Banks That Don’t Lend? Unlocking Credit to Spur Growth in Developing Countries

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This article explores the level of liquidity within the banking systems of developing countries and the potential impact on rates of economic growth from prudently redirecting a portion of liquid assets into credit to the private sector. It finds that banks in developing countries are extremely liquid and growth rates per capita might increase substantially in response to heightened lending to the private sector. It then summarises the primary obstacles to this and presents several policy reforms that can augment the level of credit to the private sector in developing countries.

1 Introduction

Most developing countries have failed to achieve sustained economic growth during recent decades despite significant macroeconomic reforms, an end to state domination of the economy and increased global trade. One of the reasons why economic prosperity has remained elusive throughout the developing world is a widespread lack of access to credit for individuals and businesses. Financing constraints make it very difficult for entrepreneurs to launch new businesses and for existing businesses to grow and expand, especially small businesses which comprise the main source of employment in developing countries (Demirgüç-Kunt and Maksimovic, 1998; Love, 2003; Beck et al., 2005).

In an efficient financial system, individual savings are mobilised by financial intermediaries and allocated to their most productive uses (World Bank, 2001). In most developing countries banks are the primary financial intermediary; in an efficient financial system these banks would therefore mobilise savings, usually in the form of deposits, and allocate them to productive businesses through loans. The allocation of savings to productive enterprises results in increased employment and higher GDP.

The financial systems in most developing countries are extremely inefficient; they are not particularly effective at mobilising savings or allocating them to the most productive uses. Substantial personal savings are never captured by the financial system. Many people do not have bank accounts and instead keep their money at home,

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1. The World Bank (2001) notes that efficient financial markets also involve ‘monitoring managers (so that the funds allocated will be spent as envisaged)’ and ‘transforming risk (reducing it through aggregation and enabling it to be carried by those more willing to bear it)’.

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‘under the mattress’. In some countries the amount of savings that is kept under the mattress is equal to a sizeable percentage of GDP. Even when savings are deposited into the financial system, the funds often fail to reach productive enterprises. Banks maintain a very high level of liquid assets, such as short-term government bonds, central bank debt and cash, while only allocating a modest amount of funds to private sector firms.

Although it is widely acknowledged that banks in developing countries provide a low degree of credit to the private sector, we have not encountered much work directly addressing the level of liquidity maintained by banks and how this impacts on economic growth. This article helps to fill the gap by analysing banking sector liquidity and implications for potential growth rates from more efficient credit markets. The article is constructed as follows. Section 2 provides a brief summary of some of the empirical literature on the relationship between finance and growth, with particular focus on banks. Section 3 provides an overview of the condition of credit markets in developing countries. Section 4 presents data on banking sector liquidity and potential improvements in per capita economic growth from prudently redirecting a portion of liquid assets to private sector credits. Section 5 summarises the primary reasons why credit markets in developing countries are inefficient. Section 6 offers a number of policy reforms that can improve the efficiency of credit markets. Section 7 discusses the feasibility and sequencing of reforms. Section 8 provides some concluding thoughts.

2 Finance and growth

Over the past 15 years there has been a tremendous volume of research on the relationship between financial development and economic growth. Previously there had been debate about whether financial development causes economic growth or merely occurs in response to it. The recent empirical studies ‘demonstrate a strong positive link between the functioning of the financial system and long-run economic growth’ (Levine, 2004). The evidence also suggests that financial development is not merely a response to economic growth, but rather, financial development causes growth (Levine, 2004; Levine et al., 2000; Beck et al., 2000; Beck et al., 2005; Rousseau and Wachtel, 1998). In addition, recent research suggests that financial development disproportionately benefits the poor and reduces income inequality (Beck et al., 2004b).

One of the ways that financial development directly impacts on growth is by reducing external financing constraints, thereby allowing firms to grow more rapidly (Rajan and Zingales, 2003). Firms and industries that are more dependent on external financing and cannot rely solely on internally generated funds for expansion are likely to grow much faster in countries with more developed financial markets, especially

2. It may be perfectly rational for people to keep money under the mattress; they may fear that the banks will lose or steal the money or the government will take it through taxation. Nevertheless, mattress savings are not an efficient allocation of capital.

3. We are not aware of efforts to estimate precisely the aggregate amount of mattress savings, but in many countries it may amount to a sizeable percentage of GDP. For example, in Russia and Argentina, two countries that have experienced banking crises in recent years, the level of mattress savings was estimated at $80 billion and $20 billion, amounting to 18% and 15% of GDP, respectively (Moscow Times, 16 July 2004; The Economist, 6 December 2003).
firms and industries with high fixed costs for plant, equipment, technology or research (ibid.). Firm-level studies have shown that financial development reduces obstacles to firm expansion and is particularly beneficial for the growth of small firms (Levine, 2004). Industry-level studies have shown that industries with significant external financing needs, such as textiles, machinery or drug manufacturing, have grown more rapidly in countries with greater financial development (Rajan and Zingales, 2003; Levine, 2004).

Numerous variables have been used to analyse the level of financial development of a country, including liquid liabilities of the financial system, the level of overall credit provided by the banking sector and the level of credit provided by the banking sector to private firms (King and Levine, 1993); stock market capitalisation and liquidity (Levine and Zervos, 1998); bond market capitalisation; and assets of non-bank institutions such as pension funds and life insurance companies (Beck et al., 2001). In most developing countries stock and bond market capitalisations are very thin and the assets of pension funds and insurance companies are quite limited; bank lending therefore represents the largest source of financial intermediation.

Since banks constitute such a large part of the financial system in developing countries, their activities have a significant impact on the economy. The degree of lending to the private sector is particularly important because private sector firms can generally use domestic savings more productively than public sector entities. Empirical studies have examined the relationship between the level of credit provided to the private sector and economic growth, and economic growth rates are often substantially higher in countries with relatively robust lending to the private sector (King and Levine, 1993; Levine and Zervos, 1998; Levine et al., 2000). A modest rise in the volume of credit to the private sector is often associated with a significant rise in GDP (Levine et al., 2000).

If increases in the level of credit to the private sector can exert a strong, positive influence on economic growth and disproportionately benefit the poor, it is important for the development community to understand the extent to which banks are providing credit to the private sector. As the data contained in Section 4 reveal, banks in developing countries generally provide only modest or minimal levels of credit to the private sector. Policy reforms that encourage banks to prudently boost the level of credit to the private sector can significantly enhance growth and reduce poverty. We use the word ‘prudently’ because policy reforms that simply mandate greater lending to the private sector will probably result in an inefficient allocation of capital and may have a negative impact on growth; loans will be made to firms that cannot use the funds productively and default rates may be very high. However, if banks carefully evaluate potential borrowers and prudently extend credit to private sector firms, then savings are much more likely to be allocated to the firms that can use the funds most productively. The result is a more efficient credit market.

3 Condition of credit markets in developing countries

Debt financing is the lifeblood for much of the productive economic activity in developed countries. The widespread availability of domestic credit makes it relatively easy for entrepreneurs to obtain financing to start a business, for established businesses
to purchase new equipment and technologies to expand their operations, and for individuals to obtain financing for the purchase of homes. The contrast with developing countries is striking. In most developing countries only large, well-established companies can obtain loans without much difficulty. Entrepreneurs and small businesses are generally unable to obtain debt financing, and instead they struggle to get funds from family and friends to start a business or expand their commercial activities. Mortgage loans are readily available to the vast majority of adults in developed countries, while only a very small percentage of adults in developing countries are able to receive loans to finance the purchase of a home.

Even when financing is available to borrowers in developing countries, the options are very narrow. Most bank loans are only offered for a very short term. Banks make lending decisions largely based on the value of assets pledged by a borrower rather than a borrower’s expected revenues and cash flows. Borrowers must often satisfy collateral requirements well in excess of 150% of the amount of the loan, effectively excluding most potential borrowers from debt financing and, in particular, excluding those desiring to start a new business.

The grave disparity between the levels of financial intermediation in developed and developing countries is reflected in the amount of domestic credit provided by the banking sector to private enterprises, available in the annual World Development Indicators (World Bank, 2004b) and summarised in Figure 1. In 2002, domestic credit provided by the banking sector in high-income countries averaged 168% of GDP. In the United States, domestic credit for 2002 was 159% of GDP – amounting to over $16 trillion in bank lending to the private sector. In contrast, the 2002 domestic credit provided by the banking sector in middle-income countries was 83% of GDP and for low-income countries was only 49% of GDP. Domestic credit provided to the private sector in 2000 for 15 of the largest developing countries (which comprised 84% of banking system deposits in developing countries) was only 37% of GDP (Hanson, 2000). The disparity between the levels of financial intermediation in developed and developing countries is even greater when other sources of credit are considered, such as bond markets.

The low amount of domestic credit provided by the banking sector in developing countries is well established; however, an important distinction needs to be made between the level of deposits in the banks and the level of credit subsequently provided by the banks. When the level of deposits in the banking sector is a low proportion of GDP, domestic credit provided by the banking sector will also be low, as lending is constrained by the level of deposits. These aspects are captured by the ‘liquid liabilities’ variable (deposits are liquid liabilities of banks) featured in the literature on finance and growth. Our main point, generally overlooked in the literature on finance and growth, is that we must also consider the level of credit provided by the banking sector in relation to the low level of deposits. A low level of credit in relation to deposits (rather than to GDP) is a different problem from either a low level of deposits relative to GDP or a low

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4. Domestic credit is defined as ‘Domestic credit provided by the banking sector to various sectors on a gross basis, with the exception of credit to the central government, which is net. The banking sector includes monetary authorities, deposit money banks, and other banking institutions for which data are available’ (World Bank, 2004b: 273).
level of credit relative to GDP. Indeed, a low level of credit in relation to deposits is the essence of an inefficient banking system. We investigate this in Section 4 by looking at the level of deposits held by banks in the form of liquid assets rather than provided as credit to the private sector.

**Figure 1: Domestic credit provided by the banking sector**
(as % of GDP according to *World Development Indicators* for 2002)

![Figure 1: Domestic credit provided by the banking sector](chart.png)

Note: ‘Domestic credit’ excludes credit to the central government.

### 4 Banking sector liquidity in developing countries

Perhaps surprisingly, the meagre size of domestic credit provided to the private sector in developing countries is not due to a lack of funds in the banking sector. Banks in developing countries choose to channel only a modest portion of their funds to private sector borrowers, while keeping a sizeable percentage of their deposits in liquid assets, such as cash, deposits with other banks, central bank debt, and short-term government securities; Caprio and Honohan (1991) refer to this as ‘excess liquidity’. Throughout the 1990s commercial bank deposits increased in developing countries, but these deposits were primarily channelled into central bank debt and government debt rather than being loaned to the private sector (Hanson, 2003).
Data taken from *International Financial Statistics* help identify the degree of liquidity in the banking systems of developing countries. Figures 2-5 summarise the key findings. These figures present data for several low-income and middle-income countries from various regions of the developing world. Data for a more comprehensive list of 35 developing countries are contained in Appendix Table A1.

The United States has one of the largest banking systems in the world, and is second only to Japan in magnitude of total deposits. It is also generally recognised as having possibly the most highly developed and efficient capital markets in the world. We therefore look at liquidity in the US banking system and provide comparisons of the data for banks in developing countries with the data for banks in the US. The US benchmark is meant to reflect a general level of efficiency in the banking sector which has been achieved in developed countries, rather than an optimum system or level of efficiency attainable immediately in developing countries. The comparison, although not perfect, permits a richer perspective on the inefficiency of banking systems in developing countries.

To examine liquidity, we construct a liquidity ratio of liquid assets to total deposits. As noted in Figure 2, liquid assets comprise just 6% of total deposits for US banks, but over 50% of total deposits for banks in some developing countries. In our sample of 35 developing countries, the liquidity ratio ranges from 14% in South Africa to 126% in Argentina and has a mean of 45% (see Appendix Table A1). In contrast, developed countries have a much lower range of liquidity ratios. The ratio in the United Kingdom is even lower than that in the US, at 2%. The ratio in Japan is higher, at 21%. The ratios in France and Germany are 31% and 34%, respectively. The average of these five developed countries is 19%. The inescapable conclusion is that developing countries have higher liquidity ratios than developed countries, and the US is likely to be the most meaningful benchmark.

We next estimate the amount of ‘additional liquidity’ in the banking systems of developing countries by comparing actual liquidity with the amount of liquidity that would prevail in the US for the same deposit base. We refer to this as ‘additional liquidity’ rather than ‘excess liquidity’ (Caprio and Honohan, 1991) as some recognition that the banks are not necessarily acting irrationally, a point we develop further in Section 5. Figure 3 reports the results for the countries examined in Figure 2. For many of the countries, this translates into billions of dollars in additional liquidity – liquidity beyond what US banks would maintain with comparable levels of deposits. In our sample of 35 developing countries, additional liquidity ranges from $67 million in Armenia to $107 billion in Brazil, and totalled $531 billion.

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5. The *IFS* data are based on filings by central banks with the IMF. The data reflect aggregate numbers for the banking sector within each country as reported to the IMF by the central bank of each country. The data gathered for Appendix Table A1 were largely derived from information on the *IFS* database as of 1 September 2003 and are on file with the authors.

6. Specifically, additional liquidity is the difference between the country’s liquidity ratio and the 6.5% ratio for the US multiplied by the aggregate amount of bank deposits: additional liquidity = (liquidity ratio - 6.5%) \times \text{deposits}.
Figure 2: Liquidity ratios
(liquid assets as % of total deposits)

Figure 3: Additional liquidity (USbn)
(liquid assets vis-à-vis US liquidity as benchmark)
Figure 4 indicates the ratio of additional liquidity to GDP for each country. The additional liquidity maintained by the banking system in many developing countries exceeds 10% of GDP, and in several cases exceeds 30% of GDP. In our sample of 35 developing countries, the amount of additional liquidity as a ratio to GDP ranges from 1.4% in El Salvador to 54.9% in Jordan, and has a mean of 14.5%.

**Figure 4: Additional liquidity relative to GDP**
(additional liquid assets as % of GDP, vis-à-vis US liquidity as benchmark)

![Bar chart showing additional liquidity relative to GDP for different countries](image)

While liquid liabilities (i.e., deposits) of the banking system and credit provided by the banking system have both been examined in the literature, no explicit attention has been paid to the gap between deposits and credit. We aim to fill part of this void by applying results in the literature to the additional liquidity uncovered above.

Table 1 provides a brief comparison of estimates measuring the impact of financial development on per capita growth from a comprehensive study of financial intermediation and growth by Levine et al. (2000). Although several papers have estimated such coefficients, this study has the advantage that it provides estimates for both liquid liabilities and bank credit (as ratios to GDP) rather than one variable or the other. The main results use a panel of 71 countries over the period 1960-95. Not surprisingly, real per capita growth is higher when the value of either variable is higher. Note that, in each of the three specifications, bank credit has a bigger impact on real per capita GDP growth than liquid liabilities. Using the most parsimonious set of independent variables, a 10% increase in private credit is associated with a 0.25% higher per capita growth rate (while a similar increase in liquid liabilities is associated with only a 0.17% higher per capita growth rate). The inescapable conclusion is that growth is more dependent on bank credit provided to the private sector than on having banks simply taking deposits. The difference in coefficients suggests that we should pay attention to the difference between liquid liabilities and credit provided for insights on...
the impact of inefficiencies in the banking system. Using more control variables, the impact of liquid liabilities and bank credit rises.  

Table 1: Summary of coefficients from Levine et al. (2000) estimating the impact of the banking system on real per capita growth rates

<table>
<thead>
<tr>
<th>Independent variable</th>
<th>Control variables used in the regression (instrumental variables estimation procedure)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>liquid liabilities/ GDP</td>
</tr>
<tr>
<td></td>
<td>bank credit/ GDP</td>
</tr>
<tr>
<td>Initial per capita GDP, educational attainment</td>
<td>1.723</td>
</tr>
<tr>
<td>Initial per capita GDP, educational attainment, government size, inflation, black market exchange-rate premium, openness to international trade</td>
<td>2.173</td>
</tr>
<tr>
<td>Initial per capita GDP, educational attainment, government size, inflation, black market exchange-rate premium, openness to international trade, political stability, ethnic diversity</td>
<td>2.788</td>
</tr>
</tbody>
</table>

Source: Levine et al. (2000: Table 3).
Note: Standard errors in parentheses.

Using the established link between credit by financial intermediaries to the private sector and real per capita growth, we can calculate the impact on economic growth rates from increasing credit to the private sector by the level of additional liquidity for each developing country. We take the main estimate (i.e., the coefficient of 2.5) from Levine et al. (2000) as representative. This is the lowest of the three coefficients specified in Table 1, but is also higher than similar coefficients reported in Beck and Levine (2004), so it is somewhere in the middle of all the estimates. We calculate the additional growth that could result from deploying additional liquidity by multiplying the proportionate

7. Other studies have estimates similar to those in Table 1. Beck et al. (2000) have very similar estimates, not reported here. Rousseau and Wachtel (2001) estimate coefficients on liquid liabilities at 2.7 or 2.8, the higher end of the range reported in Table 1. However, they do not provide estimates of coefficients on bank credit. Other papers estimate coefficients on bank credit but not on liquid liabilities. The variable was introduced in King and Levine (1993), and used again in Levine and Zervos (1998). The most comprehensive study of the variable is that summarised in Table 1. More recently, Beck and Levine (2004) have provided more coefficient estimates, in a range from 1.2 to 1.6, somewhat lower than reported in Table 1. Other variables used in the literature include: (i) the ratio of bank credit to bank and central bank credit, and (ii) claims of the non-financial private sector to total domestic credit. Although these variables capture important elements of the banking and financial systems, we focus here on the ratios of liquid liabilities and domestic credit to GDP because they more directly suggest the impact of additional liquidity in the banking system. In addition, data are more readily available for a wide variety of countries. For more extensive surveys of the variables used in the literature on finance and growth, see Wachtel (2003) and Levine (2004).
increase in private credit by 2.5. The estimates in Figure 5 reveal that the impact on economic growth is substantial – generally a 1% to 2% increase in the rate of economic growth. Growth rates in these countries have generally ranged from zero (even slightly negative) to 2.75% over the period 1995-2002, so an increase of one percentage point is economically significant. In our sample of 35 developing countries, the additional per capita growth from deploying the additional liquidity ranges from 0.1% in South Africa to 2.8% in Jamaica and has a mean of 1.1%.

The results are particularly dramatic for Indonesia, which has recently had growth of 1.07% and would have had growth of an estimated 3.33% if additional liquidity had been directed into private credit. Over a 25-year period a growth rate of 3.33% will produce a per capita GDP that is 76% higher than that achieved with a growth rate of 1.07%. In the case of Indonesia, which currently has per capita GDP of $3,228, over a 25-year period the 3.33% growth rate would result in per capita GDP of $7,421, while the 1.07% growth rate would result in per capita GDP of $4,218.

**Figure 5: Projected increased growth per capita if additional liquidity is directed into private sector credit**

Of course, increased lending to the private sector will not necessarily result in higher per capita growth rates. The manner in which the lending occurs is critical. If banks recklessly augment the volume of lending to the private sector (perhaps by lending to insiders or politically connected firms), then the allocation of capital will not be efficient and savings will go to relatively unproductive firms. The policy challenge is

8. The additional per capita growth is \(2.515 \times \ln(\text{private credit/GDP})+(\text{additional liquidity/GDP})-\ln(\text{private credit/GDP})\).
to create an environment which induces banks to increase prudently the level of credit to the private sector, resulting in the allocation of savings to the most productive firms.

5 Reasons for inefficient local credit markets

One might question whether credit markets in developing countries are really so inefficient. Could it be that government debt and cash positions are the most productive uses for bank deposits, due to a paucity of bankable private sector borrowers that could use these funds more productively? This seems highly implausible, even in the developing countries with the lowest levels of credit to the private sector. There are many businesses and individuals in developing countries that suffer from a lack of access to credit and could repay loans at interest rates far higher than the banks are earning on cash positions and even government debt. The prevalence of loan-sharks and informal lenders that charge high rates (50% per month is not uncommon) as well as microfinance institutions (that may charge up to 20% per month) suggests that the formal financial system is failing to serve many creditworthy potential borrowers. Nevertheless, banks in developing countries have many rational reasons for maintaining a much higher ratio of liquid assets relative to total deposits than banks in developed countries. The primary reasons, in general order of importance, are:

(i) higher reserve requirements due to greater macroeconomic risk and volatility;
(ii) significant deficiencies in the legal and regulatory environment which make it difficult to enforce contracts and foreclose on collateral;
(iii) widespread availability of government bonds which crowds-out private investment;
(iv) substantial asymmetric information – lenders often know little about prospective borrowers; and
(v) inadequate skills for assessing risk and managing non-sovereign loans.

5.1 Higher reserve requirements

Bank regulators in developing countries impose higher reserve requirements than regulators in developed countries, largely because of increased macroeconomic risk and volatility. If a country is susceptible to economic or financial crises, then the risk of massive borrower defaults is higher and it is prudent to keep a greater share of deposits in liquid assets. Such heightened macroeconomic risk also increases the likelihood of panics and a run on the banks, with individuals and businesses seeking to quickly liquidate their accounts and withdraw all their deposits. Deposit insurance is not widely available in developing countries, so depositors are especially fearful of losing their savings during a financial crisis. Higher reserve requirements help stem the risk from a run on the banks. However, reserve requirements are generally thought to be set too high in developing countries, given the amount of risk confronting the banking system – a policy known in the literature as a form of ‘financial repression’.
5.2 Legal and regulatory regimes

Substantial deficiencies in the legal and regulatory environment in developing countries constitute the primary reason for the low degree of credit extended to the private sector. The legal and regulatory system has an impact on the ability of financial institutions to allocate savings to the most productive firms (Levine, 1998). Creditors are not granted adequate legal rights in most developing countries. Lenders are significantly deterred from lending to the private sector for the following reasons:

(i) general difficulty in enforcing contracts without significant time delays and expense;
(ii) inadequate collateral laws that render it difficult for lenders to obtain valid security over pledged assets and then quickly repossess and sell such assets following a default by the borrower; and
(iii) bankruptcy regimes that make it very difficult for creditors to obtain recoveries from a borrower that enters into insolvency proceedings.

Contract enforcement

Enforcing contracts is an extremely time-consuming and costly process in many developing countries. Even if a borrower defaults on a loan and is in clear breach of a loan contract, it can take several years before the lender obtains a final court judgment against the defaulting borrower. The World Bank’s ground-breaking book, Doing Business in 2004, provides substantial data on the difficulties with contract enforcement in developing countries. It involved, among other things, comprehensive multi-country surveys of various aspects of contract enforcement. It found that the costs of pursuing litigation often amount to a sizeable percentage of the amount ultimately recovered from the borrower. For example, in Guatemala it is estimated that enforcing a simple contract dispute takes roughly 1,460 days and 40% of the amount of the claim goes to attorney and court fees (World Bank, 2004a). Developing countries often maintain dozens of procedural hurdles to the enforcement of a contract, including permitting appeals during the course of a trial and allowing comprehensive reviews of a case in an appeal. This results in significant delays. Judicial corruption is extensive in developing countries, and lengthy proceedings with a multitude of procedures present greater opportunities for public officials to extract bribes, thereby exacerbating enforcement costs for litigants and impairing the predictability of the outcome (ibid.).

Empirical research demonstrates that the degree to which contracts can be readily enforced is closely linked with the level of credit provided to the private sector and with economic performance (La Porta et al., 1997; Levine, 1998; Levine et al., 2000). When judicial systems provide for the timely enforcement of contracts, banks will lend more while also charging lower interest rates. Lower interest rates render debt financing a viable option for many borrowers that would not be able to repay loans at higher interest rates.

A study by Laeven and Majnoni (2003: 18) looked at the impact of judicial efficiency on the cost of credit. It concluded that ‘judicial efficiency, in addition to inflation, has appeared to be the main driver of interest rate spreads’. Judicial efficiency
was measured by a number of factors, including delays in receiving judicial decisions and corruption within the judiciary. The study estimated that interest rates in middle-income countries would drop by 2.0 to 2.5 percentage points if these countries maintained levels of judicial efficiency comparable with those of developed countries.

**Collateral laws**

Lenders require collateral from borrowers to minimise their losses should the borrower default. Collateral also serves as a device for screening prospective borrowers to make sure they are going to repay; a borrower’s willingness to risk the loss of collateral suggests that the borrower is confident that it will repay the loan. The prospect of losing collateral serves as a powerful incentive for a borrower to avoid default. Most legal systems in developing countries fail to provide for the repossession and sale of collateral without going through judicial proceedings, resulting in significant delays from the time of default to the time the collateral is sold to pay off the loan (World Bank, 2004a). In general, the process of seizing and selling collateral is much faster in developed countries than in developing countries. In a hypothetical transaction that was part of the multi-country survey for *Doing Business in 2004*, it was found that, following a borrower’s default, it generally takes just a week for a creditor in the US or Germany to seize and sell business equipment that was pledged as collateral, but it can take five years in Brazil and Chile to seize and sell identical equipment.

Due to the delays and costs involved in foreclosing on collateral and enforcing contracts, lenders in developing countries frequently require collateral in excess of 150% of the amount of the loan. Collateral is less valuable to lenders if it takes 5 years and significant legal costs to repossess and sell. In many developing countries, 150% or higher collateral requirements may be necessary for lenders to get repaid in full from the sale of collateral. Many entrepreneurs and small businesses are unable to meet this requirement, especially due to the fact that they do not have legal title to their home and land and therefore cannot offer it as collateral (De Soto, 2000). Also, collateral laws in many developing countries do not allow for inventory, receivables or other types of assets that change over time to be pledged as collateral, further limiting the ability of borrowers to post sufficient collateral for obtaining a loan (World Bank, 2004a).

Collateral regimes in developing countries also suffer from an absence of central registries for identifying and recording liens over collateral. In many developed countries lenders can search electronically to find out what collateral, if any, a borrower has pledged to other creditors. Creditors may refuse to extend credit if they cannot be certain that their lien will have priority over those of any current or future creditors. In many developing countries there are numerous local registries for identifying collateral, but no central registries or electronic databases of liens granted to creditors. The absence of a central registry with an easily searchable database makes it very cumbersome if not impossible to ascertain whether a borrower has previously granted liens over its assets, and this serves as an impediment to the extension of credit.

**Bankruptcy regime**

Bankruptcy laws and practices have an impact on lending decisions because lenders want to know that they have a reasonable certainty of recovering from defaulting
borrowers who enter into insolvency proceedings. In many developed countries the claims of secured creditors are satisfied first upon liquidation of the assets of an insolvent company, but in many developing countries the claims of workers and tax authorities are met first. Also, pledged assets often get mixed with other assets of the bankrupt company and are used to meet the claims of workers, tax authorities and other creditors. If secured lenders are not confident that their claims will be met first in bankruptcy from assets pledged to them, they will be less likely to extend credit. If they do lend, they will demand a higher interest rate to compensate for the increased risk.

Bankruptcy regimes in developing countries also discourage lending because, similar to contract enforcement proceedings, bankruptcy proceedings are time-consuming and costly. In some countries it takes more than a decade to complete insolvency proceedings, resulting in enormous uncertainty and delay for lenders seeking to recover on their loans (World Bank, 2004a). The legal and other costs of lengthy bankruptcies can amount to a sizeable percentage of the value of the underlying assets of the company. Bankruptcy regimes often fail to give creditors control or influence over the appointment of a manager or receiver to run the company after it enters into insolvency proceedings, and in many developing countries the existing senior management of a company retains control over its affairs throughout the lengthy insolvency proceedings. This makes it much more difficult for lenders to get repaid.

The importance of a country’s legal regime on financial sector development has been demonstrated by examining the different levels of bank lending for countries whose laws are based on UK common law principles as opposed to French civil law principles (La Porta et al., 1997, 1998; Beck et al., 2004a). The latter study revealed that legal origin is an excellent predictor of the level of financial sector development of a country, and countries with UK common law principles tend to have greater lending to the private sector partly because the legal regime is more adaptable. In these countries the laws have often evolved over time to afford greater protection to creditors than are offered in countries organised under French civil law principles.

5.3 Fiscal policy; crowding-out

In addition to inadequate legal regimes, fiscal policy often serves as another powerful impediment to the extension of credit to private sector firms and individuals in developing countries. Many developing countries run large deficits and this curtails growth (Easterly and Rebelo, 1993). Large debt issuances in domestic markets by national governments will increase the demand for financing, and this drives up domestic interest rates. Higher interest rates make debt financing unaffordable or less appealing to many potential borrowers. Moreover, the availability of government debt that offers moderate or high returns renders banks less inclined to search for profitable lending opportunities with private sector borrowers.

Administrative and transaction costs are much lower for lending money to the government rather than to the private sector. Lending to the private sector is generally riskier and considerably more people and time are required for a bank to manage a portfolio of private sector loans than one of government debt and cash positions. In order for banks to assess this risk adequately and charge commensurate interest rates and fees, they need to develop skills for determining the quality of potential borrowers.
and their likelihood of repayment. There is a certain internal cost associated with developing these skills; it takes time and effort to acquire them. The prevalence of government debt offerings in many developing countries discourages banks from developing these skills because they can make a satisfactory profit without them. Many small and medium enterprises (SMEs) in developing countries are unable to compete with government debt in the portfolio of local banks, and reductions in government debt may result in heightened credit to them (Hanson, 2003).

5.4 Asymmetric information

High levels of asymmetric information hinder lending to the private sector in developing countries, especially lending to individuals and SMEs. Unlike in developed countries, lenders in developing countries often know little about prospective borrowers because such borrowers lack accurate and detailed financial statements or credit histories. Businesses in developing countries often keep multiple sets of books and do not have audited financial statements based on reliable accounting standards. An empirical study by Levine et al. (2000: 36) found that ‘countries where corporations publish relatively comprehensive and accurate financial statements have better developed financial intermediaries than countries where published information on corporations is less reliable’.

In most developing countries there are few, if any, credit bureaux that collect and disseminate credit information widely on individuals and businesses. Credit bureaux generally pool such information from lenders as well as from public sources such as courts, tax authorities and public registries, and use it to prepare credit reports that include a borrower’s payment history and debt load. These reports enable lenders to better evaluate the likelihood of default for prospective borrowers.

In developed countries it is common for credit information to be available for over 90% of adults, while in developing countries credit history is available for less than 10% of adults (World Bank, 2004a). Many lenders to SMEs consider the credit history of the owner in deciding whether to make a loan, so the lack of personal credit history often precludes financing for SMEs (World Bank, 2001). The degree of credit provided by banks to the private sector is much higher when there is substantial sharing and dissemination of credit information (Jappelli and Pagano, 1999).

The widespread sharing of credit information is also associated with lower default rates and lower financing constraints for firms (Love, 2003). Borrowers have a powerful incentive to repay a loan if their repayment or failure to repay is conveyed to a credit bureau. If they fail to repay a loan they will encounter significant obstacles in obtaining a loan in the future because the lending community will be aware of their failure to repay. By the same token, if they repay a loan they will build a positive credit history that makes them appear less risky to lenders and it will be easier for them to obtain a loan in the future (Jappelli and Pagano, 1999). The sharing of positive credit history induces competition among banks for loans to creditworthy borrowers and enables good borrowers to obtain credit on more favourable terms from new banks.
5.5 Limited technical skills

Another obstacle to the growth of local credit markets in developing countries is the limited capacity of banks to assess and manage risk. Bankers are not well versed in cash-flow analysis and they primarily evaluate credit risk based on the amount of collateral posted by a borrower rather than a borrower’s expected revenues. Many banks in developing countries have been privatised recently or remain state-owned, and they have not developed the level of credit standards expected from a capable financial intermediary. For example, the Governor of the Central Reserve Bank of Serbia noted that local banks have plenty of deposits but they are not lending to small businesses partly because they ‘don’t have the skills to evaluate credit’ (The Economist, 2002). A study of bank intermediation in Central and Eastern Europe by Reiss et al. (2002) also noted that local banks are ‘still developing experience in appraising, pricing and managing risks’ and this contributes to the low degree of bank lending relative to total deposits held by banks.

6 Reform measures

There are many reform measures that governments in developing countries as well as international donors can undertake to address some of the root causes for the lack of credit to the private sector in developing countries. These measures can encourage banks and other financial institutions to prudently increase the volume of lending to the private sector, resulting in accelerated growth and poverty reduction.

6.1 Legal and regulatory reforms

The World Bank’s annual Doing Business reports (World Bank, 2004a, 2005 and 2006) identified numerous legal and regulatory reforms that can help expand the flow of credit to the private sector. Contract enforcement can be improved by establishing information systems on caseloads and judicial statistics to help identify bottlenecks and areas in need of improvement. Summary debt collection procedures that allow lenders to sue defaulting borrowers under simplified judicial procedures can significantly reduce the time needed to enforce a contract. Modifying the structure of the judiciary to allow for specialised commercial courts can also result in speedier contract enforcement.

Collateral laws can be reformed by introducing out-of-court enforcement proceedings whereby lenders can quickly take possession of collateral and sell it to pay off a loan. Collateral registries can be improved so that they track electronically all the liens throughout the country with respect to individual borrowers. Bankruptcy laws can be changed to grant priority to the claims of secured creditors in the event of insolvency proceedings, and to allow secured creditors to repossess and sell collateral swiftly despite the start of insolvency proceedings. Bankruptcy laws can also be improved by providing creditors with greater control over the appointment of a manager or receiver to take over an insolvent company.

The bankruptcy laws in many countries provide for an ‘automatic stay’ of the claims of secured creditors on the assets of an insolvent company. This blocks secured
creditors from foreclosing on collateral and getting repaid following the initiation of insolvency proceedings. Eliminating the ‘automatic stay’ (which incidentally exists in the US but not in most other common law countries) under existing bankruptcy laws can make secured lenders more confident that they will be repaid. Also, the automatic stay is associated with greater frequency of bankruptcy filings (Claessens and Klapper, 2001). Eliminating the automatic stay may reduce the incentive for borrowers to file for bankruptcy, thereby enhancing the ability of lenders to get repaid by a borrower that is experiencing financial difficulty.

6.2 Fiscal deficits

The deleterious impact of government deficits on domestic credit markets can be ameliorated by reducing fiscal deficits. Deficits are often financed through both domestic borrowing in local currency and external financing in dollars, and cuts in the domestically financed portion of deficits are more beneficial for economic growth. A study by Gupta et al. (2002) found that reductions in the domestic financing of deficits have about 1.5 times the effect on growth as fiscal adjustments based on reductions in both domestic and external financing. Reductions in domestic borrowing can drive down local interest rates and spur more lending to the private sector for new investments. The manner in which deficits are reduced also has a significant impact on economic growth. Reducing deficits through cutting the government payroll, eliminating subsidies and lowering transfer payments, such as pensions, are preferable to fiscal tightening that is obtained through higher taxes and reductions in public investment (Gupta et al., 2002).

6.3 Asymmetric information

Asymmetric information problems can be tackled by government support for private credit bureaux. Governments should institute laws and regulations that encourage the sharing of credit information among lenders and credit bureaux (World Bank, 2004a). Unfortunately, in many developing countries lenders hoard credit information because it gives them a competitive advantage. Borrowers are generally forced to go back to the same bank each time they want a loan as long as other banks are unaware of the borrower’s good credit history. The widespread sharing of information creates competition among banks, reduces the likelihood of defaults, lowers interest rates and results in higher levels of credit. The outcome from information sharing is immensely beneficial to the economy, but established lenders have incentives to withhold credit information (Jappelli and Pagano, 1999).

Laws and regulations that penalise banks for failing to share credit information with private credit bureaux can help overcome this problem. Targeted subsidies or tax incentives for private credit bureaux can also be an inexpensive way of promoting the widespread collection and dissemination of credit information, and this may result in accelerated economic growth due to increased levels of credit.
6.4 Limited technical skills

The technical skills of banks in developing countries and their capacity to evaluate and manage risk can be improved by removing barriers to entry for foreign-owned financial firms. Many developing countries impose severe restrictions on the ability of foreign-owned banks to operate in their domestic credit markets. Foreign-owned financial firms often bring greater technical skills and broader experience to domestic credit markets. Their skills and knowledge seep into the banking system and foster increased lending to the private sector. Also, the entry of foreign-owned firms will increase competition and spur domestic banks to improve their efficiency and to innovate (World Bank, 2001). Foreign-owned firms are more likely to compete with domestic banks for loans to large companies; they tend to avoid lending to small businesses. By reducing the domestic banks’ share of the loans to large businesses (and thereby reducing their profits), the presence of foreign firms can prompt domestic banks to more aggressively pursue lending opportunities with small businesses and other traditionally marginalised sectors, resulting in higher aggregate levels of credit to the private sector (Clarke et al., 2002).

Targeted credit enhancements from development banks and donors can facilitate the entry of domestic financial institutions into new markets and sectors (Freedman, 2004). Such enhancements should be structured to minimise moral hazard while also reducing the risk for new types of lending. Partial loan guarantees or debt-service reserve accounts that safeguard against an initial default by a borrower can help banks overcome the high risk aversion that impedes lending to traditionally under-served sectors, such as SMEs, housing or infrastructure. If partially guaranteed loans or other credit-enhanced lending prove profitable, such lending can demonstrate to local financial intermediaries that there are good opportunities in new sectors. The success of these loans will make other financial institutions more inclined to initiate lending in these areas (ibid.).

7 Feasibility of reforms and sequencing

The reforms outlined in Section 6 are difficult to enact and many will take considerable time to implement. Although the benefits of these reforms have been well documented, there are powerful domestic groups that fear such reforms and resist them (Rajan and Zingales, 2003). The major beneficiaries of the reforms (consumers of credit) are generally diffuse, poorly organised and lack motivation to push for these reforms, partly because the benefits seem relatively modest or intangible. The beneficiaries of the status quo are often well organised and highly motivated to stifle reforms because they fear that they will suffer significant losses from them.

With respect to reforming fiscal policy, governments always have a strong incentive to resist curbing deficits because it is more politically beneficial to raise funds through borrowing as opposed to taxes. The negative repercussions of excessive deficits are largely borne by subsequent administrations, while the benefits flow to the incumbent. Although fiscal deficits in developing countries have improved modestly in recent years (IMF, 2005), they are still extremely high and unlikely to be reduced significantly. However, efforts by donor countries and multilateral development
organisations to encourage smaller deficits and link assistance levels to fiscal policy can partially counteract incentives for excessive borrowing.

With respect to legal and regulatory reforms, large domestic financial institutions can present a significant obstacle to enacting reforms. The financial system in many developing countries is dominated by a few large banks, which often seek to stifle reforms that may spur competition or erode their dominance. These banks can extract high interest rates due to the lack of competition, weak contract enforcement and absence of credit bureaux. Firms often become dependent on the same bank to continually provide their financing; other banks will refuse to extend credit to them on favourable terms because they are unaware of their credit history and the domestic collateral laws, bankruptcy regimes and contract enforcement mechanisms are inadequate. The dominant banks will oppose reforms that improve this situation because they will make it easier for other banks, especially new banks, to compete with them. Similarly, mandatory sharing of credit information will eliminate the benefits of the knowledge they have acquired about firms and allow other financial institutions to compete with them for clients and drive down interest rates (Rajan and Zingales, 2003).

Other powerful constituencies that may seek to stifle reforms include notaries, civil servants and judges. These groups may benefit from burdensome procedures and requirements with respect to contract enforcement, registering collateral and insolvency proceedings because they allow them to extract rents.

Reforming the judicial system, particularly with respect to contract enforcement, is often a long and cumbersome process with limited success. The annual Doing Business reports of the World Bank indicate that some countries have had modest success in recent years, and by drawing attention to the problem and ranking countries the incentive to enact reforms is increased. Reforms in the areas of collateral laws, bankruptcy regimes or information-sharing are difficult to enact and still require effective judicial or regulatory institutions that can ensure that changes in laws and regulations are properly administered. Again, the annual Doing Business reports indicate that there have been modest improvements in these areas in recent years, and by highlighting the problems and suggesting reforms they help build domestic support for reform.

Another important way to increase domestic support for reforms is by allowing foreign banks to compete in domestic markets. In addition to improving the efficiency and technical skills of domestic banks, the entry of foreign banks creates a new constituency seeking reforms in the areas of contract enforcement and information-sharing. Foreign firms will find it more difficult to engage in relationship-lending to informationally opaque businesses because of language and cultural barriers, and they will prefer to lend on the basis of collateral or confidence in their ability to enforce a loan agreement. Consequently, they are likely to be a strong advocate for improvements in contract enforcement and information-sharing that will foster financial development (Rajan and Zingales, 2003). In addition, the entry of foreign banks often results in domestic firms being forced to focus more on lending to SMEs because the foreign firms primarily focus on lending to large firms. In order to increase lending to SMEs whose operations and financial records are often opaque, the domestic banks will want reforms in contract enforcement, collateral laws and information-sharing. The entry of
foreign financial institutions can thus serve as a catalyst for important domestic legal and regulatory reforms.

The General Agreement on Trade in Services (GATS) promotes the liberalisation of financial services, and it has had a significant impact on foreign bank entry (Maurer, 2003). The GATS is a multilateral agreement that is part of the World Trade Organization (WTO), including its dispute settlement structures. Many developing countries have made commitments under the GATS to liberalise their financial systems and allow foreign bank participation, albeit with various qualifications. International agreements such as the GATS are a good way to overcome domestic opposition to reform measures – it is easier for political incumbents to enact reforms if they can claim that they are doing it in order to gain favourable treatment under an international agreement. To this end, efforts to strengthen the GATS commitments or adding components to other bilateral, regional or global trade agreements that foster foreign bank entry can prove beneficial.

There is no one-size-fits-all approach to implementing reforms, and careful attention should be paid to the sequencing of reforms. There has been substantial analysis of the sequencing of certain financial sector reforms such as deregulation of the financial sector and lifting interest-rate ceilings, capital account liberalisation, reforms of prudential and supervisory regulations and restructuring of financial institutions (Johnston and Sundararajan, 1999), and there are many examples of economic setbacks due to poor sequencing of these reforms. However, existing research offers little guidance about how to sequence the types of financial development reforms discussed here (Wachtel, 2003). In countries with very high deficits, the banks will not be interested in private sector lending; they will earn adequate returns from the relatively risk-free government lending. In such an environment, legal reforms will be meaningless until deficits are brought down. In countries with more modest deficits and weak contract enforcement, it may be beneficial to develop broad domestic support for legal reforms. Making commitments under the GATS and allowing foreign bank entry can be instrumental in building such support. Due to the time-consuming nature of legal reforms, implementing multiple reforms concurrently in this arena may be advisable. For example, introducing specialised courts for commercial disputes while also rewriting the bankruptcy code and establishing centralised, electronic collateral registries is preferable to implementing each reform in succession.

8 Conclusion

The financial systems in developing countries fail to mobilise domestic savings adequately and to allocate them to firms and individuals that can use the funds most productively. Banks hold substantial liquid assets while providing only modest or minimal lending to private sector firms. It is very difficult for entrepreneurs to obtain a loan to launch a business or for existing businesses to get a loan to expand their operations, and productive economic activity is stifled by this widespread lack of access to credit. If a modest portion of the billions in liquid assets maintained by banks were prudently channelled to the private sector, many developing countries could achieve substantially higher rates of economic growth.
The primary reasons for the lack of private sector credit in developing countries include: (i) high reserve requirements, (ii) deficiencies in the legal and regulatory environment, particularly with respect to contract enforcement, (iii) crowding-out from fiscal deficits, (iv) substantial asymmetric information and (v) the inadequate skills of financial intermediaries. The tremendous scholarly work on finance and growth in recent years and the comprehensive data presented in the World Bank’s annual Doing Business reports have painted a clear picture of both the importance of improving financial markets and the policy reforms that can lead to more efficient financial systems. It is to be hoped that this picture can spur policy-makers to undertake measures to improve contract enforcement and collateral laws, encourage private credit bureaux and curtail fiscal deficits. Encouraging foreign bank entry can be extremely valuable not only in improving access to credit but also in generating support for the necessary reforms to establish effective contract enforcement, sound collateral laws, creditor rights and the sharing among lenders of credit information. Such reforms can help unlock the untapped potential of domestic credit markets to spur long-term growth in developing countries.

References


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Appendix

Table A1: Liquidity, additional liquidity and impact on growth of per capita GDP (%)

<table>
<thead>
<tr>
<th>Country</th>
<th>Liquidity ratio</th>
<th>Additional liquidity $</th>
<th>Additional liquidity/GDP</th>
<th>Additional growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>6.5</td>
<td>-----</td>
<td>-----</td>
<td>-----</td>
</tr>
<tr>
<td>Argentina</td>
<td>126.4</td>
<td>26.913</td>
<td>29.2</td>
<td>2.705</td>
</tr>
<tr>
<td>Armenia</td>
<td>34.7</td>
<td>0.067</td>
<td>2.9</td>
<td>0.884</td>
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<tr>
<td>Bolivia</td>
<td>17.3</td>
<td>0.307</td>
<td>4.1</td>
<td>0.232</td>
</tr>
<tr>
<td>Bosnia-Herzegovina</td>
<td>16.8</td>
<td>0.205</td>
<td>3.7</td>
<td>0.219</td>
</tr>
<tr>
<td>Brazil</td>
<td>98.6</td>
<td>107.209</td>
<td>28.1</td>
<td>1.717</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>29.1</td>
<td>1.245</td>
<td>7.3</td>
<td>0.835</td>
</tr>
<tr>
<td>Colombia</td>
<td>33.0</td>
<td>4.854</td>
<td>6.8</td>
<td>0.743</td>
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<tr>
<td>Croatia</td>
<td>37.1</td>
<td>4.886</td>
<td>19.8</td>
<td>0.817</td>
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<tr>
<td>Dominican Republic</td>
<td>33.1</td>
<td>1.703</td>
<td>9.1</td>
<td>0.646</td>
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<tr>
<td>Egypt</td>
<td>41.4</td>
<td>26.662</td>
<td>31.4</td>
<td>1.149</td>
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<tr>
<td>El Salvador</td>
<td>31.3</td>
<td>0.193</td>
<td>1.4</td>
<td>0.660</td>
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<tr>
<td>Guatemala</td>
<td>32.5</td>
<td>1.421</td>
<td>6.1</td>
<td>0.739</td>
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<tr>
<td>Honduras</td>
<td>25.8</td>
<td>0.540</td>
<td>8.5</td>
<td>0.542</td>
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<tr>
<td>Hungary</td>
<td>46.0</td>
<td>12.045</td>
<td>16.2</td>
<td>0.939</td>
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<tr>
<td>India</td>
<td>44.9</td>
<td>103.930</td>
<td>20.2</td>
<td>1.213</td>
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<td>Indonesia</td>
<td>69.8</td>
<td>57.328</td>
<td>31.8</td>
<td>2.258</td>
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<tr>
<td>Jamaica</td>
<td>72.2</td>
<td>2.228</td>
<td>27.7</td>
<td>2.778</td>
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<td>Jordan</td>
<td>53.2</td>
<td>4.848</td>
<td>54.9</td>
<td>1.351</td>
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<td>Kenya</td>
<td>39.7</td>
<td>1.442</td>
<td>11.5</td>
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<td>Lithuania</td>
<td>37.8</td>
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<td>7.1</td>
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<td>69.142</td>
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<td>8.468</td>
<td>21.7</td>
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<td>Nicaragua</td>
<td>67.2</td>
<td>0.965</td>
<td>39.4</td>
<td>2.051</td>
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<td>Nigeria</td>
<td>65.2</td>
<td>5.623</td>
<td>12.0</td>
<td>1.426</td>
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<tr>
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<td>39.0</td>
<td>0.365</td>
<td>8.1</td>
<td>0.815</td>
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<tr>
<td>Peru</td>
<td>39.0</td>
<td>5.047</td>
<td>8.9</td>
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<td>Philippines</td>
<td>36.6</td>
<td>12.085</td>
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<td>25.727</td>
<td>12.8</td>
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<td>54.4</td>
<td>4.914</td>
<td>10.9</td>
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<td>Russia</td>
<td>45.9</td>
<td>31.417</td>
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<td>South Africa</td>
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<td>62.2</td>
<td>0.532</td>
<td>9.1</td>
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<td>Ukraine</td>
<td>18.0</td>
<td>0.852</td>
<td>2.1</td>
<td>0.273</td>
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</table>

Notes: The liquidity ratio is liquid assets as percentage of total deposits. Additional liquidity is actual liquidity in excess of the US benchmark, in US$bn. Additional liquidity/GDP is additional liquidity as percentage of GDP. Additional growth is projected increased growth in per capita GDP if additional liquidity is directed into private sector credit.