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# CHAPTER TWO: FINANCIAL SERVICES AND DEVELOPMENT

## 2.1 INTRODUCTION

Financial services create value that contributes to economic growth (Coetzee, 1997:1). Various authors, among them Levine *et al*, 2000, King & Levine (1997) and Montiel (1996), argue that financial institutions contribute to shaping the pattern of industrial progress in many countries. According to Coetzee (1997:1), the growth of the mining and industrial sectors in South Africa was facilitated by the development of the financial markets. In the case of the agricultural sector, specialised credit institutions facilitated this. The role of financial markets in mobilising savings and channeling funds into productive investment has therefore been the strategy central to economic growth and human development. At the macroeconomic level, the raising of productive capacity is essential if real GDP is to rise through time, while at the microeconomic level, there are analogous issues. Individual producers and households require credit facilities to enable the expansion of productive capacity and to generate income-earning possibilities.

The chapter reviews the relationship between real growth and financial development, the role of finance in economic growth (both from the macro- and microeconomic point of view), and the various financial approaches that are being used by governments of developing countries in achieving economic growth.

## 2.2 THE FINANCIAL SYSTEM AND ECONOMIC GROWTH

Economists hold different views and opinions regarding the importance of the financial system for economic growth. There has been a tendency among some pioneers of development economics to neglect finance in the mainstream of economic development thought. Some economists inadvertently undervalued the role that finance plays in determining the pace and pattern of growth (Gurley & Shaw, 1955:516). Lucas (1988:6) asserts that economists "badly over-stress" the role of financial factors in economic growth, while development economists frequently express their scepticism about the role of the financial system by ignoring it (Levine, 1997:688). Economic development has commonly been discussed in terms of wealth, labour force, output and income. These real or "good" aspects of development have been the centre of attention in

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economic literature, to the comparative neglect of financial aspects (Gurley & Shaw, 1955:515). None of the pioneers among development economists (Bauer, Colin Clark, Hirschman, Lewis, Myrdal, Prebisch, Rosenstein-Roden, Rostow, Singer and Tinbergen) even went as far as to listing finance as a factor in development (Stiglitz, 1998; Chandavarkar, 1992:134). The work of Franco Modigliani and Merton Miller in 1958 gave impetus to the "non relevance of the financial structure" proposition. Their model was based on four assumptions: first, that firms can be identified by "risk class"; second, that individual borrowing can substitute for firm borrowing; third, that investors have full information about the returns of the firm; and fourth, that there are no taxes, or at least that tax policy does not treat debt and equity differentially (for a detailed discussion see Stiglitz, 1988).

A number of studies, however, have attempted to clarify the hypothesis that financial structure matters and that improvements in the financial intermediation process are preconditions for economic growth. For example, Schumpeter (1912:58-74) and McKinnon (1973:5-18) provide broad descriptions of the roles of the financial system in economic development. Schumpeter used the relationship between banker and industralist to illustrate the importance of the financial system in choosing and adopting new technologies, and McKinnon highlighted its importance in promoting the use of better agricultural techniques.

Donors and policy makers in both developed and developing countries have now started to recognise that efficient financial systems help growth, partly by mobilising additional financial resources and partly by attracting those resources to the best uses. In other words, finance matters. According to Gurley and Shaw (1955:515), development is associated with a debt issue, accretions of financial assets and the "institutionalisation of savings and investment" that diversifies channels for the flow of loanable funds and multiplies varieties of financial claims at some point in the economic system. Development involves finance as well as goods. It must, however, be pointed out that the financial system's contribution to economic development depends upon the quantity and quality of its services and the efficiency with which it provides them.

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## 2.3 ROLE OF FINANCE

Evidence based on the combination of firm-level and cross-country data is beginning to show conclusively that finance is important in development. Results from such studies are remarkable. The exogenous component of financial depth - banks and the private sector - explains a large part of growth, which is unexplained by many variables and policies commonly thought to determine economic growth (World Bank, 1992). Clarity on the role of finance in economic development was enhanced by the studies of Edward Shaw and Roland McKinnon, who challenged the Keynesian growth models that ignored finance (1988). These two economists coined the terms "financial deepening" and "financial repression". According to McKinnon, financial repression fosters dualism in developing countries and is responsible for greater income inequality and less than optimal investment efficiency. The policy implications of these models are that economic growth can be increased by abolishing institutional interest rate ceilings and other restrictions on the functioning of financial markets, to ensure that the financial system operates competitively under conditions of free entry (Coetzee, 1997:15).

Recent developments in theoretical literature by Levine (2000; 1997; 1996), and King & Levine (1993) are of importance in answering the question concerning the contribution of financial services to economic growth. These authors show conclusive evidence that finance makes a substantial contribution to economic growth. Levine (1997; 2000) created a simple framework with which to conceptualize the role of the financial system for economic growth (see Figure 2.1). According to this model, the costs of acquiring information and making transactions create incentives for the emergence of financial markets and institutions. Different types and combinations of information and transaction costs motivate distinct financial contracts, markets, and institutions. In ameliorating transaction and information costs, financial systems serve one primary function: they facilitate the allocation of resources, across space and time, in an uncertain environment (Merton & Bodie, 1995:12). This primary function is divided into five basic functions as illustrated in Figure 2.1. These functions when carried out lead to capital accumulation and technological innovation, which invariably affect economic growth.

The financial system is a key component of the institutional infrastructure that is required for the efficient operation of both product and service markets. It has the ability to induce a larger size and foster a larger degree of integration of the markets for goods and services, factors of production, and other assets. This ability is achieved by providing monetisation services and efficient management of the payment system, the development of services of intermediation between surplus and deficit economic agents, and the accumulation of store of value, the management of liquidity, and the transformation, sharing, pooling, and diversification of risk (Gonzalez-Vega, 1994:5).

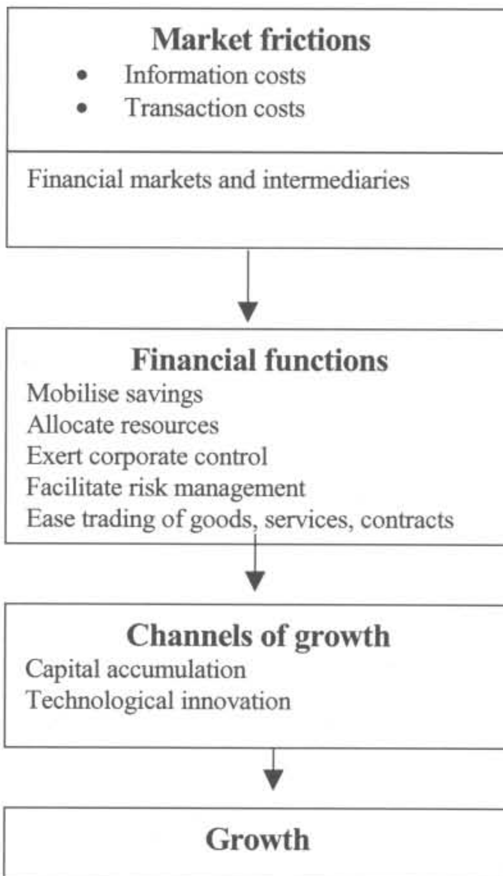


**Figure 2. 1: A theoretical approach to finance and growth**

***Source:*** Levine, 1997:691

The financial system contributes to economic development by providing access to a wide range of financial services for a wide range of the population. This is achieved through the provision of a growing range of services, including loans for different purposes as well as deposit facilities, mechanisms for the transfer of funds and currency

exchange, as well as other specialised services once the market size grows sufficiently (Gonzalez-Vega, 1989:8).

Financial intermediation increases the productivity of available resources. It allows those with better productive opportunities but insufficient resource ownership to take full advantage of socially and privately profitable alternatives, while those without opportunities can benefit by making their resources available to others (Amable & Chalelain, 2001; Gonzalez-Vega & Graham, 1995:3; King & Levine, 1993). This occurs through changes in ownership and composition (changing unproductive assets to productive assets). In the developing world, a considerable portion of tangible wealth is held in the form of unproductive assets. Storage and spoilage costs, in addition to the risks of price fluctuations are very high. According to Patrick (1966:179) the amount involved in such costs can be substantial. It is reasonable to think of ratios of tangible wealth to GNP, even excluding land, of 2 or 3. He estimated that a re-allocation of as much as 10% of this wealth to more productive forms would be equivalent to 20% or 30% of GNP and would raise the level of output by 10%. This projection was based on a simple assumption that the marginal capital-output ratio for such re-allocated capital is in the order of 2 to 3. An efficient composition of real wealth is obtained through the creation of financial assets and liabilities which provide the incentive for savers to hold their wealth in financial form and for investors to hold more productive real assets than they would have done in the absence of the financial system.

Several empirical studies have supported the notion that intermediation is an important aspect of development. It has been shown in Latin America that the "depth" of financial markets (measured as the ratio of savings deposits to nominal GNP) is positively correlated with the rate of gross capital formation. It has also been shown that the real interest rate (measured as the rate paid on deposit less inflation) is positively correlated with growth rates in nineteen Asian developing countries (Tybout, 1983:598). It therefore becomes clear that poor financial intermediation drastically reduces the "quality" of capital formation, and can thus damage a country's development prospects. Intermediaries can promote growth by increasing the fraction of resources that society saves or by improving the way in which society allocates savings, or by diversifying risks and exploiting economies of scale (World Bank, 1992). For example, a firm may

want to fund a large project with high-expected returns, but the investment may require a large lump-sum capital outlay. Such profitable opportunities often go unexploited without intermediaries that mobilise and allocate savings. Under situations where i) not all individual savers (surplus spending units) rate among the most efficient investors (deficit spending units) in terms of the optimum allocation of investment; ii) savers are not willing to make the full amount of their savings directly available to the most efficient investors; and iii) investors are not able to invest as much as they would like, the financial system has an important function in providing a market mechanism for the transfer of claims on the real resources from savers to the most efficient investors, and for diversifying and pooling of the default risk of individual deficit spending units (Patrick, 1966:182). In this way, deposits substitute for less attractive uses of the funds, while loans make better uses possible (Sirri & Tufano, 1995:86).

All economic activities are subject to a wide variety of risks (technical, economic and financial risks) (Bencivenga *et al*, 1995:160). Many of these can be covered by straightforward insurance policies, others not. The financial system can help to overcome or reduce some risks by redistributing them among market participants, or through portfolio diversification and hedging using an appropriate instrument, such as forward contracts or options. In countries where farmers cannot participate in the world futures markets (especially developing countries) to hedge the substantial risks associated with fluctuations in the world prices of their crops, the only alternative for them is to invest less and produce less; this invariably impairs economic growth (World Bank, 1992:34).

The financial system contributes to growth by providing a medium of exchange. Money (the standard unit of accounting) facilitates specialisation by reducing trading costs and linking different markets. This is not true in a barter economy, in which a mutual coincidence of wants is required. Specialisation is discouraged in economies with no medium of exchange; this results in low productivity and corresponding losses in efficiency. Without financial services, an economy would be confined to self-sufficiency or barter, which would inhibit the specialisation in production upon which economies depend. These services make it cheaper and less risky to trade goods and services and

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also to borrow and lend money (Demetriacles & Hussein, 1996; World Bank, 1989:25-26), because the financial system provides payment services.

The financial system can provide a variety of incentives to investors, which invariably stimulate growth. Among these are:

i) The availability of funds from financial institutions enables the efficient entrepreneur to assume a greater debt position than he could otherwise and concurrently enables him to engage in a larger amount of productive investment.
ii) Monetisation encourages the shift from subsistence to commercial production, with attendant increases in output due to specialisation, increased work effort, emphasis on high-income crops, and enhanced responsiveness to changes in relative prices of different crops.
iii) The financial system provides services that reduce or increase the profitability of productive real investment projects.
iv) A competitive, efficient system causes a narrowing of the margin between institutions' borrowing and lending rates. The result is advantageous for both investors and borrowers, and this acts as an incentive for transactions.

In a nutshell, the financial system can induce an increase in the rate of accumulation of capital, by reducing transaction costs, and thus providing increased incentives to save, invest and work. Stiglitz (1994:23) articulates the role of finance as follows:...." it can be thought of as the brain of the economic system, the central locus of decision-making. If it fails, not only will the sector's profits be lower than they would otherwise have been, but the performance of the entire economic system may be impaired".

Financial services contribute to more efficient household and firm inter-temporal decisions about savings (postponing consumption), the accumulation of assets, and investment. Such services facilitate a more cost-effective management of risk, liquidity and the accumulation of stores of value for precautionary and speculative purposes. However, it is important to emphasised that for the financial system to achieve those effects on the economy, the quality and quantity of services and the efficiency with which services are provided is vital.

## 2.4 EFFECTS OF FINANCIAL SERVICES ON SMALL SCALE FARMER

Access to credit and other financial services has the potential to make the difference between grinding poverty and an economically secure life. Access to financial services, especially credit is believed to have a significant impact on various aggregate and household-levels outcomes, including agricultural productivity, technology adoption, food security, nutrition, health, and overall household welfare (Diagne & Zeller, 2001:1; Diagne, 1998).

According to Diagne and Zeller (2001:2), access to credit affects household welfare outcomes through three pathways. The first pathway is through the alleviation of the capital constraints on agricultural households. Access to credit increases the ability of poor households with little or no savings to acquire agricultural inputs. Furthermore, easing potential capital constraints through the granting of credit reduces the opportunity costs of capital-intensive assets relative to family labour, thus encouraging the adoption of labour-saving, higher-yielding technologies and therefore increasing land and labour productivity, a crucial factor in encouraging development (Diagne & Zeller, 2001:2; Freeman *et al*, 1996:15; Fuentes, 1996:189). Furthermore, credit could significantly influence a farm household's income by helping its members to tap economic opportunities, thereby assisting them to get out of poverty (Adugna & Heidues, 2000:27; Binswanger & Khandker, 1995:334).

Various studies (e.g. Carter, 1989) corroborate the centrality of credit access to the evolution of the agricultural sector. However, most profit maximising banks have continuously and systematically rationed small farms out of formal credit markets. The implications of this unequal credit access are well documented in the international literature. According to Carter (1989:15), the implications are that agricultural productivity, income distribution and other facets of the agrarian structure are critically shaped by these credit rationing rules. This, according to him, has led to systematic expropriation, marginalisation, and impoverishment of the small scale farming sector. A number of the theoretical studies that have been carried out on the above mentioned questions suggest that credit indeed has a positive impact on small farm production.

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Binswanger and Sillers (1983) showed that poor access to credit was one of the constraining factors in the adoption of new technology on small-scale farms. Eswaran and Kotwal (1986) argued that varying access to credit by different farm size categories is a critical factor in shaping the organisational structure of agrarian production. A study done in Nicaragua by Carter (1989) also indicated a significant effect of credit on input use.

The second pathway according to Diagne and Zeller (2001:2), is by increasing a household's risk-bearing ability and by altering its risks-coping strategies. Access to credit and other financial services enables households to adopt more effective precautionary savings strategies, thereby enhancing such households' capacity to invest in more risky but more profitable technology and enterprises. The third pathway is that credit enables households to smooth consumption (Diagne & Zeller, 2001:2; Adugna & Heidues, 2000:27 and Binswanger & Khandker, 1995:334). By doing so it maintains the productive capacity of households. As the World Bank (1989) observes: "improved consumption is also an investment in the productivity of farm households". All these three functions help increase agricultural productivity, the rate of technology adoption, food security, nutrition, health, and overall household welfare.

## 2.5 RURAL FINANCE AND ECONOMIC DEVELOPMENT

Rural financial markets have been at the centre of policy intervention over the past four decades. Providing affordable financial services to the rural population has been an important component of development strategy during this period. Direct interventions in rural financial markets to stimulate growth and reduce poverty – through a blend of targeted credit programmes, interest subsidies, and other government policies – became widespread in the 1950s, when Keynesian economics inspired many governments to design fiscal interventions at the macroeconomic level (Yaron *et al*, 1998:147; Heidhues, 1995:106). This section puts into perspectives the various financial approaches and interventions that governments of the developing world have tried to use to achieve economic growth and to enjoy the benefits of the financial system.

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### 2.5.1 The supply-led approach/Directed credit programmes

During the early stages of government intervention, credit has always occupied a special place in mainstream thinking on agricultural and rural development. Most donors and policy makers regarded the supply of credit to farmers as one of the answers to production related problems. It was seen as an instrument for breaking the vicious circle of low incomes, low savings and low productivity. Developing countries' governments have consequently played a large role in credit allocation. For example, by 1986, seventy percent of new lending by the national banks in Pakistan was as a result of demands by government. In India, about one-half of bank assets had to be placed in reserve requirements or government bonds, and forty percent of the remainder had to be lent to priority sectors at controlled interest rates. In the early 1980s, directed credit in Malaysia accounted for an estimated thirty percent of bank portfolios. Directed credit programmes usually targeted industry, state-owned enterprises, agriculture, small and medium-scale firms, and (to a lesser extent) housing, exports and underdeveloped regions (World Bank, 1989:55-56).

Governments and donors have promoted and continuously supported supply-led rural financial institutions as devices to neutralise or mitigate the distorted "urban biased" macro-economic policies that adversely affected the rural sector. Many institutions have been involved in channelling funds to farmers. The most popular institutional ways of organising credit include state agricultural banks, multi-purpose development agencies, crop and project authorities, commercial banks and co-operative and farmer's groups. The financial landscape became dotted with these organisations, while hundreds of billions of dollars were poured into countless projects that all claimed to have the well-being of the poorer strata of the rural society at heart. It was the era of "small is beautiful", when low priced small farmers' credit became a tool for rural development. This approach was based on a number of assumptions (Proenza, 1997:3; Spio, 1995; Bouman & Hospes, 1994:10). During these periods, the credit policies and programmes of many devloping countries were designed to achieve the following objectives:

i) To alleviate the lack of cash needed to make farm investment; this is a critical constraint hampering growth in agricultural output;



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ii) To replace the fragmented and incomplete rural financial market represented by private moneylenders; these credit sources are supposed to have the effect of impoverishing their clients rather than assisting them to improve their productivity;

iii) To accelerate the adoption of new technology;

iv) To assist small farmers to overcome their inability to borrow from commercial banks or informal credit sources, due to lack of collateral and lack of information;

v) To address equity goals, whether these are related to intra-rural, inter-rural or rural-urban income distribution;

vi) To offset the disincentive effects for small farmers of policies unfavourable to them, including low output prices, over-valued exchange rates and inefficient market interventions by the state;

vii) To gain favour with farmers for political purposes; and

viii) To take advantage of the sometimes overwhelming generosity of foreign aid donors, who seemed to be prepared to endlessly pump large amounts of money into rural credit projects (Barham *et al,* 1996; Ellis, 1994:155).

The financial strategy adopted was credit disbursement rather than saving mobilisation. It chose the road of credit dependency rather than self-reliance through self-financing (Vogel & Adams, 1997:364). To accomplish these enormous tasks, the governments of most developing countries assumed the roles of planner, banker, supplier and marketing agency (Seibel, 1992:2).

#### *2.5.1.1 Effects of directed programmes*

The results of the directed credit programmes have generally been disappointing and have tended to lowered, rather than promote the development of financial services in rural and developing areas. The most recognisable effects of the direct credit programmes encountered in many developing countries are discussed below.

The programmes mistrusted the market and minimised the role of interest rates as a major instrument of resource allocation (Proenza, 1997:4; Gonzalez-Vega, 1989).

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Subsidised credit, more often than not, failed to reach its intended beneficiaries. Within the priority sectors, large and more influential borrowers benefited most. In Columbia, nearly half the funds intended for small-scale farmers were found to have been diverted to other uses (World Bank, 1989:59). By limiting the availability of credit to non-priority borrowers, directed credit programmes crowded such borrowers out of the formal credit markets and forced them to rely on retained earnings or more expensive borrowing from informal sources (World Bank, 1989:59).

The most serious consequence is the inability of intermediaries to become financially viable. Many credits became non-performing loans. The ability to borrow at cheap rates encouraged less productive investments, leading to the attendant problem of high delinquency rates. The distorted allocation of resources and the erosion of financial discipline left intermediaries unprofitable and, in many cases, insolvent. The criteria used in these programmes have not necessarily been compatible with the institution's survival (Spio, 1995:16). This also reduced the need for financial institutions involved in subsidized credit programmes to mobilise resources on their own, thereby leading to lower levels of financial intermediation.

Other criticisms were i) that the direct credit programmes increased the transaction costs for both borrowers and lenders; ii) that credit subsidies and associated taxes were distributive regressively; iii) that the direct credit programmes had a weak and ambiguous effect on production and investment decisions; and iv) that evaluation of the direct credit projects gave a misleading results (Vogel &Adams, 1997:367). The end result was that these programmes impeded the development of capital markets (World Bank, 1989:60).

#### *2.5.1.2 Criteria and principles for addressing disadvantages*

The deficiencies in and the results of direct credit programmes have led to the incorporation of certain criteria and principles into the existing approach to the credit delivery system. The alternative approach has been labeled "the financial market paradigm" (Vogel & Adams, 1997:361 or "the market performance view" (Graham, 1992:138) or the financial system approach (Rhyne & Otero, 1992:1561).

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The emerging techniques and criteria for offering financial services are directed at the following goals: Good loan recovery; low transaction costs in lending and deposit mobilisation; increasing the proportion of total funding coming from locally mobilised deposits; increased accessibility to financial services; and assurance of the self-sustainability of financial intermediaries (Spio & Groenewald, 1998:165; Spio, 1995:17; Graham, 1992:138). The new perspective is a clear departure from the old approach; the emphasis is more on the ability of financial institutions to provide services on a sustainable and widespread basis; it focuses on measures to increase access to financial services.

Three principles are necessary in the "new thinking" (Rosegrant & Hazell, 2000: 10; Rhyne & Otero, 1992:1563):

i) Knowing the market - because of time and mobility constraints, borrowers need services that are located close to their place of business, and that can process transactions quickly. Transaction costs for borrowers and savers are lowered by locating banking outlets near the clients.

ii) Innovating techniques that will slash administration costs to a level commensurate with loan size. This may involve the use of the simplest procedures for the smallest loans and decentralised approvals without them being based on a formal business appraisal, but rather on readily verifiable eligibility criteria.

iii) Innovating techniques that will motivate repayment. Roles assigned to security and loan appraisal may be taken up by a) group guarantees or pressure from social networks, b) the promise of repeat loans and increasing the amount, and c) savings requirements.

Other principles include:

i) The identification of the expected real rate of interest, as well as unsubsidised interest rates, as a major determinant of borrower, saver and lender behaviour. The interest rates must be high enough to compensate depositors adequately and

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low enough to enable lenders to cover their costs (Vogel & Adams, 1997:375; Spio, 1995:18; and Graham, 1992:138).

ii) The emphasise on mobilisation of domestic deposits and savings as a strategic ingredient for building healthy financial institutions (Graham, 1992:138). To realise this objective, the instruments used must offer safety, convenience, ready access to money and a positive real return. Adams and Vogel (1984:367) point out that in the absence of these criteria, the rural poor are forced to hold a variety of inflation hedges, many of which earn low or negative rates of return, and to pay an inflation tax on cash that is held to meet current obligations. A recognition of the importance of savings argues strongly that it should be given equal weight in finance programmes.

iii) Discarding the use of packaging loans and other similar non-market rationing devices such as fixed quotas, loans in kind or efforts to specify the ultimate use of loans, since these diminish the most attractive and useful property of finance, namely fungibility (Von Pischke & Adams, 1980:720).

iv) A strong recognition of the informal financial markets and use of some of the informal markets' innovative techniques to reduce risk and improve accessibility.

However, it must be pointed out that with all these virtues, this approach also has some limitations. In its purest form, very few loans go beyond the most risk-free clients. There is a need to arrive at some reasonable compromise between the default-ridden, borrower-dominated development bank model, which has collapsed into bankruptcy in practically all countries of Sub-Saharan Africa on the one hand and the extremely risk-averse, saver-dominated private bank model on the other. Some balance of risk and returns is required to arrive at a compromise. That criterion in the new thinking does not necessarily mean that the small-farm or enterprise bias or the state-led character of credit policy should disappear. It may therefore be argued that the full potential for the financial institutions to grow, spread and achieve greater financial self-sufficiency may be achieved through institution-building, capacity-enhancing inputs and a friendly policy setting (Graham, 1992:139).

### 2.5.2 Deregulation of the financial system

Experience has shown that government intervention in the operation of the financial markets often does not achieve the intended aims and objectives, but rather results in distorted resource allocations. It is the belief of many economists that deregulation may help to remove or minimise these distortions. The idea of financial liberalisation has therefore become today's new orthodoxy both in the academic world and the major international institutions that offer policy advice to developing countries (Bhattacharya *et al,* 1198; Alawode & Ikhide, 1997). A number of Third World countries that find themselves in situations of debt burden and dwindling foreign exchange earnings, have also adopted policies to deregulate their economies, and in particular the financial markets as part of structural adjustment programmes aimed at ensuring that the forces of demand and supply are assigned larger roles than hitherto in the allocation of resources (Brownbridge & Kirkpatrick, 2000; Jaramillo-Vallego, 1995:54; Soyibo & Adekanye, 1992:2). The more recent literature advocates privatisation of financial institutions (including participation by moneylenders), lower reserve requirements, elimination of ceilings on interest rates and indexing interest rates to inflation rates, the raising of deposit and lending rates, and the removal of credit quotas (DTI, 2000; Caprio & Demirgiic-Kunt, 1998).

It is hypothesised that i) low interest rate ceilings suppress the savings rate, thereby reducing the availability of loanable funds and investments, which in turn lower the growth rate; and ii) low interest rate ceilings and repressed financial systems result in poor allocative efficiency of credit (McKinnon, 1973). In other words, higher interest rates and reduced government interventions in the financial sector are expected to improve the allocative efficiency of credit, as well as savings (Cho, 1988:104). Many empirical studies have tested the validity of the McKinnon-Shaw hypotheses (for example Soyibo & Adekanye, 1992 and Cho, 1988). Financial liberalisation has induced many financial markets to become more competitive and integrated, hence leading to similar costs of borrowing for different borrowers except for risk premiums or transaction costs. It has also encouraged better savings mobilization.

However, the soundness of financial liberalisation has been questioned by some economists (e.g. Taylor, 1979). Most of the criticism has been based on the experiences of countries that have embarked on liberalisation. In some cases, it has accentuated the urban bias of financial systems in developing countries, which siphon rural savings into urban credit, as manifested in the dichotomy of commercial bank branches into mostly rural net deposit centres whose deposits are in excess of local credit, and the largely urban credit centres, with credit in excess of local deposits. It has in addition, not led to a splurge of market-induced financial innovation in the developing countries, which is comparable to the creation of new instruments in the developed countries (Chandavarkar, 1992:136).

## 2.6 HINDRANCES TO THE DEVELOPMENT OF THE FINANCIAL SYSTEM IN DEVELOPING COUNTRIES

Developing countries, especially in Asia and Africa, enjoyed relative financial stability under colonial rule until the end of World War II. However, their financial systems suffered from colonial neglect and stagnation. Most of these financial systems were heavily oriented towards agricultural exports, other primary production and foreign trade; they catered principally for expatriate communities, and financial services to the indigenous communities were limited. In most developing countries, the financial system was underdeveloped until independence; it consisted of a few foreign banks, co-operative societies, post office savings banks, and moneylenders. South Africa, Zimbabwe and Namibia have extensive banking systems. However, these banks have not provided any noteworthy services other than savings mobilisation (Strauss Commission, 1996) to the regions in which small scale farming by blacks predominated. Provision of financial services to small-scale farmers and microenterprises remained underdeveloped.

Among the contributing factors to poor service delivery to small-scale farmers and microenterprises are:

i) Lack of rural infrastructure. Financial institutions in the rural areas of most developing countries are beset by problems resulting from poor or the absence of

infrastructure (Asian Development Bank, 2000:9; Spio *et al*, 1995:257). A lack of ready access to social amenities such as water, electricity and communication facilities renders it relatively unattractive for qualified personnel to man the rural financial system (Spio *et al*, 1995:257).

ii) The political environment. The use of the financial system as a tool for disbursing political patronage creates strong disincentives for repayment and diminishes the confidence of the savers. The pattern of "politically giving and forgiving" credit has undermined trust in the credit system (Von Braun, 1992:128; Spio *et al*, 1995:257).

iii) Institutional weakness. This results partly from information problems and partly from human capital problems. Valuable repayment records that would allow the reconstruction of credit histories as a tool for future risk management are not available. Financial repression has frequently caused banks to under-invest in information capital (Brownbridge, 1998; Gonzalez-Vega & Graham, 1995:31). Supervision of financial institutions has not kept pace with their expansion and development, and this has led to corruption and other abuses, rendering depositors and investors unprotected. Appropriate technology has not been adopted, resulting in high transaction costs, both in monetary and non-monetary terms. The important effects of a failure to provide education - creation of human capital - cannot be over-emphasised (Asian Development Bank, 2000:9). The differences in worker productivity in developing and developed countries have been partly attributed to the human capital factor. Neither has the quality of bank management employees improved to a desirable level. The inadequacy in terms of management and density of rural financial institutions has resulted in market failures in most countries. This brings into play the attendant problem of under-capitalisation of the rural economy (Musinguzi & Smith, 2000:126; Von Braun, 1992:128).

iv) The physical environment. The physical environment in which the clients of the rural financial system operate is full of uncertainties. Widespread drought in most developing countries has led to periodic, wholesale decapitalisation, which is a particularly severe hindrance where financial markets are still in their infancy (Von Braun, 1992:128). Many, if not most, donors and policy makers saw the supply of credit to farmers in less developed countries as an important

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solution to production related problems, and therefore threw much cheap money into that sector. However, the unpleasant environment in which these farmers operated, contributed to huge delinquencies and defaults, turning many financial institutions into "white elephants" (cf. Spio, 1995:14 ). Uncertainty in land tenure and land markets inhibited the efficient utilisation of land as collateral. Deficiencies in delivery systems for agricultural inputs, and relatively drastic seasonal price fluctuations of major food and export crops, have probably contributed significantly to the poor development of rural financial markets (Spio & Groenewald, 1998:12).

v) The policy environment. Lipton (1976) apportions part of the blame to private investors, aid donors, or the too-powerful administrators for the rural deprivation that have been found in most developing countries. Urban interest, pressures and ideologies have dominated policy formulation. Policies are designed to allocate greater shares of developmental resources to urban areas. The policy environment pertaining in most developing countries has been a stumbling block in the development of the financial system (Asian Development Bank, 2000:8). The overall level of development of a country, and especially any lack of recent growth, does not provide an incentive climate in which finance and financial institutions can function well. High rates of inflation and instability in foreign exchange rates have been the order of the day. Financial repression regarding interest rates and the existence of widespread directed credit programmes have affected the ability of financial institutions to achieve a substantial outreach and attain viability (Yaron *et al*, 1998:152). The legal framework has also contributed significantly to the slow growth of the financial sector in developing countries, because it often lacks provisions to ensure enforcement of loan contracts (Spio, 1995). Other policies, like linking rural credit to agricultural input delivery systems, have also affected the rural financial markets. One of the two often hinders the other because of internal weaknesses in both systems (Von Braun, 1992:133). The interest rate policy has furthermore had a great effect on the development of the rural financial markets. A detailed dsicussions on interest rate is provided in chapter 3.

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## 2.8 CONCLUSION

A growing body of empirical analyses (some already discussed above) clearly indicate how financial markets and institutions affect – and are affected by – economic development There is a strong positive link between the functioning of the financial system and the long run economic growth. Theory and evidence make it difficult to conclude that the financial system merely – and automatically – responds to industralization and economic activity or that financial development is an inconsequential addendum to the process of economic growth.

Economist have come a long way since the time when many viewed the financial system as a sideshow, or a passive channel that allocate scarce resources to the most efficient uses. Today, almost everyone agrees that the financial system is essential for development. However, the recent East Asian financial crisis indicates that the causal link between finance and growth is determined by the nature and operations of the financial institutions and policies pursued.

Improved access to financial services can have two principal effects on farm households. First, it can raise the expected value of income, and therefore of consumption, future investments and asset accumulation. Second, it can decrease the downward risk of too low an income to satisfy basic consumption needs. These two effects tend to have significant impacts on various aggregate and household-level outcomes, including agricultural productivity, technology adoption, food security, nutrition, health, and overall household welfare.

Interventions by governments have been pervasive in developing countries. The success of these interventions has been mixed, with the scale weighing heavily towards the side of failures and undesirable effects. What is clear from this review is that an efficient allocation of resources can be achieved only through a sound financial structure, which must embody prudential regulation, supervision and control; appropriate institutions and institutional philosophy; financial instruments that are consistent with savers' and borrowers' preferences and needs; and a rational structure of positive real interest rates.