Chapter I
Mobilizing domestic resources for development

The Monterrey Consensus of the International Conference on Financing for Development (United Nations, 2002a) places the mobilization of domestic financial resources for development at the centre of the pursuit of economic growth, poverty eradication and sustainable development. It points to the need for "the necessary internal conditions for mobilizing domestic savings (and) sustaining adequate levels of productive investment" and stresses the importance of fostering a "dynamic and well-functioning business sector". At the same time, it recognizes that the "appropriate role of government in market-oriented economies will vary from country to country" and calls for an effective system for mobilizing public resources and for investments in basic economic and social infrastructure, as well as active labour-market policies.

The present chapter analyses these concerns. The first section examines the historical relationships among savings, investment and economic growth in the developing countries over the past three decades. The subsequent section addresses "investment climate" and focuses on some key economic, legal and labour-market requirements. The third section examines the role of the financial sector and the institutions that are required to guarantee the adequate provision of financial services for investment, access by the poor and small enterprises to such services, and the prudential regulation and supervision required to guarantee the stability of the financial system.

Savings, investment and growth

A long-standing view of the macroeconomic dynamics of the development process was that a poor country had to raise its savings rate (that is to say, to change from a "12 per cent saver" to a "20 per cent saver") and transform the increased savings into productive investment in order to achieve an economic "take-off" (see, for example, Lewis, 1954). Emphasis was usually placed on increasing investment in industrial sectors, but public investment in such physical infrastructure as power, transportation systems and health and education facilities was also seen as critical.

Raising the savings rate was formerly seen as necessary to achieve economic "take-off"

Subsequently, technological progress was introduced as a determinant of long-term growth, with some analysts arguing that its role was dominant, or even exclusive (Easterly and Levine, 2001). With the advent of so-called endogeneous growth models, however, investment was again recognized as a critical factor for long-term growth. Overall, theories of economic growth have been refined, modified and expanded over the years and now encompass a wide range of factors, ranging from the purely economic to social and cultural considerations. Nevertheless, most explanations include, to varying degrees and in various combinations, three underlying economic factors, namely, investment, innovation and improvements in productivity, with the three being interrelated in a variety of ways.

More recent analysis emphasized investment, innovations and productivity improvements

The relationships among savings, investment and growth have been found to be more complex than initially imagined, but it remains generally accepted that increasing savings and ensuring that they are directed to productive investment are central to accelerating economic growth. These objectives should therefore be central concerns of national policymakers.

Yet raising savings and directing them to productive investment are still crucial

Overall trends in developing regions, 1970-2002

There was a strong correlation among savings, investment, economic growth and the reduction of poverty over the period 1970-2002, especially in Asia ...

In all developing regions, savings, investment, economic growth and the reduction of poverty have been positively correlated over the past three decades (see figure I.1). In most of Asia, savings and investment rates have increased, the region has grown increasingly rapidly and the incidence of poverty has declined considerably. Although there have been improvements in all these dimensions in all the major subregions of Asia, there remain considerable differences in the absolute levels: rates of savings, investment and growth in South Asia in 1990-2002, for example, were less than those in China in the 1970s, with China having improved further in the meantime. East Asia falls between these two positions.

... while in sub-Saharan Africa declining rates of saving, investment and growth increased poverty. In the Middle East and Northern Africa, boosts to savings from surges in oil prices did not improve long-run growth

Sub-Saharan Africa' situation is opposite to that of Asia. For the region as a whole, the rates of savings, investment and growth had declined between the 1970s and the 1980s and declined further in the period 1990-2002. The Middle East and Northern Africa constitute a unique case in that domestic savings had exceeded 35 per cent of gross domestic product (GDP) as a result of the two surges in oil prices in the 1970s, but fell towards 20 per cent after 1980. The boost to savings in the 1970s did not translate into either investment or improved growth: investment has remained between 20 and 25 per cent of GDP throughout the three decades and growth of per capita GDP has been volatile but generally low, and was even negative in the 1980s

In Latin America, rates of saving and investment were lower than in Asia. Overall growth was volatile and the incidence of poverty hardly changed over 30 years

In Latin America, savings and investment rates have been lower than those in Asia, with little apparent regional trend over time. The 1970s had been characterized by domestic savings and investment rates of about 20 per cent of GDP and growth of 4-5 per cent. Thereafter, savings and investment rates fell to 17 and 19 per cent of GDP, respectively, and average growth fell to 1 per cent. More recently, savings have dropped further but investment and growth have recovered somewhat. Overall, growth has been volatile and the incidence of poverty has remained relatively unchanged for 30 years.

Savings and investment have recovered in the transition economies after the initial transformational recession

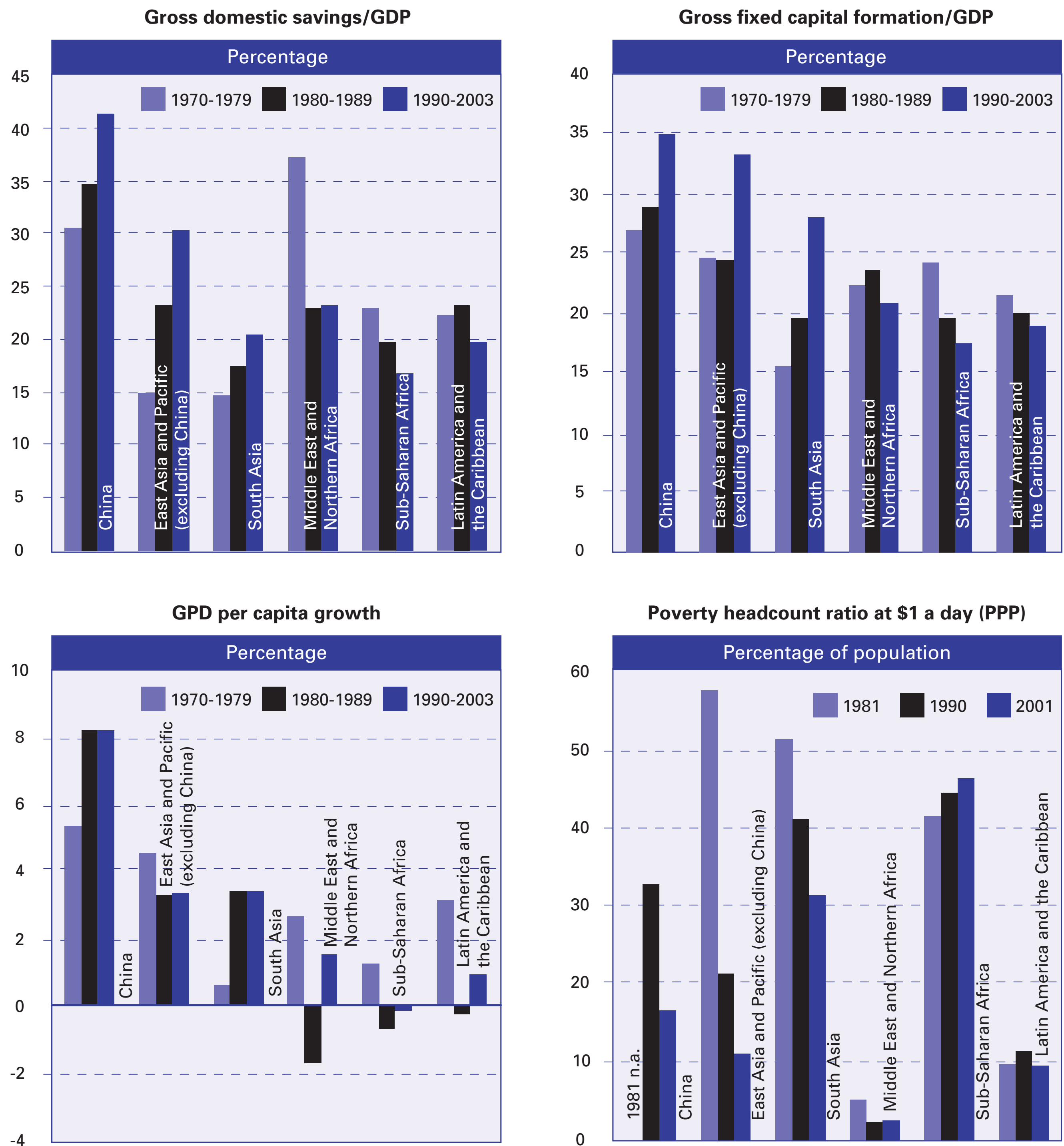
The economies in transition represent a unique case in that savings and investment rates had been artificially high under their centrally planned system, but then fell precipitously, reviving in Eastern Europe and the Baltic States in the early 1990s and in the Russian Federation and the other members of the Commonwealth of Independent States (CIS) after the Russian financial crisis of 1998. Since that time, savings and investment rates in the region, together with growth, have recovered.

Savings and growth

The Asian countries saw the sharpest rise in their savings rates—and the fastest growth rates

In the 1970s, the highest regional rate of savings had been in the Middle East and Northern Africa (see figure I.1). Revenues associated with the first oil shock accounted for a large part of savings at that time and the savings rate subsequently declined as oil prices fell. Among the remaining regions, the savings rate in the 1970s was low in East Asia and the Pacific but rose subsequently. The savings rate in South Asia had been the lowest of any region in 1970 but increased continuously thereafter while sub-Saharan Africa moved in the opposite situation: from over 20 per cent in the 1970s, its savings rate fell towards 15 per cent in the 1990s. Latin America is an intermediate case: it had maintained, and even marginally increased, its domestic savings rate of over 20 per cent from the 1970s to the 1980s, but the rate fell below 20 per cent in the 1990s.

Figure I.1.
Savings, investment, growth and poverty reduction, 1970-2003



Source: World Bank, *World Development Indicators*. Washington, D.C.: World Bank.

In China and other take-off countries, savings rates increases from 20 per cent to 34 per cent between 1970 and 1992-1994. They had lower initial incomes per head than many less successful countries

In China and nine other developing countries identified as achieving an economic take-off, savings rates are estimated to have risen from 20 per cent in 1970-1972 to 34 per cent in 1992-1994 (Loayza and others, 1998).[1] In 1970, the take-off countries had lower incomes per head than many less successful countries but they were able to embark on a virtuous circle of higher savings, higher investment and faster growth. It was also found that savings in low-saving countries exhibited higher volatility than in countries with higher rates of saving. Savings and investment rates were lowest among the least developed countries and the heavily indebted poor countries (HIPC) for much of the period.

Domestic saving and growth were positively correlated, particularly in Asia

Domestic saving and growth in output per head were positively correlated in all developing regions over the period 1970-2003, although the strength of the correlation varied across regions and time periods (see figure I.2). African countries have had varied experiences, eliminating the possibility of regional generalizations. The few countries with higher savings rates grew faster, while low savings rates were associated with low or negative growth. For Asian countries, however, there has been a consistently strong positive correlation between the two variables over time. For Latin American countries, there had been almost no correlation between savings and growth in the 1970s, but a positive relationship (that is to say, an upward slope) increasingly developed in the 1980s and 1990s. Moreover, by the 1990s, the correlation was approaching that in Asia although, in absolute terms, savings rates and growth rates were less. Within Latin America, such countries as Chile and Costa Rica, with consistently good growth rates, were able to achieve higher savings rates.

The direction of causality is as follows: growth causes savings, rather than the reverse

It is frequently assumed that increases in savings rates are necessary to achieve higher growth but empirical evidence suggests that the causality runs in the opposite direction. Empirical studies—typically based on cross-country analyses—find in general that savings usually lag growth and that it is therefore economic growth that gives rise to increased national saving, rather than the reverse (Carrol and Weil, 1993; Attanasio, Picci and Scorcu, 1997; and Gavin, Hausman and Talvi, 1997). That growth causes saving can also be seen from the fact that, while episodes of economic boom positively affect saving

Box I.1

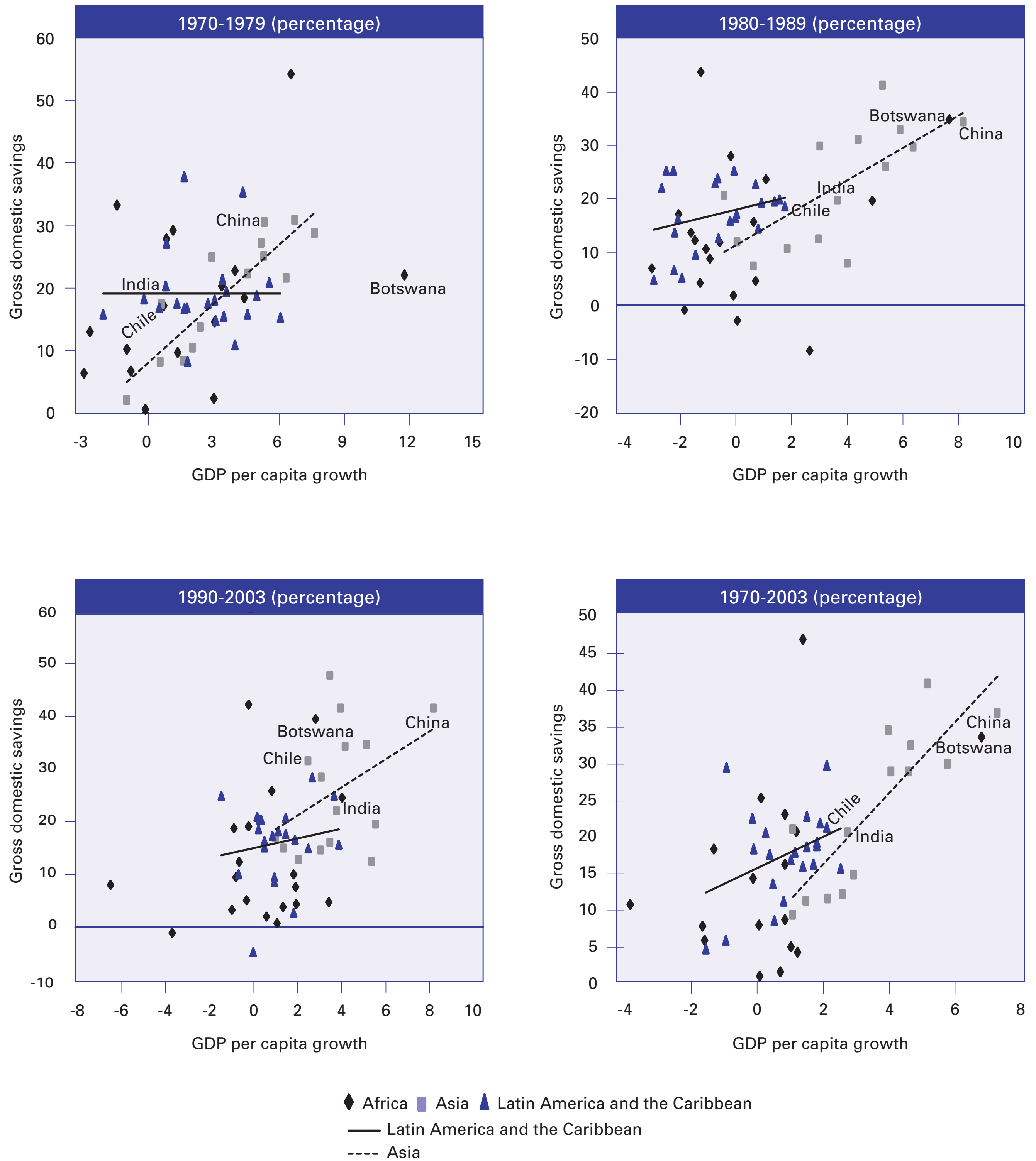
Raising household savings in China

The increase in savings in China was accompanied by a shift in its composition. The share of public and corporate saving in total savings fell from 59.1 per cent in 1978 to 19.6 per cent in 1995, while the share of household saving increased from 12.8 to 51.2 per cent over the same period of time. However, the latter may have been caused at least partially by an increase in private sector activity and, in particular, by the growing role of small firms, whose savings are often recorded as those of households in official statistics.

Financial deepening in China was an important factor in promoting private savings because it increased private households' propensity to keep a part of their income as savings in the financial system. A further determinant has been the monetization of income as employees of State-owned enterprises increasingly received their salary in monetary terms rather than in the form of goods, allowing them to keep greater amounts of money as savings. This positive effect on savings was further increased by policies in support of household income, in some cases combined with mandatory saving.

Finally, during the reform period, policies aimed at limiting population growth led to a reduction in the ratio of people under 15 years of age to the working population from 0.96 shortly before the start of the reform period to 0.41 at the end of the 1990s. This expanded the proportion of potential savers (those of working age) in the population, while the accompanying decline in the role of the family increased individuals' propensity to save. It has been argued that this demographic factor was a major determinant of the increase in savings in China (Modigliani and Cao, 2004).

Figure I.2.
Savings and growth, 1970-1979, 1980-1989, 1990-2003 and 1970-2003



Source: World Bank, *World Development Indicators*. Washington, D.C.: World Bank.

rates and such an impact persists over time, saving booms do not translate into sustained growth (Rodrik, 2000a). Such countries or areas as Chile, Hong Kong Special Administrative Region (SAR) of China, the Republic of Korea and Singapore improved their investment climate and succeeded, often through government interventions, in boosting investment and raising overall growth before experiencing a boom in the savings rate (Rodrik, 2000a).

Policy should therefore concentrate on the broad determinants of growth

The finding that growth normally precedes an increase in savings suggests that government policies and measures to improve growth should not be limited to boosting the savings rate and ensuring that the financial sector facilitates the productive use of saving. Governments also have to consider a larger number of determinants of growth, including improving infrastructure, enhancing human capital through education and training, facilitating and contributing to innovative production processes through research and development, and ensuring macroeconomic stability and a healthy investment climate.

Saving and investment

Most investment in developing countries is financed by domestic sources

The bulk of capital formation in most countries in all developing regions is financed by domestic savings so that, in most cases, gross fixed capital formation is roughly equal to gross domestic savings (see figure I.3). Not surprisingly, therefore, gross fixed capital formation as a share of GDP exhibits regional trends that are broadly similar to those of savings, with the ratio in East Asia and the Pacific having risen over time to over 33 per cent of GDP and in South Asia to 28 per cent, while that in other regions converged in a range of between 17 and 22 per cent (see figure I.1). The most marked difference between savings and investment occurred, as noted above, in the Middle East and Northern African region in the 1970s, when the region's surge in oil revenues had enabled it to become an exporter of capital.

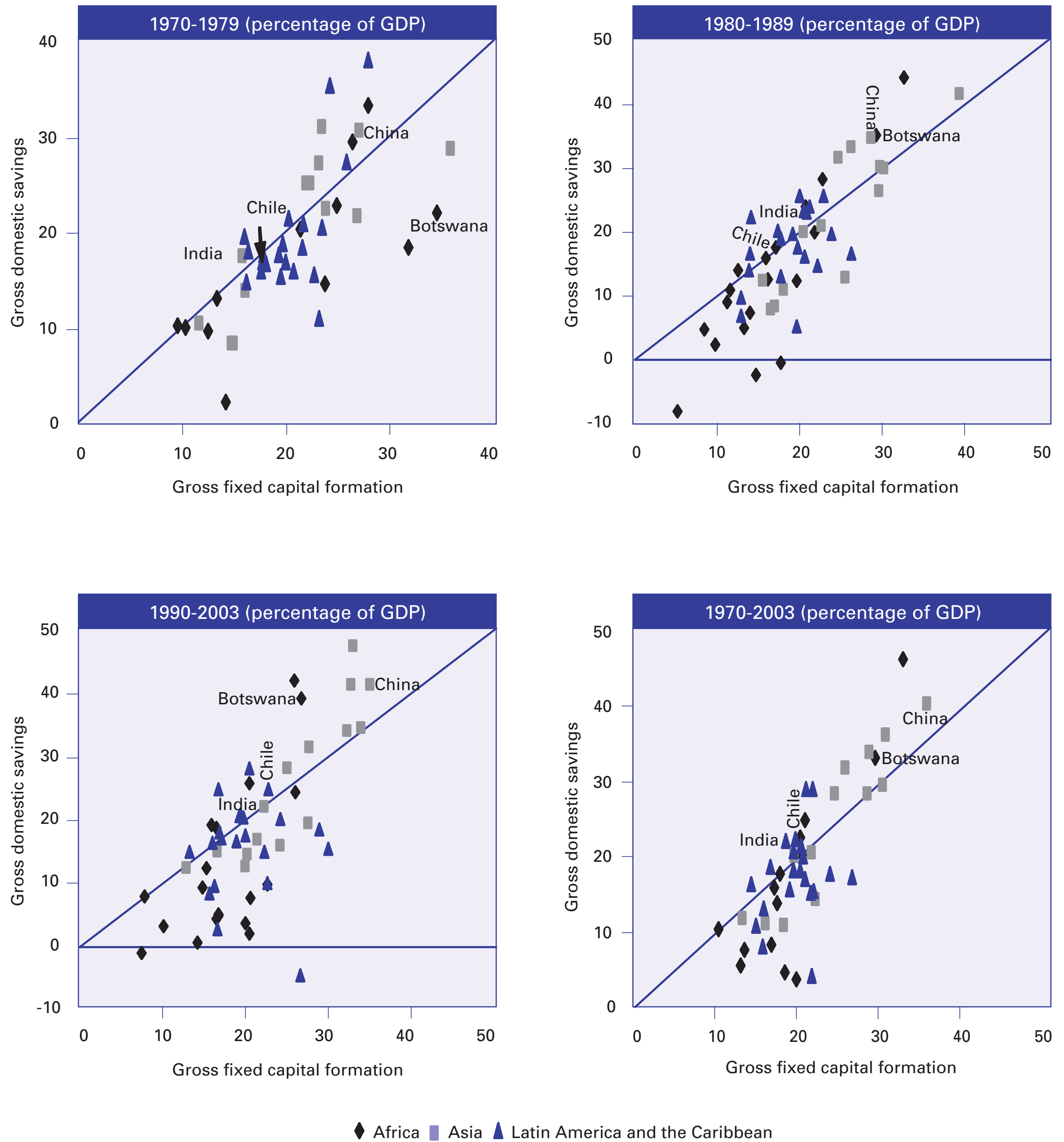
Some countries, however, such as Singapore in Asia, and African and Latin American countries, tried to use foreign savings to boost investment, but the success of this strategy varied across regions

In the 1970s, Asian countries—possibly with the exception of Singapore and a few others that opted for attracting foreign capital—had relied mostly on internal resources. Several African and Latin American countries, on the other hand, relied more extensively on foreign sources. Some African countries had low savings rates during the period and were able to achieve higher rates of gross fixed capital formation only because of inflows of foreign capital, often in the form of aid. During the 1980s, flows of foreign capital to Latin America and Africa dried up and these regions had to rely more heavily on domestic resources. In the meantime, Asian countries had started to attract significant amounts of foreign resources. The process continued and strengthened in the 1990s, up to the Asian crisis of 1997.

The different sectoral compositions of investment in India and China can explain some of the differences in their investment rates

In the two largest developing countries, India and China, the smaller share of investment in output in the former compared with the latter was partly a reflection of the different sectoral sources of growth: India concentrated on services while China concentrated on manufacturing, which is more capital-intensive. In India, the sectoral incremental capital output ratio declined in all service subsectors over time, while the ratios for the manufacturing sector increased and surpassed those in the service sector (Virmani, 2004a, 2004b). This means that additional investment in the services sector was more efficient in stimulating additional output than it would have been in the manufacturing sector.

Figure I.3.
Savings and investment, 1970-1979, 1980-1989, 1990-2003 and 1970-2003



Source: World Bank, *World Development Indicators*. Washington, D.C.: World Bank.

The role of foreign savings

It is not just the volume of foreign savings that matters, but often the new technology and skills that it introduces

Foreign savings, even in economies where they are relatively large, are almost always less than domestic savings (as can be deduced from figure I.1), but they may make a disproportionately greater contribution to economic growth. In large economies, such as China and India, foreign savings are likely to be small in relation to domestic savings but they can have broader benefits. In the case of foreign direct investment (FDI), for example, they may be accompanied by the introduction of new technology and skills and can make a critical contribution to growth (see chap. III). In many smaller economies, especially those caught in a low-income savings trap, foreign savings can be the spur needed to set them on a course of sustained growth.

Foreign savings can help a country move out of a low-income savings trap, as the experience of Botswana illustrates

Botswana represents a success story in Africa that reveals how foreign savings can be attracted so as to make possible long-term national development. As Botswana was one of the poorest countries in Africa in the 1960s, its leaders had decided to attract investment from high-class companies operating in Africa to search and develop its mineral wealth. Foreign capital brought together by mining companies financed the exploration and the initial development of the mining sector (see figure I.3). These companies had been attracted by the secure investment climate and, in the case of diamonds, spent 12 years exploring before the rich deposits were revealed. The profitable diamond business then became self-financing. Botswana subsequently enjoyed high investment rates, sustained by strong savings rates, over an extended period (see figures I.3). More recently, high HIV/AIDS prevalence has depressed economic growth despite relatively strong investment rates.

There is no clear evidence that foreign capital flows "crowd out" domestic savings: their impact varies across regions and over time

In circumstances where capital is mobile and countries have access to foreign savings, there is the question whether the level of domestic savings is affected by foreign capital flows. Some empirical studies find a degree of "crowding out" of domestic savings by foreign savings (see Schmidt-Hebbel, Servén and Solimano, 1996)—which also means that a part of foreign savings is consumed rather than invested—but the impact of foreign saving on domestic saving varies greatly across regions and over time. In Latin America, the evidence suggests that temporary (particularly short-term) capital flows are consumed, while more permanent foreign capital flows are invested (Titelman and Uthoff, 1998). In Asia, foreign savings have complemented domestic savings, contributing to the overall increase in investment. Similarly, in Eastern Europe and the Baltic States, there has not been a crowding out: rather, both foreign and domestic savings have been used to increase investment in many sectors.

In Latin America, foreign capital inflows during the 1980s had been low, but they recovered in the 1990s. However, the fact that domestic savings did not rise commensurately raises questions about the sustainability of growth

In Latin America, the picture has changed over time. In the 1970s, domestic savings had remained at relatively high levels on average, without much visible substitution. In the 1980s, the region experienced both low domestic savings and a low inflow of foreign savings. However, in the 1990s, the inflow of foreign capital increased, but domestic savings did not do so commensurately. The result has been a greater dependence on external savings as a source of investment, with any slackening of capital inflows having a damaging effect on investment and growth. In general, it had been thought that a recovery of investment in the region that was financed by external savings rates in excess of 3 per cent of GDP was not sustainable because of the vulnerability of such a pattern of accumulation to shifts in the international economic environment. This experience suggests that achieving high and stable economic growth rates requires domestic savings and investment to be raised at the same time (Economic Commission for Latin America and the Caribbean, 2002, pp. 51-52).

One view is that much of the difference between Latin American and Asia can be explained by the composition of their respective foreign capital inflows: FDI formed a higher proportion of foreign inflows in Asia than in Latin America. This view is supported by the fact that, among the Latin American countries, Chile has received proportionally more FDI and there has not been the crowding out of domestic saving that occurred in the other countries in the region. Others have argued that the differences in behaviour are more the result of secular patterns and that such patterns do not depend on the composition of foreign savings but rather on other longer-term variables.

Foreign direct investment was a much higher proportion of foreign inflows into Asia than into Latin America

Investment and growth

The evidence suggests that there is a virtuous circle between higher investment and higher growth. In the case of Asian countries, there was a strong relationship between gross fixed capital formation and per capita growth in all decades from the 1970s to the present (see figure I.4). In Latin America, investment levels also followed growth patterns: high investment levels during the 1970s, a sharp decline during the “lost decade” of the 1980s and some recovery in the 1990s. In Africa, economic performance had been poor but there was a return to positive growth in the 1990s, even though rates of investment were low.

There is a virtuous circle between higher investment and higher growth

Regarding causality, a distinction should be made between the short and the long term. In the short term, investment depends on the expected rate of growth, capacity utilization and the liquidity constraints faced by firms. For these reasons, growth may lead investment over the business cycle (although a recession may have long-term effects if it causes a major decline in investment). In the long run, it is generally believed that capital investment is an important source of growth. Particularly, it is unlikely that a higher rate of growth will be sustainable without an increase in investment. This suggests a virtuous circle between growth and investment.

Growth may lead investment over the business cycle, but in the long term investment is essential to sustaining growth although ...

Nevertheless, the evidence also suggests that investment rates alone do not fully account for economic progress: other factors, in particular the quality of human capital and technology, are involved in achieving sustained growth and some analysts argue that technological progress is the main source of growth. One view is that increased growth raises the utilization of existing resources and thereby raises productivity, giving rise to another virtuous circle (Kaldor, 1978; Ocampo, 2005).

... investment rates alone do not fully account for growth

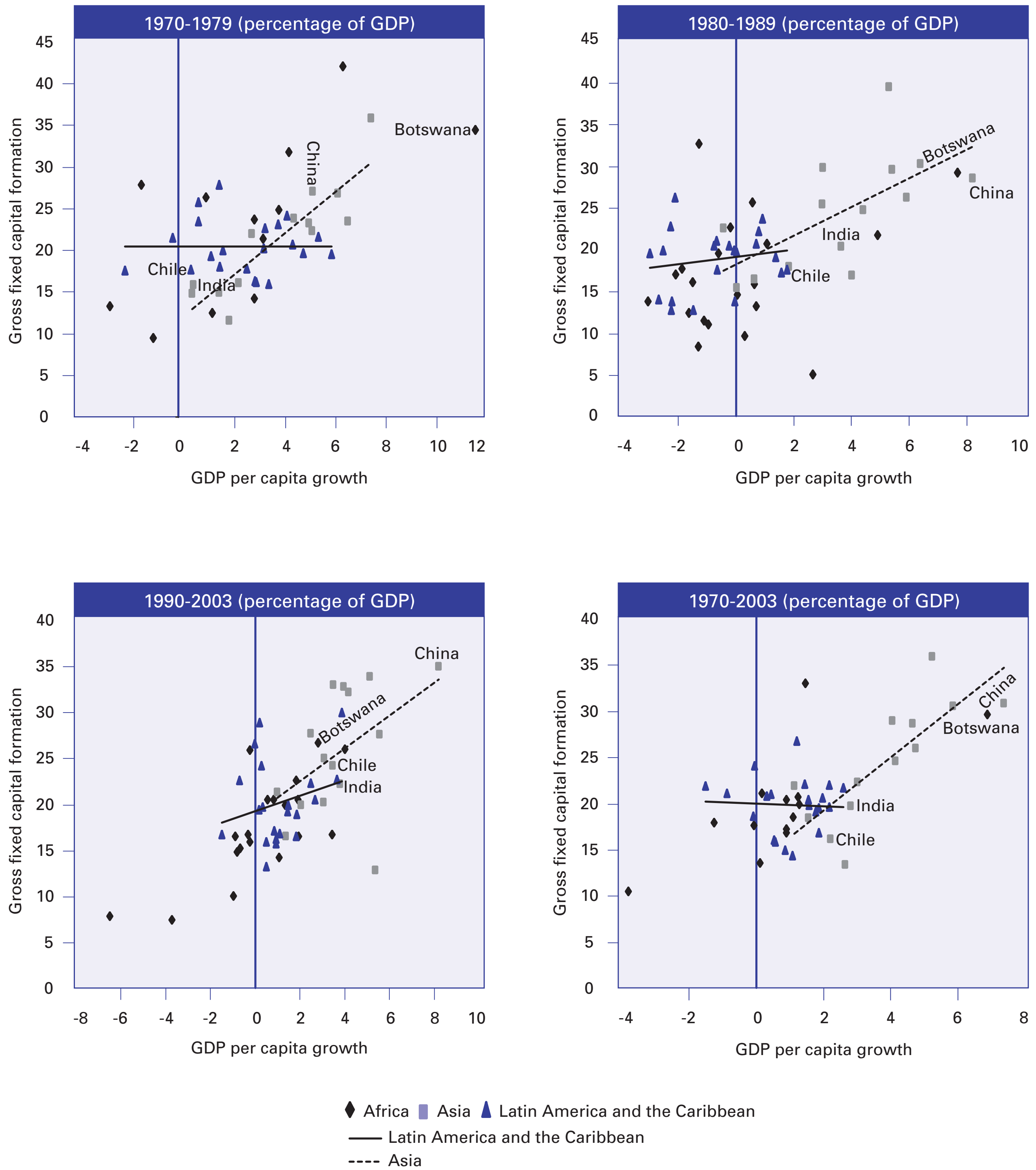
For example, among the regions, the South-East Asian “miracle” appears to have been more a result of capital accumulation than of productivity growth (see table I.1).[2] For China, the data suggest a break between the 1970s and 1980s which probably reflects the movement towards a more market-based system undertaken by the country in 1978. China illustrates how investment can lead to growth and the more efficient use of capital equipment, resulting in higher rates of growth of productivity.

The contribution to growth not accounted for by capital and human inputs varies across regions

Low investment rates explain Africa’s overall poor growth record, but poor investment productivity was also a factor. In Latin America, productivity had been a major factor affecting growth during the 1960s and 1970s but, as the investment rate declined in the 1980s, productivity fell sharply and had a negative impact on growth. In the 1990s, productivity growth again became positive (though lower than in the 1960s and 1970s). As in other cases, the causality is not clear: as indicated above, productivity growth might have been a consequence of improved economic growth (and the negative productivity performance of the 1980s the result of low growth during the debt crisis) rather than a cause of it.

Low productivity often accompanies low investment rates

Figure I.4.
Investment and growth, 1970-1979, 1980-1989, 1990-2003 and 1970-2003



Source: World Bank, *World Development Indicators*. Washington, D.C.: World Bank.

Table I.1.
Contribution of physical capital, human capital and productivity to the growth of output per worker, world and developing regions, 1961-2000

Percentage				
Region and number of countries	Growth of output per worker	Contribution of		
		Physical capital	Eduction	Factor productivity
World (84)				
1961-2000	2.3	1.0	0.3	0.9
China (1)				
1961-1970	0.9	0.0	0.3	0.5
1971-1980	2.8	1.6	1.4	0.7
1981-1990	6.8	2.1	1.4	4.2
1991-2000	8.8	3.2	0.3	5.1
1961-2000	4.8	1.7	0.4	2.6
East Asia less China (7)				
1961-1970	3.7	1.7	0.4	1.5
1971-1980	4.3	2.7	0.6	0.9
1981-1990	4.4	2.4	0.6	1.3
1991-2000	3.4	2.3	0.5	0.5
1961-2000	3.9	2.3	0.5	1.0
South Asia (4)				
1961-1970	2.2	1.2	0.3	0.7
1971-1980	0.7	0.6	0.3	-0.2
1981-1990	3.7	1.0	0.4	2.2
1991-2000	2.8	1.2	0.4	1.2
1961-2000	2.3	1.0	0.3	1.0
Africa (19)				
1961-1970	2.8	0.7	0.2	1.9
1971-1980	1.0	1.3	0.1	-0.3
1981-1990	-1.1	-0.1	0.4	-1.4
1991-2000	-0.2	-0.1	0.4	-0.5
1961-2000	0.6	0.5	0.3	-0.1
Latin America (22)				
1961-1970	2.8	0.8	0.3	1.6
1971-1980	2.7	1.2	0.3	1.1
1981-1990	-1.8	0.0	0.5	-2.3
1991-2000	0.9	0.2	0.3	0.4
1961-2000	1.1	0.6	0.4	0.2

Source: Barry Bosworth and Susan M. Collins, *The Empirics of Growth: An Update* (Washington, D.C., The Brookings Institution, 2003).

It is difficult to separate the effects on growth of physical and human capital and technological progress

Overall, there are numerous interactions between physical and human capital and technological progress; growth is the result of the joint accumulation of all three, with the specific linkages varying from case to case and over time. Moreover, the separation of physical capital accumulation, human capital accumulation and technological progress is artificial since there are strong interrelationships and complementarities among them. Physical capital and innovation are inseparable, as most technological innovation is embodied in new machines and equipment. Moreover, if all firms benefit from technological progress and the latter is driven by capital accumulation, the social return on capital is much higher than its private return.[3] At the same time, physical capital and skill formation are complementary, as new technologically advanced equipment requires a labour force with adequate skills and education. Furthermore, the reallocation of labour among industries as investment takes place may also raise productivity, making it difficult to separate the contributions of labour productivity and physical capital.

Fostering a favourable investment climate

A favourable investment climate will encourage domestic savings and investment and also attract foreign inflows

Encouraging private investment requires both a favourable environment for such investment and financial institutions that can mobilize and direct financial resources to the persons and entities that can be expected to earn the greatest return commensurate with the risk. Many of the factors that create a favourable investment climate also inspire confidence in savers, so that investment and savings should both increase with an improvement in investment conditions. Similarly, the factors that encourage domestic investment are also likely to be conducive to foreign investment. At the same time, however, efforts to improve the investment climate should take into account their impact on overall development and related national goals, such as ensuring adequate economic and social protection for all members of society, including those in the labour force.

The Monterrey Consensus outlines some of the essential components of an enabling domestic environment

The Monterrey Consensus (para. 10) stresses that an “enabling domestic environment is vital for mobilizing domestic resources, increasing productivity, reducing capital flight, encouraging the private sector, and attracting and making effective use of international investment and assistance”. It outlines the essential components of this enabling environment, including good governance, appropriate policy and regulatory frameworks, sound macroeconomic policies, transparency, adequate infrastructure and a developed financial sector. Certain institutions are crucial, especially effective legal systems, sound political institutions and well-functioning State bureaucracies.

It is difficult, though, to quantify a “favourable investment climate”

The importance now attached to developing a favourable investment climate is reflected in the numerous efforts to quantify its major components. There are, however, limits to the usefulness of measures of the quality of institutions and governance. In the first instance, as the experience of both developed and developing countries shows, there is no unique set of effective institutions for successful development; even in the recent past, there have been countries that achieved sound economic growth and a sustained reduction in poverty without conforming to the currently widely prescribed norms for governance, and institutional development and their links to national competitiveness. Second, there are methodological weaknesses in many such indicators (Herman, 2004). Finally, these indicators are likely to be subject to the bias of the organization undertaking the measurement (Lall, 2001).

National development strategies

A national development strategy can reduce uncertainty and help create a favourable investment climate

Surveys by the World Bank (2005a) of more than 26,000 firms in 53 developing countries found that overall policy uncertainty was perceived as the most important negative aspect of a country's investment climate. A national development strategy in which a country's main objectives—including its response to the Millennium Development Goals and other internationally agreed targets—and policy orientations are made explicit can reduce uncertainty and thereby contribute to the creation of a favourable investment climate. The formulation of such a strategy assists in setting priorities and deciding on an appropriate sequence for government actions. The process of formulating a strategy itself provides an opportunity for consultations with business, labour and consumers, enhancing the chances of convergence regarding socio-economic objectives, production sector strategies and policy measures.

An essential part of this strategy should be the actions to improve the country's physical infrastructure

A central element of a national development strategy should be the identification of proposed government actions to improve the country's physical infrastructure. Infrastructure is an important determinant of firms' profitability, since it affects their costs of production. Limitations in physical infrastructure—especially power, telecommunications and transport—are a major obstacle for the activities of enterprises in developing countries. Concretely addressing such bottlenecks is the ultimate solution but identifying such proposed government actions beforehand should reduce the uncertainty about intentions, facilitating private sector planning and thereby stimulating investment.

Production sector strategies can help the expansion of existing businesses or the development of new businesses

Production sector strategies, including those addressing agricultural and agro-industrial development, can provide similar support to the sustained expansion of existing businesses and to the willingness to enter new lines of business. Market-led growth or business activities may surge spontaneously in a particular branch of industry, agriculture or services. It is partly the task of the government to create conditions for the widening of such impulses and to bring about a sustained economic expansion. Policymakers, in interaction with the private sector, have an important role in identifying and encouraging the development of new sectors and activities in which a country, or a region within a country, may possess a potential comparative advantage. This requires the provision of quality infrastructure, education and training and policies to strengthen technological research and development and encourage innovation and learning in areas that have proved promising. In successful countries, export promotion has also played a key role in underpinning economic growth (see chap. II).

Production sector networks can enhance the diffusion and impact of technical and organizational change, and so should be encouraged and strengthened

There is also a need to look closely at the development of complementarities and networks, such as production sector clusters, that enhance the diffusion and impact of technical and organizational change (Ocampo, 2005). All these should aim to strengthen entrepreneurship and develop competitive firms in dynamic sectors that would generate economy-wide benefits and provide an impetus to growth and development. However, there is no single configuration of such production sector strategies for developing countries: the requisite policies need to vary in accordance with, inter alia, the economy's size and stage of economic development.

Macroeconomic stability

Macroeconomic instability is a major deterrent to investment

The surveys by the World Bank referred to above found that macroeconomic instability is the second most important negative aspect of a country's investment climate. Macroeconomic stability comprises not only nominal or financial stability but also real stability in output and employment.

Macroeconomic stability comprises not only nominal or financial stability but also real stability in output and employment

Macroeconomic stability refers, first of all, to an economic environment characterized by sustainable fiscal accounts, moderate inflation, low interest rates and, importantly, low volatility of interest rates, of the exchange rate and, increasingly, of asset prices (stocks, real estate, etc.). The inefficiencies resulting from distortions and excessive volatility in these prices are likely to reduce the rate of sustainable growth and therefore have a dampening effect on investment; but macroeconomic stability also refers to a low volatility of growth and employment and its determinants, such as low interest rates and competitive exchange rates. In fact, *real* macroeconomic instability may have a larger negative influence on private investment than that exerted by a moderate rate of inflation. The importance of real macroeconomic stability has been demonstrated in Latin America, where volatility in macroeconomic variables has adversely affected private investment over the years (Economic Commission for Latin America and the Caribbean, 2004b).

Policymakers should now pay attention to "new fundamentals" such as the strength of the banking system

Improving the investment climate also requires that attention be given to an array of "new fundamentals", such as the strength of the banking system; the quality of bank supervision; the emergence of asset price bubbles; the exchange-rate exposure of the financial sector, the non-financial business sector and the government; distortions in the economy that cause inefficiency; the adequacy of the legal and financial infrastructure; and the use to which financial inflows have been put (Wachtel, 1999, pp. 315-316). In sum, the overall conduct of economic policy that provides the confidence necessary to raise savings and investment requires not only price stability and sound fiscal policies, but also policies that smooth the business cycle, maintain competitive exchange rates and ensure that external and internal sovereign debt portfolios, domestic financial systems and private sector balance sheets are all sound.

The legal and regulatory environment

Laws and regulations evolve over time to serve the public interest and so there is no ideal set

The purpose of laws and regulations is to safeguard the public interest. Laws and regulations in the industrialized countries have evolved with changing social, political and cultural conditions. As a result, they tend to vary among countries; for example, certain aspects of the legal and regulatory environment relating to businesses in European countries differ from those in Japan and the United States of America. There is no single or simple configuration of laws and regulations that can be termed ideal.

They can be inimical to business by imposing unnecessary costs, increasing uncertainty and risks and erecting barriers to entry

Laws and regulations sometimes fail to meet their intended social objectives and, at the same time, harm the business environment by imposing unnecessary costs, increasing uncertainty and risks and erecting barriers to competition. There is therefore scope in many countries to improve the investment climate by reforming certain aspects of the regulatory and legal environment without compromising broader social goals. The ease with which such reforms can be implemented will vary among countries in line with their historical experience, their culture and their political institutions. In identifying priorities, there are three key areas where the legal and regulatory framework can have a strong impact on the business environment.

A first area relates to opening and closing a business. The World Bank suggests that the bureaucratic requirements with respect to starting a business in many countries are excessive and time-consuming. Latin America and sub-Saharan Africa are the regions in which it takes the most time to start a business. Nevertheless, improvements are being made in developing countries in all regions, as well as in many transition economies; notable examples are Argentina, Jordan, Morocco, Nepal and Sri Lanka (World Bank, 2005a).

The time required to open a new business is declining in many developing countries

The ability to close a business can be as important as opening a business because it may avert freezing usable assets in unproductive activities. At present, laws and regulations in a number of developing countries restrict the ability of enterprises to restructure or shut down. As part of their reforms in this area, a number of countries have improved their bankruptcy laws, an important aspect of which is the need to safeguard productive assets in the event of bankruptcy.

Bankruptcy laws are also being revised to safeguard the productive assets in the event of bankruptcy

A second critical aspect of the legal and regulatory environment relates to property rights. In many developing countries, a large part of land property is not formally registered. Property titling can improve land values and access to credit (since land and capital may be used as collateral to obtain bank loans), especially for small enterprises and the informal sector. It also provides security for owners by reducing the risk of the laying of a claim to their land by someone else. However, property titling programmes need to be accompanied by a number of complementary measures if they are to be effective in achieving these objectives. Most importantly, there need to be accompanying improvements in the cost and efficiency of property registry so that property does not continue to be bought and sold informally. Among developing countries, some East Asian countries have developed an efficient property registration system. Complementary improvements are also required in collateral laws (so that it is not too expensive to mortgage property) and in the legal system (so that banks can seize collateral, if warranted, when a debtor defaults).

Property needs to be registered efficiently and improvement made so that mortgaging a property is easier and collateral can be seized in the event of default

Third, the effective enforcement of contracts and the protection of creditor rights are of key importance to a well-functioning financial system (see below) and for an enabling business environment. These, in turn, require a well-functioning court system. The judicial procedure for resolving commercial disputes tends to be more bureaucratic in developing countries than in developed countries, although a number of developing countries have been making improvements in this area (World Bank, 2005a). Improved transparency and information can also facilitate the enforcement of contracts by enabling firms to know their potential partners' business history and credit standing in advance (see also below). Collateral law reform, mentioned above, should also help to enhance creditor rights.

A well-functioning court system is essential for the effective enforcement of contracts and the protection of creditor rights

Laws and regulations on such matters should be as simple as possible (compatible with achieving their objective), consistent with one another and simple to understand and apply. Moreover, they need to be backed by effective enforcement. This often calls for a strengthening of the administrative infrastructure and of the courts and ensuring that both operate in a fair and transparent manner.

Laws and regulations should be as simple as possible but backed by effective enforcement

Labour-market regulation, social protection and labour rights

The nature of the competitive market economy is such that enterprises will look for ways to cut costs. The government should set the boundaries of acceptable behaviour in this regard, so that cost-cutting represents efficiency gains and not exploitation of workers, of consumers or of any other subset of society. Labour standards are meant and designed to

Labour standards are needed to protect workers, but should not stifle the growth of private businesses

protect workers from actions of employers that are deemed to be socially undesirable. However, such standards can sometimes become overly stringent—for instance, in some countries, employers may be hindered by unnecessary reporting and detailed rules that do not achieve their intended effect but instead stifle the growth of private businesses and, by association, new job-creation. They may also contribute to the expansion of the informal sector where workers usually have no protection.

While flexibility in labour standards is advisable, stability of employment can increase the gains from "learning by doing" and encourage firms to invest in training

While moving towards greater flexibility in labour standards, countries should ensure that employment stability is not overly affected. There is evidence that stability of employment (tenure) is positively related to productivity gains; it can increase the gains from "learning by doing", as well as provide incentives for firms to invest in training (International Labour Organization, 2005). The objective should thus be to strike an adequate balance between flexibility and stability in employment.

Social protection should accompany any reform of labour standards

The reform of labour standards should include measures to ensure that workers receive the necessary social protection. Societies differ in how they define and provide social protection depending on their culture, values, traditions and institutional and political structures. Social protection is defined by the International Labour Organization as the set of public measures that a society provides to protect its members against the economic and social distress that may be caused by the absence, or a substantial reduction, of income from work as a result of various contingencies (sickness, maternity, employment injury, unemployment, invalidity, old age, or the death of a breadwinner). It also includes the provision of health care and the provision of benefits for families with children. By this definition, it is estimated that there is no formal social protection for some 80 per cent of the world's population, exposing them to enormous risk and vulnerability (García and Gruat, 2003).

Globalization has increased the need for social protection

The need for social protection has become greater as a result of globalization which, along with its benefits, has increased the vulnerability of workers to job insecurity and unemployment. Such risks can arise from competing imports, reversals in FDI or other capital flows, and cost-cutting by firms, including the introduction of labour-saving technologies. The pressures of global competition can lead to the use of non-standard and less secure forms of employment, such as part-time or temporary work. There is also a danger that the labour standards referred to above may not always be adhered to under such arrangements. Finally, there is evidence that the pressures of globalization are giving rise to increased "informalization" of the labour market, with the majority of the world's labour force working in the informal sector where conditions are often hazardous and there is little or no security of employment or income.

Social protection can be viewed as a sound investment ...

Social protection should be considered an investment. While its economic and financial affordability may sometimes be problematic in the short term, the longer-term economic and social costs of neglecting it can be immense. These costs include decreasing life expectancy, health and productivity, and rising poverty, none of which are propitious for investment. The absence of social support can also reduce poor people's investments in education and skills and thereby diminish the current and future stock of a country's human capital. Finally, there may be a loss of social capital: social trust and cohesion are essential for the functioning of democratic societies and their loss could adversely affect political stability.

... as it promotes human and social potentials and opportunities

Given concerns about the inadequacy of coverage provided by orthodox social protection, it has been argued that its focus should be extended beyond the provision of minimum well-being and the protection from risk, to the promotion of human and social potentials and opportunities (García and Gruat, 2003). Such an approach calls for measures that guarantee

access to essential goods and services, promote active socio-economic security and advance individual and social potential for poverty reduction and sustainable development.

Social protection and a healthier investment climate go hand in hand

Overall, a critical challenge is to find an appropriate balance between the social protection of the world's population and the provision of an enabling investment climate for business. In the longer term, the two go hand in hand since, in its broadest sense, adequate social protection not only serves to reduce poverty (and thereby raise demand) but also facilitates the development of a healthy, skilled and confident workforce and helps control the social and political risks that businesses face.

Domestic financial institutions and development

A well-functioning financial system enhances investment and growth

A well-functioning financial system enhances investment and growth. Developing countries diverge significantly in their level of financial development. While many countries continue to have significant limitations in this regard, others have experienced substantial financial deepening in recent years. This process is a continuing one, as financial markets and institutions have evolved with both the national economy and the international financial system. The major challenges for economic policy lie in three areas: guaranteeing an adequate supply of long-term financing in the domestic currency; making financial services available to all groups of society; and developing an adequate system of prudential regulation and supervision that guarantees the stability of the financial system. Through either direct or indirect interventions, economic policy plays an essential role in all of these areas.

Development of the banking sector

In many developing countries, financial services are provided only by commercial banks, which in turn supply only a limited range of services

The advent of commercial banks reflects an early phase of the development of the financial sector in almost all countries and commercial banks usually continue to serve as the cornerstone of the financial system even as other financial institutions emerge with the evolution of the financial sector. In many developing countries, however, the development of the financial sector has not advanced far beyond commercial banks. Moreover, these institutions are usually limited in the range of financial services that they provide, often as a matter of choice but sometimes in response to government directives. As a result, many needs for financial services remain unmet, compromising development possibilities. Compounding this difficulty, banking systems have failed in several developing and transition economies in recent decades, wreaking havoc on development in the countries concerned, frequently with adverse spillover effects on other countries.

Failures of banking systems have generated severe costs

Weaknesses in the banking system contributed to the severity of the Mexican peso crisis of 1994 and the Asian crisis of 1997-1998, among others. The costs of resolving these failures can be large and their economic impact severe: the fiscal cost of the banking crisis in Chile in 1981-1985 is estimated to have been 41 per cent of GDP while the equivalent costs of the Asian crisis for Thailand and Indonesia were 32 and 29 per cent of GDP, respectively. The recovery of the banking sector in crisis countries is usually a lengthy process, often conditioned by slow progress in corporate restructuring. Improving the institutional framework of the sector is widely seen as the best approach to preventing or resolving these crises.

Recent reforms, and an improving global economy, have strengthened banking systems in developing countries

Recent reforms of the banking sector in many developing countries and economies in transition are already showing in the performance of banks (see table I.2). The improved global economic situation since 2003 has supported the recovery of banks in these countries. Financial soundness indicators on average point to solid rates of return on assets and sustained improvements in capital and asset quality. Especially in Central and Eastern Europe and Asia, banks are performing well; but, despite economic recovery, other regions still have underlying weaknesses in the banking sector.

Asian banking systems have shown considerable improvement, but some problems remain

In Asia, banks' earnings, asset quality and capital adequacy have steadily improved since 2003. In key countries, banks' performance has been bolstered by Government-supported disposals of impaired assets. However, the region's ratio of non-performing loans (NPLs) to total assets, while declining, remains high; problem loans are especially prevalent at State-owned banks. Corporate restructuring is also lagging behind other regulatory reforms in some countries. Authorities in the region are moving towards addressing these structural issues in their banking systems. In China, for instance, the Government is making efforts to redress weaknesses at State-owned banks, some of which have been recapitalized.

European transition economies have seen heavy involvement of foreign banks, but currency mismatches could cause future problems

European transition countries have achieved a faster improvement in their banking sectors, with a declining likelihood of default, higher profitability and better prospects for growth. This improvement has been reflected in strong bank ratings. Expansion by foreign banks in a number of countries is driving the improved results. However, rapid credit growth, especially in the retail sector and intermediated mostly by foreign banks, poses a risk in some countries. The risks are greater in countries where a high degree of dollar/euroization, including of loans, exposes banks to direct exchange-rate and related credit risk. In some countries, mortgage credit has been a major component of new lending and banks have become correspondingly more exposed to the real estate market.

Improvement was also marked in Latin America while ...

Banking systems in Latin America generally appear sound, with the exception of those in countries emerging from financial crises. Even the countries most affected by major financial crises have seen some rebound in financial intermediation and an increase in bank soundness. Both stock indicators, such as capitalization and NPL ratios, and flow indicators, such as profitability, are stable or improving and so is investor confidence. The

Table I.2.
Indicators of bank financial soundness in developing regions and European emerging markets, 2002-2004

Percentage									
	Return on assets			Non-performing loans to total loans			Regulatory capital to risk-weighted assets		
	2002	2003	2004	2002	2003	2004	2002	2003	2004
Asia	0.8	1.0	1.5	12.7	11.2	10.1	14.5	15.2	14.8
Latin America	-2.6	1.0	1.4	12.5	10.1	8.6	13.2	14.3	16.2
Western Asia	1.1	1.3	..	15.4	15.2	..	15.6	15.0	..
Sub-Saharan Africa	2.7	3.0	..	19.9	17.3	..	17.7	15.7	..
Emerging Europe	1.5	1.6	1.7	9.3	8.0	7.8	17.5	17.1	16.0

Source: IMF, *Global Financial Stability Report: Market Developments and Issues: April 2005* (Washington, D.C., IMF, 2005), p. 35.

depreciation of the United States dollar may have contributed to financial strengthening in countries with currencies tied to the dollar. In general, banking systems in the region look well placed to handle an increase in international interest rates (which is relevant where banks are funded by net foreign borrowing) and the direct credit risk from rapidly growing consumer and mortgage lending.

... performance of banking systems in Western and Central Asia and Africa has been more mixed

Performance in banking systems in Western and Central Asia and Africa has been more mixed. Generally, banks in the oil-exporting countries remain highly liquid and profitable, but financial soundness indicators point to a marginal weakening in banks' performance in Western Asia. There have been improvements in the banking sector in South Africa, a regional financial centre, but banking systems in a number of other African countries continue to have serious weaknesses and reforms are progressing slowly. A large exposure to sovereign debt and a high degree of dollarization remain the main risks in most countries.

Banking systems in developing countries still face important risks

Despite the current relatively benign state of affairs and most banks' improved resilience, banking systems in developing countries continue to face risks. In countries in which banks have funded themselves on the international market, low global interest rates have contributed to a strengthening of balance sheets because of increased profits resulting from the wider margins earned on domestic loans. To the extent that these gains have been distributed and on-lent rather than added to capital or reserves, banks will need to adjust to the opposite effects on their balance sheets if, as widely expected, international interest rates rise.

Development of domestic capital markets

Domestic capital markets in developing countries and economies in transition have expanded rapidly since the early 1990s

Driven both by domestic economic development itself and by the innovation and globalization of financial markets, domestic capital markets in developing countries and the economies in transition have expanded rapidly since the early 1990s. In several cases, they now provide a viable alternative to domestic bank lending and international capital flows as a source of funding for private sector investment. In particular, there has been a surge in local bond issuance in a number of developing countries (see table I.3); in some cases, bonds have become the single largest source of domestic funding for the public and private sectors.

Different regions rely on different domestic sources of finance: bonds, bank loans and equity

The use of financial markets by public and private sectors differs across regions. For the public sector, bonds have become the largest source of local financing in certain developing countries. In Latin America, domestic bonds have also become the dominant source of funding for the corporate sector. There has also been a sharp increase in corporate bond issuance in a number of Asian countries. In Central and Eastern Europe, domestic bank lending is also the largest source of corporate finance but privatization has helped make domestic equity issuance the second largest.

Many factors, including the development of private pension schemes, are contributing to the development of local capital markets

There are many reasons for the development of local capital markets, especially bond markets, in developing countries over recent years. One has been the competitive urge to improve the intermediation of domestic savings by offering new financial instruments that broaden the set of savings options available. This has become more important as a number of developing countries have privatized their pension systems. In Chile, for example, private pension and insurance funds have generated demand for corporate bonds, reflecting a desire to obtain longer-term assets that better match their obligations and, at the same time, earn a higher rate of return than can be obtained on bank deposits

Table I.3.
Capital raised in domestic financial markets of developing countries and economies in transition, by region, 1997-2002

Billions of dollars							
	1997	1998	1999	2000	2001	2002	1997-2002
Total[a]	675	869	514	695	685	879	4 317
Equities	37	33	43	25	19	17	174
Bonds	399	639	394	456	510	522	2 920
Bank loans	239	198	77	214	155	340	1 223
Asiab[b]	160	243	268	326	339	662	1 998
Equities	28	17	36	21	11	15	127
Bonds	7	43	47	98	148	235	577
Bank loans	125	184	186	206	181	411	1 294
Latin America[c]	478	556	191	315	258	153	1 952
Equities	8	9	5	4	7	1	34
Bonds	349	548	287	300	297	245	2 027
Bank loans	122	-2	-100	11	-47	-93	-109
Central Europe[d]	37	70	54	54	87	64	367
Equities	1	7	3	1	1	0	14
Bonds	43	48	60	57	65	42	315
Bank loans	-8	16	-9	-4	21	22	38

Sources: Dealogic; IMF, *International Financial Statistics;* Standard & Poor's, *Emerging Market Database;* Hong Kong Monetary Authorities; and Tesouro Nacional, Brazil.

a Including sovereign issuances.
b Comprising China, Hong Kong SAR, Malaysia, Republic of Korea, Singapore and Thailand.
c Comprising Argentina, Brazil, Chile and Mexico.
d Comprising Czech Republic, Hungary and Poland.

(International Monetary Fund, 2003b). A parallel reason for the development of local capital markets has been the effort to attract foreign savings, including those of foreign institutional investors.

Local capital markets also contribute to domestic financial stability

Local capital markets can also contribute to domestic financial stability. Deeper local currency bond and equity markets reduce reliance on the foreign currency debt that has made the corporate sector in several developing countries vulnerable to currency movements and to the volatility and pro-cyclicality of international capital flows. Local currency corporate bonds also reduce the maturity mismatches that occur as a result of firms' financing long-term projects with short-term loans from the banking system. Finally, local capital markets reduce the concentration of risks within the banking sector and thereby ensure greater dispersion of risk across the economy as a whole.

A range of measures have been taken to develop local capital markets ...

Measures adopted to develop local capital markets have typically encompassed efforts to strengthen market infrastructure, create benchmark bond issues, expand the set of institutional investors and improve corporate governance and transparency. With respect to market infrastructure, the priority has often been the establishment of a liquid govern-

ment security benchmark in order to facilitate the pricing of corporate bonds, followed by the development of trading, clearing and settlement systems and the establishment of independent rating agencies. However, these measures are unlikely to be sufficient unless key underlying constraints on the issuance and purchase of corporate securities are also addressed (Sharma, 2001).

... including expanding the range of institutional investors

Measures to expand the set of institutional investors are of key importance in developing a strong issuer and investor base. Local pension funds have played an important role in the development of local securities markets in Latin America and Central Europe and are also beginning to have an impact in some Asian countries. At the same time, many countries control the allocation of pension funds' assets in order to prevent excessive risk-taking and this has slowed the growth of the investor base in some cases. For its part, the growth of an investor base can, in turn, be an important stimulant to developing the requisite infrastructure for capital markets.

Improving corporate governance and transparency helps expand the investor base

The growth of an investor base is also related to corporate governance and transparency. Corporate governance can be strengthened in a number of ways, including through laws to protect investors, better enforcement of these laws and contracts, and improved regulation, disclosure and supervision. Other measures to strengthen corporate governance and transparency include changes to laws governing capital markets and approving best practice codes in order to, among other things, improve disclosure and protect minority shareholder rights. Studies show that better protection of minority shareholders is correlated with the development of equity markets, although overregulation can impose large costs on issuers and thereby restrict the development of local capital markets. For example, rigid laws protecting minority shareholders could deter larger investors, including foreign investors. Reflecting such concerns, minority shareholder rights were reduced in Brazil in 1997 in order to speed up the privatization process (International Monetary Fund, 2003b).

Institutional factors and the degree of concentration in the corporate sector can also affect the development of the bond market

The base of issuers and investors can also depend on institutional arrangements and concentration in the corporate sector. In a number of South-East Asian countries, there is evidence that the interlocking relationships among corporations, banks and Governments have dissuaded companies from issuing bonds (Sharma, 2001). At the same time, there may be a negative relationship between concentration of control in the corporate sector by a few business families and indicators of judicial efficiency and enforcement (Claessens, Djankov and Lang, 1999; La Porta, Lopez-de-Silanes and Vishney, 1996). In such cases, policy measures to develop corporate bond markets could include making the banking sector more arm's-length in its dealings with companies and reducing the concentration of wealth and strengthening competition in the corporate sector.

While the sequencing of measures to develop different financial institutions is important, a healthy banking sector is a precondition for the development of securities markets

There is also the question how to sequence these measures and, more broadly, the growth of local securities markets as compared with other financial institutions, such as banks. There is no simple optimal sequencing strategy. Local capital markets provide an alternative source of financing to the banking system (especially debt markets), but a healthy banking sector is essential to the development of these complementary markets. Especially in the case of bond markets, banks can play an important role in providing liquidity to market operators, as well as in settling transactions. They also provide custodial services and undertake investment banking functions, such as underwriting and serving as market-makers. A healthy banking sector is an important precondition for the development of securities markets.

Long-term financing

Developing countries need fixed capital investment and infrastructure, and therefore long-term finance

As argued above, fixed capital investment is essential for long-term growth. Adequate physical infrastructure is, in turn, a necessary component of a favourable investment climate. Developing countries' needs for infrastructure are growing rapidly. The World Bank (2004f) estimates that the financing needs for new infrastructure investment and maintenance expenditures are about 7 per cent of GDP for all developing countries and as much as 9 per cent of GDP for low-income countries. Both fixed capital and infrastructure are long-term investments and, ideally, require corresponding long-term financing.

Yet long-term finance is insufficient in developing countries

Private financial markets in developing countries, left to themselves, usually fail to provide enough long-term finance to undertake the investments necessary for economic and social development. Firms in developing countries often hold a smaller portion of their total debt in long-term instruments than do firms in developed countries (Demirgüç-Kunt and Maksimovic, 1996).[4]

Market imperfections can explain some of the shortage of long-term finance

There are three main reasons for the insufficient provision of long-term finance: market imperfections in the financial sector; the characteristics of borrowers in the country; and macroeconomic factors that may inhibit the provision of long-term credit. First, market imperfections, or institutional factors, in financial markets contribute to the insufficiency of long-term finance. Credit providers—typically commercial banks in developing countries—typically have short-term liabilities and thus prefer the use of short-term lending as a way of reducing the risks associated to a mismatch in their portfolio. They also use short-term credit as a means to monitor and control borrowers and they are more likely to use this approach if the financial infrastructure, including accounting, auditing and contract enforcement systems, is inadequately developed. In these circumstances, it is costly, if not impossible, to enforce loan covenants and to monitor the balance-sheet positions of the borrower over a long period of time. Lenders prefer short-term lending because it allows them to check the borrower's position frequently and, if necessary, change the terms of the financing before the borrower is forced to declare default.

Different firms have different needs for long-term finance

Second, the term structure of finance in an economy also depends on the characteristics of firms. Firms are likely to try to match the maturity of their assets and liabilities; firms with mostly fixed assets, such as land, buildings and heavy equipment, are likely to seek and to be able to obtain a longer debt maturity structure. A "new" industry, which is likely to experience a long gestation period before producing any profits, needs long-term finance to match these characteristics. Small retailers, restaurants and similar businesses, on the other hand, do not require, nor would they likely receive, substantial long-term debt.

Larger firms find it easier to raise long-term finance

Firm size is another characteristic that affects the term structure of a country's finance, even in the most developed financial system. It is generally more expensive to acquire information about small firms because they are less likely to be publicly traded, and because the disclosure requirements for smaller firms are more lenient than for larger ones. This information deficiency is likely to encourage creditors to offer a series of short-term credits instead of one long-term credit.[5] Even in developed countries, small and medium-sized enterprises receive a smaller portion of their external financing in the form of long-term debt. Developing countries, where small firms are more dominant, are therefore likely to have less overall long-term debt.

High and unpredictable inflation can deter investment in long-term instruments

Third, high inflation or unpredictable inflation discourages savings in financial instruments, particularly those with a long maturity, unless they are designed to compensate for such instability, for example, through indexing (and even this is generally an imperfect form of compensation). On the other hand, policies to curb inflation usually involve

high real interest rates and these reduce the effective demand for credit: firms claim that they would like more credit, but not at the prevailing market interest rate.

A typical answer to the underprovision of long-term financing by the private sector is provided by public sector financial institutions. Development banks have been created not only in developing countries, but also in developed countries. These institutions have often provided industry with long-term finance for industrial development or for national reconstruction, as was the case after the First and Second World Wars. Some of them are recognized as having played a critical role in the rapid industrialization of some countries (de Aghion, 1999).

Development banks have been a means to provide finance for longer-term development and reconstruction

Although there is a clear trend towards increasing private sector participation in banking services around the world, public sector banks continue to play a central role in many countries. By the 1970s, the State had owned 40 per cent of the assets of the largest commercial and development banks in industrialized countries and 65 per cent of assets of the largest banks in developing countries (Levy Yeyati, Micco and Panizza, 2005). By the mid-1990s, a wave of privatizations had reduced these shares to about one quarter and one half of the assets of the largest banks in the industrialized and developing countries, respectively. There were, however, large differences across regions: the State owned nearly 90 per cent of the assets of the largest banks in South Asia, whereas the corresponding ratios in Latin America and East Asia were about 40 per cent and in sub-Saharan Africa 30 per cent (Micco and Panizza, 2005).

Not all the development banks established in developing countries to provide long-term credit for development purposes have been able to replicate earlier successes. Inadequate cost-benefit evaluation of projects, mismanagement and high arrears have often brought national and regional public development banks to the brink of collapse. The critical question is what distinguishes success from failure.

The record of development banks has been a mixed one in developing countries

Some development banks succeeded because they fostered the acquisition and dissemination of expertise in long-term industrial financing: success was less dependent on the quantity of credit they supplied. The corollary is that commercial banks in developing countries are unable to provide long-term finance because they are unwilling to bear the large risks that they associate with financing such projects and this is related, in turn, to the lack of the specialized skills to examine and monitor risky long-term investment, suggesting that it may be desirable to design institutional arrangements in which development banks play an essential role in the creation of new markets, including different mechanisms for long-term lending, but with a clear view to allowing the private sector to play the leading role as the new market mechanisms spread out. This means, in turn, that there could be several possible public-private partnerships, co-financing arrangements or even co-ownership.

Where they succeeded was through acquiring and disseminating expertise in long-term financing

Another common feature of successful development banks is their clearly set time limit on the advantages that they provide to borrowers. Successful development banks tend to keep interest rate subsidies minimal in the case of directed credit programmes or to extend subsidized loans only to small firms. After the expiry of the loan period, borrowers are often expected to “graduate” from development financing and raise funds in the market. In contrast, some development banks in many developing countries have subsidized interest rates heavily, sometimes making them negative in real terms, and have directed loans to monopolistic enterprises, many of them established by the government. In such circumstances, development banks do not put enough effort into collecting information on borrowers and monitoring their activities. Especially when the projects are politically selected, the development bank tends to view the government as the ultimate and only risk-holder.

Successful development banks have tended to set a time limit to their involvement

The role of development banks should be viewed as complementary to, rather than as substituting for, private sector financial development.

This means that national development banks can play a role both in the creation of markets for long-term financing and in guaranteeing access to financial services by the poor (see below). However, the institutional design should avoid excessive public sector risks and badly targeted interest rate subsidies, and should incorporate a view of the activities of development banks as complementary to those of the private sector and, indeed, a view of the banks themselves as agents of innovation that should in the long-run encourage rather than limit private sector financial development.

The changing roles of the public and private sectors in financing infrastructure

The public sector plays a central role in the provision and financing of infrastructure but its shortcomings have led to the direction of attention to private sector involvement

It has long been recognized that capital markets are likely to underfinance such socially desirable investments as infrastructure and that the public sector has a potential role in overcoming this market failure (Atkinson and Stiglitz, 1980; Stiglitz, 1994). A first option, which applies particularly to investments in infrastructure, is for the public sector to undertake the investment itself and then to own and operate said infrastructure as a public utility. However, the perceived shortcomings of public ownership have resulted in partial or complete privatization of public utilities over recent years. At the same time, fiscal constraints have increasingly placed limits on public infrastructure spending in many developing countries.

Private investment in infrastructure had peaked in the late 1990s but then fell

These factors had prompted many countries to try to attract private investors into infrastructure in the 1990s. Initially, private participation in infrastructure in developing countries expanded rapidly, reaching a peak of close to US$ 130 billion in 1997. However, it subsequently collapsed and was only a little above US$ 40 billion in 2004.

A new balance between public and private funding is being sought

In parallel with this decline in the quantity of private funding, a new balance between public and private sector roles for infrastructure financing and service provision has emerged. In particular, it is increasingly recognized that the viability of private participation in infrastructure may vary widely across sectors, countries and even regions within countries. Private funding has been successful in the telecommunications sector and can also have an important role in financing and participating in the power sector. However, private considerations do not always adequately capture the broader externalities, in particular the longer-term economic and social benefits, in such areas as transportation, water and sanitation. Therefore, the public sector continues to play an essential role in the financing and provision of such public goods. It may also be appropriate for multilateral development banks to become more active in financing projects in these areas (see chap. IV).

Public/private partnerships have both advantages and disadvantages ...

Public/private partnerships offer an intermediate between full State control and complete private ownership. Public/private partnerships have been successfully undertaken in a number of sectors, such as telecommunications, highways and airports, where user fees can be established and investors are able to earn adequate returns (World Bank, 2004f). However, these partnerships often have high transaction costs, are difficult to establish and sustain, and may require significant public sector guarantees that involve uncertain future public sector liabilities. Many of them have failed to meet expectations.

... so each Government must decide on the optimal public/private mix

Each Government must decide on the optimal public/private mix. In areas where private participation is desired, one objective should be to maximize the amount of private capital per unit of available public resources. One means of doing so would be to strengthen the ability of multilateral development banks to engage with sub-sovereign infrastructure-related entities and to develop instruments for risk mitigation at that level.

There has been considerable discussion of the welfare effects of private provision of essential utilities and services—such as water, health and transport—by local or foreign investors. The general concern about the underprovision of services that may not necessarily be the most profitable but that have social value is particularly pronounced in such areas. In addition, privatization requires the introduction of user fees and, without accompanying subsidies, the poor may not be able to afford essential services (Kessler and Alexander, 2004).

Special issues are raised when essential services, such as water, health and transport, are provided by private sources ...

To some degree, the welfare outcomes of private provision depend upon the accompanying policy and regulatory frameworks (Kikeri and Nellis, 2004). These could include, for example, subsidy mechanisms to ensure that the poor have access to affordable essential services, better tailoring of privatization to local conditions and a regulatory system that promotes competition yet also takes into account each country's unique political, legal and institutional context. In practice, however, achieving these conditions may be difficult for developing countries that have weak regulatory capacity. Moreover, there is no evidence that subsidy systems under private provision are any more effective than those under public provision (Kessler and Alexander, 2004).

... highlighting the need for appropriate policy and regulatory frameworks

Therefore, the private provision of essential services by foreign and local investors is more likely to have positive welfare impacts in those countries that have compatible regulatory, policy and institutional frameworks. However, many developing countries fall short in this respect and building capacity in these areas is usually a long-term and evolutionary process. In such countries, at least in the short term, there may be options for successfully reforming existing public infrastructure services without changing ownership.

However, capacity-building in these areas is a lengthy process

The development of inclusive financial sectors

Financial services in the form of savings accounts, loans, insurance and payments facilities, including international remittances, are available only to a small proportion of the world's population. Countries in sub-Saharan Africa are far behind most other regions in expanding the reach of financial access (except South Africa, where about half the population has access). In Brazil and Colombia, only about 40 per cent of the population has a bank account (Peachey and Roe, 2004). However, Asian and Central European countries have made greater progress in facilitating financial access (Imboden, 2005).

The reach of financial services is limited in developing countries ...

Typically, it is the poor who have no or very limited access to the financial system. This lack of access to finance has become a matter of wider development-related concern because deeper and more inclusive financial systems are linked to economic development and poverty alleviation.

... with the poor having little or no access

Limited access to financial services by the poor has various causes: physical distance from retail facilities, lack of financial literacy and business skills, high transaction costs for financial institutions (which are passed on as high fees), deficiencies in understanding and managing risk in lending to the poor, and biases against certain segments of the economically active population. An additional factor in some countries is the mistrust of potential clients towards formal financial institutions. In some Latin American countries, for example, poor people lost confidence in the banking system after they had lost their life savings during financial crises or when Governments froze the funds of financial institutions to restore financial order. In some cases, financial institutions collapsed owing to the theft or fraudulent use of the people's funds.

This limited access has many causes

There is a need for the poor and micro- and small enterprises to have access to financial services

A large proportion of the poor would like to have access to the financial system for saving purposes. Savings may cover consumption needs, assist in special or emergency family situations, or be used as "seed" money for microentrepreneurial activities. At the same time, starting micro- and small enterprises often requires access to lending, because spending on working capital and technology usually exceeds the limited amounts saved. Given the limited access to the financial system by the poor, the need for financial services has been either unmet or covered by informal institutions or moneylenders.

Complementary institutions such as credit bureaux and effective courts and bankruptcy legislation are missing

The absence of complementary institutions also restricts access to financial services by the poor. In some countries, parts of the financial infrastructure—sources of information on borrowers (for example, credit bureaux), effective and independent courts and bankruptcy legislation—are missing or inadequate. For example, a study of Kenya found that limited information-sharing on borrowers, uncertainties regarding the effectiveness of the legal and judicial system, the limited number of reputable banks and non-transparency and uncertainty in banking markets were the major factors restricting access to the financial system.

In the absence of formal institutions, the poor often have recourse to informal institutions such as rotating savings and credit associations

Millions of the poor who do not have access to financial institutions nevertheless save and lend in small quantities through informal institutions. Among the best-known informal institutions are the rotating savings and credit associations (ROSCAs) which take "deposits" from a group of individuals and lend the total receipts to each member sequentially. They require smaller amounts of money for the initial deposit than formal institutions do, and are more flexible in the services offered, terms of lending, payback period and form of repayment, which might be, for example, in currency, in service, or in kind. In general, loans offered by rotating savings and credit associations have lower transaction costs and lower risk of default than formal loans. Most of these institutions are part of the community they lend to and are able to use their knowledge about borrowers to screen loan participants. Peer pressure and social sanctions can be important in reducing monitoring and enforcement costs.

Informal finance often accounts for two thirds of the finance in rural areas of Africa, but the proportion is lower elsewhere. Surveys in Madagascar and Pakistan indicate informal institutions accounted for about one third of informal credit in the early 1990s. While providing an essential service, informal lending institutions may hinder the advancement of the poor and the development of micro- and small businesses. Informal loans are usually small and short-term and the geographical area serviced is often limited.

The fact that informal credit sources and moneylenders can demand high interest rates has led to the creation of alternative sources of financing for the poor

Some informal credit sources and moneylenders demand high interest rates (from 5 to 30 per cent per month) and are able to do so because of their monopolistic power and the risks involved in this type of transaction. People pay the high interest rates to moneylenders because they have no alternative. A variety of financial institutions have been established to create an alternative for extending small-scale loans and offering savings services to the poor, but their charges are typically also high because of the high cost of such small transactions. These lenders include small non-governmental organizations, and savings and credit cooperatives, some of which, such as the Grameen Bank of Bangladesh, have become large institutions.

Microfinance has grown rapidly, but still reaches only a small percentage of potential beneficiaries

Microfinance has improved the prospects for many small enterprises around the world. Microfinance activities involve small loans, typically for working capital, employ substitutes for collateral and streamlined procedures, and offer swift and frequent access. Microfinance clients are often self-employed low-income entrepreneurs and households in both urban and rural areas. Loan amounts vary according to the country and regional settings. The Grameen Bank in Bangladesh, imitated with varying degrees of suc-

cess in more than 45 countries, has provided credit to over 2 million poor people. Today, about 60 million people benefit from microcredit around the world. Yet, however large it is in absolute numbers, the reach of microcredit is small in terms of the potential beneficiaries. In Western Africa, for example, 5 million people benefit from microcredit, but this represents only 7 per cent of the total population and only 15 per cent of the economically active population.

Efforts are being made to offer services to the poor by bridging formal and informal finance networks

Several initiatives, coming from both Governments and the private sector, have attempted to extend the access of formal financial institutions that offer services to the poor by bridging formal and informal finance networks. By 1995, a federation of 155 credit unions in Togo with 50,000 members had linked its member unions to financial institutions, so that each union was able to increase funds for lending, place liquid funds in low-risk financial instruments and diversify risk. The Badan Kredit Kecamatan in Indonesia and the Bank for Agriculture and Agricultural Cooperatives in Thailand are other examples of institutions that reach the poor and still make a profit. Other formal institutions have lent directly to group-based financial arrangements (for example, ROSCAs), non-governmental organizations and credit unions or created ROSCAs themselves, for example, in India and the Republic of Korea. In Senegal, a reform of the agricultural credit programme entailed forming village groups that elected a president who, acting as an intermediary, screened, allocated and enforced credit terms (United Nations, 1999).

Telecommunications and information technologies are opening up possibilities of extending financial services to the poor

In many countries, access to financial services has been limited by the absence of a bank in poor neighbourhoods. Today, telecommunications and information technologies are opening up new possibilities for the poor. Satellite connections and hand-held devices, including cellular phones, are reducing the barrier of geographical distance, thereby making it feasible for financial institutions to serve the poor. In Mali, for example, agents of savings and credit cooperatives are able to offer and update banking services to dispersed clients by using a hand-held electronic device, while in India, the ICICI Bank has put ATMs on trucks so that clients in distant villages can carry out transactions and have easier access to their accounts.

Remittances are often sent through informal channels …

Remittance flows have become an increasingly important source of financial resources for the families of emigrants and a potential component of an inclusive financial sector. A large proportion of these flows, however, are transmitted through informal channels, lessening the potential positive impact on the migrants' families and their communities. Informal channels are used because of insufficient interest on the part of the financial system in small money transactions (which often average between 100 and 300 United States dollars) and because of the socio-economic situation of many migrant families, with recipients living in distant areas and low levels of schooling.

… whereas they could serve as a basis for an expansion of financial services

There is a potential for using remittances to introduce the poor to financial institutions specialized in their needs, such as microfinance institutions, savings and credit cooperatives and postal savings banks. Tapping this potential could have multiplicative effects on the local and regional economies. Some private and multilateral initiatives to decrease the transmission cost of remittances and support microfinance projects, for instance, through the Multilateral Investment Fund of the Inter-American Development Bank, have had positive results. Remittances could serve as the basis for financial institutions' opening and expanding their services, to include, for example, savings accounts and microcredits to the families and local communities of emigrants.

The "missing middle"—larger than a microenterprise but too small to be serviced by a commercial bank—also needs financial services

While such improvements in access of the poor to savings, credit and transfer payment services, as well as micro-insurance, are important, there is a limit to the gains that can be made at the "micro" level, in particular as regards support of enterprises. Greater needs for management skills, working capital, technology and access to markets have been among the main obstacles faced by small enterprises as they try to expand. Microbusinesses must gain economies of scale if they are to contribute more substantially to employment-generation and economic growth. This points to the need for expanded financial services for the "missing middle" of enterprises that are too big to be adequately serviced by microfinance institutions but not large enough to be an attractive customer for a commercial bank.

The future direction of microcredit is a subject for debate

Microcredit itself has followed a small business enterprise model in many countries while it has expanded into large institutions of national scope in a few countries. A major topic for debate in the microfinance industry globally is whether, and then how, to become more like a bank, without succumbing to the risk incurred by these institutions of losing their focus on servicing the poor.

Towards sounder national financial systems

There has been an extensive liberalization of the financial sector in the last few decades

Over the past few decades, there has been extensive liberalization of the financial sector in many countries, including the decontrol of interest rates, the reduction of direct government allocation of credit, the removal of barriers to entry of competing financial institutions and the elimination or reduction of restrictions on financial activities. Such measures have, in many cases, been accompanied by varying degrees of privatization and liberalization of controls on capital flows in and out of countries.

In many developing countries, the fact that financial liberalization had often been attempted without having in place adequate regulatory capacity led to banking crises

In many developing countries, particularly in Asia, financial liberalization has increased the size and depth of the financial sector. In many instances, however, financial market liberalization preceded the development of an adequate regulatory capacity. While direct controls had been largely dismantled, new, indirect mechanisms of regulation were not put fully in place. This resulted in credit booms, maturity mismatches (lending long-term on the basis of short-term deposits), currency mismatches (that is to say, lending in local currency but borrowing in foreign currency) and, eventually, banking crises.

The resulting crises prompted regulatory reform …

Such experiences themselves prompted regulatory reform. Indeed, many regulatory reforms in developing countries have come about as a reaction to crises or problems in the financial system rather than as pre-emptive undertakings (Stallings and Studart, 2002). There is now widespread recognition that reforms of the financial system require parallel reforms, and frequently strengthening, of the relevant legal, regulatory and administrative structures and that these should be phased in gradually as the financial sector develops.

… aimed at guaranteeing the stability of the financial system and that of the economy at large

Financial regulation aims primarily at reducing the risks that some form of miscalculation or other error by a financial institution might pose for the financial sector more generally and thus for the economy at large. This is achieved by imposing restrictions both on the way banks and similar institutions finance their operations and on how they allocate their portfolios. The aim is to ensure that financial institutions engage in adequate assessment of the risks implied in their activities, make provisions for expected losses and maintain sufficient capital to absorb unexpected losses.

These reforms have followed, with a lag, reforms of financial regulation in the industrialized countries which, since the late 1970s, have entailed just such a move from a "top-down" approach to an indirect approach involving a framework of rules and guidelines that set minimum standards of prudent conduct within which financial institutions are free, or at least more free, to take commercial decisions. This may be interpreted as a move away from regulation and towards supervision, that is to say, a move away from compliance with portfolio constraints towards an assessment of the overall management of a financial firm's business and the multiple sources of risk that it is likely to confront (Crockett, 2001a).

Such reforms have followed (with a lag) the indirect approach to regulation adopted in the industrialized world

Financial regulation and supervision do not exist in a vacuum. For financial regulation to be effective, there should be a solid infrastructure that allows the economy to function properly. In addition to sound and sustainable macroeconomic policies, this includes a legal and judicial framework, particularly workable bankruptcy arrangements, reliable accounting practices used to value financial assets, the availability of relevant statistics, procedures for the efficient resolution of problems in financial institutions, an appropriate safety net, an effective payment and settlement system and sound principles of corporate governance (see, on some of these issues, the discussion on the enabling business environment). These preconditions for effective financial supervision are not firmly in place in all developed nor in many developing countries (International Monetary Fund, 2004). Weaknesses in the underpinning infrastructure can render useless the most careful supervisory oversight.

For financial regulation to be effective, there should be a solid infrastructure that allows the economy to function properly

As regards necessary regulatory preconditions, unsatisfactory creditor protection and dubious accounting practices are considered to be the major problems in many countries. In respect of the latter, for instance, capital ratios, as well as disclosure and transparency, are meaningless if flawed accounting masks the true state of balance sheets. In this regard, it has been suggested that, if the information supplied by banking organizations is poor and the auditing profession is underdeveloped, then the examination of financial statements is not sufficient. Rather, regulators should focus on validating accounts and records, valuing risk assets and verifying the accuracy of financial statements. In the developed countries, supervisors played this role at an earlier stage in the evolution of their banking systems (Bies, 2002).

Unsatisfactory credit protection and dubious accounting practices are major problems in many countries

Even in an era of financial liberalization, there remain needs for some direct regulatory controls, for example, where there are market imperfections or a need to cope with sudden emergencies, such as a sharp reversal in capital flows. By the same token, policymakers might not wish to forgo completely the ability to allocate credit to priority sectors or to certain geographical areas through government-sponsored banks (see above). However, government ownership may itself create additional regulatory problems, including weak corporate governance, political interference with decision-making, conflicts of interest, difficulties in implementing and enforcing remedial measures, and the absence of market discipline (International Monetary Fund, 2004k). In short, State-owned financial firms have the same need for adequate supervision as privately owned entities.

The need for direct regulation remains, and government ownership of financial institutions creates special regulatory problems

With the advent of liberalization, the financial sector, both at the national and at the international level, has become more pro-cyclical. Market agents tend to underestimate risk during booms, making loans to borrowers with lower credit quality (Ocampo, 2003e). The rapid increase of asset prices during booms further stimulates credit growth. The tendency for provisions to be related to the current rate of loan delinquency further increases this pro-cyclical bias. During booms, delinquencies are few and provisioning for loan losses is limited; this reduces the apparent costs of lending and thus increases credit

The financial sector has become more pro-cyclical with liberalization

growth. On the contrary, during downturns delinquencies increase, provisioning has to increase and lending tends to be curtailed, and may even lead to a "credit squeeze" that amplifies the economic downswing. Concern about weaknesses in the financial system during a downturn may prompt the introduction of stronger regulatory requirements, further aggravating in the short term the problem of the availability of credit.

Forward-looking provisions can be a useful counter-cyclical tool

Counter-cyclical policy has a clear role to play in this context. It should be conducted first and foremost through macroeconomic policy, but the effectiveness of such measures should not be compromised by a pro-cyclical bias in the financial system and in the mechanisms of financial regulation. One possible means of removing this bias is forward-looking provisioning that is estimated on the basis of expected or latent losses (rather than on prevailing losses) when loans are disbursed, taking into account the full business cycle. This would help smooth out the cycle by increasing provisions or reserves during boom periods and thereby help to reduce the credit crunch during downturns.

Forward-looking provisions should be based on an entire business cycle ...

Most countries do not allow for such forward-looking provisions that would cover the business cycle, but rather use a one-year horizon to measure risk. However, in December 1999, Spain issued regulations requiring counter-cyclical provisions calculated by statistical methods that estimated the "latent risk" based on past experience over at least one entire business cycle. Along with this, and in parallel with it, regulators should encourage the adoption of risk management practices and models that would allow lending strategies that are less sensitive to short-term factors (see, for instance, Griffith-Jones, Spratt and Segoviano, 2003).

... and can be complemented by discrete counter-cyclical provisions

It has been suggested that if financial regulators are sceptical about their ability to measure changes in risk and to evaluate the probability of systemic stress, such provisions could be usefully supplemented by more discrete counter-cyclical provisions to be applied by the regulatory authority to the financial system as a whole, or by the supervisory authority for special financial institutions, on the basis of objective criteria—such as the growth rate of credit, the growth of credit for specific risky activities or assets (Goodhart and Danielsson, 2001; Ocampo, 2003e).

Additional discretionary action can also help

Regulators could also dampen the credit boom through additional discretionary action. Cash reserve ratios and secondary liquidity requirements could be increased. Loan-to-value ratios might be tightened, collateral requirements strengthened and margin requirements for speculative trading increased. Such measures were very commonly used in industrialized countries in the 1960s and 1970s. They have been or are currently used effectively in several jurisdictions, including Hong Kong Special Administrative Region of China and Singapore (White, 2004).

Financial regulations could shift risks from financial to non-financial institutions ...

There is a danger that some financial regulations may have the effect of shifting risks from financial to non-financial institutions rather than of truly reducing excessively risky behaviour. For example, standards that either involve lower risk-ratings for short-term credit or attempt to avoid maturity mismatches between borrowing and lending will reinforce the financial institutions' bias towards short-term lending. Borrowers then may either finance their long-term credit needs with short-term domestic borrowing (with the result that they incur a maturity mismatch) or secure long-term financing from abroad (in which case they incur a currency mismatch). Although the direct risk may have migrated to the non-financial institution in both cases, domestic financial institutions continue to face the indirect risks associated with the possible delinquency of non-financial firms.

Consequently, counter-cyclical regulations and supervision could be complemented by regulations in other areas. In particular, prudential regulation should establish strict rules to prevent currency mismatches, especially those incurred by firms operating in non-tradable sectors that borrow in foreign currencies, liquidity requirements and limits on loan-to-collateral-value ratios or rules on the valuation of collateral designed to reflect long-term market trends in asset prices.

… requiring complementary regulations

The globalization of finance and the growing internationalization of financial crises in recent years have resulted in increased efforts to adopt similar regulatory arrangements across countries (Knight, 2004a). There is no formal power to set and enforce regulations worldwide and, according to many, the creation of such centralized power would be neither feasible nor desirable (Crockett, 2001a). Instead, supervisors from most developed countries have been drawing up a set of standards and codes whose broader adoption is encouraged by virtue of peer pressure and market forces. Indeed, the quality of individual countries' regulatory and supervisory systems is increasingly judged by reference to these international standards: it is ever more important to be seen to be adhering to these standards as a means of attracting and retaining international capital flows.

Supervisors from most developed countries have been drawing up standards and codes whose broader adoption is encouraged by peer pressure and market forces

The East Asian crisis of 1997 was instrumental in raising the importance given to globally coordinated financial regulation and to ensuring that the multiplicity of such regulations were considered together. The Financial Stability Forum (FSF), established by the Finance Ministers and Central Bank Governors of the Group of Seven (G7) in February 1999,[6] was given responsibility for defining this required set of standards and codes. This was the first attempt to develop a single set of international rules and principles for domestic policy in the financial and monetary spheres that all countries would adhere to. However, the implementation of standards and codes was announced to be voluntary and implementation was to vary according to the circumstances of different countries and firms.

The Financial Stability Forum was given responsibility for defining standards and codes whose implementation would be voluntary and vary according to the particular circumstances

Standards and codes are seen to play a central role in promoting global financial stability. One of the principles underlying their preparation encompasses the view that the transparency of the institutional and regulatory structures and the public availability of the associated information will reduce financial vulnerabilities. However, identifying standards is a complex task. Moreover, the dynamic nature of financial markets and their increasing sophistication mean that these standards have to be flexible enough to respond to continuous change.

The standards being set must be flexible enough to respond to continuous change

The Financial Stability Forum has identified 70 standards. From among these, the G7 countries and the multilateral financial institutions have identified a subset of standards that are deemed necessary to ensure financial stability. These fall into three areas: macroeconomic policy and data transparency; institutional market infrastructure; and financial regulation and supervision (see table I.4).

The standards are divided into three groups

Mechanisms have also been established to assess compliance. The key instrument is the Report on the Observance of Standards and Codes (ROSC), prepared by IMF as a part of Article IV consultations or through Financial Sector Assessment Programmes (FSAPs) conducted jointly by IMF and the World Bank. As of early 2005, there were over 500 Reports covering almost 100 countries.

The key instrument with which to assess compliance is the Report on the Observance of Standards and Codes

Despite the proliferation of ROSCs, they are not yet living up to their full potential for providing transparency about the situation in financial markets. They are not standardized, often provide very limited information, are frequently dated and are difficult for the non-specialist to understand; moreover, there is no continuous stream of information, nor an announced schedule of coverage. There are also problems in priority-setting

Yet these Reports are still not living up to their full potential

Table I.4.
Key standards for financial systems

Subject area	Key standard	Issuing body
Macroeconomic policy and data transparency		
Monetary and financial policy transparency	Code of Good Practices on Transparency in Monetary and Financial policies	IMF
Fiscal policy transparency	Code of Good Practices in Fiscal Transparency	IMF
Data dissemination	Special Data Dissemination Standard (SDDS)/ General Data Dissemination System (GDDS)	IMF
Institutional and market infrastructure		
Insolvency	Principles and Guidelines on Effective Insolvency and Creditor Rights Systems	World Bank
Corporate governance	Principles of Corporate Governance	OECD
Accounting	International Accounting Standards (IAS)	International Accounting Standards Board (IASB)
Auditing	International Standards on Auditing (ISA)	International Federation of Accountants (IFAC)
Payment and settlement	Core Principles for Systematically Important Payment Systems	Committee on Payment and Settlement Systems (CPSS)
	Recommendations for Securities Settlement Systems	CPSS and International Organization of Securities Commissions (IOSCO)
Money laundering	The Forty Recommendations/ Nine Special Recommendations on Terrorist Financing	Financial Action Task Force on Money Laundering
Financial regulation and supervision		
Banking Supervision	Core Principles for Effective Banking Supervision	Basel Committee on Banking Supervision (BCBS)
Securities regulation	Objectives and Principles of Securities Regulation	International Organization of Securities Commissions (IOSCO)
Insurance supervision	Insurance Core Principles	International Association of Insurance Supervisions (IAIS)

Source: Financial Stability Forum.

and in sequencing follow-up action. In particular, if they are to contribute to a reduction in financial vulnerability, the Reports should focus on the critical weaknesses and players in financial markets (Schneider, 2005).

Standards and codes represent “best practices”. Their adoption by individual countries, adapted as necessary to local circumstances, can make an important contribution to the mobilization of domestic resources for development by strengthening overall trust and confidence in the financial system. From an international perspective, however, and for a variety of reasons explored in subsequent chapters, standards and codes alone are unlikely to provide complete protection from the vagaries of international capital markets. For this, a more far-reaching and comprehensive array of national and international,

macroeconomic and firm-level policy measures are required. In all these areas, ongoing work needs to be continued and refined as part of the effort to build national financial systems that contribute to development and are sufficiently robust to adjust to the rapid evolution of financial markets.

Notes

1 In addition to China, which was considered separately, the nine take-off countries or areas were Chile, Hong Kong Special Administrative Region of China, Indonesia, Malaysia, Mauritius, the Republic of Korea, Singapore, Taiwan Province of China and Thailand. Botswana was excluded because of the lack of acceptable data.

2 It is argued, however, that this would make growth in the region subject to an upper bound (Krugman, 1994).

3 Romer (1987) estimates the social return of capital to be twice its private return.

4 The average ratios of long-term debt to total debt exceeded 40 per cent in 15 out of the 19 developed countries examined in this study, while only 1 country among the 11 developing countries studied—South Africa—was the ratio to 40 per cent. Small firms had smaller long-term debt ratios than larger firms.

5 Another way for commercial banks to overcome information problems is to build long-term relationships with smaller firms (see Aoki, 2001, chap. 12).

6 Its membership comprises representatives of the national authorities responsible for financial stability in selected Organization for Economic Cooperation and Development (OECD) member countries, Hong Kong Special Administrative Region of China and Singapore, and of major international financial institutions, international supervisory and regulatory bodies and central bank expert groupings.