Foreword

The World Bank Group has long believed that, in delivering poverty reduction and growth, the effective functioning of national financial systems is key. Understanding just how finance does this, and thus how its contribution can be optimized through good policy, has been the focus of a major research effort at the Bank in recent years. From anecdote and case experience, the basis of our knowledge has expanded to include the findings of econometric analysis of extensive cross-country data sets.

Finance for Growth draws on this and other recent research to present an integrated view of how financial sector policy can be optimized in the new century.

At its best, finance works quietly in the background; when things go wrong, financial sector failures are painfully visible. Both faces of financial sector performance reflect the policy environment. Policy needs to create and sustain the infrastructure—information, law and regulation—essential to the smooth functioning of financial contracts. Above all, it needs to work with the market to help align private incentives with the public interest. In the face of global integration of financial markets, driven by the ever-diminishing cost of communications and information technology, governments must be prepared to reposition their policy stance to take advantage of the resulting opportunities and guard against the associated risks.

Reflecting research findings, this report confirms some long-held views, challenges others. Against the insouciant views of some who have regarded finance as largely passive in the drive for growth and poverty reduction, the evidence clearly shows that financial development has a strong and independent role in increasing prosperity. Thus efforts to
ensure that financial contracts can be securely made, and thus that banking and organized securities markets can prosper, will bear important fruit in the fight against poverty.

But financial firms need to be regulated, and the increasing complexity of the business calls for special attention to be given to the incentives created by the regulatory system, making the most of the potential for supplementing the scrutiny of official supervisors with that of self-interested market participants. What works best will depend on country circumstances—in some countries introduction of initiatives such as explicit deposit insurance may need to await complementary institutional strengthening.

Although there is much for governments to do, there are other areas where it tends not to have a comparative advantage, notably in ownership of financial firms. Here again it is a problem of incentives, and political considerations, such as pressures to reward different interest groups, often dominate efficiency considerations. Well-crafted privatization can yield considerable social benefits, and, even when governments find it expedient to take control of banks in a crisis, the aim should be to divest again as quickly as practicable.

Many countries are increasingly relying on foreign firms to provide some financial services; it is inevitable that this trend will continue. For one thing, the financial systems of almost all economies are small in relation to world finance; for another, the internet and related technology increase the porosity of national financial frontiers. Although governments may need to adopt capital controls on inflows in some circumstances, they would be wise to limit policies designed to protect domestic financial firms from foreign competition: growth and stability in national economies are best served by ensuring access to the most efficient and reputable financial services providers. Though financial openness does introduce new channels for importing economic disturbances from abroad, the risks are more than offset by the gains.

New developments in communications and information technology will be an important driver for finance too, both in its international aspects, and for helping extend its reach, thereby crucially increasing the access of small enterprises and others now excluded in practice from the formal financial system. Informal finance will continue to be important, of course, and that is one of the topics taken up by this year’s forthcoming World Development Report, Institutions for Markets, which in many respects will be an important complement to the current volume. To
The needed financial reform, as set out in this report, has pervasive effects and can be opposed by powerful interest groups. But the stakes are high in the indirect but highly tangible benefits in terms of broad economic prosperity. The World Bank Group will continue to work with member countries to help devise national policies firmly based on empirical evidence and replicable best practices.

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