

Key Constraints on Financial Sector Development

8

A well-developed financial sector plays a central role in promoting economic growth in a country. It raises the savings rate and improves the transformation of savings into more productive investments, by efficiently allocating these resources among competing investment projects. The productivity of an economy's aggregate investment is thereby increased, and the incentive created by the improved returns to savings in turn inspires higher savings and investment rates. Not only is growth likely to be spurred by the greater availability of capital made possible by financial development, but the development of the financial sector itself is in turn driven by economic growth, high income, and savings. This gives rise to a virtuous circle of economic growth and financial sector development (McKinnon 1989).

The review in the preceding chapters shows that virtuous circles of economic growth and financial sector development have yet to be established in PDMCs, though this is not to deny that progress in financial sector reform was made in the 1990s. All PDMCs moved from direct to indirect instruments of monetary control and liberalized interest rates, and most have maintained positive real deposit rates. Weekly auctions of Treasury bills or central bank notes became the primary method for influencing banking systems' liquidity. PDMCs also passed legislation to give central banks more authority to supervise financial institutions, for the most part upgraded their prudential regulations to bring them in line with international standards and the Basle conventions, and made

considerable progress in improving banking supervision activities.

On the down side, domestic savings mobilization remains low because there are few incentives to save, with foreign aid allowing high levels of consumption and supporting public sector investment. Liquidity is high because of a limited number of bankable projects and a lack of alternative investments for NPFs. Commercial banks finance at the low-risk end of the market, or require considerable collateral that is not readily available, given the nature of land tenure systems. DFIs are of limited effectiveness, capital markets are virtually nonexistent, and MFIs have not yet developed. In some PDMCs, substantial amounts of overseas remittances bypass the formal financial system, further narrowing the scope for financial intermediation. In this situation, even entrepreneurs with viable projects can find it difficult to get financing.

This chapter summarizes and further examines the key constraints on the development of the financial sectors in PDMCs.

THE REAL SECTOR

The most important constraint on financial sector development is slow economic growth, which has limited the demand for improved credit provision and for convenient means of accumulating savings. If financial sectors are to develop faster, the rate of growth in real sector activity must accelerate; and if financial sector development is to extend beyond the urban areas, the growth in real sector activity must include the semi-subsistence rural areas and outer islands. At present, financial intermediation in PDMCs is limited by the fact that a large part of the population remains outside the formal, monetized economy; a substantial part of scarce savings in the form of commodities cannot effectively be allocated towards investment opportunities. Growth in the real sectors in rural areas is needed if their financial services are to be improved. Without production for markets, rural people will have little or no cash to save, or with which to pay back a loan.

Faster sustained economic growth requires increased private sector investment, to be supported by good quality public

investment in physical and human capital (Duncan et. al. 1999). In general, the relative lack of private investment in PDMCs cannot be attributed to the unavailability of finance at competitive real interest rates, although in Solomon Islands and PNG, as a result of fiscal mismanagement, the public sector has notably been crowding out the private sector. More important are (i) the lack of access to finance caused by potential borrowers' lack of a track record and/or poorly prepared loan applications, and by their inability to use land as security for a loan; and (ii) a lack of profitable investment opportunities, which in part reflects the largely immutable constraints of small economy size and remoteness, but which also reflects the impact of government policies and behavior on the costs and risks of investing.

Lack of Access to Finance

Lack of access to finance that is attributable to poor loan applications and lack of a track record in borrowing can be alleviated, through provision of business services and improved monitoring by financial intermediaries. Some commercial banks now assist potential small-scale borrowers with development of a business plan. The land issue is much more problematic. As discussed in the previous chapter, land tenure systems in PDMCs have served to protect indigenous ownership of a key asset that has been permanently alienated in many other developing countries. However, the protection has come at the price of impeding domestic and foreign investment; and traditional land tenure systems are increasingly suffering the dual pressure of providing a subsistence base for growing populations, while adapting to the demands of the cash economy.

Although a leasehold title system is seen as the way forward, there are difficulties. In most PDMCs, the period of time allowed for the leasing of customary land is inadequate for large-scale development. There is also considerable uncertainty as to whether leaseholds of converted customary land should be mortgagable, and whether mortgages should be enforced against leaseholds of converted customary land. Even leases and mortgages of freehold land and government-owned land present difficulties for investors: in some PDMCs, there are restrictions on the mortgaging and leasing of freehold land; in many cases,

long-term leases and mortgages of freehold land cannot be granted to persons who are not resident citizens. Land and titles commissions and courts have been set up to deal with claims for tenure conversion and disputes over land tenure, but most PDMCs are not able to deal with the number of claims and disputes. There are substantial delays in the courts, especially with regard to disputes about customary land and customary titles. Some commercial banks work within the system, using leases as collateral. However, this is not always sound security, as there are sometimes restrictions on transferring leases to financial institutions, particularly foreign institutions that by definition are not resident citizens.

The inability to use land as collateral and to obtain predictability of land tenure for investors constitutes a major deterrent to private investors. But reform of land tenure systems will of necessity proceed slowly. The challenge for banks and other financial institutions is how to work within the existing systems to utilize land to provide greater security for investors and lenders, possibly by extending the length of transferable leases. There are also cases where private investors have made arrangements with tribal groups for sustainable land tenure. This has usually occurred because of extra facilitative effort on the part of governments.

Lack of Profitable Investment Opportunities

Profitable investment opportunities are limited by varying degrees of smallness, geographic isolation and fragmentation, limited physical and human resource endowments, and climatic shocks. Potential domestic and foreign investors must come to terms with these constraints and risks, just as Pacific Islanders in general have done for many years. Other identifiable causes of the lack of investment include specific cultural or social issues, and government policies that raise the costs and risks of investing (Duncan et. al. 1999).

In addition to the impact of land tenure systems on the viability of investment projects, there may be instances where the cultural and religious customs of Pacific Islander populations preclude or constrain investment. Customs vary considerably between and within PDMCs, so that generalization is not possible

beyond Hughes' observation that "Strategies to promote growth have to take account of the chaotic but dynamic flexibility of the way people actually arrange their lives" (Hughes 1998, 104).

The operation of government business enterprises crowds out private sector activity. Complex government rules and regulations, and their discretionary application, have resulted in high transaction costs for business. This has been especially true for foreign direct investment, which has been regarded with ambivalence and occasionally with hostility. More generally, poor governance environments and macroeconomic instability have deterred private sector investment. The first requirement in McKinnon's optimum order of liberalization is that countries have balanced government finances and deregulated domestic economies with predictable and consistent policies (McKinnon, 1993). As observed in Chapter 2, significant progress has been made in reducing policy-induced restrictions on private investment through implementation of economic and public sector reform programs. But not every country has adopted a reform program; implementation is ongoing where programs have begun; and political instability has derailed implementation, at least temporarily, in some instances. As Bruno (1994, 15) notes: "the most important—and hardest—service for a government to deliver is the irreversibility of a new policy environment and the credibility of the reform effort." Sustained service delivery is nonetheless essential if private investment is to become the engine of accelerated economic growth, and thus of financial sector development.

THE FINANCIAL SECTOR

Financial sector development also has been retarded by intrasectoral constraints, some of which can be eased through appropriate policy changes.

Lack of Competition in Banking Sectors

Competition is hindered by the high level of concentration of foreign banks and by the large amount of excess liquidity in the banking systems, which is reflected in high net interest

margins. The perceived scarcity of bankable projects even in urban areas has also hindered competition. There is an unsatisfied demand for loans, but the risk involved is too high for commercial banks, especially when land tenure systems make it difficult to reduce the risk by using land as collateral. The lack of efficient and competitive nonbanking financial sectors has also inhibited competition. Microfinance systems offer very little competition for commercial banks. The low level of development of money and capital markets has meant that there are very few savings instruments such as Treasury bills, unit trusts, or stocks to compete with bank deposits. For specialized institutions, such as insurance companies, there is often no competition at all. Even though most PDMCs have fairly open banking sectors, the small size of the markets remains a constraint to the entry of more banks.

Poor Governance

Poor governance has been a general issue in all PDMCs, and has increased the risk for, and affected the performance of, government-owned financial institutions. One major governance issue relates to the independence of central banks, which in some PDMCs has been compromised through government interference and directives. Such interference has on occasion prevented the development of appropriate prudential supervisory processes and monetary policy.

Governance has been a particular issue for development banks in most PDMCs. There has been a high level of government involvement, and in some cases political interference, in the appointment of development bank boards, as well as in some areas of lending. Such interference has combined with poor management, inadequate pricing of risk, a lack of appropriate supervision, weak loan appraisal and accounting systems, and an acute shortage of requisite human resource skills (particularly numeracy and quantitative ability), to push DFIs into financial difficulties. Greater private sector representation on boards is desirable but difficult to achieve, because of the small number of private sector individuals who could effectively serve on such boards without incurring conflicts of interest.

With one or two exceptions, DFIs continue to incur losses, some of a magnitude that puts their solvency into question. Across the region they confront

- (i) the high cost of raising funds on domestic markets, compared with commercial banks;
- (ii) the narrow skill base among executives and staff, especially in dealing with risk and new areas of business;
- (iii) high-risk lending propositions, since the commercial banks have already secured the available better-quality lending;
- (iv) lack of any formal prudential supervision, in most PDMCs;
- (v) high costs of maintaining branch networks in outer islands and rural areas; and
- (vi) susceptibility to arrears and recovery problems.

Nonetheless, because commercial banks will not undertake any significant levels of lending to rural/outer island sectors, or for development projects in urban areas, there is a need for development banking to promote economic growth with greater equity, to expand indigenous involvement in the market economy, and to generate employment growth (Skully 1999).

Poor corporate governance also has adversely affected the performance of some NPFs. In these cases, political interference in fund management has been highly counterproductive, and supervision has been inadequate. With the exception of the Fiji Islands and Solomon Islands, supervision has been the responsibility of ministries of finance rather than central banks.

Inadequate Supervision and Enforcement of Prudential Standards

Supervisory functions and enforcement of prudential standards are particularly important in small, uncompetitive financial sectors. Despite an improved legislative environment for supervision and strengthened supervision activities, the quality and effectiveness of central banks' supervisory capacities still needs upgrading. For the most part, the financial institutions departments of the central banks are too small, and the average

length of experience of staff too short, to enable the departments to function efficiently. The lack of experience and adequate training is an obstacle to supervisory capacities for both off-site and on-site supervision of commercial banks. These capacities need strengthening through long-term training and specialized external assistance, especially since the supervisory role should extend to nonbank financial intermediaries, MFIs, and, for the Fiji islands and PNG, large financial conglomerates. Improved supervision capacities will increase the scope for adding financial products and services and improving financial intermediation.

Hindrances to Development of Money and Bond Markets

The lack of autonomy and low profitability of central banks, together with the high liquidity of national provident funds, has hindered the development of money and bond markets. In most cases, absorbing the large amounts of excess liquidity in financial systems has been costly for central banks, both because of the number of instruments needed to mop up the liquidity and because sometimes it requires high interest rates to clear the market.¹¹ Liquidity has continued to grow, while the profitability of central banks has remained stagnant and the potential cost of mopping up liquidity has increased. Because some central banks do not have sufficient income (they rely almost entirely on interest earnings on external reserves), their autonomy in the conduct of monetary policy has been compromised.¹² Interest rate distortions have sometimes resulted: central banks have been compelled to pay below-market rates on their securities. Monetary policy has then been conducted through the raising of reserve requirements, moral suasion, and direct credit controls. Illiquid interbank markets in PDMCs have also hindered the development of money markets.

¹¹ The cost of mopping up an estimated SAT\$40 million in excess reserves in Samoa was calculated to amount to SAT\$2 to SAT\$6 million for an auction interest rate between 5 and 15 percent.

¹² During 1994–95, for example, Tonga experienced a surge in credit to the private sector, which resulted in a decline in foreign reserves. With a large amount of central bank securities outstanding, the National Reserve Bank of Tonga could not raise interest rates on the securities to respond to the situation, because the interest costs were too large compared with the bank's small profit.

Hindrances to Development of Corporate Bond Markets

The development of a corporate bond market has been constrained by

- (i) the lack of an active government bond market and thus the lack of a base yield curve;
- (ii) the relative liquidity of the banks, which means that loans are probably cheaper and easier for most companies than the issuance of a debt instrument;
- (iii) the lack of sophisticated intermediaries, banks, and NBFIs that could manage, place and underwrite debt issues;
- (iv) the lack of developed NBFIs looking for long-term, high-yielding investments (except in the Fiji Islands and PNG); and
- (v) the small number of companies with good historical audited financial accounts, without which risk assessment is not possible.

The issue of government bonds and bills, bank liquidity, and competition in the provision of bank and nonbank financial services must be addressed in order to ease these constraints.

Hindrances to Development of Capital Markets

To develop a capital market, there must be companies that wish to raise finance through the market. The major problem for both the current PDMC stock exchanges, SSE and POMSoX, is lack of volume, which is due to a lack of shares available for trading. A major reason for this lack is the high levels of bank liquidity and the availability of bank finance, which generally has discouraged companies from issuing shares. Another reason is the extent to which governments control large state enterprise sectors, and the lack of private companies large enough, or with accounts adequate enough, to meet listing requirements. The lack of appropriate legal, regulatory, and tax frameworks in most PDMCs is also a constraint. In particular, the lax enforcement of corporate income tax collections in some PDMCs makes it possible for closely held corporations to avoid

taxes by showing low accounting profits; this would not be possible if the corporations were traded publicly. Owners of private companies are sometimes reluctant to dilute their family ownership and control by issuing stock, or to comply with requirements to disclose information about their operations. In some PDMCs, the systems for recording the registration of companies and for monitoring ongoing compliance with the companies act filing requirements is inadequate, and is a constraint to the development of capital markets. Governments also need to define the operational scope of underwriters, brokers, dealers, merchant banks, and mutual funds.

Privatization of profitable public enterprises is potentially an important means of stimulating the development of capital markets. Such privatization refers to transfer of the ownership of a public enterprise to the private sector, whether by trade sale to a local or foreign buyer, or sale to the general public through an initial public offering (IPO). However, an IPO is usually not an option for most public enterprises in PDMCs because of their size, profitability status, and lack of proper audits. Where an IPO appears feasible, its effective implementation may be inhibited by restrictions on foreign ownership and/or on foreign exchange.

As-Yet Unrealized Impact of Microfinance Institutions

Almost 80 percent of PDMC populations live in rural and outer island areas, engage in semisubsistence economic activity, and are poorly served by formal and informal financial institutions. MFIs therefore have a potentially important role to play in furthering economic and financial sector development of these areas. However, MFIs have had little impact to date. Given the small populations and limited cash incomes involved, it is difficult to obtain a critical mass of clients to reach the scale where viability of operations can be achieved. Competition from government or donor grants for income-generating projects also impedes microfinance development. Some MFIs emphasize credit rather than saving, which has led them to perform badly. Others charge artificially low interest rates. Weak governance structures, coupled with limited institutional capacity and the lack of a proper legal

and supervisory framework for microfinance, have also led to poor performance.

Although government agencies, business advisory centers, NGOs, and business development units of development banks provide training and business advice to microentrepreneurs, these services have a number of shortcomings. Support services are often provided on a piecemeal basis, with no follow-up or ongoing service. There is a lack of coordination between the suppliers of services, resulting in duplication of effort by providers and confusion and misinformation for clients. Services are available only to a relative few. Most training is done in large groups, in English, and for short periods (e.g., half a day), lessening the effectiveness of the training and group interaction. Training is designed for small-scale enterprises and relatively well-educated participants, and employs materials that are frequently outdated and insufficiently client-focused. Where fees are charged, access to training is confined to those who can afford to pay. New and innovative products need to be introduced using local resources and indigenous skills, and with appropriate technical assistance, in order to prevent the use of inappropriate imported models.