

Policy-Based Finance: Is There a Role for Government Intervention in Financial Markets?

Government intervention in financial markets, aimed at channeling credit at concessional terms to government-defined priority sectors, has long been a major policy tool for both developed and developing countries. Despite good intentions, such intervention – especially in developing countries – has generally impeded the development of financial markets while failing to promote the development of priority sectors. Moreover, intervention programs tend to distort incentives, undermine financial discipline, invite abuse, produce high default rates and contribute to significant fiscal deficits. Indeed, many of the activities of the Inter-American Development Bank in the financial sector, are aimed at repairing the damage caused by the severe financial repression associated with these government programs.

A different approach can be observed in many East Asian countries that have experimented with a form of mild financial repression referred to as “policy-based finance.” Here government involvement in financial markets is part of an overall policy aimed at supporting priority sectors with high social returns (compared with private returns), sectors that are too risky to attract private investment without clear government support, or sectors with severe information problems. The East Asian governments have promoted a combination of limited credit support at slight interest rate subsidies (generally less than one or two percent), tax incentives, government funding for research, and other policies as a promising alternative to a more complete reliance on private financial markets. Support has often been directed to exporters or critical infrastructure development.

In early 1996, the IDB, together with the

Japan Development Bank and the Banco Nacional de Desenvolvimento Econômico e Social of Brazil, sponsored a conference on *Policy-Based Finance and Alternatives for Financial Market Development*. This conference, held in Rio de Janeiro, brought together more than 150 government officials and leaders from the private sector to discuss how some of the more universal lessons of East Asia can be incorporated into the market-oriented reforms taking place in the emerging markets of Latin America and the Caribbean. The Bank has recently published a book containing a selection of papers presented at this conference. In the final chapter of this book, Antonio Vives and Kim B. Staking discuss the necessary conditions for and the advisability of policy-based finance in Latin America and the Caribbean.¹ Their conclusions are summarized below.

Necessary and Sufficient Conditions

Government intervention in financial markets can only be justified when there is a clear market failure. Examples of such failure include markets that are unable to intermediate investment funds due to information asymmetries, markets that lack longer term financing options or diversification and hedging instruments, and financial sectors that are simply too small for the economy.

Government intervention may also be justified when major externalities are associated

¹ Antonio Vives and Kim B. Staking, “Policy Recommendations for Latin America and the Caribbean.” Chapter 10 in *Policy Based Finance and Market Alternatives: Application of Lessons from EastAsia*, Kim B. Staking, editor. Washington D.C.: The Inter-American Development Bank, 1997.

with the creation of specific markets (i.e., pilot programs in science and technology or initial support for markets serving smaller firms). To be perceived as successful, however, these intervention programs must demonstrate that they are able to correct for the perceived market failures. Specifically, governments must show that they have access to and are able to effectively use information not available to or not used by the private sector. Intervention programs must also show that they appropriately address the underlying causes of a specific externality, and not just the symptoms of market failure.

In East Asia, the more successful experiments in policy-based finance clearly worked because the interventions were limited and used market-like instruments to provide an appropriate incentive structure. Careful analysis allows us to identify several key conditions for its successful application. We can group these into two categories: conditions with respect to the economic environment and conditions governing program design.

Economic Environment

The *eight conditions* described below are basic for the functioning of all credit markets, but acquire more relevance in the case of policy-based lending or other interventions in financial markets, with their potential for distortions in the allocation of credit.

- **Macroeconomic Stability:** Policy-based financing can be granted under unstable macroeconomic conditions, but in such cases credit programs are extremely hard to manage. Likewise, the absence of stability can raise transaction costs to the point where such programs become prohibitively expensive.
- **Open Economy:** One of the best ways to ensure the effectiveness of any type of credit program, market-based or policybased, is to ensure the existence of an open economy,

subject to competition from international markets. Open financial markets encourage the flow of capital into a country, foster competition in the provision of financial services, contribute to the financing needs of local industry and can help overcome deficiencies in local savings.

- **Industry Competitiveness:** The firms or activities selected by the government must be both solvent and competitive in their own right, before or especially after the allocation of credit. The fact that a firm cannot get credit because it is not creditworthy is not a justification for government intervention. The selection of competitive firms and industries was a key feature of the credit programs of Korea and Japan. These programs used export competitiveness as a signal; international competition provided the necessary performance incentives.

- **Repayment Culture:** A culture of repayment within the lending institution is a necessary condition for the success of any credit program. Each credit must be carefully analyzed concerning its repayment potential. Appropriate guarantees or collateral should be required, and credits should be carefully monitored. The professional staff of the lending institutions must have the appropriate incentives to assure compliance with credit standards.

- **Satisfactory Legislative and Regulatory Frameworks:** Laws and regulations must be comprehensive, consistent, comprehensible and fair. Of particular importance in financial and credit markets are: the ability to enter into voluntary contracts; a delineation of the powers of and limitations on financial institutions; a clear definition of rights and responsibilities associated with various financial instruments (particularly non-traditional instruments); the ability to perfect collateral and enforce claims (including access to collateral); and the rights of the government to intervene in the affairs of a financial institution and/or to limit or

circumscribe the use of specific instruments or transactions.

- ***Properly Functioning Judicial Systems:*** Financial markets require effective and efficient judicial systems that will consistently enforce contractual obligations. The government should not be willing to grant credit if it cannot enforce repayment or repossess collateral.

- ***Appropriate Supervisory Oversight:*** Financial markets, due to the existence of information asymmetries, often require oversight. This can range from very formal supervision, as with commercial banks or insurers, to less formal oversight of traded securities (including information disclosure requirements and oversight of self-regulating organizations). It is critical that the supervisory professionals are respected, well trained and adequately compensated.

- ***Properly Functioning Financial Markets:*** Policy-based lending cannot be a substitute for imperfect financial markets. When market mechanisms do not operate, government efforts should be directed at improving those mechanisms, not at stifling their development. Governments must work simultaneously in the development of market-based financial systems.

Program Design

The above conditions will not assure success of a policy-based program. Such programs must be effectively designed, as the potential for abuse and the introduction of distortions is enormous. Policy-based programs must imitate the conditions under which a market-based financial system operates. The *eight conditions* below summarize the requirements of effective programs.

- ***Policy Consistency:*** Policy-based lending cannot function in isolation of other government policies. These must be consistent, and must complement and support each other. For instance, policy-based lending must operate

within an industrial policy that is reasonably free of price controls, has positive real interest rates and has an exchange rate policy that neither hinders industrial competitiveness nor artificially protects inefficient industries.

- ***Source of Funds with Minimal Fiscal Impact:*** The source of resources used in policy-based lending should be transparent. If fiscal resources are involved in providing a subsidy, they should be clearly identified in the fiscal budget and limited to these amounts.

- ***Small, Targeted to Imperfections:*** Policy-based lending should be in response to a market problem and as such should be targeted to overcoming that problem (or provide temporary relief while the problem is being resolved). The intervention can be neither generic nor widespread.

- ***Profitable Projects with Developmental Impact:*** Investments funded by government programs should pass profitability, solvency and liquidity criteria imposed by the market on other comparable investments. Investments should not be made in firms that need subsidies or protection to be profitable, but in firms that are viable and can contribute to the country's development in ways that would not be realized if not financed through government intervention.

- ***Multisectoral Orientation, Use of Private Sector:*** Maintaining a multisectoral orientation is often preferred. Governments have seldom proved to be more successful than private markets in identifying industries or firms that will expand and are often tempted to support non-competitive industries for political rather than economic reasons. In Latin America and the Caribbean some of the more successful efforts to support the development of financial markets have incorporated the private sector in credit analysis, risk taking, monitoring and collection.

- ***Independent and Professional Management of the Program:*** More of the problems in the directed credit programs of Latin America and the Caribbean can be traced to program management than to problems related to the goals of the programs. The accountability of managers has been almost nonexistent. For a program to be successful it must be managed as a private endeavor. The importance of monitoring and collection cannot be underestimated.
- ***Political Independence:*** Related to the previous two conditions is the *sine qua non* of political independence. Policy-based lending must be devoid of political influence and must be operated according to commercial criteria. Where political gains are to be achieved, they must be the result of and not the purpose of the programs.
- ***Temporary Nature and Limited Size of Support Programs:*** Since directed credit programs are targeted at specific market failures, information asymmetries or externalities, they should be complemented by measures to address the underlying problems. Larger programs are more likely to introduce distortions in the allocation of resources and stifle the development of market-based financial markets. The programs should be relatively small compared with the overall credit in the economy, and preferably with planned termination when the underlying causes are removed.

Although these restrictions do not call for an absolute exclusion of public involvement in credit allocation, they do strongly suggest that it will be hard to develop successful programs where there is a direct role for the government (or a government-owned intermediary) in the allocation of credit. Within the political and social environment of Latin America and the Caribbean, the application of the preceding criteria will no doubt require the allocation of

the resources using, as much as possible, the existing channels of the private financial system. The role of the state should ideally be limited to setting policies, ensuring proper oversight of financial markets, monitoring and enforcement of policies, and building the legal and regulatory infrastructure needed for the private financial markets to operate. Private financial intermediaries should be responsible for individual lending decisions and investment monitoring, and they should receive the reward or suffer the consequences resulting from their actions. Resources should be allocated at market rates, to avoid subsidies to the owners of financial intermediaries. Central Banks should have no role in credit programs and public development banks should operate under strictly commercial criteria; never in the guise of first tier, direct lending institutions. Under no conditions should policy-based lending or other directed credit programs be used to substitute for, or to crowd-out, the private financial system.

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