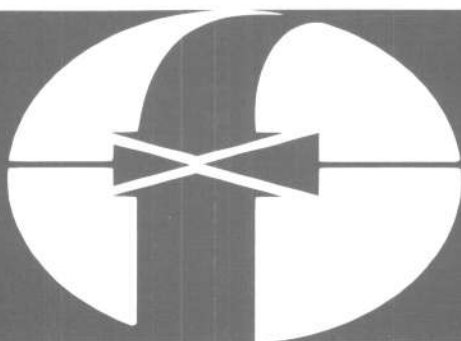


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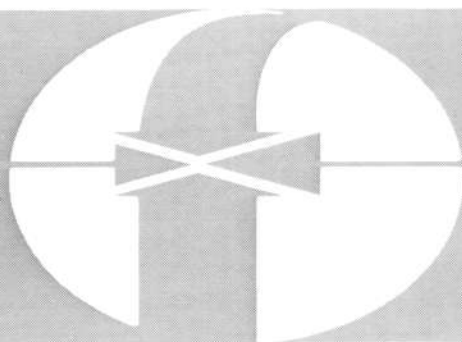
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PERSONAL SAVINGS AND FINANCIAL DEVELOPMENT: POLICIES AND PROSPECTS (*)

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Department of International Economic and Social Affairs - United Nations

1. Savings Mobilization, Financial Development and Economic Growth

For many developing countries the 1980s have been a decade of unsatisfactory economic growth and slow economic development. Given the immense burden of servicing their external debt and the poor prospects of increasing the inflow of foreign capital developing countries are now in the process of reshaping their development strategy for the 1990s. In this context policies that aim at increasing national savings and improving the allocation of financial resources to productive investment will play a major role.

The efforts to improve national savings will focus on the mobilization of personal (household) savings which constitute the bulk of national savings. Increasing the overall level of personal savings is a difficult task because the willingness of households to save depends on a great variety of social and cultural factors and the ability of households to save is determined by their disposable income. Governments have been successful with policies aimed at increasing the share of savings that households hold as financial assets (financial savings). To the extent that the increased efficiency of resource allocation as a result of increased financial savings will lead to higher economic growth, the disposable incomes of households and thus their ability to save will increase. Through this indirect effect the promotion of financial savings affects both economic growth and the overall level of personal savings [25.; 3.; 17.].

Inducing households to hold a larger part of their savings in the form of financial assets (financial deepening) and ensuring the efficient allocation of these assets to investment are two related functions of the financial system that are commonly described as "mobilization of personal savings". Financial development begins with the adoption of money in the form of currency as payments mechanism. As a next step, currency is supplemented by check deposits and other financial instruments. Even before monetization, there may be self-finance and rudimentary lending and borrowing in kind. Before banks get established, there exist usually informal financial markets which continue to operate side by side with the growing formal financial system (financial dualism). Security markets, may or may not develop while commercial banks still dominate, but specialization among financial intermediaries usually begins very early, in the form of savings banks and institutions specializing in rural, industrial or housing finance.

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The views expressed in this paper are those of the author and not necessarily those of the United Nations.

Specialization among financial institutions is the characteristic feature of the more advanced stages of financial development although economies of scale may later reverse this process with a move towards general banking [4.].

The most important problem policy makers face with improving the mobilization of personal savings is similar to that of many other goals of economic development: there are no quick fixes. Simply abolishing interventionism is not a convincing strategy in the face of successful interventionists like South Korea and Singapore. Shifting emphasis to microeconomic tasks like deregulation while neglecting macroeconomic desiderata like price stability will slow down financial development. Heavy reliance on the price mechanism to balance the supply and demand of credit in a credit market with many to imperfections will be equally counterproductive. Liberalizing the entry of new foreign or domestic banks to increase competition may result in a collapse of the large number of insolvent existing banks. Getting prices (interest rates) right will not increase the level of financial savings if depositors have little confidence in the soundness of the financial system. Therefore policymakers need to deal with more than one problem at a time and allow a reasonable amount of time for the solution of the problems.

A second problem that policy makers face is that also abstaining from quick fixes and implementing comprehensive packages of policy reforms may not yield the expected results if the individual measures in the package are not implemented in the right sequence. For example, deregulating interest rates before having brought inflation under control may produce disastrous results as the experience of Latin American countries has shown.

A third problem that policy makers face is that the solution to many financial sector problems lies outside their sphere of influence. For example, the answer to problems like poor technical management of banks and the general lack of innovative approaches to servicing small bank customers can only come from the offices of bank managers.

The paper will discuss these problems and give an overview of other important issues of savings mobilization and financial development.

1.1. Outline of the paper

The paper starts in its second part with a brief description of national policies and the international economic environment from the late 1970s to date which influenced the development of national savings and domestic investment shown in Table 1 and 2.

The paper then turns to macroeconomic policies and begins with a discussion of fiscal policies that affect savings mobilization and financial development: inflationary budget

deficits, measures to reduce the inflationary effect of government borrowing and tax policies. The discussion suggests, for example, that to the extent that budget policies contributed to the rapid increase of inflation in developing countries (on average about 50 percent in 1983-87) they slowed down financial development and were responsible for a shift of savings from financial toward real assets, a shortening of loan maturities and an increase in capital flight. (The same applies to inflationary interest policies which are discussed elsewhere). Financial development was also negatively affected through attempts at reducing inflationary government borrowing by imposing excessive reserve requirements on banks and forcing them to hold low-yielding government bonds. Moreover, government's inability to control tax evasion had a negative impact on financial development because these monies were either used for domestic lending outside financial institutions (financial disintermediation) or found their way abroad. Furthermore, a number of deficiencies in tax policy were responsible for inadequate demand and supply incentives for the development of capital markets.

The next major issue the paper addresses is interest rate policies. In the discussion of the conventional views of interest policies and in the views of its critics it becomes clear that the main problem may not be "positive real interest rates versus negative real interest rates" but how rapidly should interest rates be adjusted after having stayed at negative real levels for a longer period of time, what policy measures should be added to the liberalisation of interest rates in a policy package, and in what sequence should the individual measures of the package be implemented.

The paper then turn to selective credit policies. These policies like interest rate policies remain somewhat controversial, partly because the advocates of a free interplay of market forces tend to underestimate the market imperfections in developing countries while policy makers in developing countries tend to overemphasize the constraints that may make the market mechanism fail. The discussion of selective credit policies begins with a description of their objectives and techniques and then demonstrates their negative effects on savings mobilization and financial development. These include the misuse of funds for on-lending, the high default rates which contributed to widespread bank insolvencies, the crowding-out of non-priority borrowers which promoted the use of informal credit markets and thus financial dualism and the retardation of securities market development by the provision of readily available subsidized loans. In spite of this criticism, the paper concludes that it cannot be excluded that under special circumstances a preferential credit allocation to certain sectors, specific types of borrowers or preferred activities may be justified.

As banking regulation and supervision have currently been given much greater attention in the discussion of financial sector issues than in the past, the paper elaborates at some length on their goals and select issues. The discussion of some of the issues is resumed at a later stage when dealing with the financial sector crisis in developing countries. The issue of allowing greater bank competition is briefly addressed.

Given the importance of dealing with the problem of bank insolvencies in order to resolve the financial sector crisis and restore the stability of the financial system in developing countries, the paper analyses the symptoms and causes of the crisis, its impact on savings mobilization, financial development, economic growth and the available policy options.

In its third part the paper addresses the impact of the efficiency of financial intermediation on financial development. With regard to bank management the paper concludes that more attention needs to be given to the quality of technical management and great changes are required to transform the corporate culture of banks in order to make them more customer-oriented. The subsequent discussion of innovative approaches to servicing small customers demonstrates that in a number of countries a change of corporate culture has already begun through innovative approaches aimed at reducing transaction costs and tailoring financial products to the needs of small farmers and entrepreneurs. The approaches discussed focus on innovations by commercial banks such as group lending and money shops and the establishment of banks specialized in servicing small customers such as the Rural Banks in Ghana and Grameen Bank in Bangladesh.

2. Financial Development and Policy Environment

2.1. Approach to economic and financial development under review

2.1.1. Strong emphasis on government intervention in the 1960s and 70s

Governments in developing countries continued their intervention in the design and the operation of the financial system in the 1960s in order to make sure that the allocation of financial resources corresponded with their development strategy. They set up new financial institutions and directed both new and existing institutions to establish branches in rural areas and lend at concessional interest rates to priority borrowers.

These interventions took place in a climate of economic and financial stability. Exchange rates, interest rates, international commodity prices and domestic price levels were relatively stable. Negative real interest rates on deposits were a serious problem only

in a minority of countries with relatively high inflation. Financial stability, low inflation and fairly reasonable interest rates in a majority of countries made holding financial assets attractive. Because of these conditions, during 1965-1973, most countries depended to a large extent upon their own resources to finance their development programmes. Between 1974 and 1980, commodity prices, on the whole, remained high and international lending to developing countries increased dramatically as the revenues of oil-exporting countries were recycled. As a result of expansionist policies high inflation, which had been a serious problem only in a few countries, became widespread. Average real interest rates in developing countries declined substantially. Reflecting low deposit rates, financial deepening stalled. With limited domestic resource mobilization and easy availability of external loans, countries borrowed abroad to maintain economic growth, finance the trade deficit and increase investment [32.]

2.1.2. *Gradual shift in government interventions in the 1980s*

The second oil price increase in 1979 and the subsequent recession in the developed countries affected both the quantity of exports and the terms of trade of developing countries. Real interest rates rose in the international capital markets and increased sharply their debt service obligations. Economic growth declined sharply. Especially hard hit were developing countries with large amounts of short-term variable rate debt. When commercial banks ceased new international lending on a voluntary basis, many developing countries were unable to meet their debt service obligations and had to seek rescheduling. These developments had devastating effects on the financial structure and incomes of firms and financial institutions. Financial institutions were hit twice: indirectly, through the deterioration of the financial situation of their borrowers in the corporate sector, and directly through the impact of these developments on their incomes and solvency [32].

With the deterioration of national savings and domestic investment and a curtailment of foreign lending in the 1980s, many governments were forced to rethink their development strategy. Economic growth was weak and governments had no longer the foreign exchange to finance large current account deficits or the fiscal resources to continue subsidizing inefficient industries. The interventionist approach pursued in the past had left the financial system small and underdeveloped which was reflected in as unprofitable and to a large extent insolvent banking system. Moreover, many private investors were crowded out by public borrowing or had no access to longer-term finance and savers were discouraged from holding domestic financial assets, partly because of negative real deposit rates [38.]

In this situation many governments lost faith in the economic ideology underlying past interventionism and/or their administrative capacity to intervene. They reduced interventions in areas like interest rate controls and credit allocation and stepped up interventions in others like prudential regulation, bank supervision and the legal framework of the economy. The gradual shift in interventions is equally visible in the real sector of the economy where governments removed obstacles to foreign competition, re-privatized state enterprises, improved the infrastructure available to enterprises and offered training programmes for small entrepreneurs. In many cases these reforms were undertaken in the framework of programmes of the International Monetary Fund for member countries with stand-by and extended Fund facility arrangements and the structural adjustment loans of the World Bank.

With regard to the reduction of interventions in the financial sector it is important to note that the pace and scope of reforms have differed substantially from country to country. In Latin America Argentina, Chile, and Uruguay shifted within a few years from highly controlled to largely uncontrolled finance. In Asia the Philippines eliminated most of its interest rate controls within a very short period. In other countries in Asia reforms were even more limited and were introduced more gradually. In Sub-Saharan Africa currently financial reforms are in place or under way in a number of countries such as Côte d'Ivoire, Ghana, Guinea, Madagascar, Mozambique, Nigeria, and Tanzania. The objectives are in most cases to restructure institutions, improve regulatory procedures, and introduce a greater reliance on market signals [38.].

The change of economic conditions in the 1980s that began with the second increase of the oil price in 1979 is reflected in the deterioration of national savings and domestic investment in many developing countries which be discussed below.

2.1.3. National savings and domestic investment from the late 1970s to 1987

A recent study on the revitalization of economic development prepared by UNCTAD provides a detailed analysis of the worrying trends in savings and investment in developing countries in the late 1970s and early 1980s [35.].

The study points out that the deterioration in the external environment, in combination with domestic factors, considerably increased the difficulties of developing countries in financing the investment necessary for satisfactory growth through external and domestic savings. As may be seen from Table 1, gross domestic savings relative to GDP for developing countries taken together have followed a downward trend in the

early 1980s. Net factor income paid abroad (mainly interest payments on external debt) increased sharply, more than doubling its share of GDP. As a result, national savings fell more sharply than domestic savings. Whereas the gap between the two in terms of GDP was roughly 1 percentage point in 1979-81, it had widened to almost 3 percentage points by 1982-1984.

The analysis of trends for regional country groupings in the UNCTAD study shows that sub-Saharan Africa experienced by far the sharpest drop in the domestic savings ratio in the early 1980s, largely due to declines in per capita income. This, together with increased interest payments abroad, reduced gross national savings by more than 40 per cent during 1982-1984 compared with the late 1970s. Since increased external savings only partly offset the rise in interest payments abroad, the investment ratio fell by more than 3.5 percentage points between 1979-1981 and 1982-1984.

With regard to Latin America the study notes that in this region the decline in the domestic savings ratio was more moderate but the rise in net factor income payments abroad sharper. The latter more than doubled in the early 1980s compared with the late 1970s due to the increase in interest payments by the major debtors of the region. Interest payments continued to rise after 1982 while bank lending was sharply reduced, giving rise to negative net transfers. The swing from positive to negative net transfers between 1976-1978 and 1982-1984 accounted for more than half of the 7 percentage point decline in the investment ratio during this period. As a result, investment in Latin America in 1982-1984 was forced below the level that would have been allowed by the domestic savings effort alone.

Finally, the UNCTAD study points out that the gross domestic savings performance of the East Asian and Pacific countries remained virtually unchanged in the early 1980s compared with the late 1970s whereas their average investment ratio rose by 2 percentage points. Although interest payments as a proportion of GDP rose, the rise in external savings was even greater. Consequently, net transfers from abroad rose from about 0.8 per cent of GDP in 1976-1978 to 2.6 per cent in 1980-1984, accounting for much of the improvement in the investment ratio.

In Latin America and Sub-Saharan Africa the trend in the development of savings and investment discussed in the UNCTAD study for the period 1976-84 did not improve in the subsequent years for which data are available (1985-87). Table 2 shows that both gross national savings and gross domestic investment in Latin America remained at low levels averaging 16.1 and 17.7 respectively as a percentage of GDP for the period 1985-87 (as compared to 15.1 and 18.4 as a percentage of GDP in the period 1982-84 shown in Table 1).

In contrast to Latin America the negative trend in Sub-Saharan Africa not only continued but worsened sharply. While in 1985-87 the average gross national savings as percentage of GDP stayed with 8.5 at the low level of the period 1982-84, the average gross domestic investment as a percentage of GDP declined from 16.4 to 14.4. The combination of low national savings and declining domestic investment may further increase the already high dependence on foreign capital. A review by the African Development Bank of development programs in 16 Sub-Saharan countries in the first half of the 1980s found that the dependence on foreign capital for investment was as high as 80 to 100 percent for some of the least developed countries and averaged nearly 60 percent for the entire sample [30].

In Asia in the period 1985-87 gross national savings as a percentage of GDP climbed to an average of 31.4 percent and gross domestic investment reached 30.2 percent. This was a dramatic increase in comparison with the period 1982-84.

2.2. Macroeconomic policies remain controversial

In many developing countries fiscal, interest rate and other macroeconomic policies have set back financial development and contributed to the problems that a large number of financial institutions now face. Furthermore, the controversy over what are "right" macroeconomic policies continues. The following pages provide an overview of those issues that are of particular relevance to savings mobilization and financial development.

2.2.1. Fiscal policy

i) Budget deficits, inflation and financial development

As pointed out above, in the second half of the 1970s most developing countries had relied heavily on foreign borrowing to help finance increasing public sector deficits. When the inflow of foreign capital dried up in the early 1980s, many countries were unable to reduce their fiscal deficits. Social and political considerations made it difficult to cut spending. As a result governments turned to their central banks because domestic financial markets were too shallow to meet their increased borrowing requirements. To the extent that central banks financed such borrowing by issuing money, the result was higher inflation. The average inflation rate in developing countries increased from 10 percent a year in 1965-73 to 26 percent in 1974-82 and 51 percent in 1983-87 [38].

The acceleration in the rate of inflation had a substantial impact on the pace of financial development. In many countries real interest rates on bank deposits became negative

or more negative which prompted depositors to shift savings away from domestic monetary assets toward real and foreign currency denominated assets. Furthermore, high inflation led to a shortening of loan maturities and discouraged borrowing. Lenders were concerned about the risks of negative returns on their assets if they made longer-term commitments. In contrast, borrowers were concerned about positive real rates on borrowing if inflation were to fall. Moreover, the high inflation rate experienced by many countries had a negative impact on the development of securities markets [34.; 17.].

ii) Noninflationary deficit financing and financial development

Many governments in developing countries have sought to reduce the inflationary impact of public sector borrowing. However, the measures adopted resulted in alternative forms of taxation and therefore retarded financial development. Governments increased, for example, the reserve requirements on demand deposits to high levels. These requirements constituted forced loans to the central bank, usually at below-market rates. Another approach was to require banks, insurance companies, and other financial institutions to invest part of their funds in low-yielding government bonds. High reserve requirements and forced investments in low-interest government securities crowded out private sector borrowing and discouraged financial intermediation. These measures were equivalent to an implicit tax which reduced intermediaries' profits or was passed along to depositors and borrowers in the form of lower deposit rates or higher lending rates [38.].

Developing countries' widespread use of these methods of noninflationary finance contrasts sharply with the situation in developed countries where the authorities can rely on well-functioning money and capital markets to sell their bonds and other paper to banks and non-banks. Therefore, the financing of public deficits has a direct impact on the level of interest rates, with the result that the crowding out will occur largely through the price mechanism [34.].

iii) Tax concessions, structure of income tax and savings mobilization

The typical fiscal instruments of promoting personal savings is the provision of tax incentives through exemptions, deductions, credits, special low tax rates and bonuses. These incentives usually have the dual purpose of encouraging savings of low-income groups (small savers) and directing savings into preferred end-uses such as home ownership and specific financial assets. Although such incentives are widespread in developing countries, there have been very few evaluations of their costs and benefits. The most

important argument against a policy of providing fiscal incentives for the promotion of personal savings is that the effects of this policy may be relatively small and in conflict with other goals of fiscal policy. In the face of the low quantitative significance of income taxes in developing countries the savings incentive effect of any tax incentive is correspondingly low. Furthermore, in practice governments usually incur a loss of tax revenue and create inequities without promoting personal savings because the benefits of the tax incentives accrue to higher-income groups who will have an equal rate of savings in the absence of such incentives. In addition, governments have to bear the higher administrative costs of operating a tax system with numerous deductions and exemptions for the promotion of personal savings [10.].

While income tax deductions and exemptions do not have a significant effect on savings mobilization, it appears that the high marginal rates of income tax in many developing countries have a significant effect on the allocation of savings. Unrealistically high tax rates have led to widespread tax evasion and large amounts of "black money". Some of this money is deposited with domestic financial institutions and some of it finds its way abroad. Much is used to finance investment in sectors and activities not accorded priority in development plans. Only a small proportion of "black money" flows to formal financial institutions. The largest proportion is used for self-finance or for direct lending through informal credit markets. Insofar as the operations of these markets compensate for rigidities and deficiencies in formal institutions they facilitate the conversion of saving into productive investment [6.].

iv) Fiscal incentives for the development of capital markets

Many developing countries have made substantial progress in promoting the development of capital markets which provide long-term debt and equity finance for the corporate sector and the government. Equity markets now exist in more than forty countries. Even though some countries such as Korea have provided considerable tax incentives, it appears that developing countries in general need to give more fiscal incentives to increase the volume of savings channeled to equities (demand incentives) and incentives to increase the volume of equities available (supply incentives).

An important demand incentive is the removal of tax disincentives. One of the most common tax disincentives is the classical system of double taxation. Dividends are taxed once because they have to be paid out of a corporation's post-tax income, and a second time, because they are taxed as part of the shareholder's personal income. This system creates a bias in favor of debt finance because, in most countries, a company

can deduct its interest payments in full from its pretax income. Furthermore, as individuals are taxed twice on their share of corporate profits and corporations are taxed only once, shares are more attractive to corporations than they are to individuals. Relief from double taxation can be applied to either a corporation's income or to that of its shareholders. Relief on the corporate income side can, for example, be offered through a split-rate tax system, which taxes distributed income much more lightly than retained earnings. Tax relief to shareholders can, for example, be offered in the form of tax credits [23.].

Apart from double taxation there are other important tax disincentives. In some countries the tax-free status of time deposits or government and public enterprise bonds lessens the appeal of private corporate instruments. In many countries lax enforcement of corporate income taxes makes it possible for not publicly held corporations to avoid taxes by showing very low accounting profits. In contrast, publicly traded corporations cannot hide their profits without hurting investor confidence [23.; 38.].

In addition to removing tax disincentives developing countries have actively pursued a number of other demand incentives such as indirect purchase incentives (which increase the after-tax return on equities to savers), and the promotion of contractual and collective savings through pension funds and life insurance companies. In Africa, for example, the growth of insurance companies in the post-independence period has been phenomenal and there still exists scope for greater resource mobilization through an expansion of business into the rural areas [23.; 3.].

Supply incentives are equally important. An increased supply helps create more market liquidity and ensures that measures to stimulate demand will not simply force up prices of existing equities. Thus, while supply incentives do not directly encourage the flow of savings into equities, they are important parallel measures in promoting capital market development. One of the developing countries that successfully experimented with supply incentives is Brazil. It introduced a tax credit plan which allowed individuals to offset against income tax part of the cost of buying listed stocks, mutual funds and equities of companies in underdeveloped regions of Brazil. Another form of supply incentives is to make the granting of tax holidays for investment conditional on a public issue of some of the company's equity [23.].

2.2.2. Interest rate policy

i) Interest rates, financial development and economic growth

Until the early 1970s, the two theories that influenced interest rate policies were the

classical-neoclassical theories of growth and the Keynesian counter arguments. Under the first, high interest rates have a direct positive impact on saving and therefore investment, under the second, low interest rates bolster investment and income, resulting in higher savings [26.]. Since then establishing positive real deposit rates has become part of the standard policy advice given to developing countries by many experts, including those of international organisations. The rationale behind this advice goes back to the critique of both the classical-neoclassical theories as well as the Keynesian alternative by Ronald I. McKinnon and Edward S. Shaw and has led to the almost universal acceptance among those concerned with development economics of the beneficial effects of positive real deposit rates on economic growth [37.].

It is argued that administered interest rates that are lower than the current rates of inflation (negative real interest rates) produce lower rates of savings, of investment, and hence, of economic growth than would result from equilibrium interest rates, mainly because domestic financial savings are discouraged in favor of either the accumulation of goods or of foreign assets. Negative real interest rates also encourage businesses to undertake investments with low rates of social return, such as the accumulation of inventories, rather than using their resources to build new plants and equipment. Furthermore, by preventing financial institutions from charging higher interest rates on longer term and riskier loans governments may discourage the very sort of lending they seek to promote. Moreover, artificially low interest rates cause excess demand for credit and force financial institutions to ration their lending. Finally, it is argued that low interest policies stand in the way of developing securities markets [24.; 38.; 7.].

The proponents of positive real interest rates realize, however, that the exact interest level to which strongly negative interest rates should be raised is difficult to determine. Although prevailing circumstances may justify a sharp increase in interest rates, excessive increases must be avoided. Interest rates that are too high tend to lower economic growth by reducing investment demand. While such a policy might entail real interest rates that are negative for temporary periods, its chances for success would not be jeopardized as long as the degree of negativity was minimal and the negative rates were not maintained for an extended period [24.].

ii) Interest rates, macroeconomic stability and financial development

The level and structure of interest rates affect the ability of the central bank to maintain control over the rate of domestic credit expansion. Interest rates also influence public sector expenditures, and have a significant effect on the balance of payments. Thus,

interest rate policies determine to a considerable degree the appropriate stance of demand management policies and thereby macroeconomic stability.

As pointed out in the above discussion of inflationary budget policies, macroeconomic stability is vital for financial development. In countries that have maintained low and stable inflation through prudent budgetary and interest rate policies, financial sector growth has been rapid. The financial sector of Malaysia, for example, has grown rapidly during the past three decades, thanks largely to price stability; its financial depth, as measured by the ratio of M2 to GNP, rose from 31 percent in 1970 to 75 percent in 1987. Also Thailand's financial sector has grown rapidly since inflation was brought down; using the same measure, financial depth grew from 34 percent in 1980 to 60 percent in 1987, as real interest rates became positive. In contrast, Argentina has long suffered from high and variable inflation; its financial depth, which exceeded 50 percent of GNP in the late 1920s, had declined to around 30 percent of GNP by 1970 and to 18 percent by 1987. Other high-inflation countries have also experienced slow or negative growth in financial depth [38.].

Macroeconomic stability and, more specifically, price stability are absolutely crucial for successful financial liberalization, especially when the countries undergoing financial reforms such as interest rate deregulation have shallow financial markets. The experience of Asian and Latin American countries has shown that interest rate deregulation in a highly inflationary environment may result in extremely high real interest rates which may lead to widespread insolvency of firms and financial institutions [11.].

iii) The impact of interest rate and other policies on capital flight

In several developing countries the combination of overvalued exchange rates, high inflation, controlled interest rates and underdeveloped capital markets have stimulated the outflow of national savings (capital flight).

Economists at J.P. Morgan estimate that the stock of assets held abroad by non-bank private sector residents of the highly indebted countries amounted to US\$300 billion at the end of 1987 - more than half of developing countries' total foreign debt [15.]. If macroeconomic mismanagement in developing countries continues, this capital will stay abroad. Encouraging residents to repatriate their assets and thereby increasing the availability of national savings for domestic investment would require sound fiscal and financial policies, realistic exchange rates and appropriate differentials between domestic interest rates and interest rates abroad. In addition far-reaching microeconomic reforms to promote economic growth are required. Luring back assets that are invested comfortably abroad may, however, require more than sound macro and microeconomic

policies. Governments could, for example, offer preferential exchange rates for flight capital that comes home or allow flight capital to be lodged in dollar-denominated accounts, or to benefit from tax amnesty.

iv) Disagreements and problems with conventional views on interest rate policy

In spite of the considerable amount of research that has been undertaken on the relationship between interest rates, savings, investment and economic growth disagreements and problems with conventional views on interest rate policy remain. The main issues are discussed in recent studies by Khatkhate (1988) and Gonzalez Arrieta (1988). It is pointed out that empirical work generally faces significant shortcomings of availability of proper data and has yielded conflicting results. This may be as much due to wrong underlying hypotheses as to the inherent difficulties in covering all possible policies in a single analytical framework and relating them simultaneously to the various macroeconomic variables.

With regard to the short and longer-term effects of interest rates, it is interesting to note that various studies have demonstrated that significantly negative interest rates do not always have the adverse effect on economic growth suggested by much of the conventional theory. In some developing countries a relatively high growth rate coexisted with negative real interest rates. Similarly inconclusive results have been encountered with regard to the relationship between the level of interest rates and investment.

With regard to the effect of positive real interest rates on savings, empirical studies have yielded more conclusive results and strengthened the argument that while positive real interest rates do not significantly affect the level of savings they increase the proportion of savings held in the form of financial assets and facilitate thereby a more efficient allocation of savings. This, in turn, will stimulate economic growth which will increase the disposable income of households and thereby lead to a higher overall level of personal savings.

The most important contribution that empirical studies on interest policy in recent years may have made to the formulation of policies is that they conveyed the clear message that positive real interest rates can only be effective as part of a policy package comprising macroeconomic policies and government interventions like banking regulation, bank supervision and the strengthening of the legal framework of the economy. With regard to the sequencing of policy implementation, empirical studies have strengthened the argument that interest rates should be deregulated only after inflation has been brought under control, a significant degree of financial deepening has been achieved

and an adequate system of bank supervision has been established. This new approach of integrating interest policy in a package of general policy reforms and institution building contains many elements of the recently proposed African Alternative for adjustment with transformation [16.]

The debate over interest rate policies in developing countries is far from being settled and will require a substantial amount of additional empirical research in order to address those unresolved issues that are of particular relevance to policy makers. As far as technical issues are concerned, the above mentioned studies emphasize that empirical research needs to overcome a number of problems ranging from proper specifications of functional relationships and relevant explanatory variables to the generation of proxies for unobservable variables needed as independent variables.

It will also be necessary to continue the debate over a number of arguments that have been made in favour of maintaining negative real interest rates in developing countries. The critics of a policy of positive real interest rate argue, for example, that (a) high priority investments with long gestation periods should be financed at low interest rates; (b) high interest rate costs on credit for the financing of working capital will be passed through into prices and are hence inflationary; (c) negative real interest rates may be justified as a means of offsetting other price distortions in the areas of investment, production and foreign trade ("second-best" argument); and (d) institutional features of financial markets in developing countries such as oligopolistic pricing prevent interest rates from performing their role of influencing the level of financial savings and allocating credit to productive investment [24.; 20.; 16.].

2.3. Government interventions continue to face complex problems

The following discussion will focus on four areas of government intervention in the financial sector: selective credit policies, prudential regulation, banking supervision and measures to cope with the widespread insolvency of banks in developing countries. A closer look at these areas will show that government intervention not only faces complex technical problems but is also fraught with politically sensitive issues.

2.3.1. Selective credit policy

i) Objectives

In developing countries selective or directive credit policies are almost as common as interest rate controls. The case for selective credit policies rests on the argument that

the financial intermediation process does not by itself ensure the socially optimum use of resources. Financial institutions tend to emphasize lending that maximizes profits through high interest rate earnings, a low risk of default and low costs of administering loans. This leads to a discrimination of borrowers such as small farmers and entrepreneurs because lending to them usually involves a relatively high default risk and high administration costs. Lending to these borrowers is considered to be important for economic development and selective credit policies can assist in promoting the flow of savings to small borrowers. Selective credit policies are also viewed as an adjunct to a well balanced development programme in which planned investment is reconciled with planned savings [12].

Directed credit programmes have mainly targeted industry, state-owned enterprises, farmers and small and medium-scale firms. The aim was to provide cheap long-term finance for industry to promote investment and rapid industrialization, raise output and accelerate the introduction of new technologies in agriculture and generate employment in small and medium enterprises.

ii) Techniques

The major techniques of selective credit policies are subsidized loan rates for priority sectors, differential rediscount rates, direct budgetary subsidies, credit floors, credit ceilings, and the proliferation of specialized financial institutions. Governments often specify preferential interest rates for lending to priority sectors. These rates are substantially lower than those on regular loans, which themselves are often kept artificially low.

The main problem with subsidized loan rates for priority sectors is, of course, to persuade banks to lend at a rate that is below costs or yields an unsatisfactory profit. One way of solving this problem is to compensate lenders through concessional terms when they rediscount loans to priority sectors at the central bank. Another way of compensating lenders is to cover differentials between priority loan and deposit rates through explicit budget appropriations. Selective credit policies can also be implemented by setting minimum proportions of total credit or deposits that must be lent to specific priority borrowers (credit floors) or by setting credit ceilings on non-priority lending. Finally, selective credit policies can be implemented by heavy reliance on specialized development finance institutions (DFIs). In this case funds are extracted from nonspecialized depository institutions through high reserve requirements which are channeled by DFIs to priority sectors on concessional terms [17].

Development finance institutions have been an important means for channeling credit to priority borrowers. They are supported by bilateral and multilateral creditors. Develop-

ing countries have at least one DFI, and many have a special institution for each priority sector.

iii) Impact on savings mobilization and financial development

Recent studies undertaken by the Asian Development Bank (1985b), Fry (1988) and the World Bank (1989) have concluded that in spite of their good intentions selective credit policies had not the desired impact on resource allocation and economic growth and undesired effects on domestic savings mobilization and financial development. The studies point out, for example, that it is not at all clear from the available evidence that planners succeeded in identifying investments with high social but low private returns that justified subsidization. The fungibility of capital ensures that some borrowing can and does take place at concessionary loan rates with the intention of building up deposits yielding a higher rate of return or investing in nonpriority projects. Often lenders misclassify loans in order to comply with lending directives. Within priority sectors, large and politically influential borrowers benefit most. Furthermore, concessionary loan rates that are negative in real terms encourage highly capital-intensive production techniques and encourage unproductive hoarding.

The above mentioned studies conclude that to the extent preferential interest rates are not fully subsidized by measures like cheap rediscounts from the central bank or low-cost loans from international agencies cross-subsidization takes place through higher rates charged to other borrowers, lower rates paid to depositors and smaller profits (or greater losses) for financial institutions. As selective credit policies disregard the fact that different borrowers involve different credit risks they have contributed to the serious levels of delinquency and default in the portfolios of development finance institutions in most developing countries. By limiting the availability of credit to nonpriority borrowers directed credit programmes have crowded such firms out of formal credit markets and forced them to rely on retained earnings or more expensive borrowing from informal sources.

Finally, the aforementioned studies emphasize that extensive refinance schemes at low interest rates have reduced the need of financial institutions to mobilize resources on their own, leading to a lower level of financial intermediation. Selective credit policies have also seriously retarded the development of securities markets by allowing an excess of readily available subsidized loans. It has also become evident that once directed credit programmes are begun, they create a constituency of beneficiaries which makes it politically difficult for governments to reduce their support of these programmes.

iv) Reform proposals

In spite of this criticism it needs to be emphasized that selective credit policies may be useful to tackle certain inadequacies of financial and other markets. With regard to the lack of venture capital, for example, the World Bank (1989) points out that in a number of countries commercial banks and DFIs have been directed by their governments to provide financing for new and risky firms. Because of the high risk, interest earnings have not covered portfolio losses, and the banks (or their guarantors) have frequently lost money. It is possible, however, that some of the high-risk firms have been sufficiently successful to compensate for the poor performance of others and that the overall program produced a net gain for the economy. Yet few governments and DFIs have turned out to be successful venture capitalists.

With regard to the setting of interest rates in the framework of selective credit policies, the Bank suggests to eliminate the difference between the subsidized rate and the market rate. The lowest interest rate should not be less than the rate charged by the commercial banks to prime borrowers. Increasing the availability of credit to priority sectors should be the main focus of the remaining directed credit programs, since experience has shown that generous subsidies badly distort the allocation of resources. Charging nonprime borrowers the prime rate implies a subsidy to the extent of the added risk and administrative costs. Instead of forcing the banks to cover these costs by charging other borrowers more or paying depositors less, the authorities would be better advised to bear the costs themselves. Sectors that require large subsidies should be dealt with in the budget, not through credit allocation.

2.3.2. *Banking regulation and competition policy*

i) Goals of banking regulation and supervision

Getting macroeconomic policies right and reforming selective credit policy may make the financial system more efficient at mobilizing personal savings and allocating funds for productive investment. However, in order to ensure that the financial system will develop as intended these policies need to be complemented by adequate prudential banking regulation, banking supervision and competition policy.

Banks in developing countries hold a unique position as creators of money, the principal depositories of the public's assets, the primary allocators of credit, and managers of the country's payments systems. For this reason, governments have established public policy for banks in the public interest which is captured or codified in various laws, rules

and regulations. While prudential regulation codifies public policy towards banks, banking supervision is the government's means of ensuring compliance by the banks with public policy. Prudential regulations establish the outside limits and constraints placed on banks to ensure the safety and soundness of the banking system. They are the key elements to prevent, limit or stop the damage caused by poor management. The establishment of an appropriate regulatory framework is essential to ensure that government supervisors can carry out and enforce their responsibilities [31.]

The experience of both developed and developing countries demonstrates that the banking system may suffer from occasional instability, excessive risk-taking, and fraud. The liabilities issued by banks in response to the demands of depositors are short-term, highly liquid, and supposedly low-risk. Loans, by contrast, are usually longer-term, less liquid, and riskier. This difference is one reason why banks charge borrowers more than they pay depositors. But because banks are so highly leveraged, relatively small losses on loans can leave them unable to honor their liabilities. When the public suspects that a bank is insolvent, the result is often a run on the bank, which sometimes spreads to other, solvent, banks. Governments have devised ways of dealing with bank runs. When they occurred, central banks acted as lenders of last resort and provided liquidity by rediscounting sound loans. In several high-income countries the government provided deposit insurance to prevent runs from starting. The lender-of-last-resort facility was designed to prevent them from spreading [38.].

Adequate prudential regulations and a strong banking supervision in developing countries are particularly important in times of financial liberalization. For example, financial liberalization involving substantial increases in real rates of interest is bound to produce some casualties. Thus, supervision is needed to ensure that weak financial institutions are detected early and liquidated or merged in an orderly fashion. Regulation and supervision are therefore areas in urgent need of further research [17.]. In addition to fundamental issues, a large number of technical issues require further investigation. The following discussion addresses some of these issues and draws heavily on a recent paper by Polizatto (1989).

ii) Select issues of prudential regulation

Usually prudential regulations deal with licensing, exposure limits, loans to insiders, capital adequacy and asset classification. Furthermore, the definition of permissible activities and the treatment of problem and failed banks are important areas of regulation. Also, organisational issues are of high importance and include the choice of the

supervisory authority (central bank, ministry of finance or treasury), staffing, compensation and training.

Licensing of banks is one of the problem areas of regulation in developing countries. In many cases the granting of licenses is politically motivated and a form of patronage. In some countries, commercial and industrial conglomerates have established banks to ensure their access to subsidized credit. Lending limits that have been adopted to prevent risk concentration are often circumvented by borrowers who borrow through nominees.

In most developing countries financial institutions lack capital adequacy. They tend to be undercapitalized and in many cases stated capital is negative. As a result, the banks' potential for failure is greatly enhanced. Another serious problem involves the formal recognition of problem assets through classification, provisioning, write-off, and interest suspension. In many cases banks do not recognize problem assets, establish realistic provisions for potential losses, fully provide for actual losses, or suspend interest on non-performing assets. As a result, the balance sheet does not reflect the banks' actual condition and the income statement overstates profits.

In many developing countries, banks are subject to the same bankruptcy laws as normal corporations. Therefore, the bank supervisors lack the authority to close a bank, appoint a receiver, and liquidate or merge it in an appropriate fashion. Instead, the bank must go through a normal bankruptcy process, which may take years to complete. As a result, savers may not have access to their deposits. In addition, shareholders may retain an interest in their shares which prevents any attempt to recapitalize the institution or transfer ownership to the government or new investors. An additional problem is that permissible or prohibitive activities of banks are not adequately defined in a number of countries. As a result, banks may speculate in real estate or engage in activities that are clearly non-financial such as owning manufacturing firms.

Investor confidence in the operations of the capital market, as well as in the soundness of the various securities market institutions, is another critical aspect of prudential regulation. The extent of government supervision over capital market institutions varies widely among developing countries. In Asia, for example, the responsibility for capital market supervision often has become segmented among government bodies, whose roles are overlapping and in some cases conflicting. Often the result of this approach is that the focus of capital market regulation is vague and many times regulation is perceived as misdirected, uninformed and "bureaucratic". Another problem is that this duplication of government supervision has spread scarce regulatory skills over too many agen-

cies. Another concern is that often government authorities have been given only duties and powers to regulate and no agency is given duties and powers to promote the development of capital markets [7.].

Finally, to be effective prudential regulation must be backed by a political commitment to supervision and enforcement. The supervisory body must be given clear policy goals, and it must be independent. Too often in both developed and developing countries, supervisors are undercut by political interference. In developed countries, for example, the crisis of the savings and loan associations in the United States revealed a great deal of questionable interference. Regulators were allegedly told by the Administration or by lawmakers allied with Savings and Loans not to do their jobs and some bank examiners were hired away or scared off. In developing countries interference was blatant in the Philippines in the 1970s and early 1980s, when supervisors feared reprisals if they attempted to discipline bank managers [38.]. In some developing countries it is not unusual for the head of a ministry to place a phone call to a banker with instructions to extend a loan to a particular firm; similarly it is not atypical for an influential banker to use his influence to prevent effective enforcement by banking supervisors.

iii) Competition in financial markets

In most developing countries financial markets tend to be thin and fragmented with few institutions or instruments. In Sub-Saharan Africa, for example, most countries have only a few banks and parastatal financial institutions and in several countries the financial sector is dominated by a single institution. Aggressive competition between major banks is extremely rare. Government parastatals control practically all term debt and equity finance. The existing development finance institutions are nondepository institutions and therefore dependent on donor or government funds. With little competition, African banks have been slow to improve services and introduce new instruments. Commercial banks offer only a limited range of services, usually deposit-taking and short-term lending for primary export activities, import-substitution industries, some retail trade, and commercial agriculture. Liability instruments are short-term and banks do very little term transformation, leaving term lending to parastatals. [30.].

The lack of competition in financial markets of developing countries is primarily due to restrictions on the setting of interest rates, the entry of new institutions and the range of permissible activities. The main objective of restrictions on permissible activities is risk elimination to protect depositors. However, these restrictions also protect vested interests. For example, commercial banks object if savings banks are allowed to pay

interest on deposits unless the interest on such deposits is held below a market-clearing level; finance houses maintain that only they, and not the commercial banks or savings banks can organize long-term industrial finance; assurance companies insist that other institutions are incapable of organizing a portfolio that matches a set of actuarial liabilities. Each domestic institution insists that other domestic institutions be prevented from spreading the range of their activities, and foreign institutions be prevented from gaining a significant market share [29.].

The established banks tend to resist the entry of new banks, especially in the current situation where their ratio of nonperforming loans is high and their profitability held down by past mistakes that do not burden their new competitors. Since the political influence of established banks is considerable and they may receive strong support from labor unions, especially when banks are seriously overmanned, they may succeed in limiting new entry. To improve competition and efficiency, some smaller countries have opened their markets to foreign banks or have encouraged joint ventures between foreign and domestic institutions. The creation and maintenance of a competitive financial system is particularly difficult if the bank oligopoly consists of a few government-owned institutions. In this situation inter-bank competition may not be feasible unless these banks enjoy complete autonomy in their operations and do no longer have recourse to the government budget in the event of making losses (34.; 10).

2.3.3. Policy options for overcoming the financial sector crisis

i) Symptoms and causes of the crisis

Today in many developing countries and in some developed countries the crisis in the financial sector is of significant proportions. Even though this crisis does not involve uncontrollable runs and bank failures, the number of banks and other financial institutions that are insolvent is without precedent. In Latin America, the banks in almost all countries have been affected; in Chile the government was forced to assist all but one bank; in Argentina in 1980 depositors moved their holdings from domestic banks of which several had failed to state or foreign-owned banks; Bolivia tried to alleviate its crisis by lowering interest rates which contributed to inflation and capital flight; in Brazil, Colombia and Ecuador there have been serious problems with bank capitalization. In Asia the government in the Philippines acquired six of the private banks and had to restructure the two largest institutions which were government owned; in Korea, banks had substantial bad loans and had to be supported by government; in Thailand, several of the smaller financial institutions have recently been in trouble; in Bangladesh, the

non-performing loans in banks' portfolios are very large; in Malaysia in 1986 the central bank has provided liquidity to the financial system in order to stem runs on banks. In Africa, banks in Kenya, Madagascar, Ghana, Ivory Coast, Senegal and Liberia have had serious troubles. In the United States, apart from the crisis of the savings and loan associations, the failures of Penn Square and Continental Illinois Bank and the crisis in energy loans and agricultural finance have been widely reported. In Spain 60 out of 100 banks had to be restructured; and in Canada, two out of 14 banks failed [27.; 38.].

The crisis in the financial sector of many developing countries remains widely hidden and is hard to detect without inside information. As financial institutions have rolled over unpaid loans and have capitalized unpaid interest, their insolvency (the value of assets is smaller than liabilities) is not apparent from their accounts.

Accounting information may be kept confidential, and what is available is often unreliable. Where audits have been made using generally accepted accounting principles, nonperforming loans have proved to be substantial. In nearly all instances of government intervention, intermediaries' actual losses have proved to be far larger than reported. The number of bad and doubtful loans in the portfolios of many institutions is such that expected losses exceed the sum of capital, reserves, and loss provisions. These institutions are technically insolvent. In most cases banks are not illiquid (that is, they can still meet payment demands), but so many of their debtors are unable or unwilling to service their loans that the banks are making losses. The failure of some borrowers to service loans is common; even healthy banks expect to have some nonperforming loans. But losses large enough to impair the profitability and solvency of so many institutions in so many countries are unprecedented [38.].

The causes of the financial sector crisis are numerous, and it may be useful to distinguish between deficiencies in policy management (macroeconomic policy and government intervention) and deficiencies in the management of financial institutions. There is obviously a close link between the policy environment and the kind of decisions made by firms and financial institutions. Furthermore, there is a close link between the soundness of investment decisions made by firms and the soundness of the financial system to the extent that investments are financed by financial institutions.

With regard to deficiencies in policy management it may be recalled that many of the wrong decisions in the productive sectors were encouraged by ill-conceived macroeconomic policies in the 1970s and early 1980s. With the benefit of hindsight, the major errors included the use of exchange rate and other trade policies that overemphasized production for domestic markets; too optimistic expectations about the pace

at which the world economy would expand; the attempts to use expansionary macro-economic policies to maintain living standards and growth rates in the face of large terms-of-trade losses and sluggish international growth; the use of overvalued exchange rates to keep inflation rates down; and, of course, excessive and to some extent inefficient use of external borrowing. These policies encouraged a configuration of production capacity in many economies that could only be profitable if previous patterns of relative prices and growth rates of international demand could be restored. However, this did not happen. The world economy experienced a recession in 1981-82 and considerable financial distress was one inevitable consequence [34.; 27.]. These problems were compounded by the fiscal, interest and selective credit policies discussed above. Furthermore, deficiencies in banking regulation and supervision contributed to the problems of financial institutions.

It may be fair to say that a large number of mistakes made by financial institutions can be regarded as conventional banking mistakes rather than mistakes induced by policy intervention. For example, not only in the framework of selective credit policies but also outside that framework there was a concentration of loans to particular economic activities or clients. Some banks lost money by being overexposed in foreign currency liabilities. Others lacked good internal management procedures and were unable to resist the pressures to roll over credit facilities to large or influential borrowers when these borrowers first manifested an inability to repay credits [34.].

ii) Impact on savings mobilization, financial development and economic growth

The fact that most banks in developing countries are still liquid and seemingly do business as usual obscures the severe impact that the financial sector crisis has on savings mobilization, financial development, stabilisation policies, structural reforms and economic growth. One of the most negative consequences of the crisis is its effect on the allocation of financial resources for productive investment. Non-performing loans do not produce funds for the banks which can be used for new loans. New funds that become available to banks through new financial savings (deposits) are disproportionately allocated to non-performing debtors to prevent their bankruptcy, which would in turn lead to the failure of financial institutions. Thus potential borrowers perceive a scarcity of funds, which in turn has a depressing effect on investment and economic growth. Debtors borrow at interest rates above the rate of return on assets (distress borrowing) which is one of the reasons for the very high level of real interest rates observed in a number of countries. In fact, markets become perverse: higher interest rates lead to increased and not decreased demand for credit as debtors must borrow to pay

interest. And bankers make loans to impaired borrowers to stave off their own failure. Even viable firms suffer: they cannot borrow to expand their activities and interest rates are so high that these firms use funds generated by profits and depreciation not for investment but to repay outstanding loans [27.].

Also other aspects of financial development are affected. Most importantly, there is the danger that more and more banks will drift from insolvency toward illiquidity which would result in increased capital flight, a shift towards the holding of real assets and possibly bank runs. Furthermore, banks on the brink of collapse may be more innovative in developing short term survival strategies than in developing appropriate financial products that fit the changing needs of their customers.

Stabilization policies are influenced by the financial crisis because the weakness of firms and banks had made it difficult for many governments to tighten monetary or fiscal policy without making matters worse. This has delayed the fight against inflation and thereby affected future economic growth.

iii) Policy options

What are the possible cures to the crisis in the financial sector? In the cases where macroeconomic instability has been a major factor in generating the crisis, it can only be resolved in parallel with the implementation of stabilization and structural adjustment policies. But where financial institutions have been seriously decapitalized, stabilization policies will not be sufficient to end the financial sector crisis. In fact, stabilization measures such as devaluation and higher interest rates are likely to deepen the crises, particularly if combined with liberalization of both the real and financial sectors. For example, liberalization of the trading regime may cause changes in relative prices that could make yet more domestic firms uncompetitive and unable to service their loans. In some countries with high inflation rates the removal of interest rate controls has led to very high real interest rates which exacerbated the problem of illiquidity at the firm level. Nevertheless, countries cannot avoid the pains of adjustment as that would simply perpetuate the problems indefinitely [27.].

The first step in designing a cure is to persuade the authorities to address the problem. This is a difficult task because restructuring banks when the problem is widespread is costly and difficult. Furthermore, it is likely to prove politically embarrassing, and will force the authorities and the bankers to make very difficult decisions about the future of firms, many of which may be state enterprises. Moreover, explicit recognition of the problem, if not handled correctly, can affect the public's confidence in the banks, ac-

celerate capital flight and bank runs. As a result, many governments appear to think that costs exceed the gains of addressing the problem. However, the underlying policies and practices which in themselves are the cause of the financial crisis are a very important cause of slow economic growth in developing countries. Thus until the financial sector crisis is resolved slow growth will continue. Many countries may not act until faced by a crisis of such proportions that further delay is impossible. Those that decide to act will have to decide how to allocate the burden of past losses, determine which firms and financial institutions are viable and should be restructured, undertake the actual restructuring and recapitalization, and resolve the various issues that were responsible for the problems in the first place [27.].

The easiest solution to the problem would be the "growing-out" solution in which future economic growth will give enterprises and banks enough leeway to restructure their activities. The major advantage of this solution is that it distributes the costs of restructuring in a manner that is largely unaffected by political pressures. This does, however, not imply anything about the fairness or the equity of the outcome for salaried workers, shareholders and taxpayers. The recovery of profits that is needed to restore the financial soundness of both the productive and the financial sectors may impose a far higher burden on salaried workers than on shareholders. An alternative to the "growing-out" solution is the "inflating-out" solution. In many cases, accelerated inflation will be the unavoidable consequence of a substantially passive approach to the financial sector crisis that involves the occasional ad hoc injection of funds to paper over the more obvious manifestations of such crisis. While the inflationary approach can certainly write down the real value of the debts of the productive sector enterprises to manageable levels, it is scarcely a realistic way out of the problem. High rates of inflation cause many distortions and damage the performance of the financial sector. Consequently, the inflation route is unacceptable, the "growing-out" solution may not materialize and case-by-case strategies like the closing of non-viable firms, the restructuring of viable non-financial firms and the recapitalization of viable financial institutions are called for [34.; 27.].

In developed countries the orthodox approach to restructuring financial institutions is for the government to intervene in the recapitalization of the banks but leave the restructuring of the debtor firms to the market. Thus, banks are forced to collect as much of their debt as possible. If the banks fail in the process, they are merged, closed, or recapitalized. At the end of the process the health of the banking sector is restored and the good assets of bad debtors have been sold to other firms and the bad asset

written-off. In developing countries this approach has not been used because the ability of the private sector to absorb the good assets of bad debtors is limited. Furthermore, a widespread transfer of assets at low prices would lead to excessive wealth concentration if bought locally or loss of national control if sold to foreigners [27.].

So far, developing countries have addressed their financial sector crisis by interventions ranging from the closing of a few intermediaries with a small fraction of total assets, as in Malaysia, to the closing and replacement of nearly every bank, as in Guinea. During the next few years many more countries, especially those contemplating broader programs of structural reform, will face difficult choices concerning the restructuring of their domestic financial institutions and the reshaping of their financial systems. Governments need to consider that not all institutions are worth recapitalizing. Bailouts amount to a misallocation of scarce resources if the viability of the rescued financial institutions cannot be restored. Thus some institutions need to be closed or merged with healthier ones [32.; 38.].

3. Financial Development and the Efficiency of Financial Intermediation

3.1. Strengthening the technical management of financial institutions becomes major task

The preceding discussion of macroeconomic policy, selective credit policy, competition policy, prudential banking regulation and bank supervision has demonstrated that the efficiency of financial intermediaries is strongly affected by government policies and interventions. At the same time the discussion has highlighted the impact of poor bank management on the efficiency of financial intermediation and the need for strengthening the technical management of banks.

It appears that well managed banks may survive the crisis while banks that continue bad management will contribute to a deepening of the crisis. Therefore, apart from getting macroeconomic policies right and ensuring adequate banking regulation and supervision, the problem of poor bank management needs to be addressed urgently. Among the major criteria of good bank management are competence, leadership, compliance with regulations, ability to react to changes in the business environment, and the ability to control the application of bank policies. Poor bank management according to these criteria may be due to technical mismanagement, cosmetic management, desperate management and fraud [14.].

Looking at the present management problems of financial institutions in developing countries it seems that technical mismanagement is the major problem. It is manifested in overextension, poor lending policies, lack of internal controls and poor planning. Overextension arises from (a) lending that is out of proportion in relation to the bank's capital; (b) diversifying activities to sectors with which the bank is not familiar, and (c) mismatching of assets and liabilities by granting long-term fixed rate loans funded from variable rate short-term deposits (this has been done by financial institutions ranging from US savings and loans institutions, to Columbian financieras, and to housing finance institutions in countries such as Brazil, Chile, and Jamaica). Also the lack of internal controls is a widespread phenomenon which can take the form of (a) inappropriate credit review procedures; (b) insufficient information systems, that prevent an early detection of arrears; and (c) inadequate internal audits. When technical mismanagement leads to substantial losses banks frequently resort to cosmetic management. Cosmetic management entails hiding past and current losses through inadequate provisions and rescheduling of loans in order to buy time and remain in control. When losses become too large to be concealed managers may resort to desperate management such as lending to high-risk projects at very high interest rates and speculating in stock and real estate markets. The next stage in this process is in many cases fraud. During this process the bank becomes insolvent and collapse at a later stage cannot be excluded [32.; 14.].

In many financial institutions accountability is a major problem of technical management because organizational structures are complicated and responsibilities poorly defined. In developed countries many banks improve accountability by making use of independent profit centers. Branches and other units are managed as a profit center which are judged and rewarded on the basis of the profits they generate. Credit ceilings are used to limit the authority of branch managers and to prevent undue loan concentration on the books of a branch. Large loans require approval at higher levels. Internal prices permit the efficient transfer of resources without undermining the profit incentive of each branch. Even though the profit center approach to management is quite appealing it may have general limitations in developing countries because it is complicated, and requires experience to work well [38.]. Furthermore, this approach makes it difficult to include social and development goals in the operation of financial institutions.

Successful banks in developed countries and banks in a number of larger developing countries usually have excellent in-house training programs, where top managers train and assess future managers. Banks in developing countries could learn from the experience of these banks in devising training programs for their own staff. Countries such

as Guinea and Korea have established joint venture banks with foreign commercial banks in order to transfer skills more rapidly [38.].

Managerial vision of where the business of the bank should be in the future and the ability to foster a corporate culture which reflects that vision is a major ingredient of successful management. What banks in developing countries need most is a new corporate culture for their retail business. Managers have traditionally identified a market, offered what was allowed by law or demanded by custom and awaited the customer. However, in order to respond to the challenges of a changing economic and social environment in developing countries, managers have to change their mindset and be more retailer than banker. They need to identify markets, determine the variety of products customers demand, and invest in innovations to control costs. In their efforts of responding to the challenges of a changing environment, managers need to give particular attention to developing innovative approaches for servicing the rural poor and microenterprises. This is, of course, easier to say than to do.

How little banks in many developing countries have so far succeeded in responding to their customers' needs, is, for example, discussed in the Economic Report on Africa for 1987 [3.]. The report notes that commercial banks are essentially urban institutions and therefore reluctant to expand their network appropriately to the bulk of households and businesses in the non-urban areas. They have difficulties in rural savings mobilization or meeting rural credit needs because of their rigid procedures, and centralized decision-making. Most branches of large commercial banks in smaller towns and villages are merely smaller versions of city banks, and are therefore culturally incompatible with the areas they serve. They are unable to attune themselves to their rural customers and have commercial criteria for their operations that rural customers cannot meet.

The following discussion will demonstrate that in a number of countries innovative approaches to servicing small bank clients are in progress. Thus there are some bright spots in the otherwise bleak picture of banks' performance and it remains to be seen whether improved technical management and a change in the corporate culture can contribute to the spread of innovative approaches.

3.2. Innovative approaches to servicing small bank customers in progress

3.2.1. Risks and costs of servicing small customers

Tailoring financial products and services to the needs of small bank customers and over-

coming the high risks and costs of lending to this group is a major managerial challenge to financial institutions in developing countries. The slow progress banks have made in tackling the problem of high risks and costs and the resulting reluctance of lending to small borrowers are a major reason on the part of governments for maintaining selective credit policies.

The transaction costs of servicing small bank customers consist of the costs of mobilizing deposits and the costs of lending. Handling deposits causes costs in terms of labour, capital and materials. Costs of lending arise with loan processing, loan disbursement, monitoring and loan recovery. In addition, lenders incur risk costs in connection with loan default. Also depositors and borrowers incur costs. Depositors incur search and information costs to select a depository institution and to perform account transactions. Borrowers bear the costs of negotiating, obtaining and repaying loans. Both for depositors and borrowers the opportunity cost of time is likely to be a significant component of their transaction costs, in particular in developing countries [13.]. Therefore conveniently located bank branches and a minimum of red tape in dealing with their banks are essential for small savers and borrowers.

Spreads between borrowing and lending rates of banks reflect mainly the costs of financial intermediation, the profit of the intermediary and reserve requirements. The average spread between lending rates and the cost of funds in developed countries is between 2 and 3 percentage points. Spreads in noninflationary developing countries, are of a similar magnitude, while spreads in inflationary countries can be more than 10 per cent [38.]

In most developing countries costs have been driven up by rural branching requirements imposed by governments and directed lending to sectors with high default rates. In some instances there may also be a large element of monopolistic profits in banking spreads. Another factor contributing to relatively high spreads have been the substantial costs of information gathering because of weak infrastructures. Because of their limited ability to identify risk and monitor behavior, lenders tend to require collateral and to ration credit to the most creditworthy borrowers rather than to charge higher interest rates on riskier loans. Small borrowers with little collateral are likely to be the most affected by credit rationing. There is empirical evidence that high transaction costs of lending in combination with interest controls contribute to risk aversion and liquidity preference in the commercial banking system of developing countries. In Africa, for example, commercial banks instead of exploring new lending opportunities tend to deploy excess liquid assets in treasury bills and government bonds where risks are marginal [2.].

3.2.2. *Innovative approaches by commercial banks*

The costs of servicing small bank customers can be reduced by innovative approaches which include information processing, group lending, the establishment of specialized units within banks like the Money Shops in the Philippines and the establishment of banks specialized in servicing small customers such as the Rural Banks in Ghana and the Grameen Bank in Bangladesh.

In developed countries cost-reducing financial innovations were sparked by rapid technological progress in information processing. Some of the new technology is transferable to developing countries. For example, microcomputers have been adopted in many developing countries, but given the shortage of trained personnel and the high cost of imported components and software, it is an open question whether the adoption of new computer technology will reduce costs significantly in the near future [30.].

Banks in developing countries have been actively involved in group lending on the assumption that transaction costs could be reduced by lending to small groups rather than to a multitude of individual small borrowers. A further assumption was that joint liability, peer pressure and easier access to information about borrowers would reduce the risk of default. It was expected that lending to small farmers and entrepreneurs could be turned into a more profitable business. Two recent studies [Huppi and Feder (1988); Adams and Vogel (1986)] have come to the conclusion that in practice the success in group lending in developing countries has been limited. Further details, in particular results of the study by Huppi and Feder, will be summarized below.

It has become evident that group lending reduces the administrative costs as long as lenders do not have to bear the expenses related to group formation. These expenses can, however, be significantly reduced over time, as start up costs related to group formation disappear. In general, group borrowers' transaction costs compare favorably with costs as they would have accrued to individual small borrowers.

Usually the loan is negotiated and repaid by a representative of the group. Although almost all group lending programs rely on some form of joint liability, loan delinquency rates have not always been reduced compared to individual loans. Nevertheless, experience seems to suggest that joint liability can positively influence repayment if the groups constitute homogeneous borrowing groups which are jointly liable and assume themselves some managerial and supervisory responsibilities. Reimbursement in small, regular installments adapted to the living and earning conditions of the borrowers also seem to have a positive effect on loan repayments. A common bond other than credit,

such as mandatory deposits which will only be reimbursed to the group upon full repayment of all loans can further enhance loan repayment.

Practice has shown that the most effective and least costly way of enforcing joint liability is to deny access to future credit to all group members in case of default by the group or any of its members. As experiences in several countries have proved, this threat only works as long as the lender is in a position to provide access to favorable and timely credit services in the future. The danger of not being able to guarantee access to future services evidently increases the more a lender depends on continuous infusions of external funds and the less lending is self-sustainable through deposit mobilization.

With few exceptions, group lending programs as they currently exist have neglected to explore and build up relationships other than credit between the lender and the group or within the group itself. Including savings generation as a program component can help develop crucial skills such as financial responsibility through regular deposits. It can also enhance better repayment performance because each member's deposit can be viewed as an implicit collateral in case of default by any group member. Ways to develop borrower groups into self-financing rural credit organizations through savings mobilization should be explored. Developments along this path could lead to a natural extension of successful group lending schemes into credit cooperatives.

Another innovative approach that may deserve further experimentation is the establishment of units within a bank that specialize in servicing small customers such as the Money Shops of the Philippine Commercial and Industrial Bank (PCIB). The Money Shops are a mechanism through which PCIB can make small loans to market stall holders at a reasonable profit. Money Shops are located either within, or on the fringe of, private or public markets and meet the short-term, credit needs of commercial customers. Facilities are extraordinarily simple, often consisting of nothing more than a wooden stall large enough to accommodate a small number of employees. Money Shops usually function in fairly large urban markets, as it is felt that there must be a larger number of businesses in the immediate market site to justify the placement of a Money Shop. Depositors receive relatively attractive interest payments and borrowers have been highly disciplined so that only approximately two percent of all loans have not been recoverable. While the loans are very small, the Money Shops have proven important for the PCIB. Although they account for less than 10 percent of all PCIB branch deposits, these deposits have in recent years accounted for one fifth of the increase in deposits [5.].

3.2.3. *Banks specialized in servicing small customers*

Another innovative approach that has worked well in a number of countries is the establishment of separate financial intermediaries that specialize in servicing small savers and borrowers. The Rural Banks of Ghana and the Grameen Banks in Bangladesh are examples of this approach.

The first Rural Banks in Ghana were created in the mid 1970s. There are now more than one hundred independent, community-run financial institutions (unit banks), whose mandate is to provide deposit facilities and loans for small farmers, cottage industries and commerces. Rural Banks are located in areas not serviced by other financial institutions. The growth in locally mobilized deposits has been extremely rapid. This demonstrates that rural people will hold financial assets if they have confidence in the bank, find its location convenient and have ready access to their savings. The Rural Banks managed to catalize local initiative, based lending on the borrower's reputation rather than on collateral requirements, and kept administrative costs low [5.].

The Grameen Bank in Bangladesh is a well documented case study. The bank started as a non-governmental organisation (NGO) working in co-ordination with Bangladesh Bank and became an independent bank in 1983. Before eligible borrowers receive their loans, they go through an intensive training of one to two weeks on the philosophy of the Grameen Bank, its rules and procedures. The time it takes for a loan to be approved is approximately one month. The recipients need only submit a simple production plan showing how the economic activity will yield loan repayments. The loan guarantee mechanism used in place of collateral is the formation of groups of five people with similar economic and social status. Close and competent loan supervision is an important feature underlying the success of Grameen Bank. The Grameen Bank maintains obligatory group savings. Each member saves a minimum amount every week to develop a savings habit. This money goes into group funds. Individual members can borrow from the group fund for consumption and investment purposes with the consent of the group. By the end of 1988 there were 500 Grameen Branches in Bangladesh serving 500,000 borrowers in 10,000 villages. The reasons for the success of the Grameen Bank are manifold. Groups are formed among like-minded people of similar economic circumstances who assist the bank in loan collection. Borrowers are not required to face the desks of bank officers and are dealt with in their own familiar surroundings. The sense of responsibility and repayment morale of borrowers is strengthened by tying lending to savings mobilization [5.].

Can Grameen be replicated outside Bangladesh? In countries that are similar to

Bangladesh in terms of socioeconomic conditions, there should not be any difficulty in organizing Grameen-type credit programmes and Grameen-type institutions. In Asia, Malaysia experiments with Grameen-type credit for the poor in Selangor State. The project went into operation in 1986 and was the first serious replication attempt of Grameen outside Bangladesh. The experience of this project has been excellent and it is being expanded to cover more states in Malaysia. Furthermore, Nepal is involved in a Small Farmers' Development Programme which has many similarities with Grameen. In Africa, Malawi, Burkina Faso, Mali, Egypt are getting ready to launch Grameen look-alike projects [39.].

Group lending, Money Shops in the Philippines, Rural Banks in Ghana and Grameen-type banks are among the most frequently discussed examples of innovative approaches to servicing small borrowers and savers. They are, however, only the tip of the iceberg of financial innovations for small bank customers underway in Africa, Asia and Latin America. Further innovations are documented, for example, in the Report of the Third International Symposium on the Mobilization of Personal Savings in Developing Countries [United Nations (1986)] and a collection of studies on financial innovations for the rural poor in Asia [33.].

The great variety of innovative approaches that have been developed with a view to providing better banking services for small customers are a driving force behind financial development. They have a decisive effect on the performance of the financial system and may exert a significant positive influence on the performance of the real sector in the long-term [28.].

In spite of the hopeful indication that formal financial institutions are on their way to improve services for small savers and borrowers, the informal financial institutions like relatives, moneylenders, and savings and credit associations will continue to play an important role in servicing small customers in developing countries. A discussion of the structure, performance and potential of the informal financial sector would go beyond the scope of this paper. However, the interested reader may refer to the surveys prepared by Bouman (1977), Holst (1985), Chandavarkar (1986) and Ghate (1988).

Table 1

DEVELOPING COUNTRIES AND TERRITORIES: TRENDS IN SAVINGS AND GROSS INVESTMENT, 1976-1984*
(Percentage, based on values in current prices)

	Year	Ratio to GDP of:				
		Gross domestic savings	Net factor income	Gross national savings	External savings ^b	Gross domestic investment
All developing countries and territories	1976-78	26.8	-1.1	25.7	-0.4	25.3
	1979-81	26.0	-1.2	24.8	-0.3	24.5
	1982-84	23.5	-2.8	20.7	2.3	23.0
of which:						
Latin America and the Caribbean	1976-78	24.5	-1.8	22.6	2.7	25.3
	1979-81	22.5	-2.7	19.8	3.6	23.4
	1982-84	21.4	-5.7	15.7	2.7	18.4
East Asia and the Pacific	1976-78	25.4	-1.3	24.0	2.1	26.1
	1979-81	26.8	-2.1	24.7	4.5	29.2
	1982-84	24.5	-2.8	21.7	5.4	27.1
Sub-Saharan Africa	1976-78	17.9	-2.7	15.2	6.6	21.8
	1979-81	13.6	-3.1	10.5	9.4	19.9
	1982-84	12.7	-4.2	8.5	7.9	16.4
	15.1					

UNCTAD secretariat calculations based on World Bank data.

Note: Calculations are based on a sample of countries for which data were available for the periods under consideration.

a Data for 1984 are provisional

b Defined as net imports of goods and non-factor services less net income from abroad.

Source: United Nations Conference on Trade and Development (UNCTAD) Report submitted to the Conference at its seventh session (Geneva, 9-31 July 1987): "Revitalizing Development, Growth, and International Trade: Assessment and Policy Options", United Nations, New York, 1987.

Table 2

DEVELOPING COUNTRIES AND TERRITORIES: TRENDS IN SAVINGS AND GROSS INVESTMENT, 1985-1987*
(Percentage, based on values in current prices)

	Year	Ratio to GDP of:	
		Gross national savings	Gross domestic investment
Latin America and the Caribbean	1985	16.9	17.5
	1986	15.2	17.4
	1987	16.2	18.2
East Asia and the Pacific	1985	29.3	31.0
	1986	31.3	29.8
	1987	33.7	29.9
Sub-Saharan Africa	1985	9.0	12.4
	1986	7.2	14.5
	1987	9.4	16.4

Source: World Bank, World Development Report 1989, Table A.7, p. 149

Note: * Data for 1987 are preliminary

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Abstract

Developing countries have given the mobilization of personal savings and efficient allocation of credit through financial sector development a major role in their strategy to promote economic growth in the absence of sufficient inflows of foreign capital. This paper discusses the extent to which financial sector development could be enhanced by appropriate macroeconomic policies, and illustrates the complexity of government interventions such as selective credit policy and banking regulations. The paper pays particular attention to the sequencing of policy reforms and the role governments may play in solving the problem of widespread bank insolvencies. In addition to reforms of macroeconomic policies and government interventions, the paper addresses reforms on the microeconomic level that may improve the efficiency of financial intermediation and focuses on the management of financial institutions and innovative approaches to servicing small bank customers.

EPARGNE PRIVEE ET DEVELOPPEMENT DU SECTEUR FINANCIER: POLITIQUES ET PERSPECTIVES

RESUME

Les pays en développement ont donné à la mobilisation de l'épargne privée et à l'allocation efficiente du crédit par le développement du secteur financier un rôle majeur dans leur stratégie de promotion de la croissance économique en l'absence d'influx suffisants de capitaux étrangers. Cette étude discute la mesure dans laquelle le développement du secteur financier pourrait être renforcé par des politiques macroéconomiques appropriées, et illustre la complexité des interventions étatiques telles que politiques sélectives de crédit et réglementation bancaire. Elle prête une attention particulière à la séquence et l'ordonnancement des réformes politiques et au rôle que les gouvernements peuvent jouer lorsque les cas d'insolvabilité bancaire se répandent. Outre les réformes de politiques macroéconomiques et les interventions de l'État, l'étude traite des réformes au niveau microéconomique susceptibles d'améliorer l'efficacité de l'intermédiation financière et envisage en particulier la gestion des institutions financières ainsi que des formules nouvelles pour faire face aux besoins de petits clients bancaires.

