

FINANCE
for GROWTH



Finance For Growth: Policy Choices in a Volatile World

Gerard Caprio

World Bank

June 12, 2001



Rethinking government's role in finance

- Governments need to do
 - More and better in some areas
 - Less in others
- And to recognize how finance without frontiers is changing what they can do, and can achieve
- Because finance matters for growth and poverty reduction, and we have the evidence



What's new?

- Strength of relationship between finance and growth
- Importance of legal and information base
- Importance of private sector monitoring for development and stability
- The cost of state ownership
- The benefits of foreign banking
- How technology is leading to finance without frontiers



What it does not say

- Not to 'leave finance to the market.'
- Not to privatize banks all at once
- Not just open up to entry to foreign financial firms and leave it to them.
- Not just open to capital flows without robust regulatory system.



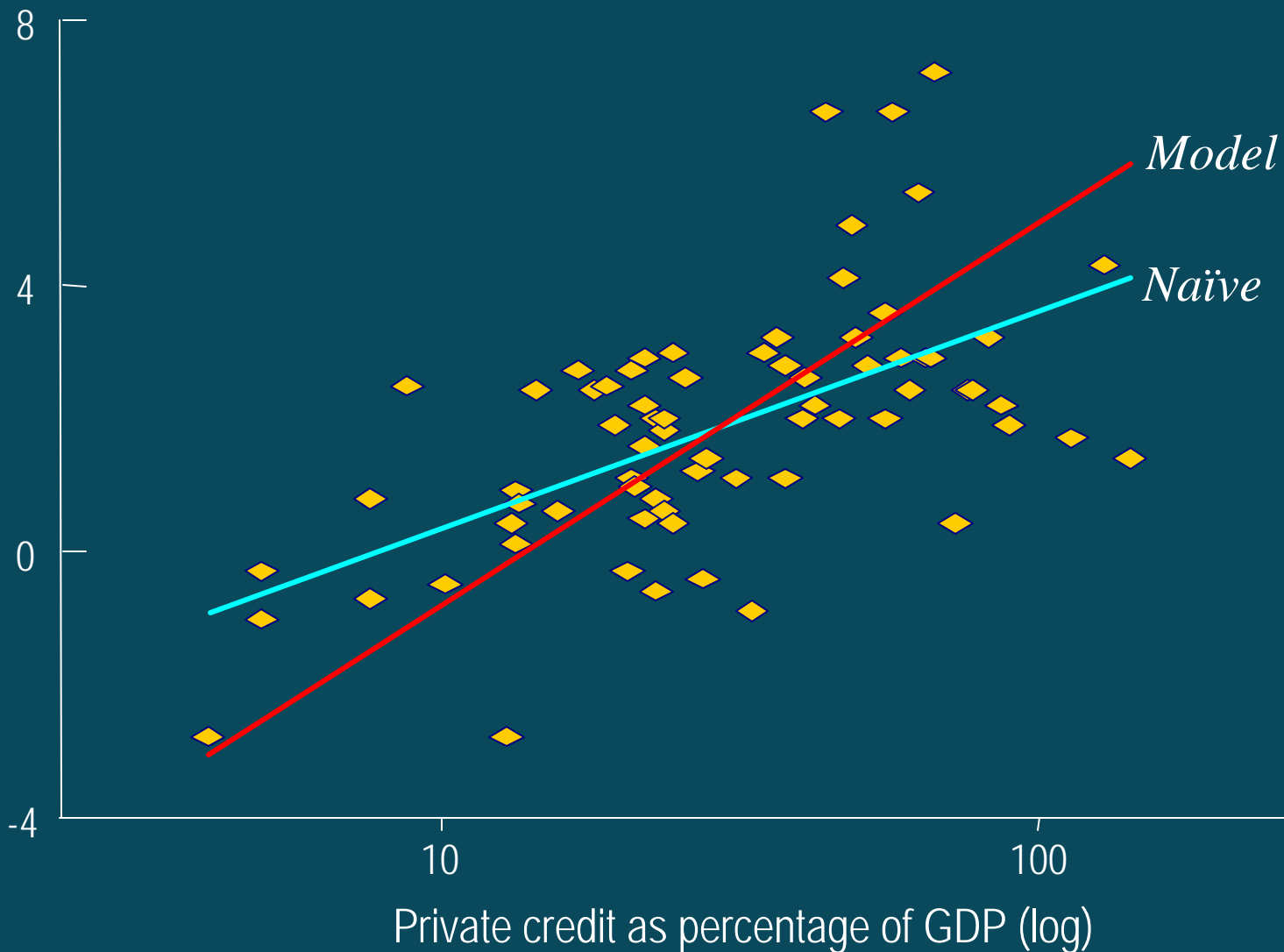
What government needs to do

- Build the legal and information foundations
- Finance is about changing money today for money tomorrow; if information about borrowers is scarce or unreliable, no credit is the result
- If contracts are not respected and enforced, no credit is the result.
- Evidence is that there are huge returns to improving the information base and the legal environment



Naiïve and modeled impact of financial development on growth

Average GDP growth 1960-95, percent per annum





But beware!

- Bigger is not necessarily better
- Focus on effectiveness – not size
- Beware of:
 - too rapid credit growth...
 - forcing the pace with state-owned banks



What to do

- Better to build a solid infrastructure
 - ...than to aim for a particular structure
- Improving the information infrastructure and technology can lower intermediation costs –
 - outweighing potential drawbacks (lost privacy and credit discrimination)



What it needs to do better

- Harness market incentives
- Encourage, not discourage, better monitoring of banks.
 - Cautions on deposit insurance
- Use incentives to motivate better bank supervision



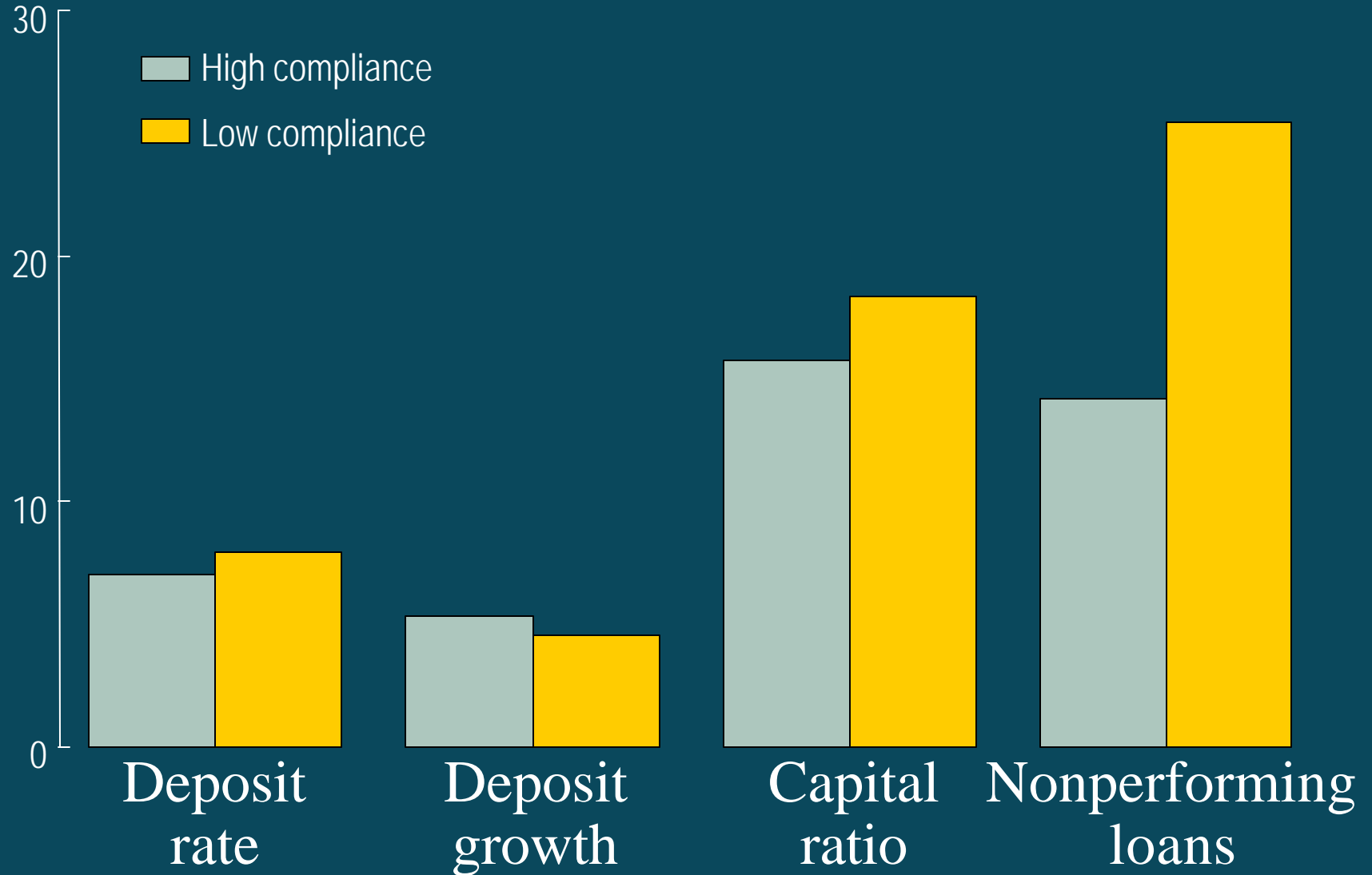
Towards better banking

- Focus more on owners and markets to monitor banks
 - subordinated debt as a potentially useful tool
- Focus on incentives for supervisors
- Limit safety nets and other subsidies to risk taking.



Subordinated debt in Argentina, 1996-99

Percent





Evidence on deposit insurance

- With explicit insurance and weak institutions:
 - odds of a crisis are *higher*
 - monitoring by markets *less*
 - financial sector development *less*
- So risk-taking grows, and taxpayers likely know it!



When adopting deposit insurance

- Focus on transparency, accountability, credibility
- Keep ceilings low
- Involve the private sector – management, mutual liability
- Do not ‘fund’ it in a weak institutional environment



What it needs to do less of

- Less state ownership
- Less attempting to replace markets during crises
 - If temporary bank ownership necessary, get out and get repaid as soon as possible
 - Use the market to pick winners and losers.



Bureaucrats as bankers: the evidence

Greater state ownership leads to:

- less financial sector development, lower growth, lower productivity
- higher interest rate spreads, less private credit, less nonbank financial development
- greater concentration of credit
- some tendency towards more crises, weaker monitoring



Privatizing banks

- Enforce regulations for all banks to reveal state banks' weaknesses; publish audits.
- Prepare regulatory/information environment, and banks themselves
- Avoid rapid privatization (Mexico) and excessive delays (Czech Republic).



Use markets to deliver the news

- Selection of winners and losers is what markets do best
- Rather than have governments pick banks, inject funds to banks that
 - secure matching private funds
 - restrict dividends/payouts for private parties
 - adhere to stiff transparency requirements

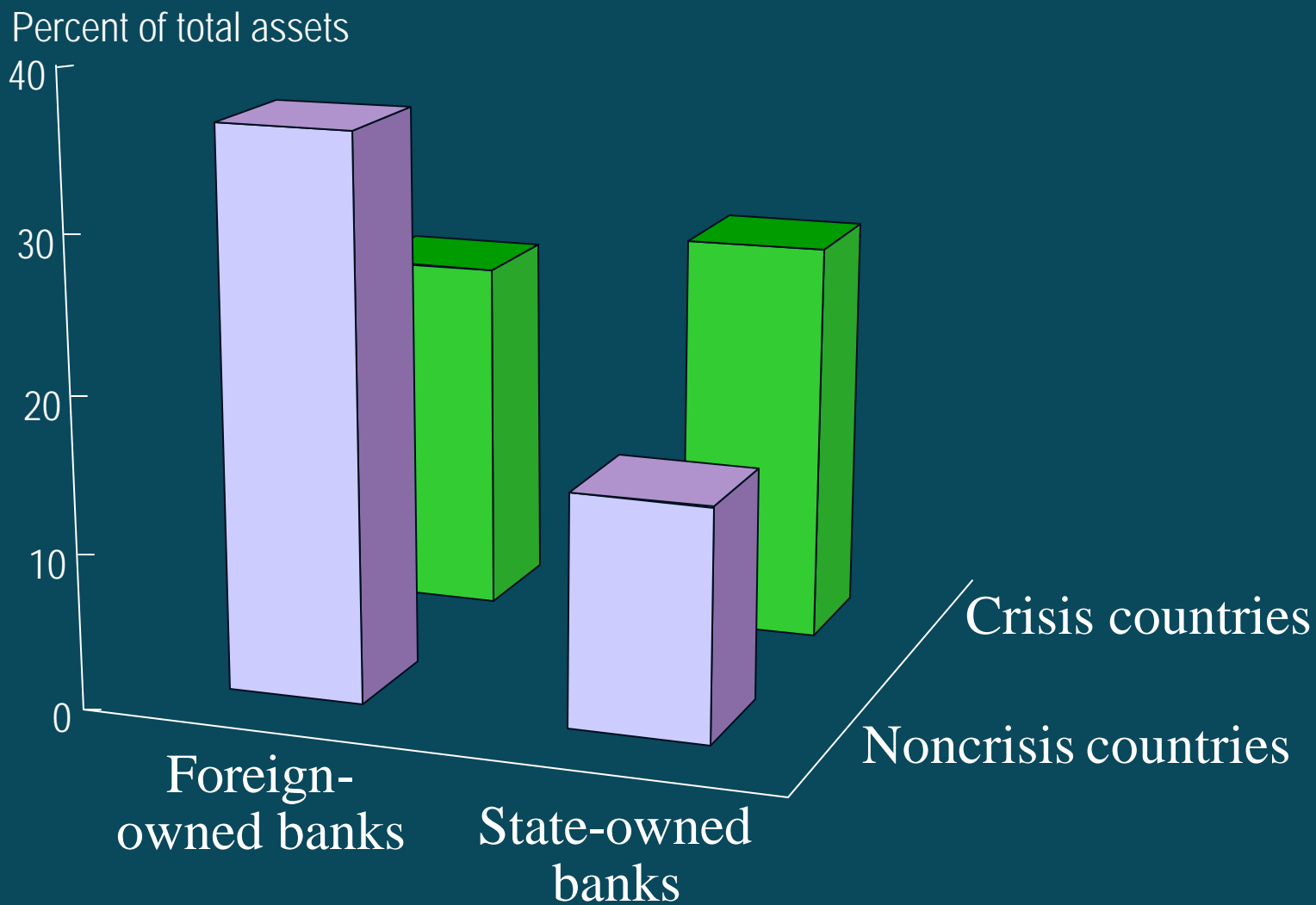


Finance without frontiers

- What services to buy, and what to build at home
 - What matters for growth is access to financial services, not who supplies them
- Most emerging markets are too small to afford a closed financial system with exclusively 'domestic' banks and other intermediaries
- Foreign banks will protect domestic taxpayers!



Comparing the share of foreign and state ownership in crisis and non-crisis countries





Summary

- Return to basics: help improve information environment, improve contract enforcement
- Work with markets, and harness market forces (for supervisors too)
- Open up to foreign financial services...while there is still a choice.