

# **Finance and Development**

The Role of International Commercial  
Banks in the Third World

**Michael DaCosta**



# Finance and Development

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## About the Book and Author

### *Finance and Development: The Role of International Commercial Banks in the Third World*

Michael DaCosta

Although commercial banks have played an increasingly important role in providing capital to developing nations, many analysts argue that private financing poses risks both to borrowing nations and the stability of the international economic system. In response, Mr. DaCosta demonstrates that developing nations that adopt appropriate policies can gain substantially by drawing on private sources of capital. His analysis indicates that many criticisms of the role of commercial banks are unfounded and that debt problems in LDCs typically are related to inadequate reserve and external debt management policies in the borrowing countries themselves. Emphasizing that economic growth in LDCs often is constrained by balance-of-payment deficits, Mr. DaCosta shows that nations relying on private capital frequently experience higher-than-average growth rates and argues that the advantages of unconditional or untied aid generally outweigh the constraints imposed by the multilateral aid agencies. In conclusion, he outlines specific policies developing nations can adopt to reduce financial risk and, turning to the needs of the poorest of the LDCs, examines a variety of proposals aimed at increasing the flow of concessional assistance to those countries that cannot qualify for commercial bank funds.

Michael DaCosta is senior economist in the Research Department of the Bank of Guyana.



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To My Parents, Irene and Philbert.

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*Michael DaCosta  
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# Abbreviations

BIS	Bank for International Settlements
DAC	Development Assistance Committee (of the OECD)
GATT	General Agreement on Tariffs and Trade
IBRD	International Bank for Reconstruction and Development - (The World Bank)
IDA	International Development Association
IDB	Inter-American Development Bank
IMF	International Monetary Fund
LDC	Less-Developed Country
LIBOR	London Inter-Bank Offered Rate
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of Petroleum Exporting Countries
UNCTAD	United Nations Conference on Trade and Development
USAID	United States Agency for International Development

# 1

## Introduction

The task of achieving rates of economic growth sufficient to improve the standards of living of the people of non-oil less-developed countries continues to be of prime concern to policymakers both within and outside the developing regions. This task is indeed monumental. For example, recent estimates show that by the year 2000, some six to seven hundred million people could be living in absolute poverty.<sup>1)</sup> To merely maintain the existing standards of living, a rate of growth of at least 2.5 per cent, equivalent to the average rate of population growth, would need to be achieved.

Growth requires resources of all kinds - human, material and financial. Few developing countries have had the internal capacity to generate sufficient levels of financial resources to satisfy the requirements of growth. As a group, therefore, they have had to supplement their domestic savings with large flows of external grants and loans. In the years immediately following the end of the Second World War and in the wake of the apparent success of the Marshall Plan in Europe, bilateral aid was widely regarded as the solution to the resource gap faced by the developing nations. However, after many years of experience with this type of assistance, disappointment with the contribution of official aid to growth is now widespread. As a result,

several plans have been advanced for increasing the volume and quality of external flows to the less-developed countries. Among these are:-

1. the SDR-aid link proposal,
2. the creation of a special institution to finance exploitation of minerals and other natural resources in LDCs, and
3. a guarantee scheme to facilitate access of developing countries to the international capital markets.

While much work continues on attempting to effect these and other proposals, multilateral and regional financial institutions have, especially in the past two years, adopted several measures aimed at raising the level of assistance to LDCs. At the International Monetary Fund, the Compensatory Financing Facility, designed to assist countries in meeting the balance of payments consequences of export shortfalls due to external factors, has been broadened to include shortfalls in travel receipts and workers remittances. In addition, the facility may now be used to compensate member countries for increased costs of cereal imports. Also, the Fund has moved into the area of medium to long-term balance of payments financing with its agreement to extend the repayment periods under its enlarged facilities to ten years. At the World Bank the introduction of the Structural Adjustment programme, and emphasis on the energy sector and on co-financing have been important recent developments. Finally, regional development banks have devoted much effort to mobilizing larger flows of external finance for their respective areas.

In spite of these efforts and initiatives, it seems clear that the official sector of the international monetary system has failed to meet the growing financial needs of the LDCs especially in the wake of the two

"oil crisis" periods of 1973-1974 and 1978-1979. Nevertheless it was over these periods that unprecedented rates of growth were recorded by developing countries largely as a result of balance of payments and development finance provided by international commercial banks.

A properly functioning international monetary system is one which ideally:

...provides a combination of international liquidity and adjustment mechanisms adequate to permit rectification of balance of payments disequilibria without imposing the necessity of severely deflationary policies on the deficit countries or obliging them to resort to balance of payments restrictions on current and capital account transactions, and over the long run provides a rate of increase of international liquidity adequate to support a steady growth of world production, trade and payments at levels as close to 'full-employment' of world resources as possible.<sup>2)</sup>

While the I.M.F. has focussed primarily on adjustment mechanisms, the international commercial banks have shown themselves to be sufficiently innovative and flexible to enable the world financial system to overcome two major disturbances. This book stresses the role of the banks not only because of their critical importance during the oil crises and their aftermath, but also because it is felt that the contribution of international banks to economic development has been underestimated in both the literature on economic growth and by policy-makers in the LDCs.

Since the thirteenth and fourteenth centuries, banks and bankers have played a crucial role not only in the development of their own countries but also in that of foreign lands. Their importance in domestic financial intermediation has long been recognized in both theory and economic policy, but their potential for transferring resources internationally from surplus to deficit countries has until recently been largely ignored. That

banks should now perform on a global scale a task so well done domestically, is not surprising given the degree of interdependence in the world economy - in turn a result of the ease and speed of international communications and the growing internationalization of business.

It is argued here that LDCs will forgo higher levels of growth, with all that it implies, for the welfare of their people unless they make a concerted effort to tap this large source of international savings. Traditional sources of external finance have proven incapable of providing the volume of funds required by the developing countries, and new proposals for larger flows seem unlikely to be implemented in the near future. In such a situation, these countries face the following options:-

1. to plead with donors for additional aid,
2. to try to expand their foreign exchange earnings from exports of goods and services, and
3. to seek additional sources of funds.

In a period of high inflation and generally tight fiscal policies in the donor countries, option 1. seems to hold little prospect for success in spite of much promising and good intentions on the part of the donors. In the long run, option 2. is clearly the most appropriate, but export diversification to maximize foreign exchange earnings requires financing. By tapping world-wide savings held in the international commercial banks and investing them in viable, export-oriented schemes, the less developed countries can aspire to a faster rate of economic growth, the benefits of which could improve the welfare of hundreds of millions of people in the Third World.

Chapter 2 presents an analysis of the relevance of popular growth models to developing countries. It looks particularly at those models in which savings and financial intermediation have a central role in promoting

economic growth. From this basis, a simple analytical framework is developed showing how the international financial intermediary role of banks can, by reducing both the foreign exchange and the savings constraints, increase the rate of growth of output and incomes in LDCs. Chapter 3 reviews the historical role played by banks in developing countries while Chapter 4, considers the current need for savings in these countries emphasizing the serious need for external savings. Having established this need, Chapter 5 proceeds to examine the various non-bank sources of external funds available to LDCs. These include bilateral and multilateral aid, the international monetary institutions, and suppliers credits and other shorter-term sources of trade finance. Since the international commercial banks are the major supplier of external funds to the developing countries, Chapter 6 is devoted to an examination of the banks as a source of medium-term finance. Chapter 7, which is the core of the book, examines the direct and indirect contribution of bank lending to the LDCs. It is concluded that by virtue of the sheer volume of lending combined with the many advantages of largely untied funds, this contribution has been substantial.

An examination of the role of international banking would not be complete without a mention of the many criticisms levelled against bank lending for balance of payments and development purposes. It is to this issue that Chapter 8 turns. An important conclusion from the evaluation is that many debt problems attributed to bank lending per se are more accurately the result of inefficient domestic policies. Consequently, Chapter 9 examines the vital role of economic management in complementing the benefits to be derived from borrowing from the banks.

In recognition of the special problems being faced



by the poorest of the less-developed countries, the penultimate chapter briefly depicts the problems and looks at some proposals to increase the flow of concessional assistance. These include the SDR-aid link proposal and the guarantee scheme to facilitate LDC access to the international capital markets. Chapter 11 incorporates some thoughts on the present and future role of international banking in the provision of funds to the developing countries.

## 2

# Theoretical Approaches to Growth and Development in Developing Countries

Theoretical concern with the issue of economic growth was expressed by the early classical economists such as Adam Smith, David Ricardo, and T.R. Malthus. For them, growth was a function of capital formation out of profits with the major limitation being diminishing returns to land and labour.

### THE HARROD-DOMAR APPROACH

It was not until the period after the Great Depression of 1929-30, with its massive unemployment of labour, closed factories, and general stagnation of economic activity that the importance of growth resurfaced in the work of economists. The Keynesian Revolution had already shown that it was possible for the economy to stabilize at a less-than-full-employment position because of an inadequate level of aggregate demand. In the Keynesian, tradition, therefore, Harrod was concerned with determining the rate of growth required from one period to the next that would be sufficient to maintain the full-employment level. Unless such a rate of growth of national income was achieved, labour and the productive capacity of the economy would be unemployed or under-utilized. In seeking the more important factors on which growth depends, Harrod and Domar isolated two: firstly, the addition to output as a result of an increment in the capital stock - the incremental capital/output ratio, and