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Development Banking and Finance

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Preface and acknowledgements

Development Banking and Finance focuses on the banking and financial issues which directly affect developing economies, aiming to set them in the context of the overall development effort. The most extant theoretical and empirical aspects in development banking and finance are integrated smoothly with institutional issues and policy questions. The analysis is illustrated through examples to show how the theories relate to the practical world of applied research, consultancy, and policy design and evaluation; special attention is paid to ongoing debates on developing economies as well as debates that encompass both developing and undeveloped countries.

The book is structured to unfold in a systematic manner. A brief introduction provides the backdrop of the book, including an account of how the discipline of development banking and finance has emerged into a distinct area; the scope and structure of the book are also presented. The rest of the book is structured into ten neatly divided, but thematically linked, chapters. Notes are given at the end of each chapter; these are followed by an appendix where applicable. The book ends with a bibliography and an author-cum-subject index.

The motivation of the book mainly derives from my teaching, research and consultancy in the subject area of development banking and finance over the last ten years. It is now over five years since I started teaching a course in Development Finance on the MSc(Econ) degree course in International

Economics, Banking and Finance at Cardiff Business School. The challenge has been such that, each academic year, it has not been possible to obtain a single textbook that covers a good proportion of the course; therefore my lecture notes have largely relied on a collection of material from journal articles, numerous books and data sources. The lack of a core book in this subject is notwithstanding the fact that development banking and finance is increasingly becoming an area for postgraduate teaching (especially on MSc and MBA degree programmes), research and consultancy.

This book therefore aims to find its place as a core volume which addresses the basics of development banking and finance. The book is expected to have its widest appeal to faculty members and postgraduate students on the MSc, MBA and research programmes in Development Finance, Development Banking and Development Economics at universities in Europe, particularly the UK, as well as overseas universities especially in developing countries. As a reference book, research students and staff will find in it adequate research orientation, not only in terms of empirical research cited or reported in the book but also in terms of promising research ideas that are listed virtually at the end of each chapter. It is also expected that practitioners in international organisations, such as the United Nations (UN), International Monetary Fund (IMF), World Bank, Overseas Development Association (ODA), United States Agency for International Development (USAID), European Bank for Reconstruction and Development (EBRD) and all others who are involved in the business of development banking and project financing will find interest in the policy and "applied" parts of the book.

The book has benefited from a number papers some of which were jointly authored with other people, over the years, to whom I am thereby indebted. Chapter 5 on financial system restructuring, especially the econometric testing and results on supply-leading and demand-following finance, has benefited from joint work in Murinde and Eng (1994a, 1994b) on Singapore and Lyons and Murinde (1994) on Ghana. Chapter 6 on development banking has partly benefited from joint work in Kariisa and Murinde (1995). Chapter 11, on how the structure of the financial system is crucial in conditioning the potency of macroeconomic policy in developing economies, has partly benefited from joint work in Green and Murinde (1992, 1993). I also thank, without implication, a number of people, in particular Christopher Green, Tim Congdon, Robert McNabb, Arnold Thomas, Niels Hermes, Robert Lensink, Ahmed Kellow, Subrata Ghatak, Andy Mullineux, Michael Atingi-Ego, Olesegun Wallace, Kamal Naser and Kent Matthews, for useful comments on earlier papers which appeared as *Discussion Paper Series in Financial and Banking Economics*.

Some parts of chapters of this book were presented in the form of papers at a number of seminars and conferences, at which participants were generous with useful criticisms and suggestions. In particular, I would like to thank participants in the weekly research seminars of the Financial and Banking Economics Research Group (FABER-G) at Cardiff Business School; over the years, these included many colleagues and research students. Parts of some chapters in this volume were also presented as papers at the 'Annual Conference of the ESRC Money, Macroeconomics and Finance Research Group' held at London Business School in September 1992; successive seminars organised by the ESRC Development Economics Study Group at the London School of Economics in October 1992, December 1993, and May 1995, respectively; the conference on 'New Growth Theory' held at Leicester University in March 1994; the 'Annual Conference of the Western Social Science Association' in Alburqueque, New Mexico, USA, in April 1994; the 'International Symposium on Economic Modelling' held at the World Bank in Washington in June 1994; the conference on 'Restructuring Financial Institutions in Emerging Market Economies' held at Tallinn Technical University, Estonia, in October 1994; the conference on 'Financial Development and Economic Growth' held at the University of Groningen, the Netherlands in December 1994; the 'Forum on New Approaches to Financing for Africa' held at the OECD Development Centre, Paris, in February 1995; the 'IDEA Annual Conference' held at the University of Glasgow in March 1995; and the '25th Anniversary Conference on Development Projects' held at the Development and Project Planning Centre at the University of Bradford in April 1995. The questions, comments and objections from seminar/conference participants forced me to sharpen, discard and/or re-examine many arguments. Most of all, they affirmed me in my belief in the importance of writing this book to demonstrate the nuts and bolts of development banking and finance.

Successive cohorts of my students on the MSc in Development Finance at Cardiff Business School, in the period October 1990 - September 1995, dealt with issues which are linked to the raw materials for this book; their questions and demands for further clarification significantly influenced me in writing and revising the draft in some places.

During the actual writing of this book, some people undertook the painstaking duty of proof-reading the drafts. Arnold Thomas, literally went through the draft with a tooth-comb; Robert Lensink favoured me with suggestions, in some cases drawing from his recent work; Mark Byoruganda constantly 'faxed' through to me detailed comments; and Patrick J Mbyemeire (Rev Fr) literally blessed almost each page of the draft, after critically examining the contents. I thank them all.

Important data and raw materials for the research, whose results are incorporated in this book, were obtained from Datastream, The Word Bank, Economic Analysis and Projections Department; and the University of Wales Aberconway Library (thanks to Nancy Hooper, Andy Lloyd and Kate Stephenson); Chapman and Hall for *Applied Economics* and *Applied Financial Economics*, Pergamon Press for *World Development*, Elsevier Science Publishing Co. (North Holland) for *Journal of Policy Modelling*, Giordano Dell'amore Foundation for *Savings and Development*, Montei dei Paschi di Siena for *Economic Notes*, Industrial Credit and Investment Corporation of India Limited for *International Journal of Development Banking and Finance* and Macmillan Publishers, kindly gave their permission for making use of materials I had previously published with them. The help rendered by the people at these places is acknowledged.

As usual, special thanks go to Heather Rowlands for her skill and patience in typesetting the volume (in office, Heather has always been my life-boat!). Initial typesetting for almost half the book was undertaken by Nona Pritchard, before Heather took over with a new programme. I am deeply indebted to Nona for the sacrifice; in particular for continuing to type some of the chapters long after she had left Cardiff Business School. I also wish to thank Jenny Firth for typing some of the work that found its way to the chapters in this book. The staff at Avebury, especially Jo Gooderham, Anne Kierby and Steven Jarman deserve thanks for providing excellent support throughout the writing of this book.

This book was completed when I was in transition from the post of Lecturer in Banking at Cardiff Business School to the new post of Senior Lecturer in Finance at the University of Birmingham; I am grateful to Cardiff Business School for the assistance offered in the preparation of the manuscript.

Finally, the inevitable caveat applies: the analysis, conclusions and policy recommendations expressed in this book are my *responsibility*; they reflect neither the position of the institutions nor the views of the persons whose assistance and contribution are acknowledged above. Until financial markets, institutions and instruments are so well developed that a secondary market exists for trading such *responsibility*, I have but to recite the well known verse that any errors or heresies in this book are *mea culpa, mea maxima culpa*.

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1 Introduction

1.1 Development banking and finance: the backdrop

The subject area of development banking and finance is increasingly attracting research attention. To put this observation into perspective, it is necessary to review the evolution of interest in this area in the last five decades. It was not until after World War II that development economics emerged as a distinct field of enquiry. At the time, however, many industrial economies did not accord policy priority to the development of strong financial systems. The developing countries did not offer a different policy attitude either. Indeed, at the academic level, most of the early literature was concerned with the real sector as well as strategic development issues such as balanced sectoral growth, poverty, international trade, labour migration, and food shortage; in general, the literature tended to relegate to the background the financial aspects of economic development. In particular, the early growth modes placed less importance on the role of banks and other financial institutions as engines of growth (see Murinde, 1994a; Murinde and Eng, 1994a). Neo-classical growth models attributed economic growth to exogenous technical change and exogenous population expansion. For example, the evidence generated in the seminal work by Solow (1957) for the US (1909-1949) suggests that gross output per man doubled with 87.5 percent of the increase being attributed to technical change and the remaining 12.5 percent arising from the increased use of capital (Shaw, 1992). However, from the work of some earlier development economists such as Prebisch, Nurkse, Lewis, and Kalecki we can trace some concern with the problem of financing economic development (Murinde, 1993a: ch.2). Although these economists expressed the view that long term development strategy, especially sustained development of the industrial sector, would only occur with the availability of finance, there was not much detailed analysis on the functions of banks and other financial institutions in providing the required development finance. Later, a number of important empirical and theoretical developments started to bring to light the role of banks and the general financial system in economic development. Goldsmith (1969, 1973, 1975) uncovered empirical evidence that a link exists between economic development and the financial structure. At the same time, theoretical research started to focus on monetary theory and financial policy in relation to the process of economic growth (see, for example, Gurley and Shaw, 1967). Subsequent contributions by Shaw (1973) and McKinnon (1973) further underlined the importance of the financial structure in inducing economic development; in particular, the spotlight was brought to bear on the distortions in the financial systems in developing economies (LDEs), with a proposal that financial controls in the credit markets should be lifted (Murinde, 1993b). At the same time, Patrick (1966) and Wai and Chorng-huey (1982) investigated the microeconomic aspects of financial markets; specifically, their research examined the contribution of financial markets to the mobilisation of financial capital in the process of economic growth. In common, the above studies significantly influenced the economic policy stance in many LDEs. The studies particularly recommended the elimination of restrictive credit policies, the de-control of the financial system and the promotion of financial deepening (Murinde, 1994b, 1994c).

However, the recommendations mainly addressed the financial intermediaries, notably banks, and largely ignored the development of public stock and bond markets. Even in the industrial countries, research progress was not remarkably rapid in the general area of finance. Much of the research output in the major finance journals in the US between 1960 and 1990 continued to revolve around the efficient capital markets theory and its implications of firm value maximisation. These research issues have greatly influenced the research agenda in finance in LDEs so much so that most existing studies on capital markets in LDEs concern themselves with research questions that were originally raised and debated in the developed capital markets in industrial economies. The main examples include the question of efficiency of securities markets, international portfolio diversification, asset pricing, capital market regulation and calendar anomalies (see Murinde, 1994a, 1995a). The main shortcoming of this development has been that the structural features and problems of the capital