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ALTERNATIVE FINANCIAL INSTRUMENTS FOR

LESS DEVELOPED COUNTRIES

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TABLE OF CONTENTS

I. INTRODUCTION

As economies grow and diversify, credit demand expands and becomes progressively more complex. The expanding demand for physical capital results in commensurate increases in demand for greater volume and new forms of credit and financial instruments. Most LDCs do not have a variety of financial instruments to meet the demand of users of funds and to attract savers. Consequently, savings is slowed and the flow of finance is deterred.

One reason for this is that laws or regulations may impose ceilings on interest or yield below the rate the market would demand and, therefore, stagnate the development of new instruments to meet new situations. In addition, many LDC governments have enacted measures that restrict the growth of primary securities markets and impede the issuance of securities. These governments have imposed limitations on the price at which they can be issued and have issued adopted tax laws that encourage companies to finance operations through bank borrowing while discouraging them from issuing equity or debt securities.

Similarly, there are legal and operational obstacles to term lending in LDCs, such as legal codes and regulations concerning security of assets, title, transfer or property, taking possession of collateral on loans in default and sharing ownership of assets, financial information systems and related prerequisites for the vigorous growth of the financial sector. In addition, many LDC governments have introduced various combinations of measures to direct or allocate commercial credit into term loans.

SCOPE AND APPROACH

This study looks at a variety of issues and approaches related to the development of new financial instruments (including term lending) in LDCs. The specific components are:

- policy restrictions that restrain the growth of financial instruments. These restrictions may include collateral requirements; prohibitions on some methods of finance, such as leasing; the effect of Islamic banking codes and its interest versus equity issues; and government control of the price at which securities can be issued inhibiting public offerings, and interest can be paid, discouraging savings;

- policy constraints that prevent LDC private sector banks from engaging in term lending (such as prohibitions on the issuance of long-term instruments required to support such lending, and on the use of term lending by non-competitive, subsidized parastatal financial institutions);

- prohibitions to term lending for privatization; and solutions to these problems.

- new policy approaches and recommendations (1) for the development of instruments that transfer funds between financial institutions and between financial institutions and productive enterprises in a timely and cost-effective manner and mobilize indigenous capital resources; and (2) that will encourage LDC banks to undertake term lending but that minimize the misallocation of scarce investment resources.

II. POLICY RESTRICTIONS AND THE GROWTH OF FINANCIAL INSTRUMENTS

The main areas of policy that impinge on the growth of savings and investments are generally interest rate restrictions; restrictive tax policies, monetary controls, institutional and legal controls; value system changes (Islamic Banking) and limited technology innovation.

These areas are examined individually in recognition of the fact that interest rate policy and, to a lesser extent, taxation are generally regarded as the two most important aspects of regulation which impact significantly on financial evolution.

1. INTEREST RATE RESTRICTIONS

(a) Nature of Interest Rate Controls

In LDCs, interest rate controls have operated in several ways. In general, however, two broad categories can be noted. The first and most common category is the imposition of ceilings on interest rates paid by financial institutions. In some cases, interest rates on obligations of financial institutions are limited through ceilings on loans. The second category involves imposing minimum rates on deposit liabilities (interest rate floors).

Experimentation with various interest rate forms, particularly in Latin America, has been the order of the day, mainly as a result of the region's high rates of inflation. Ceilings on liability rates have been used in various degrees of coverage. In some countries, they extended to all the obligations of the financial institutions, while in others they confined themselves to a particular part of the structure of interest rates and/or were applied only during some periods. On the latter score for instance, it can be noted that private investment banks escaped interest rate regulations in some Latin American countries. Rates have also been freed in some States for all private, commercial, and public banks. In certain countries, such as Peru and the Dominican Republic, usury legislation as well as attitudes in favor of usury-type regulations have served to keep rigid ceilings on all lending operations.

Unlike interest rate ceilings, interest rate floors were designed to keep real rates competitive on savings instruments. They have however, been ineffective when limits are placed simultaneously on lending rates.

(b) <u>Two Views on Controlled Interest Rates</u>

The effect of interest rate controls on the growth of financial instruments is still today a subject of extensive academic and policy debate. One point of view holds that controlled interest rates lead to low real yields, encouraging greater consumption and lower investment since the effort to ration the amount of savings draws in competitive criteria relating to quality of collateral, personal connections, commissions, etc. Controlled rates also foster low yielding safe investment and discourage risk taking since risk premium cannot be charged on loans. Proper market-adjusted interest rates would raise the marginal efficiency of investment as only the better projects with a higher social rate of return would get chosen and this would have a positive effect on income growth and savings. The real rate of interest is the key since it provides the required return on savings as well as promotes efficient investment.

Financial intermediation also benefits when real rates rise as real rates encourage diversification to reduce risks, greater operational efficiency through economies of scale, and lower information costs through specialization in a context where the real returns to savers rise. Financial restriction does not facilitate the growth of financial instruments since the object of financial repression is to provide a large seigniorage to the public sector in order to finance the budget deficit. It therefore helps segment the market through credit rationing and sectorial credit policies that offer subsidized rates for the priority sectors.

The other primary view questions the capacity of the imperfect capital and money markets in LDCs to efficiently mobilize and allocate credit without government regulations and intervention. Interest rate control is seen as important to setting priorities for the allocation of capital to sectors necessary for development. A less dogmatic variant of this position is to argue against totally unbridled interest rates on the ground that, in the context of high oligopolistic banking, imperfect information, and the absence of a developed capital market (in particular an equity market) financial liberalization spawns financial instruments that direct credit to less productive users. Bankers are motivated to concentrate on safe and less efficient borrowers since information, in particular on more efficient investors, is costly to procure. While some interest rate liberalization is considered positive, the argument stresses the limits of such liberalization in improving the allocation of capital in view of the structural problems.

(c) Some Evidence on Interest Rate Decontrol

The elimination of interest rate ceilings and floors has had a differential impact on savings and investment instruments. In Latin America, where the experience with liberalization is more recent, no increase in long-term liability holdings has been recorded in the experiments of the Southern Cone countries. In particular, bonds, stocks and long-term deposits which were expected to respond positively did not expand. However, the positive experience of Mexico in the 1950s and 1960s and post-1964 Brazil with value-indexed securities and savings deposits and government bonds subject to ex-post monetary correction, seems reflective of the value of removing interest rate restriction at the long end of the market. In Brazil in the 1960s, the removal of interest rate controls, coupled with indexation, raised significantly savings deposits outside of the traditional currency demand and compulsory deposits and provoked a shift of savings away from unproductive real assets, in particular real estate.

The Latin American experience is rather peculiar due to abnormally high rates of inflation. In Asia, the evidence on long-term liabilities is more reassuring in terms of the expected results of liberalization. In Singapore, Malaysia, Korea and Taiwan, interest rate decontrol led to an increase in savings deposits and a shift away from holding non-productive wealth. Furthermore, in financially less sophisticated countries in Africa and Asia, the positive effect of liberalized interest rates has been highlighted.

In general, the evidence on interest rate deregulation tends to show mixed results. In some cases, it has been successful in increasing savings and investment and promoting new financial instruments. In others, institutional credit continues to prevail to subsidize special industries in spite of the attempted deregulation programs. For instance, Korea and Argentina reverted to financial restriction in spite of the alleged benefits of financial liberalization.

The persistence of interest rate restriction, however, does not seem to negate the position that, on balance, flexible interest rates impact favorably on the growth of financial instruments. In reality, liberalization programs are never complete and their implementation is generally fraught with difficulties. This appears to be the reason why it is rare to find unsuccessful deregulation programs which at some stage of their application did not produce positive results on savings and/or investment. In more recent Southern Cone experiences in Chile, Argentina, and Uruguay, this observation has been borne out. Over certain periods of the liberalization programs, positive responses did occur before the reversion to restriction occurred in some cases. Similarly, in Southeast Asia, in particular; and Korea, Malaysia, Singapore and Taiwan, the experience served to underline the fact that the conditions and policies accompanying interest rate deregulation do play a critical role in avoiding the re-imposition of controls.

(d) Conditions for Effective Financial Liberalization

Several conditions and policies have been posited for the effective functioning of liberalized interest rates. Starting from a distinction between low risk and high risk holdings, it has been suggested that the preference for a mix of liquidity, safety, and return on short-term deposits should be recognized not only by an adjusted real rate of interest around zero, but also by high reserve requirements, improved supervision, and deposit insurance. Yet, it is doubtful whether these conditions would be able to withstand the onslaught of accelerating inflation.

At the high risk end of the market, complete interest rate freedom should prevail on alternative assets with significant increases in real interest rates. The conditions that should support such an interest rate approach should be greater transparency in information, anti-trust vigilance, indexation and greater competition in terms of reduced barriers to entry, etc. In Asia, the importance of accompanying flexible interest rates with changes in other related policy areas has been noted. Inter-bank agreements on deposit and loan rates as well as rates on governmental borrowing have, for instance, been underscored as two such areas that would require simultaneous attention.

Such a two-prong aproach is geared to deal with the tendency of interest rate liberalization to backfire over the long haul and end up at worst, with massive bankruptcies and nationalization, or at best, with the re-imposition of controls.

Several alternative reform packages have been proposed to accompany interest rate liberalization. The majority of them tend to concentrate more on accompanying macro-economic and stabilization policies.

Caution, however, is invited as regards the needed accompanying policies as well as with respect to the use of partial deregulation. The freeing of interest rates only on a few instruments and especially under inflation, does not produce the desired results as market rates are not reached.

2. <u>Restrictive Tax Policies</u>

In most LDCs, capital markets are small, undiversified and characterized by poor communication that causes segmentation of the market in terms of different prices of loanable funds. These imperfections lead to anomalies as savers do not wish to bank their savings and prefer to use retained earnings for investments, for capital is too expensive to finance their projects. These discrepancies, coupled with policies to control interest rates, encourage inadequate returns on savings and investment. Non-financial assets acquire higher rates of return for their liquidity.

Perception of risks is also important. In a context where Government policy closes banks, changes interest rates, and retires bonds with little or no announcements, the risk premium is considered low on savings instruments whose liquidity is not guaranteed. While rapid policy changes, generated largely by external shocks, cause such uncertainty and attitudes to risk taking, the vulnerability of financial assets (relative to non-financial assets) to taxes in these circumstances is also a major consideration. Financial assets can be subjected to quick tax changes to raise revenue as compared to non-financial assets which are harder to value and not easily noticeable.

It is in this connection that adequate tax incentives must be devised to encourage the holding of financial assets. In most tax systems, savings are doubly taxed from the source as income and from interest income that they generate. Less restrictive tax policy could induce savers to shift more into financial assets. As such, it is often suggested that personal taxes on consumption, value-added taxes on consumption and lighter tax treatment on social security contributions could encourage such a shift by replacing income taxes.

Of course, in many countries, certain types of dividend income or retained earnings, interest from certain institutions or types of assets as well as property inheritance are already tax exempted or treated more favorably. However, it is still generally the case that few countries have systematically sought to replace income taxes with sophisticated sales taxes.

well as property inheritance are already tax exempted or treated more favorably. However, it is still generally the case that few countries have systematically sought to replace income taxes with sophisticated sales taxes. Only 3 countries out of 96 examined by Cooper and Lybrand had well-developed sales taxes instead of income taxes.

Even though the potential of tax incentives has been recognized, reservations on their use persist. These reservations concern the distortions to economic welfare that could result. In this regard, worsening distribution, institutional imbalances in terms of rates of return, and tendencies to upset viable debt-equity ratios are some of the main distortions that are emphasized. On the macro-economic level, negative effects on inflation and government debt-financing have also been noted.

As a result, one argument in favor of income taxes is that the tax structure should not be altered and, instead, government should run a planned budgetary surplus which is made available to the private sector on competitive terms.

Two main objections can be made to this approach. The first is that political pressures on government can hardly lead to the kind of surpluses expected and their allocation to the private sector. This is in spite of the argument that efforts would be forthcoming to economize on administration and expenditure.

Secondly, the point about revenue considerations and distortions is usually overplayed. The ease with which governments have shifted to sales taxes as well as the over-reliance on income taxes as shown by the above mentioned study would suggest that the tax situation is far from optimal. For instance, interest on government paper and bank deposits are generally tax exempted whereas private instruments and capital gains from the sale of stocks are taxed. Lower rates of taxation on all instruments, as well as uniformity in their treatment, should result in higher savings and minimal or no disturbance to income distribution, especially in a context where the idea is to encourage savers to move out of real unproductive wealth.

Tax exemptions on new equity from retained earnings, dividends, bank deposits, company investment income, pension funds and insurance and provident contributions, have been the favorite targets of governments for increasing savings and diversifying financing.

There is no clear rationale for avoiding or reducing distortion in the use of these instruments. The overriding consideration appears to be the type of savings that is being encouraged at the time.

It is difficult to highlight specific instruments on the basis of relative success and failure. The Brazilian experience with graduated taxes that decreased incidence on exchange bills held over longer periods, personal exemption on dividends, and reduced withholding taxes on company dividends, is instructive. It served to boost savings and investment and even put some life into the equity market whose limitations have been well recognized. Such tax measures were geared particularly for the high-risk long end of the market where financial institutions rather than individuals constitute the main holders of such instruments.

3. Monetary Controls

Through the choice of its rediscounting facilities, a country's Central Bank determines the type and length of paper that commercial bank and non-bank financial intermediaries may submit for rediscounting. Similarly, different rediscount rates on different types of paper have varied effects on the portfolios of financial s'tuations.

Compulsory financial controls also cover situations where the Central Bank will only favor those private intermediaries who grant a certain amount of credit to priority sectors as indicated by the Central Bank under a selective credit control policy. In addition, the stipulation of high reserve requirements and the holding of certain types of bonds against specific types of deposits also seriously affect the lending portfolios of financial intermediaries.

High reserve requirements and the holding of government paper are generally ways used by the government to force its debt on the banking system and engage in deficit financing. Even without such formal restrictions Central Banks can convey indirectly certain constraints to bank intermediaries. For instance, it has been observed in Malaysia that the commercial banks kept excess reserves due largely to fears by the Central Bank of the effect of credit expansion on monetary stability.

In view of the fact that short-term profitability of long-term lending is smaller, especially if loans must go to new and riskier entrepreneurs, then excessive controls by the Central Bank serve to drive certain intermediaries, in particular the commercial banks, out of the term market.

Recent reforms in the Southern Cone have tended to highlight how reduced reserve requirements, less stipulation of types of paper to be held, etc. have allowed commercial banks to venture more into savings deposits and long-term lending. Caution has been expressed about the pace at which banks can get more adventurous without endangering the system through failures and bankruptcies. It has been observed that such a relaxation of controls without more state intervention and restriction later on and possibly even to total collapse.

Institutional and Legal Controls

In general, institutional and legal restrictions on financial intermediaries are determined according to the functions of these institutions. They include, inter alia, time limits on deposits, maximum amounts for certain deposits, and restrictions on the types of institutions that can receive certain kinds of deposits, etc. As a rule, these regulations involve tools which limit the liabilities of institutions which are specialized in their use of funds. The intention of the regulation is to ensure that the particular use of the funds is dependent on the particular type of liability.

The extent to which this basic rule of supervision is violated and normal controls become restrictions on the growth of financial techniques is something usually revealed in practice under the peculiar circumstances of each country.

On area, however, where supervision has been found to be generally harmful is the strict entry regulations governing the commercial banking sector. Recently, the easing of entry requirements in the commercial banking sector in Uruguay has been shown to be helpful in reducing oligopolistic interaction.

Similarly, it has been found that fixing the total amount of long-term loans and investments in securities could become highly restrictive in an inflationary environment.

Collateral requirements are another source of restriction on bank lending. "Good" collateral at times has been preferred to the soundness of projects. The role of the Central Bank is important in trying to shift collateral requirements away from tangible wealth to the use of more financial assets, particularly in less sophisticated financial environments. The process of substitution could be facilitated if financial instruments such as industrial bonds, equities, and long-term loans are made more acceptable as collateral.

5. Value System Changes: Islamic Banking

Islamic banking is based on profit-and-loss sharing rather than on a rate of interest. Depositors receive a share of the bank's profits from its operations which cover a rate of return instead of a rate of interest. The intention is to keep the bank functioning as a financial intermediary rather than convert it into an investment company.

It has been frequently suggested that Islamic Banking cannot work efficiently and that over the long-term it will impact negatively on savings and investment. Another view, however, is that insofar as Islamic Banking retains the concept of rate of return based on profits and the depositor is a shareholder participating in profits and losses, then on the basis of an expected rate of return, it is possible that this change will not affect standard banking. In Pakistan and Iran, all bank transactions must be conducted on the basis of equity participation.

Basically, the issue remains wide open as the experience with this type of risk-taking system is new and it is difficult to state how it will perform as compared to conventional banking in a modern economic environment.

The introduction of an interest-free deposit scheme in Pakistan in January, 1981 led to a sizeable increase in deposits one year later. Returns on such deposits were higher than the deposit interest rates charged previously. Although this has been confirmed, the more recent experience demonstrates a tendency for the rate of return to move from its earlier position of .5% to 1% higher than the available rate of interest under the standard system to one closer to that of the standard interest-based system.

This has been attributed to the decline in large deposits, the portfolio management problems of big deposits, and the low productivity of the banks. A noteworthy exception to this performance has been the foreign banks which have been able to maintain a higher rate of return.

Another observed trend in Islamic banking is for interest rate spreads to widen. While deposit rates of return are falling, the rate of return charged has been rising, contrary to what government and bankers claimed would happen. One consequence of this is that special rates have been introduced for favored borrowers to allocate credit.

Uncertainty about the rate of profit by bankers as well as the cost of capital by borrowers has led to banks holding abnormally high levels of liquidity. As the new system adapts, a wait-and-see attitude has emerged and this also affects the prosecution of defaulters, which has been slow in spite of the numerous defaults that have occurred already.

It is impossible to draw firm conclusions about the success or failure of this system, as obviously more time is needed for it to adjust. The following interesting facts, however, can be observed so far:

- unprofitable branches of nationalized banks have been closed down;

- nationalized bank profits have been continuously increased as well as their reserves. The latter quadrupled in four years increasing sizably gearing ratios;

- deposits grew by 14.2% from 1981 to 1983;

- the share in total domestic deposits has been maintained by Pakistani Banks;

- banks have oriented their lending policies more to the productive sectors with a concomitant decline in the advances to government and an increase in advances to the private sector;

- term lending has been introduced in bank lending policies over the last three years. Industrial term financing to the private sector doubled in this period. Before, this type of lending was provided only by specialized lending agencies;

- stricter supervision on the quality of loan portfolios has occurred with measures elaborated to identify non-performing loans and effect speedy recovery of outstanding debt, provide adequate reserves for anticipated losses and share effective control over and appraisal of borrowing by the Public Sector and State Enterprises.

In conclusion, the degree to which the use of equity participation instruments converts banks into risk-taking 'producing' units seems to introduce an added element of competition not found in standard banking systems. As banks must now survive on the basis of appropriate evaluation of risk, greater efficiency could result. A priori, this could lead to an improved savings and investment process.

6. RESTRICTIVE CONDITIONS FOR INNOVATION

Financial innovation in LDCs is still essentially the result of volatile inflation and interest rates, the level of economic development, government regulation and changes in tax policy. In Latin America, it would appear that the dominant stimuli for such innovation have been high volatile inflation and interest rate control as expressed in the widespread use of techniques of indexation and monetary correction.

Experimentation with new product and process financial instruments is therefore relatively weak. This is largely due to the dependence of the financial system on the government and the fact that government regulation does not encourage innovation. The Central Bank is almost by law and/or custom regarded as the promoter of new instruments. Unlike developed countries where the private financial community promotes innovation and takes the initiative to circumvent regulations in order to maintain optimum portfolios, in LDCs active circumvention as well as promotion is relatively absent and actively discouraged.

In terms of process innovations, the creative adaptation of modern technology to reduce transaction costs has so far had limited application.

It is obvious, therefore, that the process of mobilization and allocation of capital could benefit substantially from greater product and process innovation. A new technological policy as well as deregulation that would encourage such innovation would be helpful.

III. FINANCIAL INNOVATION FOR TERM LENDING

1. REMOVAL OF POLICY CONSTRAINTS ON TERM LENDING BY PRIVATE SECTOR BANKS

It has been demonstrated that private commercial banks can perform the same specialized function of development banks at lower transaction costs, as banks can mobilize funds at a lower cost, pool risks through a more diversified portfolio, and gather information on clients at lower costs since they are familiar with managing client accounts. The third factor reduces the costs of supervision and appraisal. Through economies of scale, specialization, and risk spreading, banks could borrow at market rates and get into viable term lending.

At present, however, private commercial banks have concentrated on financing trade and inventories. Term lending with a long gestation period cannot be easily accommodated.

In reviewing the performance of development banks in LDCs, the following main observations were made:

- instead of supplying funds to new entrepreneurs, they have provided finance mainly to well established businesses:
- they have not created links with the institutions in the money and capital markets that would allow them to mobilize funds on their own;
- poor profit performance has been recorded;
- no significant impact on small and medium-sized enterprises is discernible.

It is clear that the real source cost of lending has not been reduced as, in general, the established entrepreneurs would have been able to obtain funds on the commercial market. Subsidized rates have allowed the Development Banks to lend at lower interest rates.

With lending rates fixed to around 8 or 9%, the dependence on government funds and international agencies could not be reduced. Having no incentive to reduce their transaction costs, they have had to choose projects with a high internal rate of return which generally come from well established enterprises. The subsidy to this part of the business sector has been offered at the expense of new viable potential enterprises.

It has been shown that Development Banks, by making a case for higher interest rates, can take on commercial bank functions or induce commercial banks as well as social security institutions, to lend for long-term projects. Higher interest rates would force these banks to reduce their transaction costs and improve their project formulation and supervision.

Apart from the subsidizing of Development Banks, private intermediaries have been restricted in term lending through other ways. For instance, emphasis on direct financing of Development Banks has led to a situation where other financial institutions must provide funds to invest in Development Banks. In some cases, Government pressure has forced private intermediaries to either take equity or lend at below market rates to Development Banks.

Another method of depriving private banks of funds for term lending is to raise reserve requirements to excessive levels in order to use some of these funds to finance Development Banks.

In general, commercial banks have been confined to the short end of the market through interest rate controls on time deposits, the short length on time deposits they can offer, and high reserve requirements. Reservations have been expressed about too sharp a distinction in LDCs between short-term and long-term assets and liabilities. Attention has been focussed on the Mexican experience where such a distinction has been blurred with positive results.

One of the consequences of legal and institutional barriers to diversification has been the creation of specialized institutions by some financial intermediaries in order to tap new sources of funds, charge higher rates of interest as well as to promote specific activities as industries which would not ordinarily have been considered eligible. Commercial banks have created investment banks, insurance companies, savings and loan associations and mortgage banks. Private investment banks (financiers) have also created commercial banks.

This diversification is considered beneficial as specialization is regarded as non-viable in economies with low income levels, high inflation, and skewed income distribution and in those subject to abrupt external shocks. The latter has thus encouraged the idea of Universal or Multipurpose Banking.

In support of private efficiency in the term market, the ability of Financiers to perform well in the long-term market in spite of some undue restriction has been documented. Similarly, it has been noted that even under existing rules some private intermediaries with the right motivation in terms of improved entrepreneurship, better recruitment and promotion policies, technical assistance and decentralization as well as innovative deposit schemes can substantially reduce transaction costs to even get into small-scale credit financing.

In conclusion, it is noteworthy that the major constraints on term lending by the private sector are the existence of uncompetitive Development

Banks and the separation of banking functions that do not allow scale economies to be adequately exploited. Such separation facilitates the taxing of the private banking sectors through high reserve requirements and other measures in order to prevent efficient institutions from getting into profitable areas.

2. TOWARDS MORE EFFICIENT FINANCIAL STRATEGIES AND INSTRUMENTS

The effectiveness of financial instruments in providing finance for increases in the physical capital stock must be judged in terms of the variety of mechanisms and the number of ways in which they have integrated the financial market by eliminating imperfections and reducing transaction costs. In fragmented markets in LDCs, the terms of lending vary across different classes of borrowers. These terms of lending are largely determined by transaction costs and involve variables other than interest rates, such as security, repayment terms, profit margins, etc.

Financial innovation for term lending, therefore, which seeks to channel more savings into the most profitable investments on an appropriate risk/return basis has to be assessed in terms of how it lowers transaction costs and/or inconvenience, thereby reducing the price of intermediation by lowering the spreads or inconvenience costs. This efficiency criterion is the main yardstick in evaluating innovation, although it must be recognized that innovation is also linked to market desires for protection, liquidity, etc. which calls for more market completeness but not necessarily an improvement in efficiency.

Generally, efficiency can be judged in terms of the mobilization, transformation and allocation of savings. These stages could be assessed as follows:

- **Mobilization of Savings**

In developing countries it is the household sector which has a surplus of savings needed to finance the deficits of the government and business sectors. A large part of household savings, however, is in the form of non-financial assets. Recent estimates tend to put the ratio of financial to non-financial assets to around a half. In Bangladesh, Malaysia, and Thailand, the proportion was 35, 45, and 33 per cent, respectively.

It is desirable, therefore, to increase the amount of savings held in financial assets through a diversion of household investment away from real assets as land, scarce commodities etc. which are sometimes acquired at high interest rates in unorganized markets.

In addition, the potential saving of the household sector needs to be more efficiently mobilized. In the rural and semi-urban areas, lack of adequate financial institutions and instruments cause part of this to go into consumption.

Getting the household sector to hold more financial assets would require instruments that meet the savings preferences of this sector. It has been shown that the major part of household financial saving has been held in the form of money, deposits, and claims on social security institutions (life insurance, pension, provident funds, etc.).

Since claims on financial institutions account for the bulk of household savings, A.I.D. should promote this indirect type of asset-holding by encouraging LDCs to adopt changes in laws and regulations and financial instruments that put less emphasis on direct methods of savings relating to claims on corporate and government sectors. As a result, the tendency, for example, to want to create a securities market in which government and corporate bonds will be traded should give way to greater concern for methods to make savings instruments compulsory. In essence, this approach involves jumping the first stage followed by developed countries and which largely covered direct external financing through the purchase of government securities, industrial debentures, mortgage and corporate stocks.

Support for a mobilization strategy that is more indirect and covering claims on commercial banks, savings and loans associacion, credit co-operatives, insurance companies, etc. is also based on the poor performance of capital markets in LDCs. The slow evolution of the Brazilian stock market, in spite of the policy efforts to strengthen it, has already been underscored. The development impact of capital market changes towards the issuance of more stocks, bonds, etc. continues to be generally small. Even though the useful contribution that securities markets can make in the right circumstances has been stressed and the constraints considered less binding, caution has been expressed with respect to the rapid provision of new issues of stocks and bonds.

In view of the little gain perceived for households to participate in a wide range of direct long-term financial instruments, A.I.D. should encourage LDCs to adopt new voluntary and compulsory deposit schemes that take due account of the motives of savers for safety, liquidity, and real return and which can be competitive with non-financial assets. Of course, interest rates should be set to be comparable to the rates of lending adjusted for spread and risk premium. Tax deductions for such deposits comparable to those on social security claims could also assist. Value-linked savings and social security instruments as those mentioned earlier in the case of Brazil would also be useful.

In pursuing efforts in the primary and secondary markets, A.I.D. should encourage LDCs to go in the direction of bills and government securities issued at market rates and take advantage of the scale of economies of intermediation in a process of portfolio optimization.

Finally, as regards coverage, the significance of widening and deepening of the geographical and functional scope of financial intermediaries to cover the rural and semi-urban areas should be underscored. Some observers have expressed preference for commercial banks on the grounds of their solid infrastructure and their observed steady upward flow of funds. The importance of cooperative and other local organizations has also been noted as well as arguments have been advanced to show the comparative advantage of postal savings institutions in rural areas in relation to high cost branches of commercial banks. On the latter score, the streamlining of costly bank branches in Latin America would appear to reinforce this position.

- <u>Transformation</u>

Financial assets have been held in forms generally unsuitable for long-term lending. In the main, they are in the form of currency and sight deposits, post office savings, and insurance policies. Postal savings are usually offset by post office holdings of government securities, and insurance companies tend to prefer holding non-productive assets as real estate.

Time deposits, which are the main source of household savings in developed countries, are small and with short maturities in developing countries. In the Southern Cone of Latin America, over 80% of the time deposits are for less than 30 days.

Under these conditions, maturity transformation is difficult. This is why A.I.D. should encourage LDCs to adopt a new approach that places greater emphasis on the venture capital role of financial intermediaries along the lines of the German-Japanese model. Along with the new risk taking, this would involve a much less stringent reserve requirement policy and the channelling of 50-70% of the financial saving into long-term lending as compared to 20% under the existing systems modelled along the U.K. model.

There is obviously some merit in this suggestion but it would need some further exploration. Less adventurous and a useful complement to any such strategy would be to lower reserve requirements for social security institutions. This could release a substantial amount of long-term resources which usually go into financing the government deficit.

In view of the preference in Latin America for short-term deposits, maturity transformation presents even more difficulty. Attempts at solution usually involve some type of indexation on long-term loans to the costs of short-term money. This serves to protect financial institutions involved in term lending against interest risk.

For low-income countries with little monetization of assets, special consideration will most likely have to be given to other strategies such as specific rediscounting policies that could provide this type of finance.

- **Allocation**

The original motivation for specialized public credit institutions geared to the long-term market was rooted in a belief that private banks cannot be expected to get involved in projects covering new untried entrepreneurs whose projects reflected a high divergence between the private and social rate of return. It was recognized as well, that private sector banks were not so motivated and did not have long-term lending on their agendas.

The continued low profitability of Public Development Banks vis-a-vis Private Development Banks as well as the success of private financial entities such as the Financiers in the provision of cost-effective medium and long-term financing have tended to focus more attention on the role of private sector institutions.

The key to successful allocation centers around the absence of restriction on lending rates and adequate project formulation and supervision. As noted earlier, the latter can be easily acquired on more cost-effective terms by private sector intermediaries.

Finally, it does appear that a necessary condition as discussed earlier is proper supervision of loan portfolios by the Central Bank. This appears necessary in view of the persistent high linkages between private sector financial intermediaries and businesses.

IV. TERM-LENDING FOR PRIVATIZATION

Privatization has implications for term lending, especially if it has to take the form of divestment and the easing of entry requirements. The former is where the government sells its shareholding assets to private individuals and entities. The latter involves deregulation that seeks to lower barriers to entry by allowing private entrants to compete with government.

The availability of credit to purchase public sector assets or to enter into competition with public sector firms can be limited as a result of several factors. Among them, some of the more important factors are outlined below:

- restrictions by the Central Bank on private sector lending for areas deemed sensitive. These can include essential services, basic goods industries, or just simply undertakings where the government is making a monopoly profit;
- the issue of government bonds and securities which outperformed private sector equities and bonds on the basis of their favorable tax-saving encourages less investment in private asset holding as well as less resources for onlending by the private institutions.
- Governments involved in productive activities crowd out term lending for privatization as invariably the government resorts to the private sector to raise its loans;
- unsophisticated capital markets and preferences for safe and more liquid assets also hinder steps toward privatization;
- continuous huge budget deficit financing that drains away resources from the private banking system.

It is evident that greater liberalization of the private financial sector along the lines discussed earlier should release more long-term funds for the purchase of public assets or the establishment of new enterprises in competition with those of the public sector.

Above and beyond this, it would be useful to think creatively of measures to overcome the limits of the capital market as well as would favor privatization in terms of spreading participation and fostering new counter coalitions.

The use of "Revenue Bonds" in Turkey recently for the sale of the Bosphorus bridge appears to be an interesting method worth examining. The provision of attractive tax-saving assets as well as tax incentives as used in the U.K. is also another. In addition, the granting of free or discounted stock to employees and special customers as well as the encouragement of new and small investors through discount on the offer price seems useful to bear in mind, especially in economies where a high concentration of wealth prevails on underdeveloped capital markets.

A strategy of joint ventures with foreign firms also should be entertained. In Turkey at present, traditional state monopolies are entering into such arrangements in order to overcome local market constrains.

International lending for private sector banks could also assist in providing funds to on-lending purposes in this area. Favorable trends in this regards have already been detected.

Finally, in lower income LDCs, restrictions on cooperatives and credit associations, particularly in rural areas, could be lifted for this purpose.

V. Conclusions and Policy Recommendations

The study had as its first task an examination of policy issues and approaches needed for the development of financial instruments that can mobilize more local savings as well as expand private sector term lending. The second objective of this work related to measures that would enhance term-lending for privatization.

The discussion on policy issues focused on the policy constraints that impede adequate mobilization and allocation of capital. It highlighted in particular the need to eliminate regulated interest rates, restrictive tax policies, subsidized development banking, excessive monetary controls and institutional and legal restrictions. Special attention was paid to the significance of removing impediments on private sector term lending as well as financial mechanisms that would make the market function more efficiently for purposes of long-term lending. In this context, some specific techniques for term-lending for privatization were identified.

As conditions in LDCs vary widely, the study attempted, where appropriate and without making any rigid classification of LDCs, to indicate conditions under which policies could be successful. In summary, policy approaches and measures are recommended under the following conditions:

- in non-inflationary circumstances, A.I.D. should encourage instruments that appear to offer the best chances at the short end as currency and demand deposits. At the longer end, savings deposits, housing bonds and government bonds seem to perform well in association with indexation and monetary correction. Equities and corporate bonds are more unresponsive since other factors such as investor confidence and the thinness of securities markets, are seem more binding;

- under inflationary conditions, A.I.D. should focus on indexed and/or rapidly adjusting rates on short-term deposits. This strategy seems more justifiable in view of household preferences for safety and liquidity. The scope for making long-term instruments attractive under these conditions is still not clear and probably could not be, given the intrinsic conflict between preserving the real value of assets and high inflation rates. While certainly indexation and monetary correction may be of some help, it is not evident that they can increase such savings in this environment. Compulsory social instruments may be more responsive;

- in financially repressed environments. A.I.D. should encourage financial liberalization and carefully monitor the process of interest rate decontrol to ensure that appropriate banking and macro-economic policies are adopted that would sustain the process of liberalization and avoid a return to restriction. In this connection, A.I.D. should examine the relevance of specific banking and macro-economic policies. Such an examination should pay attention to the significance of deposit insurance, high reserve requirements, improved supervision and adjusted real rates around zero for short-term deposits at the low-risk end of the market. At the high-risk end, transparency of information, anti-trust vigilance, and reduced barriers to entry appear worthy of consideration;

- under restrictive tax conditions A.I.D. should promote lower and uniform tax rates on financial instruments with particular attention being paid to private instruments where taxes are higher. Such a policy should also have as its objective a shift of taxation away from its heavy concentration on income taxes to more sophisticated sales taxes. Some of the tax relief measures on financial instruments that A.I.D. should include in an examination are graduated taxes that decrease incidence on exchange bills held over longer periods, personal exemption or dividends, and reduced withholding taxes on company dividends.

- in circumstances of excessive monetary controls, A.I.D. should encourage in particular lower reserve requirements, less holding of government paper and less stipulation of the type of paper to be held by private banks;

- A.I.D. should focus on the reduction of institutional and legal controls such as time limits on deposits, maximum amount for certain depositors, rigid classifications of the types of institutions of the types of institutions that can receive specific kinds of deposits, easy entry requirements in the commercial banking sector and the shift of collateral requirements away from tangible wealth to more financial assets;

- A.I.D. should continue to monitor Islamic Banking with a view to determining whether term lending is more characteristic of this type of institution;

  in circumstances where Development Banks play a major role in long-term financing, A.I.D. should discourage the practice of private intermediaries either being made to lend below market rates to Public Development Banks or to take up equity in these public institutions. In addition, A.I.D. should promote the policy of higher interest rates on loans from Public Development Banks in order to force these institutions to reduce their transaction costs;

- in low-income countries, A.I.D. should encourage legislation that would foster a less rigid distinction between short-term and long-term assets and liabilities and allow financial intermediaries to diversify into other financial markets in order to overcome the scale problems associated with over-specialization in small markets. A.I.D. should examine further in this connection the role of Universal or Multipurpose Banks as well as the Mexican experience;

- A.I.D. should lay emphasis on more indirect methods of saving and discourage claims on the corporate and government sectors. Such a mobilization strategy should pay more attention to claims on commercial banks, savings and loan associations, credit co-operatives, insurance companies rather than against corporate stocks and industrial bonds. Compulsory deposit schemes, should be an element in this approach. Such a policy would appear to have general application in all LDCs, but would have increased relevance in conditions where financial markets are less sophisticated and a large percentage of household savings is in the form of non-financial assets. Further action in indirect primary and secondary markets should be confined more to government securities (issued at market rates), bills and mortgage bonds. A more selective and gradual approach to the development of capital markets (in terms of new issues of stocks and bonds) should be encouraged by A.I.D.;

- in low-income LDCs, A.I.D. should link the promotion of the above-mentioned indirect financial instruments to the task of multi-purpose banking for taking advantage of the economies of intermediation in a process of portfolio optimization;

- in less monetarized and sophisticated financial markets, A.I.D. should encourage greater geographical and functional scope for financial intermediaries. A.I.D. should examine the suitability of financial intermediaries for the conditions in each country, paying particular attention to the specific advantages of commercial banks, local cooperatives and postal savings institutions.

- in circumstances where there is a strong preference for financial assets with short maturities, A.I.D. should promote policies for term lending that lower reserve requirements on social security institutions and the private financial institutions in any effort to encourage them to play a more venture capital role along the liens of the German and Japanese banks. Under high inflation where the preference for short-term assets is even greater and maturity transformation even more difficult, A.I.D. should examine the method of index-linking long-term loans to the costs of short-term money. The experience of Argentina could be instructive in this regard;

- in economies with low monetarization and unorganized markets, A.I.D. should focus more on Central Bank rediscounting policies as a method of providing long-term finance for private institutions;

- A.I.D. should examine the contribution that the creative adaption of modern technology could make to financial innovation in LDCs;

- in circumstances where stock markets do not exist or are too thin and where wealth is too concentrated, A.I.D. should promote tax-saving methods and discounted stock to employees as ways of financing privatization. A.I.D. should monitor the use of 'revenue bonds' in Turkey in order to determine its usefulness in this respect. A.I.D. should also encourage the removal of restrictions on cooperatives and credit associations to allow them to purchase assets of public companies; and

- A.I.D. should foster the use of foreign investment and international lending for privatization, particularly under conditions where local capital resources are scarce and the specific public venture concerned requires management inputs from abroad.

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