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THE FINANCIAL SYSTEMS APPROACH TO DEVELOPMENT FINANCE: ORIGIN, EVOLUTION AND PROSPECTS

Mukhitdinova Dilnozakhon
Tashkent State University of Economics
d.mukhitdinova@tsue.uz

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Received:	11th November 2023	This article focuses on the prospects of the financial systems approach to development finance to ensure sustainable access to financial services for microentrepreneurs. It discusses three prerequisites for the success of this approach: the continued application of financial liberalisation policies; the delivery of financial services on a commercially viable basis by emulating the successes of informal financial intermediaries in solving the problems normally experienced by the formal financial sector when serving microentrepreneurs; and the continued appropriate support from governments and the donor community.
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INTRODUCTION

It is generally accepted that microenterprises consist of self-employed owners plus a maximum of nine employees which, typically, operate informally. The international practice of development finance in the final decade of the 20th century is to a considerable extent focused on ensuring sustainable access to financial services for such microenterprises in developing economies. This practice is known as the financial systems approach to development finance. This is a far cry from the practice of investing in large-scale projects to promote the industrialisation of developing economies which dominated development finance for the greater part of the second half of this century. Taking into consideration that this shift in emphasis is not only the result of the failure of the original approach, but also of certain structural changes that have taken place in the economies of the world, this article considers the prospects for success of the current approach. In the process, the origin and evolution of the financial systems approach to development finance will also be discussed. After World War II, the developed world was of the opinion that developing countries could not generate enough savings internally for investment purposes and it consequently advocated the injection of external funds. These funds, in the form of grants or subsidised loans, flowed either directly or via development banks to large-scale projects, often of an infrastructural nature. The belief was that the benefits flowing from these projects would 'trickle down' and result in broad-based development of the country's economy (Schmidt & Zeitinger, 1996: 243). During the seventies this approach came under increasing attack as the expected industrialisation had not materialised and widespread poverty was still rife. Local development banks that had directed the subsidised funds started failing due to huge loan losses. In this regard the World Bank (1975: Annexure 12) reported that in the mid-1970s more than half of a sample of 44 development finance institutions worldwide had arrears rates in excess of 50 per cent. A number of factors had contributed to these losses. Development banks, being non-profit institutions and thus not subject to the disciplines that the profit motive requires, were inter alia not very concerned with screening applicants properly or very diligent in monitoring recipients' activities with a view to ensuring repayment, and charged rates of interest far below the cost of their operations. Improper screening of applicants resulted in high-risk lending; funds were made available to borrowers who were unable to repay the loans. Borrowers also took advantage of development banks' lack of commitment to ensure repayment. The consequence of the above was the first of three major shifts that can be identified in the focus of development finance. The inability of large-scale projects to deliver sufficient benefits to the poor originally resulted in a shift to funding a variety of programmes that benefited them more directly, eg basic health, education and microenterprise development programmes. With this shift in focus came the realisation that the traditional development banks were, for various reasons, not the best vehicle of delivery. What were needed were development finance institutions that were in close proximity to the

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poor in order to respond quickly to changes in demand. The highly centralised system of development banks and lack of a network of branches were not conducive to realising this goal. Furthermore, the financial difficulties many development banks were experiencing at the time presented an opportunity for other intermediaries to offer their services. Into this void stepped the non-governmental organisations (Dichter, 1996: 260-1). Non-governmental organisations (NGOs) - with their commitment to socialwelfare goals, their non-profit orientation, their closeness to the community, and their high level of motivation - presented a viable alternative to development banks. Donors realised this and funded NGOs to provide a myriad of services (health, education, etc) directly to the poor aimed at their upliftment. While some NGOs specialised, others undertook a multitude of services. One of the areas of service that attained prominence during the mid-1980s was microenterprise development (Dichter, 1996: 260). Originally NGOs supplied mainly an integrated package of services: training, technical assistance and access to credit (Rhyne & Otero, 1994: II). Towards the end of the eighties this increasingly gave way to a narrower focus on access to credit facilities, indicating the commencement of the second major shift in the focus of development finance.

LITERATURE REVIEW

Empirical investigation of the relationship between financial development and economic growth is abundant globally. Empirical evidence over time has not been conclusive on this relationship with three prominent outcomes from these studies; positive, negative and no impact. The tables below shows a summary of studies in different countries or regions, their major findings and it equally indicates the methodology used. The objective is to have a global view of countries or regions with positive, negative and no impact (Tables 1 and 2). Financial development has played a leading role in many economies of Less Developed Countries (LEDCs) and Africa especially. Although the relationship between financial development and economic growth has received widespread attention in the modern history of economics, the conclusions have been far from conclusive. The finance growth nexus debate can be traced to the work of Schumpeter (1911) during the early twentieth Century. The thrust of the debate has been whether financial development has any impact on economic growth, and if it has, whether the impact is positive or negative. However, there has been a widespread believe among policy makers that financial development enhances productivity and thus promotes growth. From the panel 1 perspective, Fry 1988; Beck et al.(2000), Beck et Levine (2004), King and Levine (1993), Jeanneney et al. (2006) amongst other studies have found evidence that development of the financial sector leads(positive impact) to economic growth. In addition, from panel 2 perspective, Tabi et al. (2011), Elie (2015), Djoumessi (2009) and Madiefe (2015) have reinforced the argument that financial development has a positive impact on economic growth in Cameroon and some sub-Saharan African countries such as South Africa. Despite the overwhelming evidence that financial system development has a positive impact on economic growth in panel 1 and 2, alternative points of views still exist. There are a number of studies that provide evidence in support of the fact that financial development has a negative impact on economic growth. Al-malkawi et al. (2012), De Gregorio and Guidotti (1995), Bernard and Austin (2011) amongst others found a negative impact of financial development on economic growth in certain countries. In addition to the strong view that there is a relationship between financial development and economic growth, irrespective of whether this relationship is positive or negative, there have been a few studies that suggest that financial development has no impact on economic growth. These studies provide evidence in support of the notion that financial development and economic growth are not related and they are two different phenomena that are independent of one another. Such studies include Bloch and Tang (2003), Levine and Zervos (1996), Ram (1999), Andersen & Trap (2003). Furthermore, some empirical studies such as Yıldırım et al. (2013), Hakeem and Oluitan (2013), Islam et al. (2004), Kar and Pentecost (2000) showed evidence that there exist a unidirectional causality from economic growth to financial development in some countries. On the other extreme, Adusei (2013) provides evidence that financial development undermines growth in an economy (financial development is an anti-growth factor).

METHODS

The experiences of the 1980s have led many developing countries to reconsider their approach to development Though countries differ in the scale of government intervention and in the extent to which they have already stabilized and restructured their economies, most have decided to rely more upon the

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private sector and market signals to direct the allocation of resources. To obtain all the benefits of greater reliance on voluntary, market-based decisionmaking, they need efficient financial systems. A financial system provides services that are essential in a modem economy. The use of a stable, widely accepted medium of exchange reduces the costs of transactions. It facilitates trade and, therefore, specialization in production. Financial assets with attractive yield, liquidity, and risk characteristics encourage saving in financial form. By evaluating alternative investments and monitoring the activities of borrowers, financial intermediaries increase the efficiency of resource use. Access to a variety of financial instruments enables economic agents to pool, price, and trade risk. Trade, the efficient use of resources, saving, and risk-taking are the cornerstones of a growing economy. Governments' efforts to promote economic development by controlling interest rates, directing credit to priority sectors, and securing inexpensive funding for their own activities have undermined financial development In recent years, financial systems have come under further stress when, as a result of the shocks of the 1980s, many borrowers were unable to service their loans. This has led many developing country governments to intervene to restructure insolvent financial intermediaries. Such restructuring provides governments with an opportunity to rethink and reshape their financial systems (see following article by Millard Long and Eirik Evenhouse). The development of a more robust and balanced financial structure will improve the ability of domestic financial systems to contribute to growth. By restoring macroeconomic stability, building better legal, accounting, and regulatory systems, specifying rules for fuller information disclosure, and levying taxes that do not fall excessively on finance, governments can lay the foundations of well-functioning financial systems. The World Development Report 1989 reviews the lessons of past experience in both high-income and developing countries, and tries to identify the measures that will enable the developing countries' domestic financial systems to provide the services needed in the 1990s. Future growth in the developing countries will depend in part on the policies of The World Development Report 1989 is a Bank staff report prepared by a team led by Millard F. Long and comprising Yoon Je Cho, Warren L. Coats, Jr., Eirik Evenhouse, Barbara Kafka, Catherine Mann, Gerhard Pohl, Dimitri Vittas, Robert Vogel, and Robert Wieland. The Bank's International Economics Department prepared the statistical material and projections. The work was carried out under the general direction of Stanley Fischer. Copies available from World Bank Publications, P.O.Box 7247-8619, Philadelphia, PA USA 19170-8619. $12.95. English, French, and Spanish. Finance & Development I September 1989 high-income countries and their impact on the global economy. But far more important will be the policies pursued by the developing countries themselves. They can improve their growth prospects by continuing to focus on fiscal balance and trade reform. The recent fall in foreign capital flows underlines the need for policies that encourage domestic saving and investment and that direct the flow of resources to profitable activities, in other words, for policies that will improve the performance of domestic financial systems.

Such rigidly-controlled approach to banking system development is particularly effective in time of crisis since in a pure market economy or in economy with low government control market relations between subjects (people) have speculative character. It is important to recall here the views of Professor Robert Sheller of Yale University, about imperfection of the market: "In the U.S. we are just beginning join discussions on topics of morality and human values, treating them as an integral part of business life. The process is not fast. When I started working at the university, the most common opinion was the idea that the market is perfect, though I did not want really believe in it then. I looked through all the old books in search of the chapter about speculative "bubbles", but nothing in them on this topic I found. Then I began to look for the chapter about fraud. And again, to no avail. If we take modern textbooks, from this point of view, yet something has changed." The same opinion has the legendary George Soros, who at the World Economic Forum in Davos said that during the crisis earlier functioned market theory "irreversibly collapsed".It is obvious that to build the model of financial and banking system without taking account a permanent aspiration of market participants one way or another, to cheat - it is, of course, pure idealism that has nothing to do with the real economic relations. But on the other hand, limitation just with government's efforts and configuration of the banking system as an executive institution will provide lowly moderate level of development of the system. In the consequence, this leads to moral hazard in the banking system itself that makes it quite vulnerable

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and inadequate to market conditions of doing business. Despite the fact that the volume of retail lending in Uzbekistan is growing rapidly, the total retail loans in relation to GDP is only 2.4% (in 2008 - 2.5%), which is relatively lower than in a number of developing countries (Fig. 3). Consumer loans, which in Uzbekistan comprise also mortgage loans, are 6% of the total assets of the banking system. For comparison, in the number of countries in Eastern Europe, despite the slowdown in retail lending, the ratio of consumer loans (excluding mortgages) to the total assets of banks remains relatively high: in Romania - 16%, Hungary and Bulgaria - 11, Poland - 9. It can be concluded that the state initiative of banking sector development is very much needed and brings good results but only in terms of support for the sector. In other words, along with state support essential value has independent development of the banking sector, which must operate according to market rules. At this stage of development of the banking system of Uzbekistan it is necessary to increase circulation of money through the banking system. The more money will circulate through the banks the more financial resources will be available to the banks that will affect positively on the volume of lending.

CONCLUSIONS

It can be concluded that the state initiative of banking sector development is important and gives good results but only in terms of support for the sector. In other words, along with state support essential value has independent development of the banking sector, which must operate according to market rules. Results show that, at this stage of development of the banking system of Uzbekistan it is necessary to increase circulation of money through the banking system. As the Index thrift industry (the level of deposits per capita) in Uzbekistan is only 5.2. as well as Uzbek banks are sceptical of machines - the number of bank branches is higher than in the UK and France, but the number of ATMs is lower than in India. We can also conclude that the development of retail banking services is provided mainly by the government's efforts. In turn, this leads to moral hazard in the banking system itself that makes it quite vulnerable and inadequate to market conditions of doing business. Development could be achieved by expanding of privatization in the banking sector and permitting the sector to function freely according to market rules

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