? Getting financial services down to poor households is a major policy challenge. Microfinance has so far reached only a fraction of its potential market, reaching fewer than 5 percent of population in countries where it exists at all. So there is a need to scale it up and link it to the financial system at large. However, in many countries around the world, many non-poor and small and medium enterprises are also excluded from the financial services. Hence broadening the focus of attention from finance for the poor, to improving access for all excluded, is likely to have greater impact as well as political support. Policies to broaden access can take many forms, from improvements in the functioning in mainstream finance to innovations in microfinance, and improving the design of policy interventions in this area is a focus of our current research program.[13]

- How should we ensure sustained efficiency and stability of financial systems? Risk management is important for preventing financial crises and sustaining effectiveness of financial systems over the long run. Our research in this area is starting to investigate the impact of different supervision strategies as well as impact of compliance with Basel Core Principles on bank stability, the interaction of bank insolvency resolution and deposit insurance policies, and the impact of financial globalization on bank efficiency and access to financial services. We are also initiating work in the area of capital market development and insurance.

The demand from financial policymakers will continue to underpin the choice of topics for financial research at the Bank. The three dimensions of stability, growth, and access

will remain relevant. Since policy design needs to be adapted to country conditions, our examination of these issues will combine systematic case study analyses of the experiences of specific countries, with econometric analyses of extensive cross-country data sets.

We now know that finance influences the dynamism of the economy at large and promotes long-term growth. By making the economy more inclusive and contestable, financial sector development is a powerful tool to reduce the inequality of incomes, to provide opportunities, and to help accelerate the escape from poverty. Much work has gone into uncovering the underlying legal, information, and regulatory infrastructures that ensure that finance works well in this way. But much remains to be learned. In effect, understanding more precisely how finance makes this contribution is crucial to optimizing the policy recommendations.

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## Endnotes

Most Bank documents cited in this summary are available through the documents and reports portal of the World Bank http://www-wds.worldbank.org/. The word "processed" describes informally reproduced works that may not be commonly available through library systems.

[1] For greater detail and other examples, see *Finance for Growth: Policy Choices in a Volatile World* 2001: *A Policy Research Report*. Washington, D.C. and NY: World Bank and Oxford University Press.

[2] See, for example, R. G. King and R. Levine. 1993. "Finance and Growth: Schumpeter Might Be Right." *Quarterly Journal of Economics* 108(3): 717–38; A. Demirgüç-Kunt and V. Maksimovic. 1998. "Law, Finance, and Firm Growth." *Journal of Finance* 53(6): 2107–37; and R. G. Rajan and L. Zingales. 1998. "Financial Dependence and Growth." *American Economic Review* 88(3): 559–87.

[3] T. Beck, A. Demirgüç-Kunt, and R. Levine. 2007. "Finance, Inequality and the Poor." *Journal of Economic Growth* 12(1); 27-49; P. Honohan. 2004. *Financial Sector Policy and the Poor*. Washington, D.C.: World Bank.

[4] J. Barth, G. Caprio, and R. Levine. 2004. "Bank Supervision and Regulation: What Works Best?" *Journal of Financial Intermediation* 13(2): 205–48; T. Beck, A. Demirgüç-Kunt, and R. Levine. 2006. "Bank Supervision and Corruption in Lending." *Journal of Monetary Economics* 53(8): 2131-63; A. Demirgüç-Kunt, E. Detragiache and T. Tressel. 2006. "Banking on the Principles: Compliance with Basel Core Principles and Bank Soundness." Policy Research Working Paper 3954, World Bank, Washington, DC.

[5] This research is summarized in A. Demirgüç-Kunt. 2002. "Deposit Insurance Around the World: Where Does it Work?" *Journal of Economic Perspectives* 16(2): 175–95. Also see A. Demirgüç-Kunt and E. Detragiache. 2002. "Does Deposit Insurance Increase Banking System Stability? An Empirical Investigation." *Journal of Monetary Economics* 49(7): 1373–1406; and A. Demirgüç-Kunt and H. Huizinga. 2004. "Market Discipline and Deposit Insurance." *Journal of Monetary Economics* 51(2): 375–99.

[6] See R. La Porta, F. Lopez-de-Silanes, and A. Shleifer. 2002. "Government Ownership of Banks." *Journal of Finance* 57(1): 265–301; and J. Barth, G. Caprio, and R. Levine. 2001. "Banking Systems Around the Globe: Do Regulations and Ownership Affect Performance and Stability?" In *Prudential Supervision: What Works and What Doesn't,* ed., F. Mishkin. University of Chicago Press.

[7] W. Megginson. 2005. "The Economics of Bank Privatization." *Journal of Banking and Finance* 29; G. Clarke, R. Cull, and M. Shirley. 2005. "Bank Privatization in Developing Countries: A Summary of Lessons and Findings." *Journal of Banking and Finance* 29.

[8] See, for example, S. Claessens, A. Demirgüç-Kunt, and H. Huizinga, 2001. "How Does Foreign Entry Affect Domestic Banking Markets?" *Journal of Banking and Finance* 25(5): 891–911; G. Clarke, R. Cull, M. S. Martinez Peria, and S. M. Sanchez. 2003. "Foreign Bank Entry: Experience, Implications for Developing Economies, and Agenda for Further Research." *World Bank Research Observer* 18(1): 25–59. S. Schmukler, A. de la Torre, and E. Levy Yeyati. 2002. "Financial Globalization: Unequal Blessings." *International Finance* 5(3): 335–57. Also see the discussion in forthcoming *Policy Research Report on Access to Finance*. 2007. Washington, D.C. and NY: World Bank and Oxford University Press.

[9] A. Demirgüç-Kunt and R. Levine. 2001. *Financial Structure and Economic Growth: A Cross-Country Comparison of Banks, Markets, and Development.* Cambridge, Mass.: MIT Press.

[10] This research is summarized in A. Berger, A. Demirgüç-Kunt, R. Levine, and J. Haubrich. 2004. "Bank Concentration and Competition: An Evolution in the Making." *Journal of Money, Credit and Banking* 36(3). Also see other articles in this special issue.

[11] See for example, T. Beck, A. Demirgüç-Kunt, and M. Soledad Martinez Peria. 2007a. "Reaching Out: Access to and Use of Banking Services across Countries." *Journal of Financial Economics*, forthcoming; and T. Beck, A. Demirguc-Kunt, and M. Martinez Peria. 2007b. "Banking Services for Everyone? Barriers to Bank Access and Use around the World." Policy Research Working Paper 4079, World Bank, Washington, DC.

[12] See for example, T. Beck, A. Demirgűç-Kunt, and V. Maksimovic. 2005. "Financial and Legal Constraints to Firm Growth: Does Firm Size Matter?" *Journal of Finance* 60: 137-77; L. Klapper, L. Laeven, and R. Rajan. 2006. "Entry Regulation as a Barrier to Entrepreneurship." *Journal of Financial Economics* 82: 591-629; T. Beck and A. Demirgüç-Kunt. 2006. "Small and Medium-Size Enterprises: Access to Finance as a Growth Constraint." *Journal of Banking and Finance* 30(11): 2931-43, and other papers in this special issue.

[13] See the discussion in forthcoming *Policy Research Report on Access to Finance*. 2007. Washington, D.C. and NY: World Bank.