

Finance and Development

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 as the latest financial crisis amply illustrated. Both success and failure have their origins largely in the policy environment. So while the current financial crisis will also recede in memory, it is important not to relax policy vigilance.

Financial sector research at the World 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..

Research has drawn attention to slower growth and poverty reduction when financial development is neglected

World Bank research has reinforced the empirical evidence pointing to a strong and independent causal role of the sector in promoting growth.^{1,2} More recent research has 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 finance sector. They have also influenced the design of the World Bank's 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.

What we know

Transplanting developed country practices to developing countries 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, but 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 Bank 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 merits of adopting *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 policy makers to focus on more pressing financial sector reforms instead.

Government banks bad—foreign banks good?

Policy makers 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 research at the World Bank and elsewhere has 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. 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 governments that have been slow to divest—with Egypt, Tanzania, and Turkey 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 the Latin American and Caribbean region

and Europe and Central Asia, 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, improved efficiency, higher quality of the financial infrastructure, and expanded 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 economy wide 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 policy makers 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.

How limited is financial access for households and small firms?

How well does the financial system in different countries directly serve poor households and small enterprises? Who has access to which financial services (e.g., deposit, credit, payments, and insurance)? What are the chief obstacles and policy barriers to broader access?

Recognizing the serious data gaps in this area, we developed 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 United Nations Advisors Group on Building Inclusive Financial Systems, supported by the wider donor community.¹¹

Another part of our work on access looked 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. Bank research has established that small firms benefit disproportionately from financial sector improvements generated by strengthened 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

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, 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 of mainstream finance to innovations in microfinance.¹³

Current and future research on finance

Given the recent global financial crisis, the overarching theme of our research program in the finance and private sector revolves around learning from and responding to the crisis.

Building blocks of our research program:

- understanding the causes of the crisis
- the role finance and private sector plays in the recovery process
- key policy areas for preventing/minimizing risks in the future
- implications of the crisis for households, enterprises, and financial institutions and markets.

Understanding the causes

An important area of research is better understanding the root causes of the most recent crisis. The intensity of the crisis in the financial markets and the way it spread and became global surprised nearly everyone. The crisis was also a shock to conventional thinking and led many researchers and policymakers to reassess and re-evaluate their views. Questions about what went wrong and the role of globalization, deregulation, and the role of the state in this process abound. A better understanding of the underlying causes of the crisis is an important starting point for our learning process. We intend to explore new topics and take a fresh look at others.

- Is there an optimal industrial and financial structure at different levels of the development process, and what deviations from this optimal would make economies more vulnerable to crises?
- What is the impact of financial liberalization in general, and foreign bank entry in particular, in explaining the occurrence and extent of the crisis?
- Also of interest is the role of “credit crunch” in exacerbating the economic downturn.

Stimulating recovery

Among the most hotly debated policy questions with respect to the current crisis is how to stimulate recovery. Because the crisis started in and severely affected the financial sector, the conventional assumption is that recovery of the financial sector is a

precondition to recovery in the corporate sector. However, studies of past crises have challenged this view emphasizing the possibility of credit-less recoveries, showing that real sector recovery often precedes that of the financial sector. In our research we intend to dig deeper into these issues by:

- Using firm-level as opposed to macroeconomic data, to better understand how recoveries take place, whether they differ for different groups of firms, and how they are financed.
- Studying supply chain finance to investigate if inter-firm financing can substitute for formal financing during bank crises.

Preventing future crises

Every crisis heightens the interest in crisis prevention. How should we design policies so that we can minimize the risk and severity of future crises? What are some of the most important policy reforms this crisis revealed as necessary? We focus on three main areas of significant policy interest: financial regulation, financial literacy, and bankruptcy prediction and resolution.

Studying the implications

There is no doubt that the crisis will have important implications affecting the livelihood of people and the prospects of firms for many years. Our research will study both the short-term and longer-term impact of the crisis on households, enterprises and financial institutions and markets.

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, the World Bank's 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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Notes

Most research documents cited in this summary are available through the World Bank's research archives at <http://econ.worldbank.org/docsearch> or the Bank-wide archives at <http://www-wds.worldbank.org/>.

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