The Heritage Foundation Backgrounder

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WHY THE WORLD BANK SHOULD READ ITS OWN REPORT

INTRODUCTION

As the World Bank and International Monetary Fund (IMF) prepare to convene their annual meeting in Washington next week, the delegates should study what could become the hottest new publication on economic development. It is the *World Development Report*, issued each year by the World Bank. While this year's topic, the condition of financial systems in less developed countries (LDCs),[1] would seem to be tedious, the content and message of the report are anything but. They analyze how LDC governments have contributed to the deterioration of central and commercial banks, stock markets, and similar institutions in the developing world. While the Report avoids ideological stands, it suggests by implication, and sometime explicitly, reforms needed to restore these institutions to economic health.

World Bank officials should read their own report and use its insights to plan and pursue a strategy that will establish in the LDCs the private banks and capital markets necessary for sustained economic growth. The report too should be of interest to the United States and other countries attempting to deal with the LDC debt problem and to promote economic growth in these countries.

Indispensable Medium. Money, of course, is indispensable for any economy in providing a medium of exchange to facilitate economic transactions. Banks and other financial institutions allow surplus assets to be funneled into productive investments. Capital and stock markets allow money for large economic ventures to be raised and investment risks to be reduced by permitting individuals to diversify their assets.

1 *World Development Report 1989: Financial Systems and World Development Indicators*, issued in June 1989. Hereinafter referred to as the World Bank Report.

The new World Development Report documents how LDCs have undermined their financial systems and thus exacerbated their own economic problems. By requiring their banks to lend to certain industries, sectors, or enterprises, for instance, LDC governments have misallocated resources and left few funds for businesses, entrepreneurs, and consumers who did not enjoy such privileges. The Report also describes how credit privileges for inefficient state-owned enterprises cause capital shortages and lead to foreign borrowing and debt. And the Report illustrates how LDC governments, to cover huge state expenditures, ultimately resort to printing money, triggering massive inflation which undermines the currency itself.

To correct the situation described by the World Bank, reform in the LDCs is now essential. This reform should require:

1) Central banks to maintain stable, noninflated currencies.

2) Government direction of lending to cease.

3) Repeal of regulations that discourage or prohibit private banking.

4) Banks in government hands to be privatized.

5) Reform of legal systems to protect the property and rights of borrowers and lenders.

6) Grass-roots savings and credit to be encouraged.

For years the World Bank and IMF loaned money to LDCs and looked the other way as these countries practiced policies that the Bank now wisely criticizes. By allowing the LDC governments to avoid for so long the consequences of their actions, these policies continued and economic reform was impeded. The new *World Development Report* therefore is a welcome sign that the World Bank not only understands the disastrous mistakes of LDC financial policy but also has learned that lending to countries even as they continue such practices only throws good money after bad. The World Bank's vast staff would do well to study the new Report and use it as a compass to guide future policies and programs.

THE FUNCTIONS OF MONEY AND CREDIT.

Economic development is often thought of in terms of the ability of factories to produce goods, farmers to grow crops, and, ultimately, consumers to purchase the goods and services necessary for a higher standard of living. Yet financial instruments and institutions perform the indispensable function of facilitating nearly all economic transactions.

The World Bank Report correctly points out that "The financial system makes its biggest contribution to growth by providing a medium of exchange."[2] Money has several characteristics that make it far superior to the

2 World Bank Report, p. 26.

exchange of goods by barter. As it originally developed, money was a commodity, usually gold or silver, that was durable and thus could be stored for long periods, unlike perishable goods. It was easily divisible, unlike bartered goods such as houses or cattle. Money was compact and easy to carry. Further, the market values of goods could be compared in terms of money.[3]

"Renting Out" Surplus Funds. At any given time there always are some businesses or individuals who might not wish to spend their surplus assets on immediate consumption or investments. At that same moment, however, there are others who might not have funds on hand to meet their consumer or investment needs. Those with surplus money are often willing to "rent out" their funds to others, with the original loans plus the rent or interest being paid back out of the borrowers' future earnings or profits.

The World Bank Report observes that "Savings determines the rate at which productive capacity, and hence income, can grow. On average, the more rapidly growing developing countries have had higher saving rates than slower-growing countries."[4] For example, the Report found that countries with savings rates averaging 28 percent of Gross Domestic Product had high annual growth rates of over 7 percent. Countries with savings rates of around 19 percent grew at a slow annual rate of less than 3 percent.

Grass Roots Money Lenders. Much development occurs from the ground up with the efforts of individuals and small businessmen. The Report notes that "...firms and households finance much of their investment directly out of their own saving. Only when investment exceeds saving is it necessary to borrow...."[5] It notes further that, "In the early stages of development, relatives, friends, and moneylenders may be the only sources of external finance. As the financial system grows, local banks, then national financial institutions, and finally securities markets and foreign banks become sources of funds for investors."[6] The Report notes, for example, that in the late 1940s, Nigeria had as little as 29 bank branches. Money lenders operated in the informal sector in institutions known as "*isusu*." With the growth of indigenous national financial institutions, the financial system began to expand. By 1962, there were more than 200 commercial banks in Nigeria.[7]

The existence of savings and credit allows households to enjoy the immediate benefits of various goods and services by borrowing against future earnings. For businesses, credit is crucial. Short-term credit is essential for merchants to keep inventories at levels to meet customer demand. Longer term credit is important not only for establishing productive enterprises but also for expansion, purchases of new equipment and machinery, research and

3 See Ludwig von Mises, *Theory of Money and Credit* (Irvington-on-Hudson: Foundation for Economic Education, 1971) for a discussion of the origins and functions of money.

4 World Bank Report, p. 27.

5 World Bank Report, p. 28.

6 World Bank Report, p. 29

7 World Bank Report, p. 48, Box 3.4.

development of new products, and modernization of the production process for maximum efficiency.

Implied by the World Bank Report is that, for economic growth to be steady, the supply of money also must grow at a slow and steady pace. Large, erratic fluctuation of the money supply would cause the value of the currency that is being saved, lent, or borrowed to fluctuate similarly. The use of money for economic activities would become increasingly risky and such activities would suffer.

THE COMPONENTS OF A FINANCIAL SYSTEM

For economies to develop rapidly and efficiently, intermediate institutions between savers and investors are indispensable. States the World Bank Report:

> Financial systems provide payment services. They mobilize savings and allocate credit. And they limit, price, pool, and trade the risks resulting from these activities. These diverse services are used in varying combinations by households, businesses, and governments and are rendered through an array of instruments (currency, checks, credit cards, bonds, and stocks) and institutions (banks, credit unions, insurance companies, pawnbrokers, and stockbrokers).[8]

Among the key financial institutions are:

Central Banks. Money in the form of paper currency is provided in all countries today by government monopolies called central banks. While in the past currency was backed by commodities like gold, today paper currency, which is produced in limited quantities, in various denominations, and which is replaced when it wears out, is useful as a medium of exchange to the extent that governments increase its supply on a slow, steady basis. The value of one country's currency against that of another's might rise or fall depending on such factors as the relative supplies of each currency, the desires of individuals to invest in a given country, and general confidence in a given country's government and economy.

Commercial Banks. Banks provide a place for individuals and businesses to deposit savings and to obtain loans. In the U.S., banks that accept savings and make loans to individuals and businesses are legally separate from investment or commercial banks. The latter specialize in purchasing and marketing stock to help finance business ventures.

The World Bank Report points out that commercial banking was crucial to economic growth in the West. Modern banking and accounting practices were

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8 World Bank Report, p. 25.

developed in the city-states of Northern Italy during the 15th century by individual businessmen seeking better ways to finance trade and lessen the risk of loss for exporters and importers.[9] Only later did governments become involved in banking regulations.

When central banks keep money supplies stable, interest rates are determined by the supply of savings and the demand of loans. Bankers who judge wisely and lend to productive individuals and businesses make a profit. Those who do not, lose money. In a system with private banking and no major restrictions on market entry, competition provides incentives for bankers to direct funds to the most productive enterprises and provides customers with greater access to credit.

Capital and stock markets. Many business activities require substantial, long-term investments and access to credit. Capital markets provide long-term debt and equity finance for the government and the corporate sector. Debt finance occurs when borrowing is used to finance expenditures. An interest charge is paid for the amount borrowed. Equity financing occurs when stock is bought and the buyer receives a dividend for his purchase.[10] Stock markets allow many individuals to pool their investment resources. Shares of stock are usually purchased from businesses and marketed by commercial banks. If the business makes a profit, stock owners receive a profit or dividend for each of their shares. Stock markets also allow individuals to reduce their financial risks. By owning shares in many different enterprises, an individual does not lose all of his assets if one investment goes bad.

Legal institutions and accounting practices. Protection of private property rights and the certainty of legal titles to property are essential for any market system, and especially crucial to the financial system. The World Bank Report observes that an individual's or business's property often provides the necessary collateral against which banks make loans, for example, "by allowing borrowers to offer security in the form of mortgages over real estate...."[11] The Report also observes that business laws and conventions define what is meant by a contract and what are the obligations of the parties involved. A legal system provides adjudication of business disputes and the enforcement of contractual agreements. Standardized accounting practices allow businesses and investors, lenders and borrowers, to know the value of their assets, whether a profit or loss has been realized, and in general, how an enterprise might be expected to perform in the future.[12]

Macroeconomics. A theme found throughout the World Bank Report is that correct macroeconomic policies are important to the health of a financial system. Government taxing, borrowing, and spending policies can deter

9 World Bank Report, pp. 41-43.
10World Bank Report, p. 109.
11World Bank Report, p. 87.
12World Bank Report, p. 85-86.

investments and absorb much of a country's savings, leaving little for private businesses and individuals. Trade restrictions can rob industries of access to necessary inputs and consumers of access to goods that could raise their living standards. Government regulations and restrictions on business can deter business creation and expansion, slowing down economic growth. Massive government spending and borrowing by LDCs, and printing currency to cover the resulting debts, has contributed to high inflation rates. "The average inflation rate in developing countries increased from 10 percent a year in 1965-73 to 26 percent in 1974-82 and 51 percent in 1983-87. During 1983-87, seven countries (Argentina, Bolivia, Brazil, Nicaragua, Peru, Sierra Leone, and Uganda) had average inflation rates of more than 100 percent...."[13] Financing public sector industries has been costly for LDCs.

CAUSES OF FINANCIAL DISTRESS IN THE THIRD WORLD

In light of the importance of financial institutions to economic growth, most LDCs began on the wrong financial footing. In most cases the government owned some or all of the commercial and savings banks, in many cases prohibiting private banking altogether. This set the stage for serious abuses. The World Bank Report paints a picture of many (probably most) LDC governments systematically undermining the ability of their citizens and businesses to engage in productive activities, and thus bringing about their own economic problems.

Directed Credits. The World Bank Report describes how LDC governments sought to promote economic growth by forcing investments into certain sectors of the economy. It points out that

> ...in Pakistan in 1986, 70 percent of new lending by national banks, which dominate the banking system, was targeted by government...In India about one-half of bank assets had to be placed in reserve requirements on governments bonds, and 40 percent of the remainder had to be lent to priority sectors at controlled interest rates. In Yugoslavia in 1986, 58 percent of short-term loans were directed credits. In Brazil in 1987, government credit programs accounted for more than 70 percent of credit outstanding to the public and private sector.[14]

Sometimes, governments would use loan guarantees to specific enterprises to assure that credit was distributed according to government desires.[15]

But whether the banks involved were government-owned or private, and whether certain industries or enterprises were singled out for special favors by directed lending or loan guarantees, in the end, the government was

13World Bank Report, p. 62.
14World Bank Report, p. 55.
15World Bank Report, p.57

forced to cover the costs to the financial sector of their policies. And with governments requiring banks to make specific kinds of investments, little capital was left for business that did not enjoy government favor. Especially hard hit have been small businessmen, entrepreneurs, and of course, the consumers. Further, by directing funds by law or decree to certain sectors and industries, governments removed much of the incentive for bankers to be concerned about the quality of their loans.

Priority for State-Owned Enterprises. In many cases, government-directed credit went to state owned enterprises (SOEs). The World Bank Report states that, "The share of SOEs in nongovernmental borrowing from domestic banks in 1983-85 was 56 percent in Guyana, 43 percent in Mexico, 25 percent in Nepal, and 18 percent in Brazil."[16] Then, in one of its most damning statements, the Report explains that "Whatever conclusion is drawn concerning the impact of directed credit programs on growth and the distribution of income, it is clear that they have damaged financial systems. Many directed credits have become nonperforming loans."[17] This was in part because, "Directed credit programs have often been used not to correct the inadequacies of financial markets but to channel funds to priority sectors regardless of whether these were the most productive investments."[18]

Many of the state-owned enterprises turned into inefficient, wasteful, and corrupt money losers. Rather than shutting down such enterprises, for political reasons LDC governments continued to keep them afloat with new directed or borrowed money. Further, in the case of many failing private businesses, rather than let them shut down, governments continued to provide subsidies and in many cases simply nationalized such enterprises.

By diverting credit to inefficient enterprises, governments dried up credit for more productive endeavors. The situation became worse during the worldwide economic problems of the 1970s. Instead of adjusting to changing economic realities, most LDC governments increased their intervention and subsidies. The result: staggering costs of directed and subsidized credit. The World Bank Report finds that:

> ...in Brazil in 1987 [subsidies] were estimated at between 4 and 8 percent of GDP [Gross Domestic Product]. In Mexico subsidies relating to development finance institutions and official trust funds were estimated to average 3 percent of GDP during 1982-87. Subsidies of this magnitude, when financed by the central bank or charged to the government budget, have compromised efforts at monetary or fiscal restraint.[19]

16World Bank Report, p. 57.
17World Bank Report, p. 59-60.
18World Bank Report, p. 59
19 World Bank Report, p. 59.