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1

Domestic Resource Mobilization and Financial Development: Introduction

George Mavrotas

Recent years have witnessed a new interest in the relationship between finance and growth, at both micro and macro levels, and empirical research has blossomed,¹ but the relationship between domestic resource mobilization and financial development has not been properly explored.² However, issues related to domestic resource mobilization and financial development are central to the overall development process and recently they have been raised in connection with the attainment of the Millennium Development Goals (MDGs). Financial development, broadly defined to include not just financial sector deepening but also improvements in the efficiency of the financial sector and the banking institutions in developing countries and emerging economies, can enhance domestic resource mobilization, which is vital for pro-poor growth.³

The policy agenda has recently moved in new and interesting directions, partly because of the relevance as well as the importance of domestic resource mobilization for accelerating progress in achieving the MDGs, and partly through the emergence of new initiatives, such as the United Nations International Year of Microcredit (2005) and the 'blue book for policy-makers', *Building Inclusive Financial Sectors for Development*, published in 2006 by the United Nations Capital Development Fund (UNCDF) and the UN Department of Economic and Social Affairs (UN-DESA), and which emphasized in particular the issue of 'financial access' and the centrality of 'inclusive financial sectors' (UNCDF and UN-DESA 2006; see also Cheru and Bradford 2005; Claessens 2005).

It is broadly recognized that developing economies often lack an appropriate financial sector, one that provides incentives for individuals to save and acts as an efficient intermediary to convert these savings into

credit for borrowers. The financial liberalization experience of many low-income countries in recent years, although in the right direction in certain cases, seems to suggest that transforming the financial structure of an economy is a complex process that assumes a deep understanding of the entire set of interactions between financial sector reforms and the economy. At the same time, the experience of the Asian financial crisis clearly suggests that, while financial liberalization may be desirable, the process must be regulated correctly, and this requires the building of institutional capacity – a costly, though important, process (Brownbridge and Kirkpatrick 1999; Stiglitz 1999, 2002).⁴

It is equally fair to argue that, until very recently, building the domestic financial system towards domestic resource mobilization has been neglected as a potential source of development financing in connection with the MDGs. However, there is substantial potential there which, if realized, can help to accelerate progress significantly with the MDGs. It also needs to be stressed that the above important route has the additional advantage of engaging local communities directly in the overall development financing process. Further to building the financial system as whole, it is also vital to provide micro-credit and to create insurance mechanisms for the poor (Dercon 2004).

The above discussion clearly suggests that, while substantial progress has been made in recent years on the research and policy front in this important area, a number of issues remain unresolved and require further attention. In this regard, this volume brings together a collection of essays by leading experts in the field, who discuss various aspects of the financial development–domestic resource mobilization nexus in an effort to delve more deeply into this important relationship. The volume also provides a good balance of recent theoretical developments in this area; the application of recent innovations in econometric methodology; important case studies that discuss country experiences with financial sectors reforms – in both Africa and Asia (including China); and useful policy lessons.

An important issue in the overall finance–growth literature is related to the role of stock market development in the growth process. Salvatore Capasso argues in Chapter 2 that since the 1990s economists have devoted considerable attention to the study of the relationship between financial market development and economic growth. In particular, the emergence of stock markets with economic development is an intriguing and interesting aspect of such a relationship, and as yet has been relatively unexplored. The chapter examines the most recent findings in the theoretical and empirical literature in an attempt to determine the

rationale behind the development of stock markets along the path of growth, and the nature of the interrelationship between real and financial variables.

The bulk of the literature on financial development is associated with empirical work on the overall relationship between financial-sector development and economic growth. George Mavrotas and Sang-Ik Son, in Chapter 3, explore the relationship between financial-sector development (broadly defined as going beyond financial depth) and economic growth using a database covering 65 countries (both industrial and developing) over the period 1960–99, and by employing various indicators of financial development in the empirical analysis. Empirical results obtained from the estimation of a series of panel data models seem to suggest that financial development does contribute to economic growth, although the magnitude of the impact varies depending on the type of financial indicator employed, the level of development (that is, industrial *vis-à-vis* developing countries) as well as the impact of other non-financial variables in the process. The authors also find evidence that seems to suggest that financial development can accelerate growth by improving the allocation of capital.

A substantial part of the financial development literature deals with financial crises, particularly after the emergence of the Asian crisis in 1997. Chapter 4, by Panicos Demetriades and Bassam Fattouh, provides a novel empirical analysis of the South Korean credit market and reveals large volumes of excess credit since the late 1970s, indicating that a sizeable proportion of total credit was being used to refinance unprofitable projects. The authors argue that their findings are consistent with theoretical literature suggesting that soft budget constraints and over-borrowing were significant factors behind the Korean financial crisis of 1997–8.

Iftekhhar Hasan and Mingming Zhou, in Chapter 5, document the financial and institutional developments of China since the 1980s, as China was transforming successfully from a rigid, centrally-planned economy to a dynamic market economy. The authors examine empirically the relationship between financial development and economic growth in China by employing a panel sample covering 31 Chinese provinces during the important transition period of 1986–2002. The evidence reported by the authors suggests that the development of financial markets, institutions and instruments have been associated robustly with economic growth in China.

Chapter 6, by Machiko Nissanke and Ernest Aryeetey, examines the source of financial market fragmentation in Sub-Saharan Africa within

the framework of institutional economics. By using fieldwork data from Ghana, Malawi, Nigeria and Tanzania, the authors analyse financial risk management, the transaction costs for loan screening and monitoring, and contract enforcement. They show how, faced with various institutional constraints, the range of clientele selected by both formal and informal lenders becomes both narrow and at the extreme ends of the market. The chapter also evaluates the prevailing state of managing risks for market structure, and binding institutional constraints for market transformation and deepening in Sub-Saharan Africa.

Using a vector error-correction model, Chapter 7, by Mina Baliamoune-Lutz, explores the short-run dynamics and long-run linkages between financial reform and the mobilization of domestic saving in Morocco. In the short run, financial depth (defined as the volume of intermediation) is shown to have a positive influence on private saving, while increases in real interest rates have a negative impact. The author argues that the effectiveness of financial intermediation does not seem to have a *direct* effect on saving, but has a significant influence on the volume of intermediation. In the long run, savings have a stable relationship with financial reform but the influence of interest rates remains negative, implying that the income effect dominates in the long run as well.

The focus of Chapter 8 by Alemayehu Geda is on the structure and performance of Ethiopia's financial sector in the pre- and post-reform periods. Geda notes that, since 1992, Ethiopia has been engaged in liberalizing its financial sector: the hallmark of the strategy being gradualism. The approach is not without problems, according to the author, especially from Bretton Woods institutions that saw the reform as a sluggish process. The chapter examines this liberalization programme by analysing the performance of the sector both before and after the reform. The author notes that, given the nascent development of the financial sector in the country, the relatively good shape in which the existing financial institutions find themselves, and given that supervision and the regulatory capacity of the regulating agency is weak, the government's strategy of gradualism and its overall reform direction is encouraging. However, the chapter also argues for charting out a clearly defined time-frame for liberalization, and exploring the possibility of engaging with foreign banks to acquire new technology to enhance the efficiency of the financial sector in general, and the banking sector in particular.

Chapter 9, by Samuel Maimbo and George Mavrotas, explores the relationship between financial-sector reforms and savings mobilization in Zambia. The authors argue that, while an extensive literature exists on financial-sector development and savings levels in developing countries,

there does not seem to be any satisfactory work on the above nexus for Sub-Saharan African countries, particularly Zambia. Along these lines, the chapter examines the linkages between the financial reforms of the early 1990s and savings mobilization. It considers the characteristics of banks and non-bank financial institutions (in particular microfinance institutions) and savings levels, and identifies problems associated with the relatively poor performance of savings in recent years. It concludes with a set of policy guidelines for strengthening savings mobilization, highlighting the expected effect on poverty-reducing growth.

The final chapter in this volume, by Pham Thi Thu Trà and Robert Lensink, deals with the determinants of loan contracts to business firms from a private bank in Vietnam. The authors focus on the main loan contract features the bank uses in lending to business firms; namely, loan maturity, collateral and loan interest rate. Based on the simultaneous equation model of Dennis *et al.* (2000) and the bank's loan contracting policies, they examine the possible interdependency of the three different loan contract terms. They try also to determine which firm characteristics and exogenous factors are relevant for loan contracts. They find strong interdependencies between these contract terms with significant bi-directional relationships between collateral and loan maturity, loan rate and loan maturity, and a uni-directional relationship between loan rate and collateral. The authors argue that the conflicting signs within the collateral–loan maturity relationship and the loan interest rate–loan maturity relationship can be explained by their hypothesis that the choice for a certain loan maturity is determined primarily by borrowers' behaviour, whereas the loan rate and the collateral requirements are determined primarily by banks' policies. In addition, their results support the relevance of firm quality, agency costs of debt, and relationship lending in loan contract design.

A central message that emanates clearly from the volume is that policies enhancing domestic resource mobilization – for example, by mobilizing domestic savings, expanding the tax base in developing countries (particularly in Sub-Saharan Africa), increasing access to financial services, and deepening financial sector development – have a prominent role to play in the challenging effort to use all available sources, both domestic and external, to accelerate progress with the MDGs. In particular:

- *Deepening financial sector development* is becoming a key priority in low-income countries, along with the challenge to move beyond financial deepening towards *improving substantially the efficiency of the financial sector*.

- Policies that attempt to build better financial institutions (thereby increasing the confidence of savers), encourage competition and provide a broader variety of instruments for saving can further strengthen *the overall savings mobilization process* in low-income countries with substantial gains in the area of poverty-reducing growth and MDG achievement.
- Most individuals, and small and medium-sized enterprises continue to depend on informal and non-financial assets for their savings facilities and arrangements. Policy-makers need to encourage *the role played by microfinance institutions*, which, with a relatively smaller cost base, is a more viable option in the effective delivery of financial savings facilities to low-income individuals, and small and medium-scale enterprises, especially in rural areas.
- On the other hand, *the challenge for microfinance institutions* is to create structures that facilitate successful clients of microfinance-institutions to access larger, more diverse and longer-term sources of finance.
- Efforts to improve domestic resource mobilization should be made within the overall context of *improving the state of the economy*. Investment in domestic financial assets will only be successful if the domestic currency is stable, interest rates are positive, and local banks and non-banking financial institutions are managed prudently and safely.
- Last, but not least, *improving access to savings institutions* is of crucial importance for domestic resource mobilization. Rural savings mobilization, in particular, requires an institutional network providing easy access to potential savers. The absence of savings institutions collecting deposits from the rural sector, especially in remote areas, may simply discourage saving or encourage consumption, and perhaps wasteful expenditure, or it may lead to saving in a non-monetized form.

It is hoped that this volume will contribute in a fruitful and forward-looking way to the ongoing debate in the international development community regarding the mobilization of domestic resources in developing countries, and the crucial role that financial development can and should play in this regard.

Notes

- 1 Arestis and Demetriades (1997), Levine (1997), Caprio *et al.* (2001), Demirgüç-Kunt and Levine (2001), World Bank (2001), Green and Kirkpatrick (2002), Goodhart (2004), Wachtel (2004), Abiat and Mody (2005), Detragiache *et al.*

- (2005), Green *et al.* (2005) and Rousseau and Wachtel (2005); more recently, another strand of literature has worked to shed light on issues related to the important link between financial-sector development and poverty reduction – see Beck *et al.* (2004), Honohan (2004), Green *et al.* (2005), Claessens and Feijen (2006) and Guha-Khasnabis and Mavrotas (2008).
- 2 Among the few exceptions are the study by Bandiera *et al.* (2000), which, by using data on a selected group developing countries, has concluded that financial-sector development does not necessarily raise private savings; Loayza *et al.* (2000), who focus on the factors affecting savings disparities across the world; Kelly and Mavrotas (2003), who show a rather strong positive impact of a financial-sector development index on private savings in Sri Lanka over the period 1970–97; and more recently, Kelly and Mavrotas (2008), who estimate the impact of various measures of financial development on savings for a heterogeneous panel of seventeen African countries; Mavrotas (2005) provides a detailed discussion.
 - 3 The need to strengthen the domestic financial sectors in low-income countries stems also from the fact that the current international finance architecture has not been able to address the various credit constraints that developing countries face, partly a result of the numerous problems associated with external finance (for example, foreign aid, but also private capital flows); see Akyüz and Cornford (2002) for a comprehensive discussion in connection with the overall globalization process, and Addison (2007) for an authoritative assessment of development finance issues.
 - 4 At the same time, it should be borne in mind that the quality of financial institutions in low-income countries may crucially affect the overall relationship between finance and growth, as recent work seems to suggest – see Demetriades and Andrianova (2008), among others, for a detailed discussion.

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Key: **bold** = extended discussion; f = figure; n = endnote/footnote; t = table.

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