DEVELOPING FINANCIAL STRUCTURES TO FOSTER ENTERPRISE DEVELOPMENT[?]

By

Andy W. Mullineux and Victor Murinde
The University of Birmingham

Correspondence to: Andy Mullineux, Department of Economics, The University of Birmingham, B15 2TT, U.K.
E-mail:A.W.Mullineux@bham.ac.uk
Tel: 00 44 (0) 121 414 6642
Fax: 00 44 (0) 121 414 7377

March 2001

[?] We gratefully acknowledge financial support from the Department for International Development (DFID) under the "Finance and Development Research Programme", Contract No. RSCI06506. However, the interpretations and conclusions expressed in this paper are entirely those of the authors and should not be attributed in any manner to DFID.

1. Background Policy Issues

Banks and organised capital markets play an important role in enterprise financing because of lack of full information on the credit standings of borrowers.[1] In this context, banks fill the vacuum created by market failure. Borrowers normally have more information about their credit standing than lenders and consequently there is asymmetry of information (see, for example, Brock and Evans, 1996), which is most acute in developing countries where banks dominate the financial system (Bhatt, 1994).[2] As banks gain expertise in lending, essentially appraising credit risks, they can develop well diversified loan portfolios to underwrite their commitment to repay deposits, on demand, and at their full nominal value. In the process of developing such portfolios in pursuit of profit they should allocate capital to its most efficient uses and ensure that it continues to be used efficiently. As more information accumulates and is disclosed by borrowing firms, capital markets naturally develop (Kumar and Tsetseko, 1992). The capital markets then take over the role of financing investment by the larger firms; for example, there seems to be a strong link between stock market activity, enterprise profitability and further investment (Blanchard, Rhee and Summers, 1993).

It is widely recognised that banking systems are inherently unstable (see Mazumdar (1996) for example) and it is rational for depositors to panic when confidence in the soundness of banks is lost (Diamond and Dybvig, 1983; Diamond 1991). Bank failures are extremely costly and disruptive of economic development (IMF, 1993; World Bank, 1994). Hence banks must be

---

[1] Information collection and processing is costly. Hence, full information may be achieved at such a high cost that in the long run it does not pay and it requires not only substantial and costly disclosure but assurance, through auditing, of the quality of the disclosed information.

[2] Traditionally, retail banks have predominantly held loans as assets and earned some fee income from providing payments, accounting (statements) and safe keeping services. As banks diversify into securities (broking and dealing) or 'investment' banking businesses, then the sources of fee income multiply and fee income grows in importance relative to income derived from the 'spread' (or 'margin') between lending and borrowing interest rates.

regulated to protect depositors and to underwrite economic stability. However, implicit deposit insurance through 'lender of last resort' intervention to rescue and prevent bank failure leads to a moral hazard problem.[3] Managers, knowing that they no longer face the threat of mass deposit withdrawals, can take on excessive risk. This moral hazard problem, combined with the risk of fraudulent use of funds for direct personal gain or through patronage, necessitates the regulation of banking (Tsiddon, 1992). The first step in developing a policy for efficient enterprise financing is therefore to ensure that the banking system is well regulated and supervised.[4]

Apart from bank domination, another common feature of financial systems that is important in the context of enterprise financing in developing countries is government intervention. This raises the wider issue of whether governments should be in the business of directing credit or interfering with commercial interest rate setting at all. If, however, governments do not intervene, what form should social, regional and industrial policy take? Is industrial policy about pro-actively 'picking winners', in the form of individual firms or particularly sectors, and directing funds towards them, or is it about privatising enterprises (including banks) and allowing a well regulated and supervised financial system to allocate credit and capital efficiency. In developed countries there has been a move away from directed credit and interference in interest margin and spread setting towards market allocation of finance, but there remains a tendency to try to pick winners. The UK government, for example, has been trying to ensure that high-technology sectors receive adequate finance and support. The policy instruments are, however, subsidies and tax incentives, rather than directed lending and interest rate controls. The role for development banks then becomes one of

[3] Mispriced explicit deposit insurance can also create moral hazard problems (Miller, 1996) or adverse selection, as in the US savings and loans crisis.

[4] Indeed, as the wider financial system develops, attention must increasingly be paid to its effective regulation and supervision.

addressing market failures through the provision of loan guarantees and finance, perhaps in partnership with the private sector for infrastructural projects (Murinde, 1996a).

Monetary policy may come into conflict with industrial and general development policy in setting the nominal interest rate and aligning it to the appropriate real rate? Attempts to hold real rates at low or negative levels to ensure cheap industrial finance are not only likely to be inflationary, but also counter productive. As the seminal model by McKinnon (1973) and Shaw (1973) demonstrates, financial repression will result because the development of intermediated finance and bank lending is inhibited.[5]

Credit rationing is another consequence of asymmetric information (Stiglitz and Weiss, 1981) and is most acute where information asymmetry is greatest. Small and medium sized enterprises are thus likely to be most exposed to credit rationing because less is known about them and their credit standing; most often they have no collateral (Stiglitz and Weiss, 1986). Specifically, credit rationing occurs because banks have insufficient information to accurately rank SMEs according to their credit standing. The banks have a pretty good understanding of the average credit risks involved in lending to various sectors (e.g. farming and retailing), but are less able to accurately assign 'credit ratings' to individual borrowers. They thus tend to charge interest rates which are an average (for the sector) risk related mark up ('spread') over the base rate. This discourages better (low risk) borrowers, who regard the rate as too expensive, and encourages 'bad' (high risk) borrowers, who regard the rate to be cheap. An 'adverse selection' problem then arises as the average risk faced by the lender is pushed up by the preponderance of high risk borrowers. To protect themselves against this tendency, banks reduce their exposure by rationing the supply of

[5] In general, however, financial repression is diagnosed by looking beyond the real interest rate symptoms. It is also characterised by high reserve requirements (which reduces the amount of loanable funds) and misaligned (especially overvalued) exchange rates; see, for example, Lensink, Hermes and Murinde (1998) on the simultaneous use of these three measures of financial repression for a sample of African economies.

credit to markets where they are unable to adequately assess the individual credit ratings of borrowers. SMEs in developing countries are thus likely to face more severe rationing than SMEs in developed countries because the latter have stricter reporting and auditing requirements (imposed by the tax and company registration authorities). Also, smaller and newer firms tend to face more severe rationing than older and larger firms.[6] Rural enterprises (especially farms) in many developing countries are commonly small and thus rural credit is a particular problem given the added geographical problem of delivering of financial services to remote areas. These rural enterprises are the engine for higher consumption and saving in developing countries (see Durojaiye, 1991). Small urban enterprises, however, also suffer from this 'financial exclusion' problem. There are obvious implications for economic growth overall, although these arguments are presented in the context of an economic growth model (see Barro and Xala-i-Martin, 1995).

To deal with the rural 'financial exclusion' problem, special initiatives may well be required, such as mobile banking units and microfinance (Murinde and Kariisa-Kasa, 1997). Microfinance, along with other community finance initiatives (CFIs) involving mutual financial institutions (credit unions, social investment funds, mutual guarantee schemes) may also help resolve urban 'financial exclusion' problems. More generally, the problem of credit rationing is commonly addressed by state-run loan guarantee schemes. These provide subsidised loan guarantees to reduce banks' exposure to credit risk, thereby encouraging greater bank lending to SMEs. It should be noted that loan guarantees can be targeted (with different levels of risk cover and subsidy) on different sectors of the economy in pursuit of industrial policy (eg encouraging lending to start-up and 'growth'

[6] This is partly because the larger SMEs are commonly older and have a 'track record' and partly because of 'fixed costs' of lending problem. Smaller firms commonly require smaller loans and the size of loan required may simply be too small to cover the (relatively fixed) costs of originating the loan.

enterprises in the high-technology sector) and social policy (eg rural credit, lending to women, lending in deprived urban areas).

Against this background, this paper argues that strategies for stimulating business enterprise finance should revolve around: establishing effective bank regulation and supervision; setting an appropriate positive real interest rate; reducing unnecessary government intervention, guidance and direction (which also presents opportunity for corruption and 'cronyism'); and addressing the credit rationing and financial exclusion and other problems, such as inadequate competition in banking, that arise from market failures.

The remainder of this paper is structured into five sections. Section 2 discusses the role of the financial sector in promoting the growth of enterprises. Financial system restructuring, as a means of correcting broad policy-induced distortions, is examined in Section 3. Section 4 considers the financing of SMEs. The role of development banks is examined in Section 5. Section 6 focuses on the possibility of utilising venture capital. The prospects for developing capital markets is discussed in Section 7. Concluding remarks are offered in Section 8.

2. The Role of the Financial Sector

Most enterprises finance their investment and further growth using a combination of internal finance (retained earnings) and external finance (eg new equity issues, bank loans or funds raised by issuing debt instruments including bonds).[7] Thus, the capital structure of most enterprises includes retained earnings, debt and equity (see Brealey and Myers, 2000; Bertero, 1994).

As new enterprises develop, there comes a point at which external finance is required to accelerate their growth. Internal finance, however, remains the major source of funding for ongoing

[7] This analysis focuses exclusively on the formal financial sector. However, there is evidence to show that the informal financial sector is in some cases paramount in fostering enterprise development (see Thomas, 1993; Montiel, Agenor and Ul-Haque, 1993).

investment in all firms.[8] Much less commonly, because of fear of loss of control, private enterprises also accept investment from venture capitalists. This typically takes the form of equity investment by individuals ('business angels') or through a private equity fund which pools the personal wealth of investors. In general, however, enterprises tend to have a "pecking order of financing choices"; they prefer using internal finance before they resort to external finance (Myers, 1984; Myers and Majluf, 1984; Baskin, 1989). Again, this may be because of the governance implications of expanding the share of external funding.

The importance of internal finance and external private capital means that careful consideration has to be given to the tax treatment of profits earned from direct private investment, especially when they are re-invested, or from indirect private investment (via venture and other private equity funds, or direct equity participations). 'Over taxation' is likely to result in under investment and/or tax evasion. 'Under taxation' can however lock capital into established enterprises, eg the *Chaebol* in South Korea, starving potential new and more efficient users of capital. A careful balance thus has to be struck and it may well be that re-invested profits from start-up and early stage growth investments should be taxed at a lower rate than profits from ongoing internally generated capital investment by larger and older firms.

The overall goal should be to establish a financial system that allocates capital efficiently on a dynamic and ongoing basis. Hence, capital needs to be continuously allocated to its most efficient uses. This will involve re-allocation of capital, withdrawing it from inefficient uses and re-allocating it to the most efficient users or projects identified at any point in time. To achieve this, effective bankruptcy laws are required and the use of capital allocated by the financial sector should be continuously and efficiency monitored (and be seen to be monitored). Effective, well designed, fair

[8] This is true of large firms as well as SMEs, where internally generated finance (undistributed profits) is the major source of capital investment funding, as well as for start ups, where access to private capital, in the form of the personal wealth of the entrepreneur and family and friends, is of crucial importance.

to creditors and debtors, and well prosecuted bankruptcy laws are thus a key component of an efficient financial sector.[9]

It is also clear from the above that the role of the financial sector in corporate governance needs to be carefully considered. As the allocator of debt (loan and bond) and equity finance, the financial sector is a major stakeholder in the economy. It also has fiduciary duties to other vicarious stakeholders, namely those that have deposited and invested their monetary and savings balances with financial sector. The infrastructure required for the efficient operation of a financial sector thus includes an effective corporate governance system, of which bankruptcy laws can be viewed as part. As the financial sector develops, the importance of institutional investors (pension and mutual funds and insurance companies) tends to increase relative to that of banks (Asikoglu, Kutay and Ertuna, 1992).

As holders of the majority of shares (equity) and bonds (debt contracts), the way in which the institutional investors exercise their voting rights becomes increasingly important. Because of asymmetric information, however, banks will remain the major suppliers of debt (loans/credits/overdrafts) to small and medium sized enterprises (SMEs) and thus will also have a crucial role to play in corporate governance through their role in monitoring their exposure to credit and other risks.

For most developing and transition economies, banks are still the major source of external capital for large as well as small enterprises, and indeed for the private sector and the economy as a whole. Debt finance thus tends to dominate equity finance, and bank debt (loan) finance dominates bond finance. This argument is consistent with the "pecking order of financing choices". Moreover, it takes time to develop capital (bond and equity) markets, a matter to which we return in Section 7.

Given the widespread dominance of the banking sector in most financial systems, it is important to ensure that the banking sector operates efficiently.[10] The potential for banking sector instability and its damaging effects have been illustrated by the 1997/8 Asian and other financial crises in the last couple of decades. As explained in the introduction, it is clear that banks need to be regulated. As a result of the work of the Basle Committee on Bank Regulatory and Supervisory Practices, there is an increasingly widespread acceptance of how

banks should be regulated. This has been codified in the "Core Principles for Effective Banking Supervision" (see BIS or Finance Stability Forum websites). What is required is the establishment of the appropriate legal structures and of a supervisory body to ensure that banks adhere to the regulations. We have no space to discuss this further here – see Mullineux and Murinde (2001, Section 4) for further discussion. Banks should monitor firms that have borrowed from them to ensure that they use capital efficiently and banking firms should themselves be monitored to ensure that they use their capital and the deposits they collect, and thus people's monetary and savings balances, efficiently and non-fraudulently.

There is clear evidence that banking instability and the subsequent recapitalisation of banks are expensive in terms of charges on the state budget and lost growth (see IMF, 1993; World Bank, 1994). Hence prevention of instability should be given a high priority (Simon, 1992; Ciarrapico, 1992). There is also evidence that macroeconomic instability discourages investment and reduces

---

[9] An appropriate balance between the rights of creditors and debtors must be struck, so that entrepreneurship is not stifled and yet banks remain willing to lend, and the courts must deal with the cases efficiently (promptly and consistently etc.).

[10] Brealey and Myers (1996, p. 366-7) report that for all non-financial corporates (NFCs) in the US over the decade 1981-94, internally generated cash was the dominant source of corporate financing and covered, on average, 75 percent of capital expenditures, including investment in inventory and other current assets; the bulk of required external financing came from borrowing; net new stock issues were very minimal. The observation is consistent with the findings by Rajan and Zingales (1995) in their international comparisons of capital structures in seven OECD countries, as well as the evidence by Corbett and Jenkinson (1994), Bertero (1994), and Edwards and Fischer (1994) for selected OECD countries. However, these studies also find some evidence of a shift from bank loans to direct financing from the capital (and particularly the bond) markets as part of the securitisation process associated with the financial liberalisation of the 1980s and 1990s.

economic growth (Fingleton and Schoenmaker, 1992). Clearly, a bout of financial instability, including bank failures, will generate macroeconomic instability, but macroeconomic instability can occur independently of financial instability and result in increased financial fragility. Furthermore, fluctuations in growth and inflation clearly have an impact on the balance sheets of firms and banks. Bank supervisors must take this into account.

The monetary authorities may or may not be responsible for both supervising banks and controlling inflation using monetary policy. Those responsible for inflation control must however recognize that the monetary brakes can only be applied, in the form of an aggressive rise in interest rates, if the financial sector is stable. This will only be the case if banks and the firms to which they lend are well governed. However, the symbiosis between financial and macroeconomics stability works in the other direction too. The more stable the macroeconomic environment, the easier it is to develop strategic investment plans and the more efficiently will capital be allocated. Faster economic development will result. Macroeconomic stability and the efficiency of the financial sector are thus highly interrelated

and good macroeconomic (and microeconomic) policy formulation must take this into account (see Green and Murinde, 1998).

Finally, as capital markets develop, and indeed to facilitate their efficient development, attention needs increasingly to be paid to ensuring that the wider financial sector, not just banks, is effectively regulated and supervised and that a 'level playing field' prevails in the financial sector so that distortions are avoided.

3. Financial Sector Restructuring

Financial system restructuring derives from the need to correct government policy-induced distortions in the financial sector (Murinde, 1996a) and is inspired by the theory and evidence in favour of supply-leading finance rather than demand-following finance (see Murinde and Eng, 1994; Lyons and Murinde, 1995). There are two main forms of government intervention. The first form relates to intervention in the implementation of monetary policy (see Murinde and Ngah, 1995). The choice is between direct controls on levels of bank lending, which are likely to be distortionary, or a more market oriented approach of manipulating the price of money i.e. interest rates. Many countries have intervened in bank interest rate setting in pursuit of social goals (e.g. cheap housing or rural finance) by setting ceilings on nominal lending or deposit levels or fixed margins over some base interest rate set by the monetary authorities (Hermes, Lensink and Murinde, 1998). Further, direct controls on bank lending are often imposed in pursuit of regional or industrial

The second main form of intervention invalues final repression through holding real interest rates at low or negative levels (see McKinnon, 1973; and Shaw, 1973). Econometric work on variants of the McKinnon-Shaw model has shown that many developing countries are either currently experiencing, or have experienced, 'financial repression' (see, Fry, 1995; Murinde, 1996; and Hermes, Lensink and Murinde, 1998). However, the appropriate level

of the real interest rate for a developing country is hard to gauge. It is important to note, however, that both overly high positive real rates and inappropriately negative rates are damaging (see Abebe, 1990). Low positive real rates are likely to stimulate more saving and higher aggregate bank deposits, leading to more lending than in the case of artificially low (negative) real rates; this is notwithstanding the criticism that 'cheap credit' undermines rural development in developing countries (Adams, Graham and Von Pischke, 1984). Meanwhile, excessively high rates aggravate 'credit rationing'.

Restructuring is also required following a financial crisis. It should be considered as a means of increasing both financial stability and the efficiency of capital allocation; and thereby facilitating the achievement of a more rapid economic development.[11]

In some cases, financial restructuring may take a form of financial liberalisation (see Murinde, 1996). Key liberalisations are likely to include interest rate deregulation and removal of restrictions on branching, foreign bank entry and the range of financial activity (scope). The objectives are to increase the supply of loanable funds and achieve higher savings levels. However, the responsiveness of investment to financial liberalisation is debatable (see Gupta and Lensink, 1996; Hermes, 1994). In some countries, financial liberalisation has been associated with financial sector failures (Honohan, 1993). Rural credit markets may be completely wiped out by the introduction of financial liberalisation (Herath, 1994). In addition, financial liberalisation may not be able to stave off capital flight (Hermes, Lensink and Murinde, 1998). It is, however, not merely the levels of investment that matter, for in the larger sea it is the quality of the investment that assures competitiveness.

The efficient allocation of capital is only possible if there is efficient financial intermediation. Broadly, this requires setting real (i.e. inflation adjusted) loan and deposit interest rates at levels that reflect the risk of lending and allow an adequate return to be made by lenders and other financiers on their capital whilst rewarding savers and depositors appropriately. Where there is widespread state ownership of banks and other financial institutions, there may be a temptation to hold lending rates down to stimulate growth. This is likely to be counter productive and distortionary, with negative consequences for the pace of economic development in the medium term. It can lead to overborrowing, overinvestment (investment that earns an inadequate return on capital) and

[11] The bottom line argument is that financial intermediation is strongly linked to economic growth; see Bencinvenga and Smith (1991).

overindebtedness (too much debt relative to equity and income streams). The distortionary effects will be compounded if lending is directed, in accordance with some government plan, to preferred sectors; regardless of the risk to return ratios involved. Whilst much directed lending is well intentioned, most prominently in the formerly centrally planned economies, it is also subject to abuse and corruption (particularly *graft*) and political interference and can lead to the sort of problems faced by the *Chaebol* (particularly Daewoo) in South Korea and the state-owned enterprises in China in the late 1990s.[12] The result is an increase in financial instability since the lending banks and other creditors will face rising bad debt problems as a result of lending to inefficient enterprises.

Low interest rates also discourage the public from placing monetary and savings balances with banks, and may well lead to a lower level of savings (Fry, 1995). Hence low (particularly negative real) interest rates reduce the volume of funds to be intermediated or lent by banks and other financial intermediaries. Seemingly paradoxically, raising interest rates to positive real levels may well not only stimulate more saving and lending, but, in making borrowing more costly, discourage inefficient lending and overinvestment (Murinde and Mullineux, 1999). The net result is likely to be a more efficient allocation of an increased volume of capital, and a more rapid development of the financial sector (through reduced 'financial repression') and the economy as a whole.

This line of argument also suggests that it is best to reduce the amount of directed credit and free the financial sector to pursue profits, through the efficient allocation of their capital, whilst ensuring that regulatory infrastructure is in place and banks are adequately supervised.

[12] The *Chaebol* and industrial conglomerates which borrowed heavily from banks in order to expand the scale and scope of their activity. By the mid 1990s they had very high debt to equity ('gearing') ratios: When interest rates were raised following the onset of the 1997 crisis they struggled to service their debts and were encouraged by the government to sell assets in order to reduce their debt levels. The Chinese state owned enterprises (SOEs) are heavily indebted to state-owned banks and are not sufficiently 'profitable' to service the debts properly. The problem is likely to be aggravated following China's prospective entry into the WTO, which will expose the inefficient SOEs to further competition.

In order to give banks the right incentives and help protect them from political interference, they should then be privatised as soon as possible. However, privatisation of banks is only possible once their bad debt problems have been addressed (Doukas, Murinde and Wihlborg, 1998). It should also be noted that financial sector restructuring is likely to take place within the context of wider policy reforms. If a financial crisis has occurred, or needs to be prevented, then financial sector restructuring is likely to take place whilst attempts are being made to assure macroeconomic stability, and to improve corporate and economic and political governance in general i.e. as part of widespread legal, political and economic reform.

The recent examples of bad debts and bank privatisation in the transition economies of Eastern and Central Europe have prompted policy makers and analysts to rethink their strategies (Doukas, Murinde and Wihlborg, 1998). The dominant view is that privatisation of banks and other state owned enterprises must be preceded by a work-out of outstanding debt relationships between them, especially when the banks are faced with bad or doubtful debts (Murinde and Mullineux, 1999). The resolution of the banks' bad debt problems paves the way for the privatisation of other state-owned enterprises. The banks' bad debt problems are usually resolved using some combination of removing bad loans from their asset portfolio and recapitalisation . There have been numerous recent examples of how this can be done e.g. the US savings and loans crises and the Nordic banking crisis (Shull, 1995). Because banks' bad loan assets are debt problems for the borrowing enterprises, their resolution leads effectively to a financial restructuring of indebted firms. If the enterprises are state owned, as is often the case in formerly centrally planned economies, then the financial restructuring of the banks' asset portfolios leads to a financial restructuring of state owned enterprise liability portfolios, paving the way for their privatisation too. If, as in Poland for example, the financial restructuring of banks and enterprises is done in tandem as part of the process of preparing them for privatisation, then more comprehensive enterprise restructuring, involving the establishment of new management structures, can be made a condition for government financial assistance; which is invariably required. Mass privatisation in the absence of prior restructuring under such conditionality, as executed in Russia and Czech Republic, has proved problematic. In the Czech case, because governance structures were weak, and in the Russian case, because the process facilitated the formation of oligarchies.

The financial and enterprise restructuring process may well require the breaking up of large conglomerate units; such as the *Combinats* in East Germany, and the *Chaebol* in south Korea. This will prove difficult to achieve unless adequate bankruptcy laws and mechanisms for welfare provision by the state are in place.

The process of globalisation and trade liberalisation is exposing more and more sectors in more and more economies to competition (see Banuri and Schor, 1992). As trade barriers are dismantled it becomes increasingly important that capital is allocated to the sectors in which the country or region has a comparative advantage. Trade liberalisation has gone hand in hand with capital account liberalisation in recent years, making it easier for countries to import capital to supplement domestic savings and thereby to accelerate development (see Anderson and Khambata, 1985). As with domestic sources of capital, it is important that capital inflows from abroad are efficiently invested and do not lead to over investment and/or inflationary pressures (and 'bubbles'). The problem of excessive capital inflows, leading to artificially low interest rates and an exposure to capital flight, has been recurrent in recent years and seems to have been a root cause of the Asian financial crisis (Dickinson and Mullineux, 2000).

The combination of capital account liberalisation, as strongly advocated by the IMF, at least prior to the 1997/8 Asian Financial Crisis, and the General Agreement of Trade in Services, especially relating to financial services, in the Uruguay round of the GATT concluded in the mid 1990s, have acted as drivers for increased financial sector competition. Entry by foreign banks and other financial institutions has increased in many countries. Their entry has often driven down interest rate margins and brokerage fees and facilitated the transfer of skills and 'know how', leading to enhanced efficiency. Not surprisingly, entry is not welcomed by vested interest groups, including indigenous financial institutions, but the overall impact seems to be beneficial and some recent studies on the effects of GATS in developing countries have concluded that financial liberalisation *enhances* stability (Murinde and Ryan, 1999). It is well known that banking sectors subjected to increased competitive pressures can become more fragile if they are not carefully managed, hence bank supervisors should be especially vigilant during periods following liberalisation.

The possibility of excessive short term capital inflows also needs to be carefully monitored and this has implications for exchange rate policy (Dickinson and Mullineux, 2000; and Lensink, Hermes and Murinde, 1999). A lesson of the Asian crisis is that exchange rate pegs (including currency boards) can outlive their usefulness as stabilisation devices. Once they do, then flexibility (floating or crawling pegs) or participation in a currency union become the only viable alternatives. It should be noted that, if directed lending is to be progressively abandoned, then the traditional role of development banks is called into question (see Bhatt, 1993). We will turn to this issue in Section 5.

4. SME Financing

There is growing recognition of the role of the small and medium sized enterprise (SME) sector in employment creation. Even in the developed industrial economies it is the small and medium sized enterprise sector, rather than the multinationals, that is the largest employer of workers (Mullineux, 1996a). As globalisation progresses and international competition increases, the largest corporations have tended to shed labour, at least in their country of origin, in pursuit of cost efficiency. Job shedding by large enterprises has been particularly evident in the transition economies as former state owned enterprises have sought to achieve international competitiveness. Invariably it is to

SMEs that countries look for the job creation necessary to absorb the labour shed by the larger firms. During periods of industrial restructuring, including those involving privatisation programmes, it is particularly important that the SME sector thrives and creates new jobs.

As indicated in the introduction, SMEs normally face credit rationing as a result of an adverse selection problem resulting from information asymmetry (Stiglitz and Weiss, 1981). Credit rationing of this sort, which results from the inability of banks to accurately gauge and price risks and the inability or unwillingness of SMEs to provide adequate collateral or third party guarantees, becomes more acute in financial crises. It is also exacerbated by an aggressive tightening of monetary policy. In such acute cases, it is often dubbed a 'credit crunch'. Credit rationing can also result from 'financial exclusion', which occurs when potential borrowers wish to borrow amounts that are seemingly too small for banks to lend at a profit. Essentially, the 'fixed costs' of making the loan appear to be too high relative to the potential return given the uncertainty about the riskiness of the loan applicants.

To help resolve the risk exposure problem, developed countries commonly employ loan guarantees. Government funds, usually managed by an agency, are used to guarantee (cover) a proportion of the credit risks incurred by banks in extending loans to SMEs that qualify for loans under the scheme. Schemes vary in the extent of the guarantee and the degree of state subsidy.[13] Subsidised insurance premia are commonly paid by firms in the form of a supplement to the interest rate charged by the lending banks, which normally manage the loans. The accumulated premia rarely cover the disbursements from the fund resulting from defaults on loans. By reducing banks' risk exposure, it is hoped that banks would lend more than they otherwise would to SMEs.

[13] Riding (1996) reviews a number of schemes.

Schemes such as the UK's 'Small Firms Loan Guarantee Scheme' were introduced on an experimental basis with the objective of encouraging banks to engage in and learn the business of lending to small firms. Having succeeded in that aim, the UK's scheme was retained, but increasingly the guarantees have been focused in pursuit of industrial policy. Firms with employment growth potential and high tech firms, have, for example, been increasingly targeted in the 1990s. This has left smaller firms still facing credit rationing. In the US the targeting has also been used as part of social policy. The US Small Business Administration runs schemes targeting minority ethnic groups and women, for example, many developing countries have experimented with loan guarantee schemes of the variety presented above. The major drawbacks of the existing schemes are as follows:

* They are poorly publicised among industrialists, policy makers and corporates.
* They are difficult to access and use.
* The actual situations that would be most appropriate for their use are unclear to both the end users and the banks.

Overall, however, there is potential for guarantee schemes which underwrite loans to state-owned and parastatal companies, Treasury Bill and bond issues, and international issues. Here, guarantee of loans to the economically weaker borrowers can reduce price and increase access to funds.

What can be learnt from the experience of operating loan guaranteed schemes in developed countries? It is noteable that the amount of bank lending to SMEs under the UK's scheme appears to have been sensitive to the extent of the guarantee and the take up by SMEs, not surprisingly, seems to be related to the size of the premia and hence the degree of subsidy (Mullineux, 1994). Failure rates amongst SMEs, especially start-ups, are relatively high. This is in part due to the inexperience and lack of training of the managers and the difficulty of accessing good advice. Loan guarantee schemes are thus frequently linked to the provision of pre and post finance training and business advice. This is true of the US Small Business Administration (SBA) and the UK's new Small Business Service.

The SBA has provided a model for the UK's new small business financing, training and support scheme, the Small Business Service introduced in 2001. An alternative model is the German system which revolves around the development bank (KfW) and regional guarantee banks, which are in turn supported by Chambers of Commerce (see Mullineux, 1994). The KfW provides implicitly subsidised medium to long term loans to SMEs and helps underwrite loan guarantees extended by the guarantee banks. The guarantees are also partially covered by state (Länder) governments. The Chambers of Commerce provide expertise to help screen the loan applications submitted by the potential lenders (banks) to the guarantee banks. The originating banks are expected to screen the loans prior to applying for guarantee and to manage the loans once guarantees are agreed. The process of screening the loans thus encourages the development by banks of expertise in SME lending, and helps to facilitate the spread of best practice in screening loan applications by providing direct or indirect feedback by experts to banks on their screening processes. In so doing, the tendency for banks to rely too heavily on collateral to secure or underwrite loans is reduced.

As noted above, the 'fixed costs problem' creates an additional hurdle for smaller and new or young SMEs to jump before they can gain access to external finance. They can face 'financial exclusion' if the sums they wish to borrow are not large enough to cover the fixed costs of originating a loan. This is a problem commonly faced by farming communities in developing countries who operate on high fixed costs but do not have enough equity to cover the costs. Such problems can be exacerbated by geographical remoteness. Many urban communities face similar financial exclusion problems, however. It should be noted that members of poorer communities are less likely to be able to secure loans with suitable collateral.

A number of schemes are being developed in the US and Europe to tackle financial exclusion problems of this sort. These include microfinance schemes, which were pioneered in rural areas in developing countries. Microfinance schemes involve banks or agencies lending small amounts from specially created funds on an unsecured basis. They often target women, whose repayment record is generally good and as a result, default rates are normally remarkably low and they are much more profitable than might be expected. However, they rarely generate the return on capital that commercial banks have come to expect and they are usually run by agencies with social and early stage development objectives. The most famous example is the Grameen Bank.[14]

Mutual and cooperative banks have emerged in many countries as means of self-help providing finance and education on money management. There are numerous examples. Cooperative banks have been formed to serve agricultural communities in many countries and have been prevalent in France and Japan, for example. 'Raiffeisen banks' emerged in a number of European countries to service the needs of urban craftsmen. Like their credit union cousins, which service the financial needs of individuals rather than enterprises, these banks tend to operate through the pooling of savings for lending to members. In this way information problems are reduced and peer pressure can help assure prompt and full repayment of borrowed funds. The Raiffeisen banks were essentially urban cooperative banks or business credit

[14] The Grameen bank extends microfinance in rural Bangladesh, targeting its lending on primarily women; who have been found to be more reliable debtors than men. This is believed to reflect their more highly developed sense of family responsibility and their susceptibility to peer group pressure (shame of non-repayment). There were naturally some problems with the repayment of loans to the Grameen Bank following the floods in Bangladesh in 1998/9. The objectives of the scheme frequently include education and training about the management of money and business.

unions. The general principles of mutuality have also been applied to insurance and house building and purchase (UK building societies and US saving and loan associations).

A related idea is that of a mutual guarantee scheme (MGS). In this case the participating enterprises pool savings which they use to provide a guarantee to leverage loan finance from banks to corporates (Barclay and Watts, 1995). In so doing they overcome the fixed costs problem by borrowing sufficiently large amounts and also the lack of collateral problem. As with the other examples of mutual or cooperative self help, however, savings have to be built up first. These savings represent internal investment that has been foregone in the hope of accessing larger amounts of external funds in the future.[15]

In developed countries, many of the older mutual and cooperative banks have grown to the point where they are operating more like commercial banks. Their close relationship with the members has consequently been lost. There is thus a case for facilitating the creation of 'new mutuals' to tackle financial exclusion. The establishment of such 'community finance institutions' (CFIs) could be encouraged by special tax and legal treatment and access to subsidised loan guarantees. The CFIs can also be used as a means of providing pre and post finance training. There are numerous schemes in the US and many of the ideas are likely to be transferable to developing countries. The provision of finance in combination with training appears to be the key to success (May et al, 1998). One way of achieving this is to establish 'incubators' in 'business parks'. The incubators provide offices and clerical, administrative, accounting and marketing etc support to new enterprises for a limited period until they are established and able to set up on their own (or not, as the case might be).

[15] The government of Mauritius commissioned a study to advise on establishing a Mutual Guarantee Fund to help foster the development of mutual guarantee schemes. The consultants were asked to advise on whether the Mauritius Development Bank or some other public or private sector institution or agency should manage the Fund.

The main role of the incubators, which may be publicly and/or privately funded and may or may not seek a share of the profits, and the microfinance, mutual and cooperative schemes is to allow participating enterprises to grow to the point where it becomes profitable for mainstream banks to enter into a normal (but perhaps with the help of loan guarantees) lending relationship. Given that CFIs provide a supply of potential new clients to banks, the banks may be encouraged to provide capital to support their activities (see Mayo et al, 1988). CFIs could also be used by banks to supply basic banking services cheaply to people who would otherwise be financially excluded.

Thriving or 'growth' SMEs with good access to bank finance are soon likely to need access to equity finance in order to avoid 'overgearing' (an excessively high debt to equity ratio). It is to providers of private equity ('business angels' and venture capital funds) that they are likely to turn in the first instance. It should, however, be noted that if the founding entrepreneurs intend to continue to manage the expanded business then they will probably need further training and access to more sophisticated business advice. We return to the role of private equity and the development of capital markets in Sections 2 and 5, but we must first consider the future role of development banks in addressing market failures in enterprise finance.

5. Modern Development Banks

For purposes of future policy strategies, modern development banks should aim to achieve three functions in a mutually reinforcing manner, namely: the financial function; the developmental function; and the technological development function.

The financial function acknowledges that a development bank is first and foremost a financial institution and hence its performance and efficient utilisation of resources should be determined on the basis of its financial statements (Jain, 1989; World Bank, 1994). The idea is that if the bank is performing profitably, its investments are doing well in terms of income generated. In addition, the profitability of the bank also depends on the efficiency of the bank itself. In this tradition, the analysis of the adequacy of profits and the overall rates of return is often based on the standard financial ratios. In other words development banks should be required to allocate capital efficiently; otherwise they will have a distortionary influence within the financial sector as a whole. That having been said, due account should be given to the external benefits derived by the infrastructure investment they finance.

The developmental function relates to the main objective of setting up development banks (Meeker, 1990). Given that the main business of development banks is project financing, it may follow that unless these projects are successful, the bank will not have succeeded in its main objective (Grzyminski, 1990). In judging success , or failure, the positive externality, as well as financial ratios, should be taken into account. However, the ability to repay the loan cannot be used as the sole criterion for the success of development banking; for example, financial statements could show a rosy picture if projects used non-project sources of income to repay the project loan. For the bank to have a positive developmental function it must get involved right from the beginning through identification, promotion and financing of business opportunities. The bank may also promote projects in accordance with the overall national development policies. This is particularly important because it has been observed that in developing countries there are few viable projects presented to development banks in a proper form (Sender, 1993). Thus, the bank needs to identify a number of opportunities and choose those which it thinks are the best in terms of profitability, economic feasibility and easy implementability (Hu, 1981; Bhatt, 1993).

The second step is to identify the personnel who will manage the enterprise; the entrepreneur's ability, integrity and commitment have to be identified. In a case study, Dugan (1990) cites Zraly, Senior Manager at Zivnosteuska Bank in Prague, who believes that their main objective is to look at the quality of management for a project proposal. If the sponsor is lacking in managerial qualities, the project is bound to be plagued by problems, however profitable it may appear. It can therefore be argued that development banks should have in place a mechanism and relevant criteria which will facilitate their judgement in this direction (Westlake, 1993). Development banks also need a system which will give early warning signals once the project commences; the system would enable the bank to intervene as soon as trouble is detected. Baum and Stockes (1985) observe that there is a need for close bank-client relationship between the borrowers and development banks to facilitate guidance and financial discipline.

The technological development function re-inforces the developmental function. It is widely held that developing countries lack the required technology to achieve higher levels of economic development (Dowrick, 1992). Specifically, according to the 'two gap' theory, developing countries lack the necessary domestic savings as well as the foreign exchange to facilitate technological development (Todaro, 1996). Development banks are strategically placed to act as technological development institutions during the process of importing intermediate inputs and to facilitate development of intermediate technologies. Since the banks finance industrial projects and the projects need industrial equipment and technology to be successful, the banks can serve to fill this gap and shape the type of technology which should be imported or produced domestically.

However, the bank must have the technical capability to assess not only the suitability of a suggested technology but also the trend of technological developments taking place in other economies. In circumstances where it does not have the required expertise, the development bank can enlist the services of research and consultancy firms.

A case study by Bhatt (1993) on the use of research firms to assess technological developments reports that the Korean Development Corporation has quite often relied on the expertise at the Korean Institute of Science and Technology. Technological policy also seems to be working in India and Brazil, where development banks have created engineering consulting subsidiaries to ensure that appropriate technological policies are promulgated (Jaquier and Hu, 1989). Even if all the stages of project identification, promotion, appraisal and implementation are properly done, unforeseeable events in the macroeconomic environment can affect the performance of development projects and, by implication, the development bank (Bennett, 1993). In addition to external shocks like oil prices, many developing countries are characterised by high inflation, slow or stagnant growth and balance of payments difficulties (IMF, 1993; Murinde, 1993). These factors are not conducive to industrial development as they make it difficult for firms to plan ahead. Given that a development bank cannot take direct policy action to change the macroeconomic environment, it is necessary that the bank takes a direct interest in the implementation of projects to ensure that timely action is taken to insulate the project against macroeconomic shocks.

It is important that development banks aid, rather than impede, adjustments required in response to good liberalisation. Thus financial sector liberalisation and privatisation if banks may necessitate the reorientation, restructuring and perhaps even corporatisation of domestic development banks, as in Sri Lanka. As part of 'private finance initiatives' modern development banks can be expected increasingly to engage in co-financing arrangements with banks and other financial institutions. Their role should thus increasingly be to ensure that positive externalities are reaped in cases where private finance is unlikely to be sufficiently forthcoming e.g. in sponsoring infrastructural projects, or projects where social benefits are substantial, even though financial rewards are not sufficiently high to sustain private financiers. In other words, the case for intervention by development banks should rest largely an identification of market failures that result in an inadequate supply of private sector finance.

As access to international capital markets has increased and as, over time, domestic capital markets develop, we can expect to see the role of development banks as financiers of mainstream business activities decline. Increasingly they should engage in the co-financing, with the private sector, of infrastructural projects; perhaps drawing on external financial assistance. They (or some other agency) should also address the market failure in the supply of finance to SMEs and provide training and other support services to small businesses.. In developing loan guarantee schemes, developing banks could make a major contribution to the successful development of the crucially important SME sector. In addition, development banks might take on the role of developing venture capitalism, the topic to which we turn next.

6. Developing Venture Capitalism

Venture capitalism involves the provision of equity capital for the start up and development of enterprises (see Kitchen, 1992). The capital is usually raised from investors in the form of a fund which is used to make private equity investments in businesses. There is also a growth in private equity investment in SMEs by rich individuals, or 'business angels'. The private equity investors essentially provide capital to supplement that sunk by the initial entrepreneurs and in return normally require a say in how the business is run. Taking on private capital from outside is thus a big step for SMEs because it entails dilution of control over their enterprises. Banks generally interfere much less, so long as businesses are performing satisfactorily. Many potential growth SMEs thus fail to exploit their full potential because they do not wish to dilute control.

As mentioned in the introductory overview, it is important to ensure that the tax system is conducive to the provision of private risk capital, both by insiders (the start-up enterprises) and outsiders, who come on board at a later date. It is also important that firms and private investors wishing to re-invest profits, rather than take them out of their businesses, are given a fiscal incentive to do so. To encourage the participation of business angels, access to information on potential clients is also important. A government business support agency, possibly the development bank, could construct a database to be accessed via the internet, for example. Indeed, there seems to be an important role for business support agencies in fostering the supply of private equity or venture capital. Development banks could adopt a market development role here, perhaps through co-financing or through a dedicated fund – this is a role which the European Investment Bank has recently been assigned.[16] As the venture capital market becomes established, development banks would be expected to withdraw after spinning off or winding down active funds.

Increasingly, venture capital funds and business angels are looking outside their country of origin for opportunities, perhaps because they have developed sectoral expertise (Sagari and Guidotti, 1992). They are thus likely to become a growing source of foreign capital if the tax incentives and legal infrastructure are conducive[17] and could play a key role in enterprise restructuring programmes. There is a tendency for older and larger funds (eg 3i in the UK) to withdraw from start-up and early-stage investments and to concentrate on investing in growth enterprises and sectors (eg Communications and Information Technology). Their focus is increasingly on financing management buy-outs and buy-ins. Whilst they perform a useful role in the restructuring process and the financing of medium sized enterprises, a new gap in small enterprise equity finance can emerge. For this reason a sympathetic tax regime should be retained to encourage 'business angels' and new entry into the venture capital business and the development bank might maintain an interest in providing start-up capital in the medium term.

[16] The government of Mauritius commissioned a study to advise on the establishment of a State sponsored Venture Capital Fund and which public or private sector institution or agency should manage it. The Mauritius Development Bank was considered alongside alternatives.

[17] It would seem sensible to offer similar tax and exemption packages to those aimed at attracting Foreign Direct Investment, thereby differentiating the supply of private equity capital from portfolio investment. As regards the legal infrastructure, the amount of capital that flows in is likely to be greater the easier it is to get it out (liberal capital account) and the greater the legal redress (good bankruptcy and anti-fraud laws).

Just as SMEs are likely to graduate, from Community Finance Initiatives (CFIs) or mutual financing, to bank financing, so 'growth SMEs' may soon outgrow venture and business angel financing. The external providers of the equity funds will anyway want to liquidate their investments for re-investment in the next batch of growth SMEs. At this stage it is common for the former SMEs to become a fully fledged public companies by abandoning their private status. This can be done through stock exchange floatations or initial public offerings (IPOs). Essentially shares are issued to the general public and the private capital providers (initial entrepreneurs, venturers and angels) can redeem their investments. They can, of course, reinvest some of the capital by purchasing shares in the public company. It is important to realise that private equity funding will be more plentiful in countries with well developed capital markets that can provide the funders with an 'exit route' in the medium term. It is to capital market development that we turn next.

7. Developing Capital Markets

It should be emphasised that well functioning capital markets cannot be created overnight and are unlikely to emerge until the appropriate stage of economic and financial development has been reached. A sound regulatory and supervisory framework needs to be in place and buyers and sellers in the market will not have confidence in it until it is tried and tested. As confidence grows, then more and more buyers (investors) and sellers (issuers) of securities will come to the market and its liquidity (and stability) will increase. This cannot be achieved by decree and it is also necessary that there are attractive bonds and shares or stocks which can be traded on the markets. Foreign portfolio investment can help deepen markets if the capital account has been liberalised, but recent experience suggests that capital can flow out as quickly as it flows in, causing large swings in stock prices. Transparency, sound regulation and vigilant supervision are important means of encouraging foreign investors to take the additional risk (including exchange rate risk) of investing overseas. It is not just financial risks and economic stability that matters, capital inflows and outflows are as much, if not more, affected by the level of political stability, it should be noted.

In developing and transition economies, the privatisation of state-owned enterprises can provide a supply of shares that are potentially attractive to investors. Indeed, there are some lessons which the emerging stock markets can learn from the experience of the developed markets, such as the London Stock Exchange, in terms of their potential for financing enterprises as well as the impact of government intervention in the market (see Green, Maggioni and Murinde, 2000). The attractiveness of the shares will of course depend on how well the enterprises have been financially and organisationally restructured prior to privatisation. This is as true of banks as non financial firms and, as mentioned in Section 2, it is important that plans are in place to deal with outstanding bad debt problems, or perhaps preferably that such problem have already been resolved.

The growth of the insurance sector and the creation of funded pension schemes will help to 'deepen' the capital markets by creating a relatively stable demand for equities and bonds to satisfy the long term portfolios needs of such institutions. Also, as earlier noted, such institutional investors should be encouraged to play a role in corporate governance.

Some impediments may constrain the developmental role of stock markets (Atje and Jovanovic, 1993). The high costs of complying with stock exchange registration requirements may, however, discourage the issuance of shares ('initial public offerings', or IPOs) by 'growth SMEs'. For this reason, many developed countries, particularly in Europe (eg France, Germany and the UK) have introduced special stock markets designed to attract IPOs by 'growth SMEs', who later hope to graduate to the main stock exchange. Generally these exchanges have a lighter regulatory regime (with reduced reporting requirements etc) that is less costly to comply with. It is these specially designed stock markets that increasingly commonly provide the necessary exit route (through IPOs) for private investors.

As financial systems evolve, new marketable financial instruments develop. These allow companies to issue a range of debt instruments across the maturity spectrum, from commercial paper and bills through to medium to long term corporate bonds. In larger firms these securities are increasingly replacing bank intermediated debt finance. This process of disintemediation is a natural product of financial sector evolution (Arndt and Drake, 1985). Corporate bill and bond markets require benchmark interest rates against which risk premia can be gauged. These are typically provided by treasury bill and government bond markets and thus the development of the latter can be regarded as part of the process of developing capital markets to facilitate corporate finance. Central banks commonly play a major role in helping develop these markets for government debt, but development banks might well have a role to play in helping to establish interbank and corporate bond markets.

It should be noted that banking sectors will be unable to allocate capital efficiently without access to an effective interbank market. Banks with surplus funds and a shortage of profitable lending opportunities should be able to lend to other banks in the opposite situation. Such markets typically use treasury bills and short dated bonds for benchmarking, making the development of a treasury bill market and a government bond repurchase ("repo") market are key foundations of the wider development of interbank and other money markets. The development of money markets is in turn important for the sophisticated operation of monetary policy. In addition, good monetary policy implementation is itself conducive to enterprise development and stable economic growth (Green and Murinde, 1992, 1993).

Initially, short term tradable corporate securities are likely to take the form of bank accepted (underwritten or guaranteed) 'commercial bills'. As the reputation of the issuers develop, acceptance by banks, for which they charge fees, becomes an unnecessary expense and tradable commercial paper issued instead. Over time, other debt instruments have been developed in the Euromarkets and elsewhere eg. floating rate notes (FRNs) and so too have hybrid debt/equity instruments (eg. perpetual FRNs).[18] These too have displaced a great deal of bank variable interest rate lending. Larger corporations can issue corporate bonds, provided there is a suitable government bond to serve as a benchmark and if their credit ratings are high enough.[19] This development should be encouraged since it reduces the demand by large corporations for bank financing, focussing banks on the needs of smaller companies and SMEs. It also reduces the need for domestic bank borrowing from the international banking markets through which they raise foreign currency for onlending . This borrowing in turn increases short term capital inflows, as in the case of Thailand; where banks borrowed heavily in dollars through the Bangkok International Banking Facilities (BIBFs) in the run up to the summer 1997 banking crisis (Mullineux, 2000).

As the capital markets develop towards the stage already reached in the US and being approached by the countries participating in the Economic and Monetary Union (EMU) in Europe (or 'Euroland'), 'junk bond' markets are likely to develop. These are markets in bonds issued by companies which the credit rating agencies are unable to give an investment grade rating. The bonds issued thus have relatively high and uncertain credit risks and earn high rates return for investors in reward for their risk exposure. Over time smaller and smaller companies may gain access to such debt markets, but only to the point that issuance is cheaper than raising bank debt finance. Falling fixed costs of issuance will facilitate this process, but it is not limitless and is likely to be gradual.

[18] A floating rate note is a note whose interest payment varies with the short-term interest rate. The word 'note' is used here to refer to unsecured debt with a maturity of up to 10 years. Perpetual floating rate notes are floating rate notes whose maturity is indefinite (ie is for ever and ever).

[19] Credit rating agencies assign ratings to borrowers on the basis of the risk of default; some of the main credit rating agencies are Standard and Poor's and Moody's (see Murinde, 1996b).

Also in the later stages of financial sector development, markets in financial derivatives (swaps and options etc) will develop and domestic banks will offer customised derivatives 'over the counter'. Financial derivatives facilitate the hedging of risks, as well as speculation. They are thus useful tools for risk management by banks and other enterprises, but it is by no means clear that countries should rush to develop domestic products and markets given that they are accessible through off shore and other major international financial centres.

It is important to ensure that regulatory development and supervisory competence keeps pace with the liberalisation of the financial sector and the capital account of the balance of payments; and the financial innovation and increased competition that results. The development of sound capital and banking markets will have the added benefit of attracting longer term foreign capital in the form of foreign portfolio and direct investment. The less restricted the outflows, the greater the inflows tend to be (see Fischer, 1993; Greene and Villanueva, 1991). Increased longer term inflows will in turn reduce reliance on less stable short term capital inflows and thus help reduce private sector short term debt exposures. It has been argued that if Thailand and the other worst affected South East Asian countries had had more developed capital, particularly corporate bond, markets, then the crisis would have been less severe. With the benefit of hindsight, this may be true, but it must be stressed that the development of sound capital markets has taken a long time in the US and cannot be achieved overnight in emerging market economics. Indeed, highly developed capital, and especially corporate bond, markets are a rarity and there is a case for carefully embarking on their development without delay, but there are few shortcuts. Reputation must be earned. As noted, good regulation and supervision is one of the foundations of stability, but there is less consensus about how best to regulate capital markets than there is for banks.

8. Concluding Remarks

Government intervention, in the form of regulation and supervision of the wider financial sector and in the provision of loan guarantees and other small business support services, is necessary due to market failures (information asymmetry and fixed cost problems in the main), but market-led financial reforms are the key to the evolution of the financial sector and enterprise development. The private sector should be brought into partnership with the government (eg in overcoming financial exclusion through bank financing of community finance institutions) and markets should be used to provide incentive compatible solutions (eg risk related capital adequacy and deposit insurance) wherever possible.

Banks will continue to play a leading role in promoting the growth of enterprises, especially the SMEs, although over time stock markets will become increasingly important in most developing and transition economies. Financial system restructuring, as a means of correcting broad policy-induced distortions, is an important ingredient of the symbiotic growth of the financial and corporate sectors. To sustain the momentum for growth, mechanisms for financial sector regulation and supervision have to be in place. Pending the development of domestic capital markets or access to international capital markets, development banking will remain important for funding long term investment and infrastructural projects. Developing countries will continue to use development banks to tap into international capital flows by offering co-financing prior to the development of fully-fledged capital markets. The development banks (or some other agency) should also develop loan guarantee schemes and provide training and other services to the small and medium sized enterprise sector. In other words, development banks should focus on addressing market failures. As the market failure in the provision of long term capital to larger enterprises declines in importance (as their access to capital markets increases), the development (and commercial) banks should increasingly focus on meeting the needs of SMEs. For it is SMEs that will be the engine of future development.

References

Abebe, A. (1990) Financial repression and its impact on financial development and economic growth in the African Least Developed Countries, *Savings and Development*, 14, 1: 55-85.

Adams, D.W, D.H. Graham, and J.D. Von Pischke, (eds.) (1984) *Undermining Rural Development with Cheap Credit*, Boulder, Colorado: Westview Press.

African Development Bank (1989) *Africa and the African Development Bank*, London: Economy Publications.

Anderson, D. and F. Khambata (1985) Financing small-scale industry and agriculture in developing countries: the merits and limitations of commercial policies, *Economic Development and Cultural Change*, 33, 2: 349-371.

Arndt, H. W. and P. J. Drake (1985) Bank loans or bonds: some lessons of historical experience, *Banca Nazionale del Lavoro Quarterly Review*, 155: 373-392.

Asikoglu, Y., S. Kutay and I. O. Ertuna (1992) Mutual funds in developing capital markets. In: Fischer, K.P. and G.J. Papaioannou, *Business Finance in Less Developed Capital Markets*, Westport and London: Greenwood Press.

Atje, R. and B. Jovanovic (1993) Stock markets and development, *European Economic Review*, 37: 632-640.

Banuri, T. and J. Schor (1992) *Financial Openness and National Autonomy*, Oxford: Oxford University Press.

Barclay, S. and G. Watts (1995), "The determinants of corporate leverage and dividend policies", *Journal of Applied Corporate Finance*, Vol. 7 (Winter), pp. 4 - 19.

Barro, R. J. and X. X. Sala-i-Martin (1995), *Economic Growth*, New York, McGraw Hill.

Baskin, J. (1989), "An empirical investigation of the pecking order hypothesis", *Financial Management*, Vol. 18, Spring, pp. 26-35.

Bencinvenga, V. R. and B. D. Smith (1991) Financial intermediation and endogenous growth, *The Review of Economic Studies*, 58: 195-209.

Bertero, E. (1994), "The Banking System, Financial Markets and Capital Structure: Some Evidence from France", *Oxford Review of Economic Policy*, 1014, pp. 68-78.

Bhatt, V. V. (1993) 'Development banks as catalysts for industrial development', *International Journal of Development Banking*, 11, 1: 47-61.

Blanchard, O., C. Rhee and L. Summers (1993) The stock market, profit and investment, *The Quarterly Journal of Economics*, 108, 1: 115-36.

Brealey, R. A. and S. C. Myers (2000) *Principles of Corporate Finance*, McGraw-Hill, New York (6th Edition).

Brock, W.A. and L.T. Evans (1996), "Principal-Agent contracts in continuous time asymmetric information models: the importance of large continuing information flows", *Journal of Economic Behaviour and Organisation*, 29 (3): 523 - 35.

Ciarrapico, A.M. (1992) *Country risk: A Theoretical Framework of Analysis*. Aldershot: Dartmouth.

Diamond, D. and P. Dybvig (1983) ‘Bank Runs, Deposit Insurance and Liquidity”, *Journal of Political Economy,* 91, 401-419.

Diamond, D. (1991) “Monitoring and Reputation: the choice between Bank Loans and directly placed Debt”, *Journal of Political Economy,* 99, 689-721.

Dickinson, D.G and A.W. Mullineux (2000) Lessons for the East Asian Financial Crisis: A Financial Sector Perspective, *Geoforum* (forthcoming).

Doukas, J., V. Murinde and C. Wihlborg (1998), *Financial Sector Reform and Privatisation in Transition Economies*, North-Holland, Amsterdam.

Dowrick, S. (1992) Technological catch up and diverging incomes: patterns of economic growth 1960-1988, *The Economic Journal*, 102 (May), pp. 600-610.

Dugan, A. (1990) ‘Banks in the firing line’, *Euromoney*, September: 119-33.

Durojaiye, B.O. (1991) Rural household consumption-savings behaviour in low-income nations, *African Review of Money, Finance and Banking,* 1: 85-95.

Edwards, J. and K. Fischer (1994), *Banks, Finance and Investment in Germany*, Cambridge University Press, Cambridge.

Fingleton, J. and D. Schoenmaker (1992) *The Internationalisation of Capital Markets and the Regulatory Response,* London: Graham & Trotman.

Fischer, B. (1993) Success and pitfalls with financial reforms in developing countries, *Savings and Development*, XVII, 2: 111-135.

Fry, M. J. (1995) *Money, Interest, and Banking in Economic Development,* London and Baltimore: The John Hopkins University Press.

Ghatak, S. and P. Levine (1994) The adjustment towards national solvency in developing countries: an application to India, *Journal of International Development,* 6, 4: 399 - 414.

Green, C.J. and V. Murinde (1992) The potency of budgetary and financial policy instruments in Uganda. In: C.Milner and A.J.Rayner (Eds.), *Policy Adjustment in Africa*, London: Macmillan, 1992, Chapter 8.

Green, C.J. and V. Murinde (1993) The potency of stabilization policy in developing economies: Kenya, Tanzania and Uganda, *Journal of Policy Modelling*, 15, 4 (August): 427 - 462.

Green, C.J. and V. Murinde (2000) Regulatory lessons for emerging markets from transactions costs and stock price volatility in the London Stock Exchnage, *Journal of Banking and Finance*, 15, 4 (April): 427 - 462.

Greene, J. and D. Villanueva (1991) Private investment in a developing country, *IMF Staff Papers,* 38 ,1: 33-58.

Grzyminski, R. (1991) ‘The new old-fashioned banking’, *Harvard Business Review,* 69: 87-98.

Gupta, K. L. and R. Lensink (1996) *Financial Liberalisation and Investment*, London: Routledge.

Herath, G (1994) Rural credit markets and institutional reform in developing countries, *Savings and Development Quarterly Review,* XVIII, 2: 169-191.

Hermes, N. (1994) Financial development and economic growth: A survey of the Literature, *International Journal of Development Banking* 12/1:3-22.

Hermes, N. and R. Lensink (1996) *Financial Development and Economic Growth: Theory and Experiences from Developing Economies*, London: Routledge.

Hermes, N., R. Lensink and V. Murinde (1998) Does financial liberalisation reduce capital flight? *World Development*, 26, 7, 1349-1368.

Honohan, P. (1993) Financial sector failures in Western Africa *Journal of Modern African Studies* 31/1 : 49-65.

International Monetary Fund (1993) *World Economic Outlook*, Washington DC: International Monetary Fund.

Jain, P. K. (1989) 'Assessing the performance of a development bank', *Long Range Planning*, 22: 100-6.

Jequier, N. and Y.S. Hu (1989) *Banking and the Promotion of Technological Developments*, New York: International Labour Office and St. Martin's Press.

Kitchen, R. (1992) Venture capital: is it appropriate for developing countries? In: Fischer, K.P. and G.J. Papaioannou, *Business Finance in Less Developed Capital Markets*, Westport and London: Greenwood Press.

Kumar, P.C. and G. Tsetseko (1992) Securities market development and economic growth. In: Fischer, K.P. and G.J. Papaioannou (eds.), *Business Finance in Less Developed Capital Markets*, Westport and London: Greenwood Press.

Lyons, S.E. and V. Murinde (1994) Cointegration and Granger-causality testing of hypotheses on supply-leading and demand-following finance, *Economic Notes*, 23, 2: 308-316.

Mayer, C. (1994), "The Assessment: Money and Banking: Theory and Evidence", *Oxford Review of Economic Policy*, 10(4), pp. 1-13.

Mazamdar, S.C. (1996), "Bank Regulation, Capital Strucuture and Risk", *Journal of Financial Services Research*, 19,2, 209-228.

Meeker, L. G. (1990) 'Development finance: doing the undoable deals', *Journal of Commercial Bank Lending*, 72: 13-26.

Montiel, P.J., P. Agenor and N. Ul-Haque (1993) *Informal Financial Markets in Developing Countries*, Oxford: Blackwell.

Mullineux, A.W. (1992a), 'Introduction', in Mullineux, A.W. (ed.) *European Banking*, Basil Blackwell, Oxford, pp. 1-11.

Mullineux, A.W. (1992b) *Privatisation and Small Business Financing in the UK and Germany: Lessons for Central and Eastern Europe*, London: The Anglo German Foundation.

Mullineux, A.W. (1994) "Small and Medium-sized Enterprise Financing in the UK: Lessons from Germany", *Anglo-German Foundation Report*, London (September).

Mullineux, A. W. (1996), "The Funding of Non-Financial Corporations (NFCs) in the EU (1971-1993): Evidence of Convergence?", *Mimeo*, Department of Economics, University of Birmingham.

Mullineux, A. W. (1997), Banking Sector Restructuring, Debt Consolidation and Small and Medium-Sized Enterprise Financing in Formerly Centrally Planned Economies. In: S.

Gangopadhyay, *Institutions Governing Financial Markets*, New Delhi: Allied Publishers Ltd., pp. 74 - 87.

Mullineux, A.W. and Murinde, V. (2001), 'Financial Sector Policies for Enterprise Development', Commonwealth Secretariat, forthcoming.

Mullineux, A. W. (2000), Lessons from the Financial Crisis in Pacific and East Asia, forthcoming in Ford et al ed (2000).

Murinde, V. (1993) *Macroeconomic Policy Modelling for Developing Countries,* Aldershot: Avebury.

Murinde, V. (1996a) *Development Banking and Finance*, Aldershot: Avebury.

Murinde, V. (1996b) Financial markets and endogenous growth: an econometric analysis of South East Asia. In: N. Hermes and R. Lensink (eds.) *Financial Development and Economic Growth,* London and New York: Routledge.

Murinde, V. and F. S. H. Eng (1994) 'Financial development and economic growth in Singapore: demand-following or supply-leading', *Applied Financial Economics*, 4: 391-404.

Murinde, V. and J. S. Ngah (1995) Central bank financing of the budget deficits: the CFA Franc Zone Versus Eastern Africa, *International Journal of Development Banking* , 13, 2 (July).

Murinde, V., J. Agung and A.W.Mullineux (2000), "Patterns of corporate financing and financial sector convergence in Europe", *forthcoming.*

Myers, S. C. (1984), "The capital structure puzzle", *The Journal of Finance*, Vol. XXXIX, No. 3 (July), pp. 575 - 592.

Myers, S. C. and N. S. Majluf (1984), "Corporate financing and investment decisions when firms have information investors do not have", *Journal of Financial Economics,* Vol. 13, June, pp. 187 - 222.

Olomola, A.S. (1991) Credit control policies for improved agricultural financing in Nigeria, *African Review of Money, Finance and Banking* 1: 23-37.

Oshikoya, T.W. (1992) Interest rate liberalisation, saving, investment and growth, *Savings and Development*, XVI, 3: 305-320.

Rudnick, D. (1993) 'ADB boosts local markets - borrowing or raising funds on capital markets', *Euromoney*, April: 16-8.

Rwegasira, K (1992) *Problems of Financial Analysis in Institutional Lending Operations,* Aldershort: Avebury.

Sagari, S.B. and Guidotti, G. (1992) Venture capital: The lessons form the developed world for the developing markets, *Financial Markets, Institutions and Instruments*, 1, 2: 1-59.

Sender, H. (1993) 'Banking more for less', *Far Eastern Economic Review*, 56: 52-3.

Simon, J.D. (1992) Political-risk analysis for international banks and multinational enterprises. In: R.L. Solberg (ed) *Country-risk Analysis*, London and New York : Routledge (Chapter 6).

Stiglitz, J. E. and A. Weiss (1981), "Credit rationing in markets with imperfect information", American Economic Review, 71, 3, 393-410.

Stiglitz, J. E. and A. Weiss (1986), “Credit rationing and collateral”, in J. Edwards, J. Franks, C. Mayer and S. Schaefer (Eds.) *Recent Developments in Corporate Finance,* Cambridge, Cambridge University Press, 101-135.

Thomas, J. J. (1993) *The Informal Sector in Developing Countries*. London: Macmillan.

Todaro, M. P. (1996) *Economic Development,* 6th Edn., London: Addison Wesley Longman.

Tsiddon, D. (1992) A moral hazard trap to growth, *International Economic Review,* 33: 299-321.

World Bank (1994) *Assessing Development Effectiveness: Evaluation in the World Bank and International Finance Corporation,* Washington D.C.: World Bank.

Young, P. and T. Theys (1999) *Capital Market Revolution,* London: Financial Times.