



Development Finance

What is the relationship between the ability of a country to improve their citizens' well being and the development of its financial institutions – such as a [stock market](#) or a banking system? In the wake of financial crises in regions such as East Asia, Russia, Brazil, and Turkey in the past several years, this question is particularly relevant.

Recent studies have pointed to a relationship between economic growth and the expansion of financial institutions, or “[financial deepening](#).” However, these studies have important limitations. For example, the direction of causation is often unclear – does the expansion of financial institutions cause an economy to grow faster, or is financial development simply a by-product of high growth? More importantly, too little attention is paid to differences in types of financial institutions and to the rules that govern them.

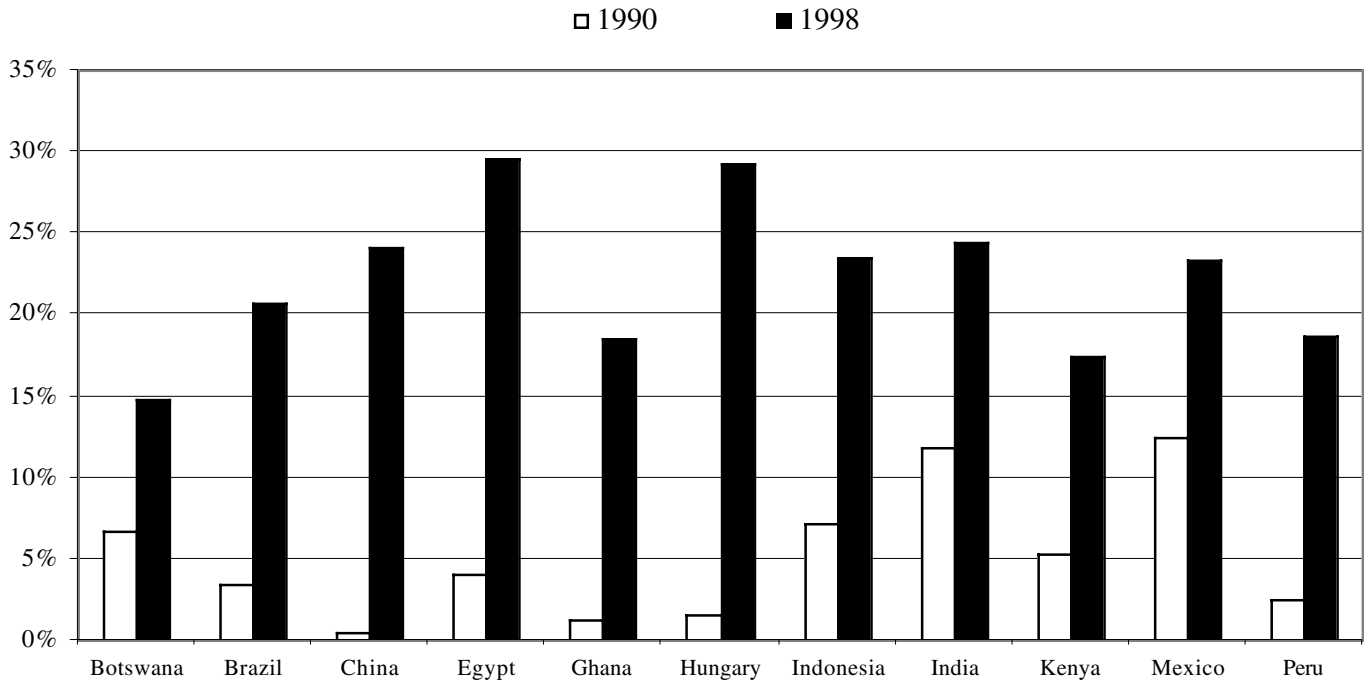
A well-functioning financial system contributes to development by making economic resources available to people who put them to use in ways that benefit society. The success of financial development, therefore, depends on how effectively finance can be channeled to generate high levels of social benefits. Unfortunately, many financial systems perform poorly. Often only a fraction of the population has access to financial institutions – usually those people who already own a stock of assets. Communities in underdeveloped regions often fail to take

advantage of investments with large social benefits because of lack of finance. Such financial inefficiency has real costs in terms of unrealized improvements in welfare.

Recently, international organizations, such as the Financial Development Corporation – a part of the [World Bank](#) – have promoted the expansion of stock markets in many developing countries, under the assumption that markets will improve efficiency. But are stock markets the right type of financial institution for developing countries? An increase in instability has accompanied the growth of stock market activity around the world – measured as the total value of traded stocks, or stock market capitalization, relative to the size of a country's economy. Often investors focus on short-term or speculative gains; more long-term productive investment is overlooked. The expansion of stock markets is also associated with larger flows of short-term investment (called [portfolio investment](#)) that can, in a moment of panic, trigger a financial crisis with real impacts on ordinary people. Finally, many markets are remarkably shallow – only a handful of companies account for most of the activity. Often small players are not able to finance their activities through stock markets.

There has been a broader international trend towards embracing market-driven finance for development – the expansion of stock markets being an

Stock Market Capitalization as a percent of GDP



Source: *World Development Indicators 2000*, table 5.2.

important example. As markets are deregulated and the rules of the game change, many countries have faced a higher risk of financial instability that compromises their development strategies.

Are there alternatives to deregulated markets and stock exchanges? Extending credit through banks and specialized financial institutions is one option. Bank-based systems often direct finance towards long-term or socially beneficial investments better than markets. Likewise, micro-finance organizations supply small loans to poor communities that are frequently denied access to other sources of credit. The benefits of these loans can be dramatic. Finally, banks often link their practices to industrial and government policies to pursue a coordinated approach to economic development in a way that markets cannot.

This is not to say that bank-based institutions are without problems. Some banking systems lack transparency, are prone to mismanagement, and extend credit in ways that do not reflect broader priori-

ties. However, these problems underscore an important lesson for harnessing finance to help achieve development goals – the type of financial institution matters.

Sources:

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