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Sequoia Institute is pleased to announce the convening of the fourth in a series of seminars addressing critical issues of Third World development on Friday, June 3, 1988, at the Vista International Hotel in Washington, D.C. (1400 M Street, N.W.). The seminar addresses **"Capital Markets and Development,"** in accordance with the following agenda:

7:45	Coffee
8:15	Welcoming Remarks, **Jerry Jenkins**
8:20-8:30	Introduction of Agenda and Contributors by **Alan Walters** and **Steve H. Hanke**.
8:30-10:15	Presentation and discussion of **"Money & Capital in Economic Development: A Retrospective Assessment,"** by the paper's author, **Lawrence H. White** and lead-commentator, **Ronald I. McKinnon**.
10:15-10:30	Refreshment Break
10:30-12:15	The discussion of **Rolf Luder's** paper, **"Latin American Contrasts: Capital Markets and Development in Chile and Argentina,"** is initiated by **Murray Scherwin**, Executive Director at the World Bank for New Zealand, a country which provides concrete illustration of implementation of the lessons to be drawn from the retrospective of the preceding session, after years of ignoring them. This session strives to draw parallels between the conditions and consequences of New Zealand's policy tranformation and the experiences of Argentina and Chile.
Lunch	**L.E. Birdzell, Jr.'s** luncheon address, **"Too Little, Too Much, and the Lessons in Between: The Development of Capital Markets and Countries in History,"** provides the discussions of the day with the perspective of time and more.
2:00-4:00	A presentation by **Terrence C. Reilly**, a noted practitioner in the development of equity markets throughout the world, launches the discussion of **"Equity Markets in Capital Market Development; A View from the Trenches."**
4:00-4:15	Refreshment Break
4:15-5:15	**Steve H. Hanke** and **Alan Walters** lead the wrap-up of the day's proceedings, with particular concern for drawing conclusions about the most useful courses of action which development agencies, including the seminar's A.I.D. sponsor, might take with respect to the development of countries' capital markets.
5:15-6:30	Closing Reception

<u>INCLUDING THE EXCLUDED: Extending the Benefits of Development</u>, is the theme of a series of seminars introduced by Sequoia Institute in 1987. Expected to conclude in 1991, the series seeks to shed new light on critical issues of "third world" development -- light that will enable development assistance to accelerate the inclusion of <u>all</u> people in the process of individual and societal development.

Fora

In order to facilitate an intensive exchange of views, each of the day-long seminars is restricted to no more than 50 participants, including authors and lead-commentators on papers prepared for the series. Dialogue is additionally facilitated by delivery to invited participants of the three papers prepared for a seminar at least one week prior to its convening.

Because attendees will have already read the papers, the time allotted for authors' introductory presentations of their work is limited to 15 minutes. A like amount of time is accorded to lead-commentators for initiating the general discussion among all attendees. The hour- to two-hour-long discussion of each session correspondent with a paper may largely consist of questions and answers, and an author may, in fact, occupy most of a session's time in the course of addressing issues raised by other participants. The final 10 minutes of each session are allotted to author(s) for the presentation of concluding remarks.

Both the structure of each seminar's proceedings and the characteristics of invited participants reflect a preeminent objective of the series: to serve as a catalyst for a new generation of thinkers and ideas on development and its assistance.

This endeavor is epitomized by the series' "select scholar" program.

Select Scholars

Approximately ten of each seminar's invited participants are selected from nominations of outstanding scholars who are relatively "new" to LDC/international development issues, by virtue either of their youth or of their concentration of previous scholarship on other subject matter.

Nominations of "select scholars" for participation in the series are welcomed from social scientists throughout the United

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States. A nominator's letter of recommendation should indicate for which seminar(s) the nominee's participation would be of greatest mutual value, and be accompanied by a resume reflecting the nominee's qualifications.

Nominations should be mailed to:

Select Scholar
Sequoia Institute
1800 K Street, NW, Suite 929
Washington, DC 20006

The select scholar program embodies the intention of the series to encourage increased (and fresh) attention to third world development issues both among younger academics who might become specialists in the field and among established scholars who might never become "third world specialists." What all have in common, however, is their demonstration of: (1) original thinking, (2) outstanding scholarship, and (3) keen interest and penetrating thought regarding development issues.

Publications

In order to serve as a catalyst for a new generation of thinkers and thinking about development and its assistance, the dialogue of the seminars must reach the vast audience unable to have participated in their occurrence. To this end, ICS Press is publishing and distributing the entire series' product. Thus a widely advertised volume will result from each of the seminars.

In addition to at least three papers and lead-commentaries prepared for a seminar, the corresponding book includes selections from the transcribed discussion of each paper and commentary, and the authors' conclusions in response to the commentary and discussion of their respective papers.

In order that the ensuing book might accurately reflect their thoughts, each participant is provided a complete transcript of the seminar which she or he attended, and approximately two weeks after receipt of the transcript to revise and/or elaborate upon contributions to the day's proceedings. Within one month of a seminar's occurrence, authors are provided copies of these revisions for enabling them to prepare fully responsive conclusions regarding their respective topics.

Series Titles

The first seven titles in the projected 10-seminar series, by the anticipated date of their occurrence, are:

1. Policy Reform and Equity
(May 20, 1987)

2. The Underground Economy and Growth in LDCs
(October 22, 1987)

3. Trade and Development: Development Priorities in the Uruguay Round (January 15, 1988)

4. Capital Markets and Development
(June 3, 1988)

5. Democratic Institutions and Development
(October 1988)

6. Technological Change and Development
(March 1989)

7. Culture and Development
(September 1989)

Seminars are scheduled well in advance in order that few individuals will be precluded from contributing to the series due to prior commitments. Nonetheless, the anticipated dates of seminars four through seven are subject to some modification, contingent upon their acceptability to potential contributors.

In addition, the subject matter of the three seminars that will conclude the series are intentionally unspecified in order to enable responsiveness to emerging interests and intensities of preference of a new generation of development thinking.

Individual Seminars in Series Context

The initial seminars. No two seminars could be better suited for introducing and illustrating this theme than those launching this series. "Policy Reform and Equity" is in many respects the other face of "The Underground Economy and Growth in LDCs." That is, the accomplishment of policy reform and equity decreases the need for and growth of underground economies. The growth of underground economies is often a testament to the large number of people engaged in beneficial economic activities who are effectively excluded from participation in formal economies. Burgeoning undergrounds, bear testimony to the stark inequality among peoples' opportunities to attempt to achieve in accordance with their aspirations.

Underground economies are a product of policies in need of reform. But while their growth can be a tribute to the individuals who create and sustain them, they are not themselves to be glorified. Far better that changes in institutions and policies were effected whereby the occupants of informal economies could become participants in formal economies that exclude no one.

The first two seminars establish that issues of growth and equity are inseparable. The exercise of a country's full range of talent and energy is inhibited by institutions and policies with criteria that address characteristics other than individuals' skills and efforts. Such exclusions make for inefficiencies, reducing economic growth.

This series and its theme are an extrapolation from the policy dialogue endeavors of its sponsor, the Agency for International Development. Underground economies would not exist but for restrictive government policies and practices, many of which have been targeted by A.I.D.'s policy dialogue for at least the past six years. The Agency has anticipated what has been increasingly recognized by many LDC governments. This seminar series is expected to carry forward and broaden the scope of an ongoing policy dialogue debate.

<u>The third seminar</u>. The concerns addressed in the initial seminars are extended in the third to the international arena. The adoption of increasingly exclusionary (e.g., protectionist) policies by the major industrial countries is likely to reinforce restrictive policies of Third World governments. Barriers to domestic competition are increased, not diminished, by the expansion of exclusionary policies in the arena of international trade and investment.

During the initial meeting of the Uruguay Round of multilateral trade negotiations, the delegates agreed that there will be increases in the contributions and negotiated concessions of developing countries in correspondence with improvements of their economies and trade situations. Therefore, the central questions to be addressed in the third seminar are: what LDC strategies will be most beneficial to them in light of the agreements of the initial meeting of the Uruguay Round; how should the New Trade Round take account of the special needs of the least-developed countries; what concessions by developed nations are of most value to developing nations; what inclusionary international trade policies by the NICs should be promoted; and finally, what inclusionary trade policies would be most conducive to the adoption of corollary policies within countries?

<u>The fourth seminar</u> explores issues related to capital markets in developing countries. In many LDCs, a variety of government regulations and economic policies have discouraged

domestic savings and have restricted local and foreign investment. These policies and regulations effectively exclude from formal markets the investments and commercial transactions that otherwise might have occurred, and thereby inhibit the growth and maturation of indigenous capital market institutions. The consequences have been less saving, less investment, less efficiency, and less growth than is experienced in countries where policies and regulations do not discourage the entry of individuals into formal capital markets.

The correspondence between human capital flight (to undergrounds) and monetary capital flight (to other countries) underlies questions to be addressed by this seminar regarding the impact which changes toward more open capital markets might have on capital flight, income disparities, and investment disequilibria.

Some LDCs are now studying ways to facilitate capital market development by reducing inhibiting regulations, strengthening local institutions and stimulating on-lending and private foreign investment flows. In recognition of these ongoing assessments, the fourth seminar will be concerned with examining policies which LDCs might adopt for facilitating the development of indigenous capital markets.

Seminar five examines the inclusiveness (exclusiveness) of political and economic institutions, and explores both their interrelationship and their consequences for the economic growth and development of countries. The central question of this seminar will be: What democratic institutions promote or are necessary for a viable and peaceful transition from mercantile (exclusionary) to market (inclusionary) economies, thereby enhancing the accelerated growth of both economies and equity?

Inclusionary markets have been impeded by the politicization of economies both in countries which possess democratic political institutions and in those which do not. Conversely, inclusionary markets have been established in countries whose democratic institutions are shallow and limited as well as in those where these institutions are deep-rooted and extensive. Given these juxtapositions, each of the contributors to this seminar is expected to provide one or more answers regarding the institutions of political democracy that are "necessary and/or sufficient" for enabling greater equality of opportunity among individuals to participate in both polities and economies. Among the factors to be considered in assessing this relationship are institutional weaknesses and political extremism.

Technological change is addressed by the sixth seminar. The technological revolution shows no signs of decelerating. It has expanded the potential for positive interdependence between countries and, in some cases, altered the comparative advantage of labor-intensive modes of production. Indeed, there is a strong case that the bio-genetic technology underpinning the Green Revolution has generated another revolution wherein investments of capital and labor are no longer inversely related. At the very least, one result of the ongoing technological revolution is an almost constantly changing agenda.

Ten years ago, this seminar might have confined itself to addressing the optimal mechanisms for facilitating technology transfer and LDC strategies for coping with technological change. These important issues remain, but today, the determination of which technologies are most appropriate to any given country are themselves increasingly uncertain. Hence, decisions regarding the optimal technologies to be transferred, and the optimal means for their transfer must be conditioned by questions as to the optimal means for determining which technologies should be transferred.

One thing is clear. The technological revolution has increased the capacity of individuals within LDCs to participate in the international market no matter how exclusionary their government's institutions and policies might be. An implication of this phenomenon is that exclusionary policies of any government are subject to expanded circumvention by their citizens. Another implication is that exclusionary institutions and policies of governments are being undermined by changes over which no government has control. Yet another implication is that those governments which understand this revolution least are likely to suffer most.

Some governments attempt to exclude their countries from both the effects and precepts of the revolution in technology. Today, the most publicized of these governments are those enmeshed with Islamic fundamentalism. Such considerations are incorporated by the subject matter of <u>the seventh seminar</u>. It inquires into what can be the most intractable sources of exclusionary institutions, policies and practices. These include divisions among people that are either imbedded in differences of race, nationality, lifestyle (including religion) and gender or that are established within these sources (e.g., a caste system based in religion).

Culture, at root, is a product of the ways in which a people think.

It is appropriate that a seminar series which strives to encourage new thought about development should address how we think others do about their own futures.

Academic Advisory Board for . . .

INCLUDING THE EXCLUDED:
Extending the Benefits of Development. . .

a seminar series addressing critical issues of foreign development and its assistance; conducted by Sequoia Institute, with the sponsorship of the Agency for International Development.

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Money and Capital in Economic Development:

A Retrospective Assessment

Lawrence H. White

Department of Economics
New York University

and

Department of Economics
University of Georgia

Paper for discussion at the Sequoia Institute /
U. S. Agency for International Development seminar on "Capital
Markets and Development," Washington, DC, June 3, 1988.

Thanks are due to Jerry Jenkins, Alan Stockman, Michael Todaro
and Bernard Wasow for discussion. They are blameless for the
views expressed in this paper.

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Money and Capital in Economic Development:

A Retrospective Assessment

One way of approaching the assignment reflected in the title of this paper -- to provide a retrospective assessment of Ronald I. McKinnon's 1973 book *Money and Capital in Economic Development* -- would be to focus on the impact the book has had on the thinking of economists and policy-makers in the field of development finance, on the formation of actual policy, and ultimately on the performance of developing economies. Such a review of the fortunes of the book's ideas in the real world would be of considerable interest, for the book has clearly had a tremendous impact on both thought and practice concerning monetary and financial systems in LDCs. It has cemented as an undisputed cornerstone of modern development economics the proposition that the money-banking-and-finance sector is crucial in the development process. It has raised at least to predominant acceptance the proposition that the financial sector better promotes development when liberalized, i.e. freed from regulations that repress intermediation through formal financial institutions.

References to the book's impact often pair it with the contemporaneous and like-minded book of Edward S. Shaw (1973).

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Its influence on economic thought is evident in the recent comprehensive text on development finance by Maxwell J. Fry (1988, p. xv), which begins by citing "the path-breaking work of Ronald McKinnon and Edward Shaw in 1973." Fry refers repeatedly to the work of the "McKinnon-Shaw school" (of which he confesses to being a member), and devotes the first three chapters of his book to "McKinnon-Shaw models." The current edition of the leading collection of readings in development economics (Meier 1984) now includes an excerpt from a piece by McKinnon (1980) which in effect summarizes the message of his book.

Evidence that McKinnon's book has influenced policies and events in the world of development financial systems is not difficult to find. Reviewers of the Chilean experience with financial liberalization often prominently link McKinnon's ideas with the reforms adopted there (Diaz-Alejandro 1985, p. 1; Edwards 1985, p. 250).

The retrospective assessment provided here is nonetheless primarily internal, offering a detailed critical assessment of the text from the perspective of 1988. This approach reflects the present assessor's comparative advantage (or disadvantage) as an academic monetary economist only lately concerned with modern development issues, In other words, the title can grace an unusually long and unusually delayed book review. The external impact of the book is traced only as far as the boundaries of the economics profession, and even there only in a few instances.

Fry's (1988) review of the development finance literature fortunately makes it unnecessary to attempt a systematic survey here. To others closer to the "action" is left the task of tracing the influence of McKinnon's thought on policy-making in such places as the International Monetary Fund. (Two suggestions can be made, however, to those who would undertake that task. The first is that in the case of the IMF McKinnon's ideas have undoubtedly been transmitted in part by his student and collaborator Donald J. Mathieson, who in 1975 became an officer in the Financial Studies Division of the IMF's Research Department. The second is that the interests of the IMF and others in adopting the ideas of liberalization needs to be explored. It is possible that we have here a counter-example to George Stigler's (1982) stricture that the economist acting as "preacher" is wasting his time.) The job of reviewing the experience of LDCs with McKinnon-esque policies is left to Rolf Luders (1988). It has also been undertaken by McKinnon himself (1986).

The retrospective herein proceeds as follows. The following section briefly reviews previous contributions to the literature of financial liberalization in order to provide a background for appreciating McKinnon's contribution. Shaw's book, for the same reason, is also compared and contrasted with McKinnon's. The larger part of the paper then critically reviews *Money and Capital in Economic Development* chapter by chapter. Finally, the message of the book is summarized through a review of its reception by reviewers.

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The Earlier Literature of Financial Liberalization

The idea that a liberal policy toward banking, interest, and finance is favorable to economic growth and development is as old as classical liberalism itself. Among the earliest expressions of liberalism were defenses of usury by such seventeenth-century writers as Hugo Grotius (see Bohm-Bawerk 1959, i. p. 23). The argument for financial liberalization is clearly articulated in the work of Adam Smith. His statements are worth quoting as examples of the venerable wisdom that has led Douglas Rimmer (1973, pp. 59-60) to remark: "The [development] policies defensible by economic canons have an old-fashioned look. ...They invoke Adam Smith rather than Dr. Raoul Prebisch or Professor Jan Tinbergen."

In his *Lectures on Jurisprudence* Smith (1978, pp. 505-6) argues: "it is manifest that banks are beneficial to the commerce of a country, and that it is a bad polic[y] to restrain them." In the *Wealth of Nations* (1976, p. 297) he testifies that its free banking industry had "contributed a good deal" to the "very considerabl[e]" growth of his native Scotland. The contribution Smith emphasizes (p. 320) is the formation of productive capital allowed by the banks' replacing metallic money with banknotes, i.e. outside money with inside money: "It is ... by rendering a greater part of [the nation's] capital active and productive than would otherwise be so, that the most judicious operations of banking can increase the industry of the country."

In an oft-quoted passage, Smith (1976, p. 456) conveys the vital message that the wealth of nations is better served by the decentralized and self-interested strivings of private investors than by central government direction:

> What is the species of domestic industry which his capital can employ, and of which the produce is likely to be of the greatest value, every individual, it is evident, can, in his local situation, judge much better than any statesman or lawgiver can do for him. The statesman, who should attempt to direct private people in what manner they ought to employ their capitals, would not only load himself with a most unnecessary attention, but assume an authority which could safely be trusted, not only to no single person, but to no council or senate whatever, and which would no-where be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself fit to exercise it.

We will below quote a like-minded statement by McKinnon.

A second landmark of classical liberalism relevant to our theme is Jeremy Bentham's 1787 *Defence of Usury* (reprinted in Stark 1952). In criticizing Smith's (1976, p. 357) suggestions for fixing a legal maximum rate of interest, Bentham emphasizes the growth-promoting function of market-determined high interest rates. The very title of his open letter to Smith invokes the "discouragements opposed ... to the progress of inventive industry" by restraints on interest rates. Shaw (1973, p. 157) cites Bentham's tract.

In the twentieth century the importance of banking and finance in economic development has been stressed by Joseph A. Schumpeter's classic *The Theory of Economic Development* (1934), and by Raymond W. Goldsmith's *Financial Structure and Development* (1969). In neither book is liberalization stressed. The dual message -- the joint importance of finance to development and of liberalization to finance -- is significantly advanced in two

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collaborative volumes put together by Rondo Cameron to survey the historical role of banking in the early growth of the industrialized nations: *Banking in the Early Stages of Industrialization* (1967) and *Banking and Economic Development: Some Lessons of History* (1972). These volumes offer a historical focus rather than the theoretical thrust of McKinnon and Shaw, and focus on past rather than current development. Nonetheless the essays of Cameron (and to a lesser extent those of his collaborators) anticipate McKinnon's dual message in many specific points.

There is clear common ground between Cameron and McKinnon-Shaw regarding the relationship of finance to the development process. Cameron (1967, p. 1) notes that development goes hand in hand with "a proliferation of the number and variety of financial institutions," as Shaw emphasizes] and with "a substantial rise in the ratio of money and other financial assets relative to total output and tangible wealth," as McKinnon emphasizes. He recognizes (p. 8) that "obstacles to financial innovation, whether legal, social, or other, may hinder the growth of financial institutions and thus retard the progress of industrialization." As McKinnon later does, he points out (p. 9) that "improvement of financial markets should ... produce a narrowing of the dispersion of interest rates among different types of users, among geographical regions, and over periods of seasonal fluctutation." Cameron (p. 10) notes that credit-rationing criteria are particularly important in the allocation of funds in economies where markets are less perfect. A greater

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availability of funds would allow entrepreneurs to assume more debt and to make larger investments. Monetization of the subsistence sector is important for encouraging production for market, specialization, greater effort, focus on higher-yield products, greater responsiveness to relative prices, and increased output.

The merits of liberal financial policy are clearly emphasized in Cameron's concluding remark (p. 313) that "insofar as the criterion for judging bank performance is the contribution of banks to growth, the best results have been achieved when competition was freest and most unfettered." The same theme permeates his discussion of the free banking system of Scotland in the eighteenth and early nineteenth centuries. Cameron (p. 97) traces "the superiority of the Scottish system" to the "freedom and competition" which allowed the banks to innovate and to develop naturally. In particular the freedom of note issue "facilitated the establishment of new banks, increased competition, and immediately provided the banks with the means to engage in productive credit creation." Together with freedom in the establishment of branch banking it produced "the resulting popularization of the banking habit, which led to the early developement and widespread use of bank deposits as both outlets for saving and means of payment."

Cameron's program for liberalization goes beyond McKinnon's in a provocative way: he thinks freedom of private note issue a reform worth considering in LDCs today. His survey of various countries' historical experiences indicates (p. 295) that in a

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country with an underdeveloped banking system, the right of note issue is an effective means of eliciting growth in the number of banks and in the public banking habit. Hence it promotes saving and economic growth. He concedes (p. 319) that central bank note monopolies may be here to stay (a "not necessarily felicitous conclusion"), but persuasively maintains that there is still much to be said for the "local banks of issue" which have historically played the role of "habituating the populace to the use of financial instruments and institutions." Cameron makes the interesting proposal that experiments along these lines today, which would be "highly instructive," may yet be possible in LDCs where traditions of regional autonomy remain. The present author has elsewhere (White 1987) made a similar proposal for allowing private note-issue in LDCs.

Cameron (1972, p. 25) summarizes the "lessons" of his second volume is an unmistakably liberal way. The case studies in the volume reinforce the view that

> where banking was left most free to develop in response to the demand for its services, it produced the best results. Restrictions on freedom of entry almost always reduce the quantity and quality of financial services available to the economy, and thus hinder or distort economic growth. Competition in banking, on the other hand, acts as a spur to the mobilization of idle financial resources and to their efficient utilization in commerce and industry.

This summary of Cameron's work is intended to show that the linkage between financial liberalization and development had been made by economic historians. Their work certainly did not anticipate McKinnon and Shaw in every important respect. To cite again the most obvious dissimilarities, Cameron's volumes neither study modern-day LDCs, nor offer an explicit

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reformulation of monetary theory. Nor do they have anything to say about the impact of interest rate restrictions, the keystone of the "financial repression" studied by McKinnon and Shaw. Evidently interest restrictions were no where, in the cases studied, deemed to have been binding enough to have had a significant distortive effect.

McKinnon's Book and Shaw's

A final preliminary necessary to set the stage for McKinnon's book is a brief discussion of its relationship to the already-mentioned book of Edward Shaw which appeared in the same year, *Financial Deepening in Economic Development*. Many commentators have noticed the similar themes (and even similar titles) of the two books, and the books have been reviewed jointly. McKinnon (1973, p. 2) credits Shaw with convincing him of the importance of financial processes in economic development. He notes that Shaw was an adviser to the Korean reforms of 1965-66, the effectiveness of which stimulated McKinnon's further research.

Shaw (1973, p. viii) in turn thanks McKinnon for his "collaboration in antecedents" of his volume. The two Stanford economists were at one time working jointly on a book about monetary and financial policies in economic development. An extant jointly authored typescript from about 1968, "Policies in Restraint of Development," offers insight into their common ground which will no doubt be very useful to future historians of

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economic thought. The typescript is 75 pages in length. The co-authors split, so the Stanford oral tradtion has it, over the relative importance to be attached to outside money balances (McKinnon) versus a wider range of financial instruments (Shaw) as vehicles for saving and capital accumulation. A paper by Maxwell J. Fry (1978) explores this difference and renders an empirical judgment on which view is more applicable to the semi-industrial Asian LDCs (Shaw's).

An detailed discussion of the similar and disimilar points of the two books is beyond the scope of the present discussion. But it is worth making the general observation that one finds a more nearly laissez-faire outlook in the Shaw's book. Shaw (1973, pp. 80, 87) is far more apt to formulate his policy advice as a case for "free-market rates of interest" and for "financial authority in lagging economies ... to let deposit and loan rates alone, for the market to determine". Shaw (1973, p. vii) proclaims openly that his work "implies a bias toward decentralization of economic choice," a bias which is not quite as obvious in McKinnon's writing. In a festschrift for Shaw, edited by McKinnon (1976, p. 280), Donald J. Mathieson remarks that "in Shaw's optimal system, there would be free banking with no required reserve ratios." Shaw (1973, pp. 129-30) indeed describes such a system, though his belief in its supremacy over alternative systems is left implicit. There is no evidence of a similar view on McKinnon's part.

As far as such a thing can be measured by citation counts, McKinnon's has been the more influential of the two books.

Articles citing *Money and Capital*, as recorded in the *Social Science Citation Index*, total 28 for the period 1971-75 (17 of them book reviews), 65 for 1976-80, 102 for 1981-85, and 24 for 1986 alone. The corresponding numbers for *Financial Deepening* are 18 (12 reviews), 44, 56, and 11. The respective totals are 219 and 129. Both are healthy sets of numbers. It is probably invidious to seek an explanation for the greater recognition of McKinnon's book, other than to hypothesize superior pricing and distribution by its publisher, the Brookings Institution.

A Critical Review of the Text: Chapter 1

Main themes are briefly stated in the first chapter. McKinnon (1973, p. 3) makes it clear at the outset that the lion's share of blame for poor growth in LDCs, contrary to the prevailing ideology of the 1960s, is not to be laid at the door of the wealthier economies. As long as other nations do not raise tariff barriers, "successful development rests mainly on policy choices made by national authorities in the developing countries. Correspondingly the inadequate economic performance of many LDCs is attributed to repressive, though understandable, policies that they themselves have pursued." In this respect McKinnon's message is complementary to that of P. T. Bauer, whose *Dissent on Development* (1971) had been a lonely voice in favor of liberal policies.

The central policy choice to McKinnon (p. 3) is whether authorities "decide to nourish and expand the 'real' stock of money ... or allow it to remain shrunken and heavily taxed." Evidence shows that grwoth in real M2 coincides with greater saving and income, and with greater efficiency of investment. Existing theory could not explain why, with its assumption that real money balances and physical capital are substitutes. McKinnon will set out a theory in which they are instead complements.

Fragmentation and Intervention: Chapters 2 and 3

In chapters 2 ("Capital in a Fragmented Economy") and 3 ("The Intervention Syndrome") the patient's ill are diagnosed. McKinnon (p. 5) is quite critical of the consequences of the interventionist policies practiced by LDC governments, taking as the first question to be answered, "Why is public intervention so pervasive and generally so unsuccessful?" In the retrospective light of the last 15 years of Public Choice economics, he is surprisingly charitable -- even naive -- concerning the motives behind the policies:

> Intervention is ususally prompted by the perception -- sometimes correct -- that a particular market is functioning badly, so that authorities feel pressed to 'do something'. An infant textile firm is helped by a tariff; or the price of an agricultural product may be raised to permit farmers to use a new ferilizer-intensive technology; or a tax exemption may be granted to a foreign firm for automobile assembly. This pressure for public intervention is the result of severe fragmentation in the underdeveloped economy.

No mention is made here of the possibility that intervention is instead usually prompted by the desire to augment the revenue or power of government, to create artificial rents, or to

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redistribute wealth for the sake of favored beneficiary groups. Such activity is generically known in the public choice literature as "rent-seeking." Stanislav Andreski in *Parisitism and Subversion* (1966, p. 77), an important sociological analysis of Latin America, speaks of it as the "parasitic involution of capitalism," which he defines as "the tendency to seek profits and to alter market conditions by political means in the widest sense of the word." Andreski (p. 84) cites as an important aspect of such acquisitive interventionism in Latin America "the stranglehold which cliques of big capitalists have on credit facilities."

As Douglas Rimmer (1973, p. 54) has written, we need to "consider the hypothesis that the primary purpose of so-called 'developmental activities' and 'growth policies' is to control the distribution of the national income, not to raise it."

Though the beneficiaries of the rents created by a policy may attempt to justify it by complaining about the inadequacy of the domestic capital market, such complaints may be no more than camouflage. Very similar rent-seeking goes on in nations with highly developed capital markets, after all, though apparently to a lesser degree. McKinnon's examples are all perfectly explicable under the rent-seeking hypothesis. Particular markets are said to be "functioning badly" by firms who find their profits squeezed. The "infant" textile firm pleading for a protective tariff is a prime example. The price of an agricultural product may be raised simply in order to make its producers wealthier. Talk about the supposed benefits of using a high-cost fertilizer-intensive technology is beside the point, because an increase in product selling price by itself does nothing to change the least-cost input combination. The prevalence of an argument for a policy actually designed to promote the use of high-cost fertilizer should lead one to suspect that the producers of fertilizer have been spreading it. In none of these cases does the pressure for public intervention stem from the severe fragmentation of the underdeveloped economy.

As McKinnon elsewhere recognizes (p. 7), modern fragmentation is the result of intervention. It is not clear why he chooses to regard it also as an initial cause (p. 8). It is unlikely that McKinnon's reluctance to emphasize the rent-seeking origins of repressive LDC policies could have originated in the belief that nothing was to be gained by appearing to impugn a particular government's motives, for such a point can be made quite generally. Something is surely to be gained by frank appraisal of the problem.

In a similarly charitable vein we have McKinnon's statement (p. 6) that LDC governments have chosen to offset the legacy of colonialism "by interfering directly to help some individuals or sectors of the economy at the expense of others." What McKinnon regards simply as the unfortunately chosen means -- helping a few at the expense of the majority -- may instead have been the deliberate goal of these policies. It would be more than a bit ironic for such favoritism to masquerade as the inverse of colonialism. McKinnon (p. 70) later recognizes this point when he characterizes as "neocolonial" LDC banking systems "where

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favored private and officieal borrowers still absorb the limited finance available at low real rates of interest". If favoritism is the very point of official policy, then advice for improving the operation of factor markets will not be sufficient "to persuade authorities to cease intervening in commodity markets" as McKinnon (p. 8) hopes.

With regard to the *consequences* of interventionist financial policies McKinnon's analysis is cogent and compelling. A government that fragments the capital market "causes the misuse of labor and land, suppresses entrepreneurial development, and condemns important sectors of the economy to inferior technologies" (p. 8). Thus capital market liberalization is the key to a general improvement in economic performance.

The internal dynamic to interventionism, as Shaw (1973, pp. 12-13) and Basil Moore (1975, p. 124) emphasize, can lead a government that begins with capital market interference to impose successively more general fetters on economic activity. Controls on loan interest rates and foreign-exchange rates create excess demands for loanable funds and foreign-currency funds. These shortages call forth discretionary official rationing of funds. The allocation of the underpriced funds creates a new round of distortions. Typically the favored recipients of funds are firms that propose long-term and heavy investments in plant and capital equipment, investments that look profitable only because of the artificially low interest and exchange rates. These overly capital-intensive firms, mimicking the production techniques of more developed countries, employ a small proportion of the labor force at relatively high wages. The unduly capital-poor remainder of the economy can provide only low-wage jobs. A dual labor market results. The industrial labor force may gain union monopoly power and a minimum wage law. Rural laborers are drawn into the pool of the numerous urban unemployed until the probability of landing a high-wage job becomes low enough to discourage further migration, a situation analyzed by the well-known model of Harris and Todaro (1970).

McKinnon (pp. 31-32) adds to this explanation for the coexistence of overly capital-intensive and unduly capital-poor production techniques. Ceilings on *deposit* interest rates deter the owner of a profitable enterprise from placing his "surplus" funds with intermediaries. Because the high marginal returns to capital funds elsewhere in the economy are not conveyed to him by intermediaries as a relevant opportunity cost, he will reinvest his funds internally until the marginal rate of return is driven quite low. Thus the lack of outlets for savings leads to excess use of capital equipment in some enterprises while others suffer from inadequate capital.

McKinnon's analysis of the market for capital is built on the fairly solid microeconomic foundation provided by Irving Fisher (1930). In accordance with Fisher's focus on the preferences and constraints facing individual savers and would-be investors, McKinnon (p. 11) rightly emphasizes the dispersion of knowledge among numerous entrepreneurs concerning the economy's best investment opportunities. Though McKinnon attributes it to the dispersion of technical expertise and factors of production, an important source of the dispersion of relevant knowledge is simply the specialized familiarity with local and immediate circumstances (the land, labor, machines, and other resources available, and the production techniques to which their particular capabilities are suited) held by the individual on the spot. Hayek (1948, pp. 84) made this point vigorously in his classic critique of the view that general equilibrium theory provides a useful blueprint for central planning: "We need decentralization because only thus can we insure that the knowledge of the particular circumstances of time and place will be promptly used."

An undistorted market system is indispensible for allowing the economy to take full advantage of the specialized knowledge of entrepreneurs on the spot. It communicates to them through prices the accurate information about relative scarcities and demands they need to dovetail their individual investment plans with the plans of other actors in the economy. As McKinnon (p. 11) puts it, "there is no single authority or narrow class of individuals who can extract saving and allocate investment according to a neoclassical menu of best-practice production techniques." In this respect LDC economies are no different from developed economies. Where LDC governments have attempted to steer investments, particularly into modern plant and equipment, the results (p. 14) have been "highly perverse" from the point of view of improving rates of return. Andreas Fuglesang (1984) has provided complementary examples from African agriculture where the overriding of local farmers' knowledge by outside technicians' plans has resulted in disastrously poor yields.

What is different about less developed economies is the greater dispersion in realized rates of return to investment. For McKinnon (p. 9) this is a matter of definition (he unconventionally defines "economic development" as the reduction of dispersion in rates of return), but it is true even when "less developed" means "poor" or "backward". The persistence of low-payoff uses of capital while high-payoff uses go wanting is indeed a major cause of poverty. To quote Andreski (196~~7~~6, p. 119): "Although in a country like Paraguay or Bolivia there is very little wealth available for anything, in the richer countries of Latin America the unproductive use of existing funds constitutes as important an obstacle to economic progress as the paucity of wealth." McKinnon (p. 15) justifiably insists that "the release of resources from inferior uses in the underdeveloped environment is as important as new net saving per se." Certainly it is a less costly source of increases in output.

Wasteful uses of capital persist in LDCs because governments' encourage them. The encouragement comes through ceilings on loan interest rates, the rationing of artificially low-priced loans, and direct credit subsidies. Small-scale entrepreneurs with potential high-mean-payoff projects cannot outbid the well-connected sponsors of established low-payoff projects for the scarce funds available through the organized banking system. These entrepreneurs lack the wherewithal for self-finance. Pockets of profitability go unexploited. McKinnon tells this story persuasively, and wisely relegates technical diagrams to an appendix.

Chapter 3 analyzes seven categories of government policies commonly found in LDCs. McKinnon again charitably considers them all to be "policies for circumventing the [inadequate] domestic capital market", and thus justifiable at least in principle under the theory of the second best.

McKinnon is certainly not blind to the monopoly rents that the policies create, but insists (p. 25) that an LDC government's "favoritism toward an 'in' group of entrepreneurs cannot be explained away as pure corruption. ...In an appropriately liberalized economy, one would expect it to be no more common than elsewhere." This suggests that McKinnon does not wish to attribute *all* rent-seeking, but only the *extra* rent-seeking apparent in developing countries, to attempts to circumvent inadequate capital markets. There is an alternative hypothesis to be considered. In accordance with the framework proposed by Douglass North (1979), one could attribute the extra "favoritism" or wealth-transfer activity to lesser constraints against exploitation by the national government. The relevant constraints are informed and ideological public opinion, effective democratic or constitutional processes, and the mobility of the citizenry. An empirical test of the competing hypotheses would be of great interest.

The chapter's list of common interventionist policies is as follows: (1) tariffs for "infant industries"; (2) import licences; (3) other monopoly privileges; (4) artificial cheapening of capital goods; (5) manipulation of agriculture's terms of trade; (6) land redistribution; (7) restrictions and concessions toward foreign direct investment. The common element of capital-market circumvention McKinnon (p. 30) finds in these policies is that they "relieve the constraint on external finance by enriching the holder of a production opportunity, or by making that opportunity appear to be more profitable so that the immediate cash flow from it increases." In other words, they create flows of artificial profits or rents. The capitalized value of the flows constitutes wealth for the beneficiary. Certainly the flows can be used as evidence of credit-worthiness to enable the beneficiary to borrow more readily in the present, or can be used for self-finance as they accrue. Nonetheless one suspects that the enrichment of the beneficiary and not the circumvention of constraints on external finance per se is typically the real reason for which the policies are enacted.

McKinnon quite forcefully criticizes these policies for creating expensive and corrupt bureaucracies, for creating monopoly power, for distorting the allocative function of spot prices, and for tilting the aggregate distribution of income toward the relatively rich. Most emphatically he insists that they provide an inefficient reward structure for encouraging saving and truly productive investment.

Only one reservation needs to be expressed concerning his argument, namely that his strictures against foreign direct investment (p. 29) seem to extend unjustifiably even to unsubsidized cases. The statements that "direct investment may

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be expensive" because of the greater risk perceptions of foreigners, and that "relying on direct investment from abroad may break the external financial constraint at the cost of relinquishing investment opportunities to foreigners at bargain-basement prices" are difficult to accept as reasons to block domestic residents from selling labor services and land to, or buying products from, foreign capitalists. No matter how high a risk premium is required by foreigners, it is difficult to see how their supplying of capital can make a capital-poor economy worse off. So long as foreigners lack the local entrepreneurs' knowledge of time and place, they will be unable to take up all the investment opportunities available. So long as foreign capitalists are not prevented from competing with one another, they will be unable to take up many opportunities "at bargain-basement prices". In any event it is better for the domestic resource owners, labor suppliers, and consumers, that a foreign investor fill an opportunity to buy domestic inputs at "bargain-basement" prices, in order to transform them into more highly valued ouputs, than that no investor does. It is the mission of profit-seeking entrepreneurs everywhere to find inputs which are underpriced relative to the outputs they can produce (Kirzner 1973).

Against the view that fiscal devices (taxes and subsidies) may be useful to remedy factor price distortions caused by financial repression, McKinnon (pp. 34) cogently argues that useful subsidies would have to be "tailored to a degree of fineness beyond the knowledge and administrative capacity of the

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government," given the fragmentation of markets in developing countries. He instead indicates (p. 36) that fiscal policies should be confined to the tasks of stabilizing the macroeconomy, providing public goods, redistributing income, and "mobilizing an economic surplus of revenues over current expenditure for capital formation" in both the public and private sectors.

It is clear from the extensiveness of this list of tasks that McKinnon is not wedded to a laissez-faire ideal. Leaving disagreements over the first three tasks aside, the last fits particularly ill with what one would have supposed is the point of a program of financial liberalization. Surely the point is to allow resources to be allocated by markets so as to reflect the genuine preferences, particularly time-preferences (Irving Fisher's "impatience"), of the economy's participants. (McKinnon indicates that he accepts a time-preference theory of the equilibrium rate of interest.) There is no warrant for a policy of forced savings through taxation. Even if non-distortive taxes were available, there is no case for forcing the public to sacrifice more current consumption than it is voluntarily willing to sacrifice at the tradeoff rate against future consumption represented by an undistorted interest rate.

Money, Banking, and Financial Repression: Chapters 4 to 9

Chapters 4 through 9 highlight the role of commercial banking as the most important component of the financial system in a developing economy. Its importance means that to "nurture" capital markets a government must stop discouraging the holding of bank liabilities. Because there is little financing of enterprise through bonds and equities, intermediation through banks provides the predominant means of finance. The public holds a large share of its claims on intermediaries (two-thirds is the figure McKinnon cites) as claims on the banking system (central bank included).

McKinnon chooses to call all deposits of the banking system "money". So long as this remains merely a matter of terminology there is no reason to object to it on any grounds other than its awkwardness. But it is important not to lose sight of two potentially important distinctions that this terminology blurs. The first is the distinction between basic money (full-bodied commodity money or fiat money, which is no one's redeemable liability) and secondary money (bank liabilities redeemable for primary money).[1] The holding of basic money can be a vehicle of saving, but unlike the holding of secondary money it does not provide the banking system with funds for intermediation. Secondary money can be either deposits or banknotes. During the nineteenth century the holding of banknotes constituted a major source of bank funding. The second important distinction is between checkable (M1) and non-checkable (M2) bank deposits. The advantages of holding a means of payment are crucial to explaining the holding of currency and checkable deposits, but are not relevant to the holding of non-checkable deposits.

[1]The first distinction is one that I have elsewhere (White 1987) expressed by contrasting "outside" with "inside" money. In light of Gurley and Shaw's (1960) different usage, those terms are probably better avoided here.

McKinnor's approach to inflation, the price level, and money demand and supply embodies the standard insights of monetary theory. The equilibrium price level P is determined by the ratio of the central-bank-determined nominal stock of money M to the public's real money balances demanded $(M/P)^d$, thus equating the actual real stock of money M/P with the public's real money balances demanded. He emphasizes the importance of the real return to holding money, its nominal interest yield (zero in the case of currency and some demand deposits) minus the expected rate of inflation, in determining the real money balances demanded. While in a liberalized financial system we are accustomed to thinking that inflation appreciably affects only currency's real yield, the nominal yields on deposits adjusting like all other competitive interest rates to changes in expected inflation, in an economy where the authorities impose binding nominal deposit ceilings (or require heavy holdings of non-interest-bearing reserves against deposits) we find that inflation directly penalizes the holding of deposits as well. The authorites determine the real returns on currency and deposits by their choices of inflation rate and deposit interest rates. Thus the demand for real money balances is particularly at the mercy of government policy.

The point to which McKinnon brings novel emphasis is this: as goes the quantity of real money balances, so go the quantities of real saving, intermediation, and capital formation in the less developed economy. One measure of the accomplishment of the book is that today such a conclusion makes obvious sense. In 1973 the economics profession was under the sway of neoclassical money growth models from which the opposite conclusion emerges. In those models real money balances and physical capital are treated as alternative forms of wealth for households. A lower real return to holding money, as created by inflation, is thereby found to encourage capital accumulation. Inflation promotes real growth. This notorious result is known as the "Tobin effect" in recognition of work by James Tobin (1965).

Because the Tobin effect and the models generating it have been widely accepted in the economics profession as valid, McKinnon quite justifiably devotes Chapter 5 to "a critique of prevailing monetary theory". He exposits an archetypal neoclassical money growth model and quite appropriately notes that it harbors a bias toward inflation. His initial indictment (p. 50), that "the neoclassical model does not transfer well to poor, fragmented economies," is from today's perspective rather mild. It suggests, perhaps unintentionally, that the model provides adequate guidance in analyzing and making policy for developed economies. McKinnon later (pp. 52-3) notes its real shortcoming: the model fails to incorporate the transactions purpose for holding money. Once this purpose is given its place, real money balances become complementary to the accumulation of physical capital.

This insight is somewhat obscured by McKinnon's choosing to associate the transactions-facilitating function of money with "imperfections in capital markets," on the grounds that in a perfectly frictionless economy everyone could arrange their payments without anyone having to hold any special money-like instruments which yield less than the rate of return to capital. Given this association, there is more than meets the eye in his pointing out (p. 52) that the "imperfections in capital markets" which undermine the applicability of the model to less developed economies "also exist in advanced countries, albeit in less extreme forms." In fact, the key condition -- the transactions purpose for holding money -- that McKinnon (p. 53) identifies for less developed countries is every bit as applicable to advanced economies: "Cash balances are needed to intermediate between income and expenditures."

The current state of professional debate on the Tobin effect directly reflects McKinnon's insight. Alan Stockman (1981), twice citing McKinnon's (1973) argument, has presented an influential model in which a "cash-in-advance" constraint is used to capture the idea that cash balances already acquired are needed in order to make expenditures on consumption and capital goods. Inflation then reduces the net return from accumulating capital by making more costly the temporary holdings of money needed to buy capital goods and to trade the income from capital for consumption goods. The result is that capital accumulation is discouraged by higher inflation, contrary to the Tobin effect. Empirical work by other authors, using data from developing countries, has generally found neither a Tobin effect nor its inverse (see Danthine 1987).

Chapter 6 presents McKinnon's alternative model of the relationship of money to growth. The central result of this model is the complementarity between money and physical capital. A straightforward way to establish such a result would be to note that most of the measured money stock consists of bank liabilities, matched on the banks' balance sheets by investment loans. As George A. Selgin (1987, p. 441) has recently argued, an increase in the public's willingness to hold bank money at a given price level "is tantamount to an outward shift in the supply schedule of loanable funds to be intermediated by the banking system." In the literature this line of thought is known as the debt-intermediation view, and is associated with Edward S. Shaw (1973). McKinnon, however, takes a more roundabout route.

In McKinnon's model, the stock of money is assumed to consist entirely of basic fiat money. Commercial bank liabilities are excluded from consideration. The government's proceeds from creating fiat money are assumed not to be used for capital formation, so that neither does the central bank act as an intermediary. These assumptions are meant to duplicate the usual money-supply assumptions of the neoclassical money growth model. The contrast in results between the two models must then arise elsewhere. It arises from differing assumptions concerning money demand. In McKinnon's model "all economic units are confined to self-finance" (p. 56), so that temporary accumulation of money balances is the only vehicle for financing discrete (or "lumpy") investments in physical capital. It follows from these assumptions that desired real money balances will vary directly with desired investment activity. More to the point, desired investment activity will vary directly with the desirability of

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holding money. The reasoning foreshadows that later embodied in Stockman's model: a higher real return to holding money, say due to a lower rate of inflation, reduces the cost of saving up for the purchase of capital goods. McKinnon calls this the "conduit" effect of money. It produces the reverse of the Tobin effect. Inflation discourages real growth.

For the sake of completeness one should, as McKinnon does, note that even in his model the Tobin effect (which he calls the "competing-asset" effect) can potentially return to dominate the conduit effect. If the real return to holding money rises high enough, money-holding for its own sake becomes an attractive alternative to holding physical capital. This likely occurs only when the rate of inflation becomes significantly negative.

The enduring value in McKinnon's money demand model lies in the backing it gives to his surely warranted conclusions (p. 67) that "inflation is a poor way to deal with the scarcity of real capital," and that "monetary mismanagement resulting in high inflation may be much more damaging that prevailing theory would suggest." Economists who take the neoclassical model of inflation seriously have had a notoriously difficult time understanding why inflation should be considered any more burdensome than a minor excise tax on currency holding. Axel Leijonhufvud (1981, chs. 9-10) has offered an extensive critique of that misconception which in some respects overlaps with McKinnon's.

McKinnon ventures onto less secure ground when he deploys his model as a guide to "optimization" by monetary authorities.

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In this exercise we find the real return on money that maximizes the rate of self-financed investment. No reason is given for supposing that government ought to impose that goal on society. The exercise suggests -- perhaps unintentionally -- that the authorities should not allow the real rate of return on money to rise "too high," a suggestion that one would certainly not want to see carried over to an economy with bank-issued money, or employed as a rationale for government monopoly over money. Here the intuition of Cameron (1967, p. 313) is persuasive: "the theoretically optimal growth path of the ratio of bank assets to national income is also the 'natural' growth path that would result from free competition."

Chapter 7 presents the analysis of "financial repression" for which *Money and Capital in Economic Development* is best known. The "formal" banking and financial sector is repressed primarily by interest rate ceilings on both sides of the balance sheet, which are particulary binding when inflation is high. Artificially low (sometimes even negative) real returns discourage the holding of bank liabilities, holding down intermediation through the banks and saving in total. Artificially low loan rates create an excess demand for loanable funds that is rationed through favoritism toward licensed importers, large-scale exporters, protected manufacturers, and (naturally) government agencies and the national treasury. Unfavored enterprises are excluded from the long-term finance of the formal banks, and left to borrow at much higher rates from the "informal" financial sector or "curb market" of local moneylenders, shopkeepers, pawnbrokers, and cooperatives.

Far from making cheaper loans available to the small borrower, then, interest rate ceilings have the opposite effect. Loans are more expensive to all but the favored few. McKinnon makes this point vividly by citing a truly alarming differential between official and unofficial lending rates in Ethiopia: 6 to 9 percent versus 100 to 200 percent. He then considers government attempts to patch over the problem by further interventions. Extending the usury ceiling to the informal sector does not remedy the problem, but worsens it by making credit still less available. Restrictions on the collateral moneylenders can demand do likewise. Relieving farmers of the need to finance inventories, by having government buy and store farm produce, does nothing to relieve the shortage of capital (government borrowing is now larger), and shifts the pricing of produce into the political realm. This in turn leads to central planning of agriculture.

The route to economic sanity is clear: eliminate financial repression so that bank-intermediated funding becomes available to entrepreneurs throughout the economy. The expansion of bank lending to small-scale, rural, and other formerly excluded enterprises can make use of the specialized knowledge about potential borrowers held by the informal lenders who had been serving them. As McKinnon (p. 78) suggests, banks can lend funds to the moneylenders for relending, or can hire them as loan officers. Alternatively, with free entry into banking the moneylenders can transform their own operations into formal banks.

The importance of private ownership and free entry for competitive and efficient results in banking is unfortunately neglected by McKinnon, and in one uneasy passage seems even to be denied. He proposes (pp. 78-9) that "banks can be organized ... to simulate competitive lending and deposit practices, even if the banking structure remains highly concentrated." Instructions for simulation of competitive practices are then given, presumably for the benefit of monopolistic government-run or government-fostered banks. Profit-motivated private banks, constrained by genuine competition, would find such instructions unnecessary or irrelevant.

The fact of the matter is that competitive results cannot be attained by asking state-owned or state-sheltered banks to "simulate competitive practices". This is so for two reasons -- lack of knowledge and lack of incentives -- which should be familiar to students of the classic debate over the feasibility of "market socialism" (see Lavoie 1985 for a secondary account).

(1) Though one can specify roughly the directions in which practices in a particular non-competitive system would have to move to be more like those observed in competitive systems in similar developmental settings -- and such a rough specification is all that McKinnon's instructions provide -- the pattern of activities that competition would produce in a given time and place cannot be known in any detail without letting actual competition operate. We simply do not know, but must rely on the competitive selection process to show us, which activities and

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practices will allow banks to survive and prosper in a particular economy. Competition is not just a means for enforcing static cost-minimization in a world of given products, known production techniques, and given input prices, but is an essential means for uncovering previously unknown higher-valued products and lower-cost production methods appropriate for a specific setting (see Hayek 1978). McKinnon's instruction to price loans to reflect "the general scarcity [cost] of capital and the peculiar administrative costs of serving each class of borrower" would be operational only if those costs were somehow already known.

(2) No method analogous to profit competition has yet been devised for compelling a public agency or sheltered private monopoly to act as if it were *trying its best* to produce competitive-like results. An institution created by politics faces political incentives which pull it in quite another direction.

For these reasons a case can be made for privatization of state-owned financial institutions, and for free entry into financial markets, which applies with special relevance to developing countries (White 1987). McKinnon may well accept this case. He may intend his instructions merely as "second best" policy advice for a government that refuses to privatize and open up its economy's financial sector. Or he may not. His position is not clear. Discussion concerning the rules of the game necessary for "first best" banking -- private ownership and free entry in particular -- is conspicuously absent from McKinnon's book. Its absence is highlighted by the emphasis on the importance of genuinely competitive conditions in the more recent literature. Fry (1988, pp. 299; see generally pp. 261-322) rightly insists that where government-owned or -controlled banks misallocate resources and operate wastefully, "financial liberalization cannot by itself rectify the problem."

The lack of clarity about the first best ideal continues when McKinnon speaks (p. 79) of relieving financial repression through a "preferred strategy of high real rates of interest -- where real finance is plentiful at those rates," as though the real interest rate and the real quantity of loanable funds can appropriately be regarded as policy instruments rather than as a price and quantity whose correct determination must be left to competitive markets. The following paragraph likewise considers the adjustment of nominal interest rates to variation in the inflation rate as a strategic problem for "the banking authority" rather than as a market outcome in a regime of competing financial firms. In neither paragraph is a second-best apology offered.

The final section of Chapter 7 introduces McKinnon's novel prescription for relatively painless disinflation (which he persistenly calls "deflation") in financially repressed economies. The orthodox method of disinflation is to slow the growth of the nominal money stock, thereby in quantity-theoretic fashion lowering the equilibrium growth rate of the price level. This approach is typically painful, in monetarist analysis (e.g Darby 1976), because the "momentum" of the price level keeps it rising at the old rate for a time even while the rate of money growth is reduced. During this period the prices of goods in general are too high given the slowed growth of money balances: there is not enough money in circulation to support such high prices. An excess supply of goods (corresponding to an excess demand for money) develops at the existing price level, reflected in unsold inventories. This leads to cutbacks in production, layoffs, and all the other features of recession, until the price level decelerates to its newly warranted path.

McKinnon's diagnosis is different from, though not inconsistent with, the foregoing. In his account (p. 87) a reduction in nominal money growth, given the momentum of the price level, means a fall in the quantity of *real* money balances and thereby (given that most of M2 consists of bank liabilities matched on the balance sheets by loans to business) a reduction in the real supply of bank credit to manufacturers. (Here McKinnon implictly drops his own self-finance model in favor of something akin to Shaw's debt-intermediation view of money.) Firms dependent on bank credit must contract operations for lack of working capital to finance thier inventories and wage bills. Unemployment and recession ensue. In this account the excess demand for money constrains firms through its effect on the banking system's real balance sheet rather than through its effect on final sales.

The key to avoiding recession when disinflating, in the "orthodox" monetarist view, is to make the lower growth path of the money stock credible in advance. Then price-setters will moderate their periodic price adjustments so as to avoid setting prices too high. In the limit, the price level will shift immediately onto its new equilibrium path, unsold inventories will not accumulate, and recession will be avoided. The major problem is how to make an announcement of lower money growth credible. One method often discussed in developed countries is to bind the government's hands through some constitutional constraint so that it cannot expand the stock of base money *ad libitum*. That method may be completely inapplicable to a developing country that lacks effective constitutional mechanisms for binding government in any respect. There may simply be no method for the monetary authority of such a country to make a credible pre-commitment.

McKinnon does not explicitly consider the question of whether a disinflation can be made credible in advance, but implicitly answers in the negative with his quite general assertion that "orthodox direct restraints on the *supply* of money and credit are indeed likely to bring misery and hardship in their wake." As the use of italics in that statement suggests, he goes on to recommend that disinflation be driven by way of the alternative route: increasing the real *demand* to hold money. Increasing the public's real money balances demanded, as seen in the simple price-level analytics of Chapter 4, brings down the price level so as to equate actual with demanded real balances. People trying to acquire greater real balances will be more eager to sell and less eager to buy commodities, thus bidding down their prices.

The authorities of a financially repressed economy have a ready means at hand for increasing the real demand to hold money balances: they can raise the real return to holding money (broadly defined) by raising their ceiling on deposit interest rates. In accord with McKinnon's diagnosis of recession, this route avoids the shrinkage in the real stock of money and accompanying credit contraction that make an orthodox disinflation so painful. In fact the real stock of money can rise at the outset of the disinflation. In the orthodox disinflation, the real stock of money shrinks at first and only much later (as lower inflationary expectations become established, raising the expected real return to holding money balances) does it rise.

What McKinnon's advice offers here is not a "price stabilization without tears," as he puts it, so much as a price stabilization in which a spoonful of sugar helps to mask the bitterness of the medicine. The sugar is of course the removal of financial repression: lifting interest rate ceilings allows real intermediation to increase as the market for loanable funds clears at the greater quantity supplied. The medicine, whose bitterness is unavoidable in the absence of credibility for the announced disinflationary path for money, is the creation of an excess demand for money during the transition to a lower path of prices. McKinnon's demand-led disinflation does not avoid creating an excess demand for money as part of the process of bringing down the path of prices. Correspondingly an excess supply of commodities, and presumably some layoffs and idling of capital cannot be avoided. The only way to avoid the tears associated with disinflation is to avoid inflating in the first place. But the boost to the real economy from the removal of financial repression helps to offset the monetary shock. So too would other policies to promote the aggregate supply of real income. One suspects that McKinnon would be at most ambivalent about being associated with supply-side economics, but there is some similarity in their respective prescriptions for disinflation. There is also, we will see below, similarity in their support for a value-added tax.

In Chapter 8 McKinnon provides several case studies of LDCs which in the years prior to 1973 had successfully liberalized their financial sectors. The important empirical issues to be resolved are (1) whether the quantity of real money balances in fact exhibits complementarity with investment and growth, and (2) how sensitive private saving is to the rise in real interest rates produced by liberalization. Germany and Japan in the postwar era are studied as examples of sustained growth in both real output and in real money balances per unit of real output. Argentina, Brazil, and Chile in the same period show similar joint movement, only in reverse. The financial reform of South Korea in the 1960s provides a fairly persuasive picture of "financial reform without tears."

The Korean reform abruptly reduced inflation (measured by the wholesale price index) from the 20-35 percent range of 1963-64 to the 6-10 percent range of 1965-70, without creating a recession in the growth of the Korean economy. From the perspective of the present it is interesting to contrast

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McKinnon's view of how this was possible with the current wisdom on ending inflations, as represented by the recent rational-expectations view of Thomas J. Sargent (1986). Sargent emphasizes the credibility issue: inflation can be stopped quickly and without tears *if* inflation-rate expectations can be reduced. As expectations are formed rationally, lower inflation-rate expectations can be only be created by the announcement of *credible* change in the path of money growth. The chief condition for credibility, in Sargent's view, is a simultaneous change in fiscal policy such that less revenue from money creation is needed.

From McKinnon's account we do find the fiscal-reform condition fulfilled in the Korean case. Indeed he cites it, much as Sargent would, as an important factor lending credibility to the government's control over nominal money growth, and thereby dampening inflation-rate expectations. In McKinnon's account, however, the dampening of inflation-rate expectations acts indirectly rather than directly to mitigate any painfulness of disinflation. Lowered expectations of inflation increase the expected real yield from bank liabilities, thereby increasing real deposit-holding and correspondingly real intermediation, and thereby boosting aggregate supply. A more detailed historical investigation would be necessary to disentangle the direct and indirect contributions of the lowering of inflation-rate expectations to the painlessness of the disinflation.

Chapter 9 provides a theoretical digression on the topic of "optimum" monetary policy, i.e. policy which allows for maximization of the benefits of money-holding net of cost. In general, optimum money-holding occurs where the marginal opportunity cost of holding money (difference between the real rates of return to money and to capital) equals the marginal benefit of holding real money balances rather than physical capital (the implicit payment-service or "convenience" yield of money), which in turn equals equals the marginal cost of producing real balances. In the standard neoclassical model, real balances consist entirely of fiat money, on which a real yield equal to the rate of return on physical capital can be provided costlessly by perfectly anticipated deflation, and whose payment services are available at zero cost. The point of optimum money-holding is thus obtained where the marginal payment-service benefit of holding real balances goes to zero, and where the rate of return on money equals that on physical capital.

McKinnon presents a geometical model which modifies the assumption of zero-cost money in a straightforward and sensible way. In his model real money balances are provided at a positive marginal cost by a banking system. Optimum money-holding therefore occurs where the marginal benefit of holding money equals the positive cost of providing the services of a bank account, and where the real return on money is lower than the return on physical capital by that same cost.

Implicitly, McKinnon's approach assumes that the cost of providing the payment services of a bank account is identical to the cost of intermediation (which transforms claims to the returns on physical capital into bank accounts). In principle these two costs are distinct. The first can be covered by explicit transactions fees (per-check and per-account charges). In that case the spread between the rates of return on bank assets (reflecting the returns on investments in physical capital) and on bank liabilities reflects only the cost of intermediation.

For monetary policy purposes the addition of banking costs to the model seems to make no difference. Both McKinnon's model and the neoclassical model conclude that the optimal rate of seignorage extraction by government is zero. The process of extracting seignorage by issuing new fiat money imposes a distortive tax on holders of existing money, because new issues dilute the purchasing power of existing money. Positive rates of seignorage drive a wedge between the economically necessary and the actually perceived costs of money-holding, inefficiently depriving the public of potential benefits.

McKinnon (p. 123) correctly emphasizes that seignorage collection is typically the prime motivation behind high rates of monetary expansion in LDCs. He then proposes that "the temptation to divert seignorage to the public exchequer" depends on the capacity of the government to raise revenue by other methods of taxation being "unduly limited". This proposal is perhaps easier to accept once we remove the modifier "unduly". Given the natural temptation of government to consume and

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disburse revenue, seignorage is a tempting revenue source so long as the capacity to raise revenue through other taxes is limited, period. Which is to say: seignorage is always tempting. It is more tempting when revenue is wanted more urgently, which is why high rates of monetary expansion so regularly accompany warfare, particularly because there is no other way to raise so much revenue so quickly as by printing money. To limit a government's appetite for seignorage it is necessary either to persuade it to reduce its spending or that its attempt to raise revenue through seignorage has entered the region of negative returns.[2]

Seignorage is an attractive (to government) way to raise revenue at all times because the public is not prepared to resist or evade it. Its incidence is hidden. Its collection, unlike overt taxation, requires little apparatus for coercion. The only coercion involved is that supporting the domestic government's exclusive monopoly on the issue of basic money. It is not always appreciated (and McKinnon does not mention) that such measures extend to devices which reduce the availability of legal substitutes. By reducing the elasticity of the real demand for government-issued money to changes in the inflation rate, such devices enhance seignorage revenue. Foreign exchange controls and other policies to prevent "dollarization" of the economy can be understood in this way. Interest rate ceilings on bank deposits serve the same purpose (Nichols 1974). Much of the apparatus of financial repression then, to return to an earlier

[2] As with any tax, the revenue-maximizing rate of seignorage is finite. At too high a rate of monetary expansion the tax base of real money holdings melts away. For a clear exposition see McCulloch (1982, ch. 5).

theme of this paper, serves the revenue interests of government.

The remainder of the chapter emphasizes that the complementarity earlier noted between money and physical capital runs both ways: not only does increased saving in the form of money-holding (as promoted by financial liberalization) feed capital formation, but growth in capital and wealth stimulates acquisition of additional money balances. The "portfolio effect" of growth on saving thus completes a "virtuous circle". Liberalization boosts savings and hence growth, which *itself* promotes additional saving and hence more growth. This helps to explain (p. 129) "why a discrete improvement in monetary policy can have such a sharp impact on observed growth and saving rates," and why the impact can persist over time.

Foreign Trade, Currency, and Capital: Chapters 10-12

Chapter 10 discusses the case for liberalization of foreign trade, and its implications for the fiscal policy of a government which relies heavily (as LDC governments do) on tariffs for revenue. Setting forth a now-widely-accepted case against import-substitution policies, McKinnon sagely argues not for new policies in the direction of export-encouragement, but simply for an end to trade-distorting policies. Dismantling of protective tariffs and quotas on imports will alone do enough to encourage exports through the two-sidedness of international trade.

The remainder of the chapter frets over the failure of indirect taxes (sales taxes, customs duties, excise taxes) to raise proportionately more revenue as gross national product grows. It is taken for granted that government should grow at least in proportion to GNP. A value-added tax is recommeded as a remedy. In common with supply-side economists, McKinnon likes the fact that the VAT excludes saving from the tax base, increasing the incentive for saving over consumption. Unlike supply-siders, McKinnon complains that the VAT is "not a suitable vehicle for effecting significant income redistribution from the rich to the poor." The ethical merits or demerits of such a wealth transfer receive no discussion. More surprisingly, no mention is made of the possibility that expropriation of the rich, or at least of those who acquire their riches through honest enterprise and accumulation, may discourage saving and growth.

Chapter 11 argues, through a parable of the Alpha economy and the Beta economy, for liberalization without reliance on inflows of foreign capital. Chapter 12 reinforces the argument with anecdotal evidence. Taken as a case against international agencies providing subsidized rates or credit guarantees on loans to LDC borrowers as an inducement for liberalization, or LDC governments themselves providing firms with artificial incentives to use foreign financing, the argument is compelling. Taken as a case for erecting artificial barriers against capital flows, even temporarily, it is not. Used to support interest-rate and exchange-rate manipulations, capital controls, and discrimination against foreign direct investment in the name of "balanced indigenous development," the argument is ironic if not perverse.

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Here McKinnon seems to forget the principle of Chapter 10, that past distortions do not justify future distortions in the opposite direction. He also seems to contradict the principle announced in Chapter 1 (p. 4): "Complete rather than partial liberalization is more likely to be ultimately successful."

One sees here the first steps being taken into that tangled thicket which is known as the "order of liberalization" literature. The essential point to be made in rejoinder to McKinnon's case for transitional capital controls has been made by Alan Stockman (1982, p. 190) in a comment on an article by McKinnon (1982):

> The issue is whether capital flows facilitate mutually benficial exchange and help promote economic growth. McKinnon's argument for controls rests on the assumption that the 'authorities' (the government) can make better decisions about foreign investment issues than the investors who are risking their own money."

One only need add, in light of the bailouts that in retrospect seem to have undermined the Chilean liberalization, that it is vitally necessary for both foreign investors and domestic banks to believe that that they really are risking their own money.

Conclusion: The Policy Message Conveyed

The reception accorded to *Money and Capital in Economic Development* by economists reviewing the book was overwhelmingly positive (see Luders 1974, Waters 1974, Grubel 1974, Price 1974) with only an occasional dissent (Reubens 1974) from the old guard. One senses in reading their reviews that the old paradigm in development theory was ripe for replacement. We can glean an answer from these review to the question: what was considered novel in McKinnon's message? The reviewers in 1974 stressed the following five points.

(1) *Development begins at home.* The policy choices by the LDC governments themselves are reponsible for their various growth performance in the post-war era. (McKinnon 1973 , p. 2) himself calls his approach "heavily 'bootstrap' in emphasis." Successful development can therefore proceed without reliance on foreign aid or foreign capital.

Regardless of the policy route to be recommended to LDC governments, the message that praise or blame belonged with them, not with the already developed nations, was in 1973 an unusual point of departure.

(2) *Well-functioning domestic financial and monetary sectors* are crucial to economic development. Grubel (1974, p. 333) comments that developement theory had previously focused almost entirely on the "real" sector, a "gap in the literature" which McKinnon helps to fill.

(3) *Monetary and financial regulatory policies* which stifle domestic intermediation, creating "financial repression," are the policies primarily reponsible for poorly functioning domestic monetary systems and capital markets, and thus for poor growth. Interest rate ceilings on deposits and loans, combined with inflationary rates of monetary expansion, are the most important policies creating "financial repression."

The combination of point (3) with point (1) means an emphasis not on the overall scarcity of capital in the LDC (difficult to remedy except by massive capital transfers from abroad), but on its misallocation due to policy-induced distortions (possible to remedy simply by eliminating the bad policies).

The contrast of three three points to the intellectual status quo then prevailing is obvious from the remark of Price (1974, p. 188):

> For a quarter of a century the dominant prescription in much of the literature of economic development for poor countries has been to seek foreign capital through grants and loans, through so-called planning to control investment and all markets including the capital market, and to follow a protectionist policy with respect to foreign trade. ...In most poor countries in the fifties and sixties little or no attention was given to development of domestic capital markets that would provide necessary incentives for saving and provide an efficient means for allocating financial resources among investment opportunities.

(4) *Liberalization reduces the painfulness of stabilization,* because inflation can then be brought down by an increase in demand for money (as interest rates on deposits are allowed to rise, and as increased intermediation augments the volume of real income) rather than by a reduction in its supply.

(5) *Liberalization of domestic financial markets is the key to growth.* This conclusion is easily derived from the prior four points. As Reubens (1974, p. 500) puts it, the book offers "a bootstrap approach to economic development, using monetary straps." Grubel (1974, p. 333) distills from it the message that "the road to economic development is paved with competitive financial intermediaries operating in free markets and under price stability."

Whatever quibbles have been entered above with respect to the details of McKinnon's argument, the essential message reflected in these five points is surely correct and vital. Its vitality as an intellectual achivement is evidenced by its continued citation in the literature, and by the very assignment of this retrospective. Its vitality as a policy manifesto is evidenced by the amount of liberalization thus far achieved, and by the amount remaining to be achieved. It is for the citizens of the Third World, on whom the crushing weight of poverty is increased by financial repression, that the essential message of Ronald McKinnon's modern classic is especially vital.

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First Draft
Do not quote

LATIN AMERICAN CONTRASTS: CAPITAL MARKETS AND DEVELOPMENT IN CHILE AND ARGENTINA.

Rolf J. Lüders
Catholic University of Chile

Santiago - Chile
May, 1988

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LATIN AMERICAN CONTRASTS: CAPITAL MARKETS AND DEVELOPMENT IN CHILE AND ARGENTINA

INTRODUCTION

This paper has been written as an analytic and comparative history of financial developments in Argentina and Chile during the 1970-1987 period. These two countries experienced very similar economic development problems up to the mid 1970's, while they were following an import substitution strategy. This strategy favored a protectionist and interventionist role of government. Then, in both countries, military take-overs took place, to among other things, change the economic development strategies. In Argentina, the move towards a relatively free market economy, lasted only until 1981, and then country went back to pre-1976 economic policies. In Chile, while experiencing in the early 1980's a deeper financial crisis than Argentina, the so called Social Market Economy, survived. As a result, financial policies in both countries were very different during most of the study period. The exception was during the 1977-1981 liberalization in Argentina. This comparative study provides therefore a unique opportunity to draw some lessons on financial development from the experience of two middle income countries of similar cultural and historic background.

In the text the expressions financial and capital markets are used very loosely, largely because it is so done in the development literature, but also, because in Argentina and Chile, more so in the first than in the second, capital markets are relatively under-developed. Depository institutions (commercial banks and finance companies), like in most developping countries, dominate financial markets, and become almost synonymous of the total. However, the last

section of the paper deals with relatively interesting developments in the Chilean capital market, and there the term is referred to the share (and other variable return investment papers) market.
Space limitations, as well as style, determined the presentation of the data in the paper. The basic and (where possible) comparable information is presented in a Statistical Appendix. This information is, with very few exceptions, not repeated in the text, to make the reading easier. However, the main variables are shown in graph form early in the paper, and in a few other scattered places. Moreover, the paper, draws heavily on work by others, and on two reports written by the author on the financial liberalizations of Argentina[1], and Chile up to 1982[2]. The information presented in previous studies on the subject, used for the analysis, is normally not repeated in the text, but the reader is referred to the source.
The paper is organized, besides this introduction, in two big "chapters". The first "chapter" summarizes the main overall economic development features of the two countries during the period of study. The second "chapter" relates then the financial developments to those features. Each "chapter", in turn, is divided into two parts, one referring to Argentina, and the other to Chile. Constantly, during the description of events, comparisons between the two experiences are highlighted.
Some striking lessons, confirming established theory, but also suggesting new approaches to capital market development, emerge from the study. Argentina had, during most of the period analyzed, a severely repressed financial system, while Chile liberalized its internal financial market early during its overall liberalization experience. As a result, and as expected, financial deepening, as measured by official indices (money to GDP ratios) almost trippled in Chile, while it declined by about 30 per cent in Argentina. Moreover, during the brief liberalization in this latter country, financial deepening indices increased significantly. In the case of Argentina,

[1]Lüders (June 1986)
[2]Lüders (September 1986)

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the effects on these indices of the interest rate fixing was aggravated by extremely high financial intermediation costs, in all likelihood a reflection of lack of competition in the financial sector. During the first phase (1974-1982) of the Chilean financial liberalization, interest rates rose to extraordinary levels, contributing decisively to the severity of the 1982-1983 financial crisis. The paper illustrates that these high rates are not "caused" by the liberalization, but by macro-economic conditions and management, but also that in the event of a liberalization, their level should become a policy concern. Financial liberalization, the study suggests, is probably not sustainable if a country has, as Argentina did, a large public sector deficit. If fiscal discipline exists, as in Chile, governments will not be tempted to crowd out the private sector to finance the deficit, and they can avoid either business insolvency, balance of payments problems and/or inflation, without having to intervene directly in the financial markets.

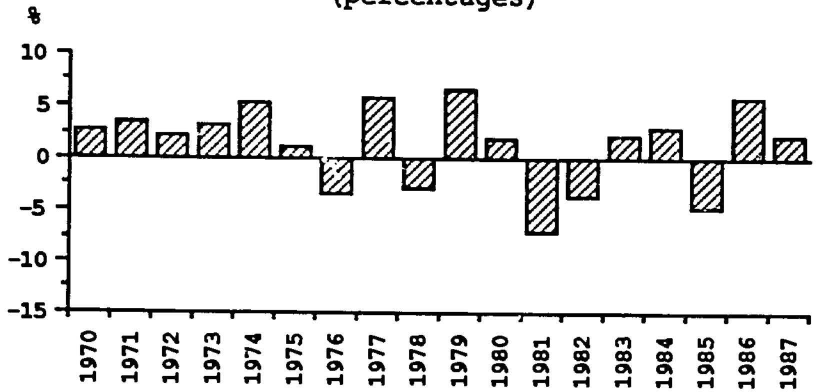
It was found out that in countries in which state owned (SOE's) constitute an important proportion of the business enterprise sector, like in those studied and most other Latin American countries, privatization can become a very powerful instrument for capital markets development. This can be achieved, as the case of Chile suggests, if a significant privatization takes place, and privatization methods are selected to spread ownership. Even more, foreign indebted countries can through a debt to equity conversion mechanism, generate a capital market development process, while at the same time contribute to reduce the burden of the debt.

Finally, some lines about the overall relationship between the particular financial policies followed, and the observed growth rates in Argentina and Chile. The increase in the Chilean financial savings rate is impressive. Moreover, the development of the formal financial market, as well as the existence of a positive interest rate, must have contributed to total savings and investments (other factors constant). However, the behavior of the remaining macro-economic variables (terms of trade, changes in permanent income expectations, the financial crisis, etc.) overshadowed these effects, and the resulting average savings and investments rates, over the whole period of study, are relatively low. The trend of these rates during 1979-1981, and 1985-1987, could perhaps be encouraging. In Argentina, on the contrary, savings and investment rates have been declining ever since the mid 1970's, although during 1978-1980, together with the financial liberalization, considerable financial deepening took place. More important perhaps, since financial policies are (and were, in the cases studied) an integral part of the overall economic development strategies--a free market economy is not conceivable with heavily intervened financial markets, and a relatively centralized economy requires government controlled financial institutions--the resulting growth rates might perhaps help to answer the implicit question posed at the beginning of the paragraph. Over the whole 1970-1987 period, GDP grew by about 22.5 per cent in Argentina, and 50 per cent in Chile. Moreover, between 1980 and 1987 , chosen to suggest the speed of recovery from the crisis, GDP dropped by 5 per cent in Argentina, and has grown 10 per cent in Chile. If, to measure the same, the annual rate of growth in GDP from the lowest point (1982 in Argentina, 1983 in Chile) is preferred, these turn out to be 1.5 per cent for the former, and 4.9 per cent for the latter.

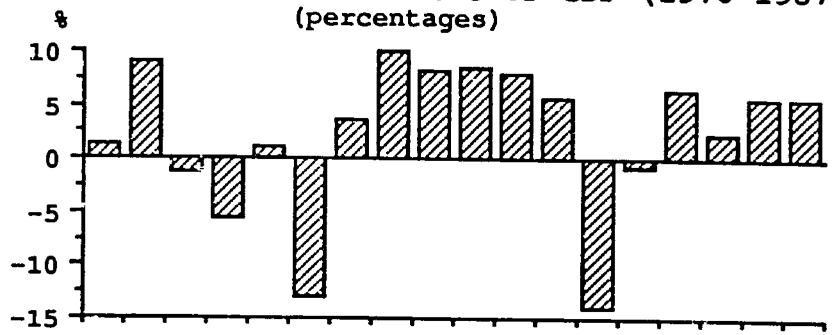
1970-1987: STOP AND GO DEVELOPMENT POLICIES IN ARGENTINA, AND A CLEAR CUT ECONOMIC LIBERALIZATION IN CHILE

In this section of the paper a description of the development policies of Argentina and Chile is presented, to relate to them later the capital market and financial policies of these countries. As background information, a series of graphs, providing basic

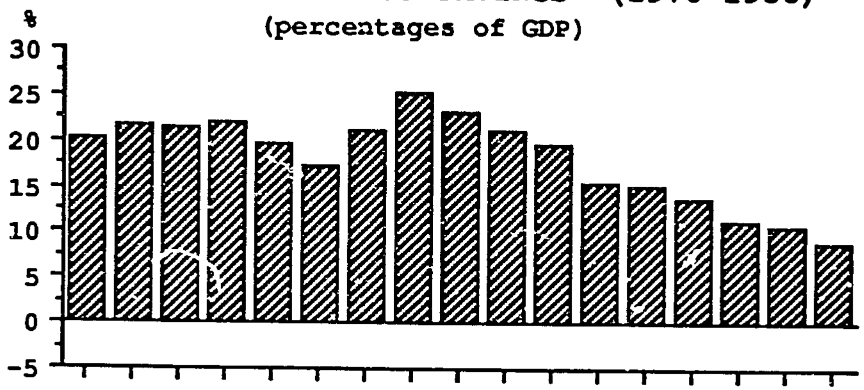
1. ARGENTINA:RATE OF CHANGE OF GDP (1970-1987)
(percentages)



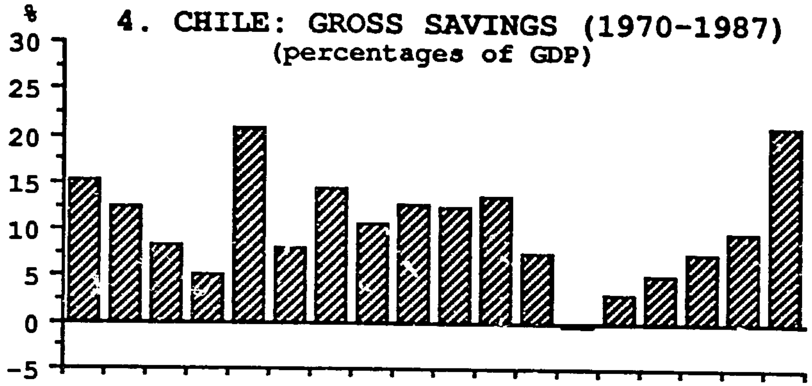
2. CHILE: RATES OF CHANGES OF GDP (1970-1987)
(percentages)



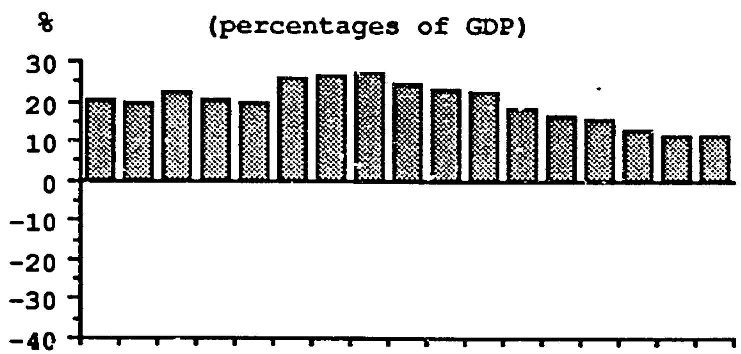
3. ARGENTINA: GROSS SAVINGS (1970-1986)
(percentages of GDP)



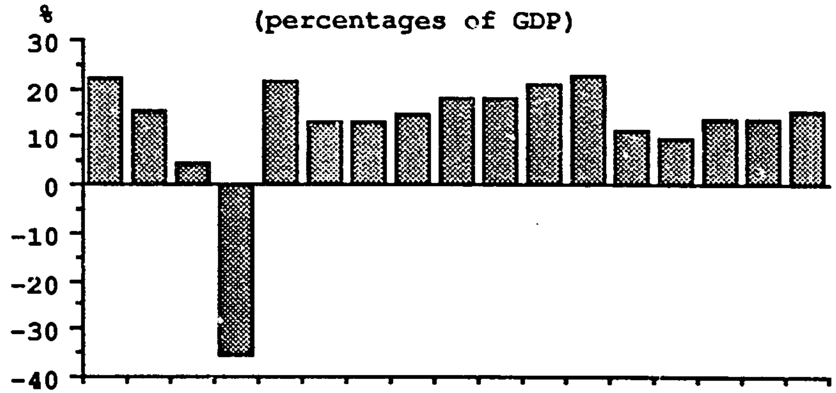
4. CHILE: GROSS SAVINGS (1970-1987)
(percentages of GDP)



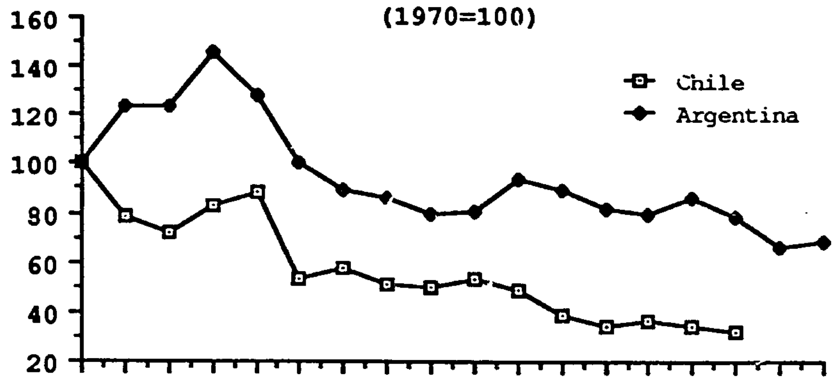
5. ARGENTINA: GROSS CAPITAL FORMATION (1970-1986)



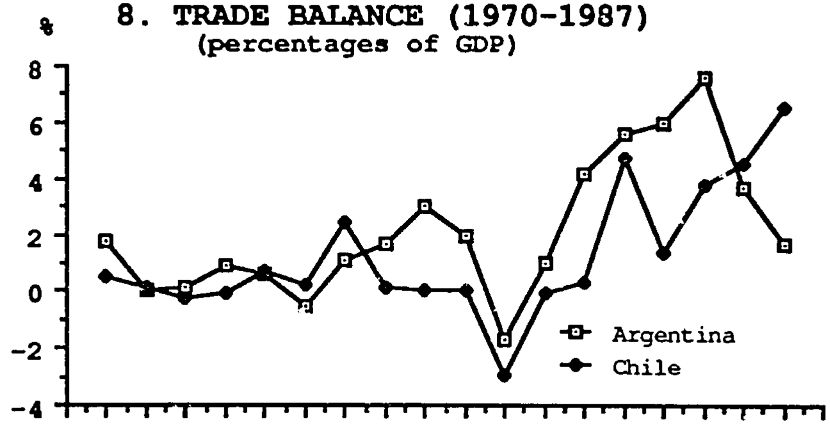
6. CHILE: GROSS CAPITAL FORMATION (1970-1986)

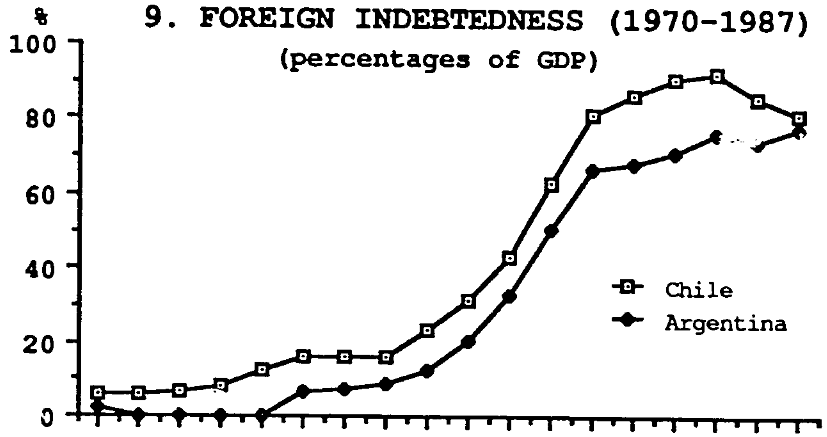


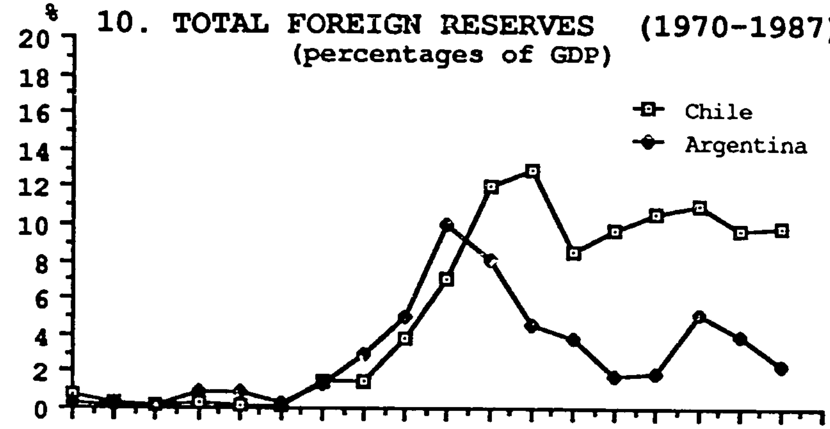
7. TERMS OF TRADE

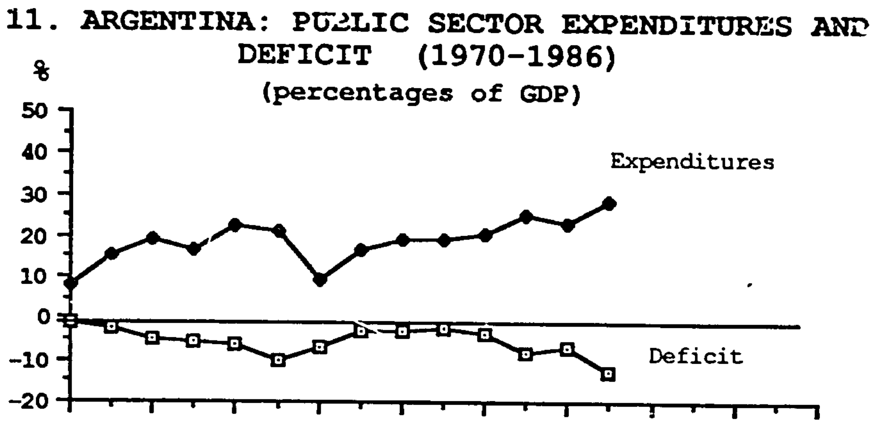


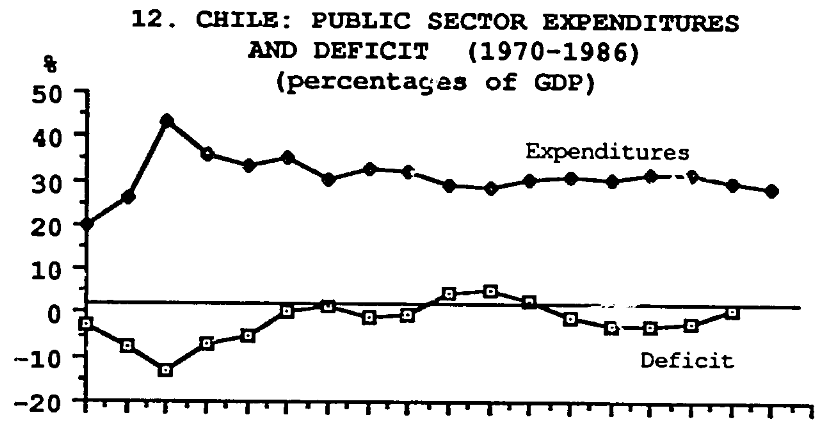
8. TRADE BALANCE (1970-1987)




9. FOREIGN INDEBTEDNESS (1970-1987)
(percentages of GDP)
%
100
80
60
40
20
0
Chile
Argentina


10. TOTAL FOREIGN RESERVES (1970-1987)
(percentages of GDP)
%
20
18
16
14
12
10
8
6
4
2
0
Chile
Argentina


11. ARGENTINA: PUBLIC SECTOR EXPENDITURES AND DEFICIT (1970-1986)
(percentages of GDP)
%
50
40
30
20
10
0
-10
-20
Expenditures
Deficit


12. CHILE: PUBLIC SECTOR EXPENDITURES AND DEFICIT (1970-1986)
(percentages of GDP)
%
50
40
30
20
10
0
-10
-20
Expenditures
Deficit

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macro-economic information, are shown. The data used to prepare these graphs can be found in the Statistical Appendix.

Argentina: a case of policy reversal

One hundred years ago Argentina was one of the ten richest countries in the world. Its **per capita** income reached 73 per cent of that of the USA. Today it barely exceeds 35 per cent of the same[3].

The import substitution policy of the 1940-1976 period

Argentina is a richly endowed country, and therefore most analyst attribute the relatively bad performance of its economy to the application of wrong economic policies. Since the 1940's and up to 1975, Argentina followed the so called "import substitution" development strategy[4]. This strategy was adopted by most Latin American countries as a reaction to the catastrophic effects of the Great Depression of the 1930's. The strategy consisted in promoting industrialization through protective custom duties. The policy package associated with this strategy included the creation of state owned enterprises (SOE's) to produce strategic inputs for the industrialization process (steel, petroleum, electricity, etc.); public sector credits at subsidized rates to foster private sector investments in industry; commercial bank credit realization for industrialization; import taxation of "luxury" goods to "save" foreign exchange; foreign exchange controls; etc. This discriminatory government intervention in the economy had to increase through time, as the import substitution became more difficult. The strategy also included income redistribution measures, such as wage and price controls, and a steeply progressive income taxation, starting at

[3]Bradford De Long, J. "Have Productivity Levels Converged? Productivity Growth, Convergence, and Welfare in the very Long Run.". Working Paper No. 2419, National Bureau of Economic Research,Cambridge, Massachusetts. October 1987. Page 18.

[4] Luders, R. J. "The Economic Comission for Latin America:its Policies and their Impact" Conference on Fiscal Policy, Carnegie-Rochester, April 1976. .

relatively low income levels. Normally price distortions generated by the system were compounded by controls imposed to check the inflationary process generated by associated to public sector deficits.

In Argentina the import substitution strategy was adopted during the mid 1940's by the then authoritarian President Juan Domingo Perón. It was still in effect --in spite of a few, temporary efforts to modify it-- during the early 1970's, when the aged Perón returned from exile. He was elected to return Argentina on a path of growth, price stability and economic welfare. During his absence the country had experienced relatively low average rates of economic growth, increasing, and eventually very high, rates of inflation, and growing balance of payments problems.Perón and his wife Isabel Martinez, who assumed the Presidency after his death, were unable to reverse the trend in the economic variables, because they were unwilling and/or unable to produce a drastic change in the policies that had been followed. Conditions reached a crisis stage, and on March 24, 1976 a military take-over took place[5].

The economic liberalization experiment of 1976-1981

The new Military Government appointed José Martínez de Hoz Economic Minister, who lead a relatively brief period (1976-1981) of economic liberalization. A few years before, the economic team of General Pinochet had initiated, although with more vigor, but for similar reasons, the same task in Chile. The Chilean liberalization policy has been mantained up to now, in spite of the negative impact of two deep "imported" recessions and some macro-economic management errors. In Argentina, on the contrary, the failure of the liberalization effort of Martínez de Hoz, for reasons to be given, resulted in an economic policy reversal towards interventionist and protectionist development strategies. Therefore, the economic model in Argentina is today very different from the one in Chile.

[5]Luders (June 1986) pp.26-27.

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Beginning in 1976, Martínez de Hoz did aim to transform the protectionist and interventionist economic development strategies of Argentina. He intended to limit government intervention in the economy to the "proper functions" of the state, which he understood to be the provision of guidelines to the private sector, by means of monetary, fiscal, exchange rate and commercial policies. He also intended to correct the existing price distortions by reforming custom duty regulations. Finally, the government tried to reduce drastically the rate of inflation, without affecting the rate of unemployment. The first two objectives reflect the governments intention to liberalize the economy, while the third pointed towards fiscal discipline. During the four years of the liberalization experiment, substantial progress was achieved in some aspects. The exchange rate was unified early in the period, and foreign capital movements were freed. Taxes on exports were eliminated, and domestic taxes were reimbursed to exporters. Price controls were eliminated early, and wage and interest rate controls remained only during some time. The exchange rate was fixed, up to 1978, as a crawling-peg on the basis of past price movements, and then, as an active-crawl-reduction scheme based on the pre-announcement of future rates of depreciation (known as the "tablita"). The last "tablita", announced in late 1980 and to be in effect during several month of 1981, had a low implicit inflation rate[6].

However, progress was slow, or nil, in some other aspects. After eliminating some "water" from the tariff scheme during 1976, in 1978 a tariff reduction program was announced, to come into effect over a five year period starting in 1979. But by 1980 the average tariff rate on manufactured products still exceeded 50 per cent, although some progress was made to replace import quotas, prohibitions and licenses for tariffs. In spite of a significant increase in tax revenues, and a temporary reduction in the public sector deficit from 14.1 per cent of GNP during 1975, to 9.0 per cent during 1979, the

[6] Luders (June 1986) pp.29-33.

same increased again to 16.4 per cent during 1981[7]. The inflationary pressures of these deficits were temporarily reduced, initially through internal indebtedness, and during 1980-1981 through foreign indebtedness.

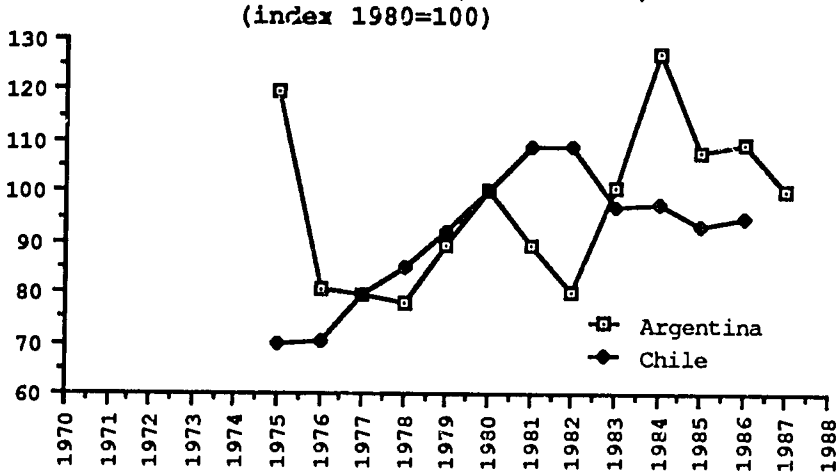
By 1980 Martínez de Hoz had achieved a relatively free financial system, free international capital movements, and a reasonably freely working labor market. However since there was only a relatively modest change in the protectionist trade policies of the past, the implementation of the order of the liberalizations seems to have been exactly the opposite from that considered desirable by most experts[8]. Moreover, the size of the public sector had rapidly grown, few and relatively minor privatizations had taken place, and the (high) public sector deficit remained unchanged. Lead by the public sector, total expenditures in the country had grown, while at the same time the inflation rate had been reduced slightly below the three digit level, and unemployment had reached record low's. However, these achievements were obtained at the expense of a somewhat reduced investment rate, and a very significant foreign indebtedness[9].

[7]Cavallo and Peña (1983) pp.39-78.

[8]See Edwards (1985), Edwards and van Wijnbergen (1983), Khan and Zahler (1985), Mackinnon (1982), and Mussa (1983), among others.

[9] See Statistical Appendix.

14. REAL WAGE INDEX (1975-1987)
(index 1980=100)



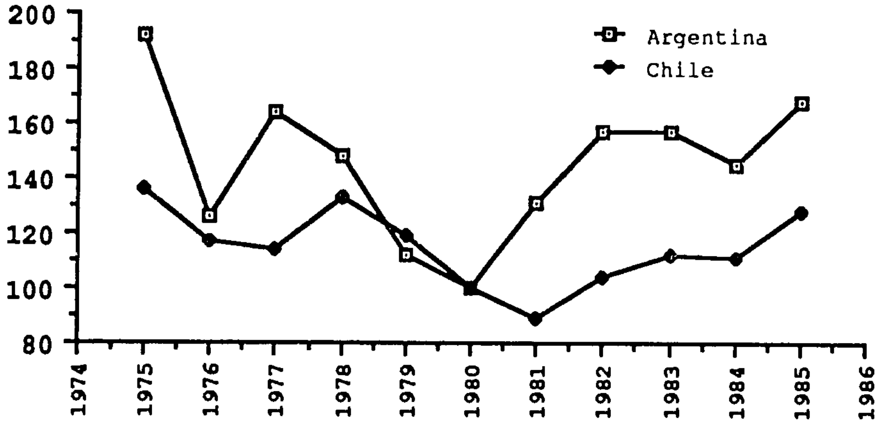
<u>The economic and financial crisis of 1981-1982.</u>

The foreign debt of Argentina increased during the Martínez de Hoz period to about US$ 36.6 billion, from US$ 8.2 billion in 1976. This phenomenal increase parallels that of most other Latin American countries, including Chile, suggesting its relationship to a supply of foreign funds shock. The shock had its origin in the recycling of the petro-dollars. Nevertheless, there also had to be willing takers of those funds to explain the indebtedness levels reached. The nature of these takers varied from country to country, as well as the reason for their willingness to get into debt. In the case of Argentina, two phases can be distinguished. A first period, up to 1979, when the government financed a significant part of its deficit by increasing its internal indebtedness level, and by crowding out the private sector[10]. This sector then took advantage of the freing of the international capital movements, to finance part of its own expenditures through foreign indebtedness. After 1979, the government financed its deficit mainly by increasing the debt of public sector firms directly abroad. The private sector, betting that the government, because of the size of its deficit, would, rather sooner

[10]Cavallo and Peña, <u>ibid.</u>

than later, have to abandon the "tablita", grabbed those foreign funds (which had to be monetized to pay for the government expenses in pesos) and generated during 1980-1981 a record capital flight of about seven billion US dollars. In the process, interest rates in Argentina

15. REAL EXCHANGE RATE INDEX (1980=100)



rose significantly, reflecting devaluation anticipations[11].

In early 1981, economic uncertainty was compounded by political events, since a change of government was about to take place. The rise in the interest rates, and the dramatic change in relative prices between tradables and non-tradables brought about by the massive inflow of foreign resources (and their effect on the real exchange rate), had started a financial crisis. Many businesses were not any more in a position to service their debt because of the interest rate level, but also a significant proportion of these were facing operational losses. Some of the largest financial institutions in the country, unable to finance their losses due to non-performing assets, were intervened by the Central Bank. Since the Bank was guaranteeing deposits, pressures on the foreign exchange market increased even more. The country was loosing its foreign exchange reserves very rapidly, in spite of the also rapidly rising (and already very high "real") interest rate. Since the incoming government, also military,

[11]Luders (June 1986) pp.38-46.

did not declare its support to the existing "tablita", pressures on the foreign exchange market became unbearable, and the peso was devalued. The liberalization experiment --never completed, unaccompanied by the necessary fiscal discipline, and perhaps involuntarily tied in the minds of the population to a certain (mistaken) exchange rate and macro-economic policy-- had in fact ended. The country was submerged in a deep economic and financial crisis, reflected, among other things, in GDP declines of 7.1 and 3.8 percent during 1981 and 1982 respectively.

The long and slow recovery from the economic crisis (1982-1988)

Following the devaluation, Argentina returned gradually to the economic system prevailing before the described liberalization episode. The banking system, as we shall see, was operating before 1976 as a 100 per cent reserve system. After the devaluation of 1981, the desire to sterilize the monetary base expansion associated to the fiscal deficits and to the commercial bank rescue operations, induced the Central Bank to raise, during the second semester of 1982, reserve requirements again to 100 per cent.Although they were later reduced, they averaged close to 75 per cent since then. In addition, interest rates were again fixed by the authority on most banking operations, and the government intervened heavily in the credit allocation. Inflation rates, in spite of the partial sterilization described before, rose rapidly, and selective price fixing was again introduced. Wage levels were regulated by the authorities. Foreign capital movements, on a voluntary basis, became unthinkable after the international financial crisis broke out during 1982. That is, the country returned to a relatively closed economy, with heavy (and discriminatory) government intervention in the financial sector and in the determination of basic prices (interest rate, wage rate, foreign exchange rate). The public sector continued to play an important role in the management of the large existing SOE's[12].

[12]Artana and Szewack (1988).

Within this basic economic framework, and faced with rapidly declining terms of trade[13], the governments of Argentina tried to solve the problems generated by the economic crisis (solvency of the banking system, over-indebtedness of the private sector, and the level of the foreign debt of Argentina), as well as to satisfy, in the **relatively short run**, the main economic demands of the citizen (full employment, significant real wage increases, and price stability). These latter demands, in all likelihood, weight more heavily in the Argentine economic policy making decision process then in the Chilean. In Argentina, the government had changed to civilian hands during 1983, possibly as one consequence of the War of the Malvinas (Falkland). The Chilean government, strongly in power, was in a position to take a longer view on such demands and, in part perhaps because of it, to satisfy them better and sooner.

It is well known that internal adjustment to strong adverse foreign shocks (terms of trade, international capital movements) is no easy task. Argentina, faced with "political" restrictions, found out that more often than not, because the basic desequilibria had not been eliminated, an acceptable solution to any one of the problems inherited from the crisis generated another problem. For example, the solution to the **internal indebtedness problem** was obtained by fixing the interest rate, both on deposits and credits, while the rate of inflation was allowed to rapidly rise. The resulting income transfer from depositors to creditors reduced, as expected, the debt to equity ratio of the business enterprise sector to "normal" levels, but at the cost of a big inflationary push, and a rapid reduction in the financial deepening levels[14]. Another example. Aggregate demand management policies to have at all times a reasonably **low unemployment** rate (a first priority in Argentina) and **"high" wages**, given the severe foreign resource restriction, contributed decisively to the rapidly increasing inflation rate during 1984-1985, and the dropping

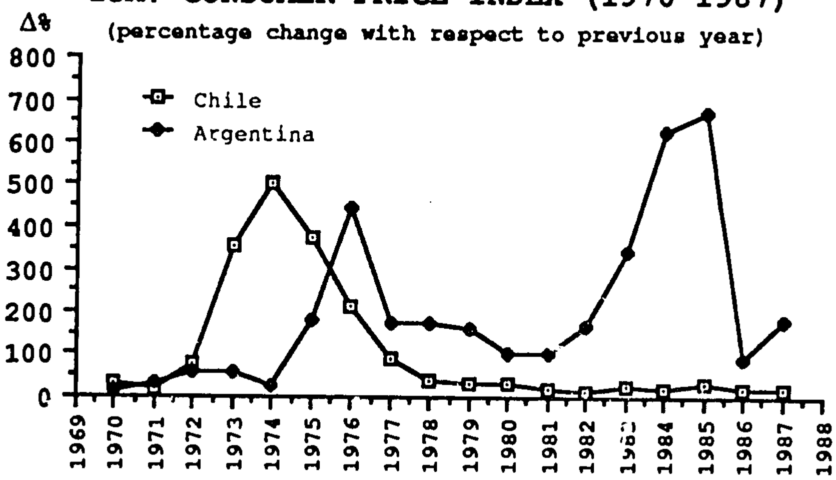
[13]See Statiscal Appendix.
[14]Baliño (1988).

savings-investment rate during whole 1982-88 period. Finally, the different solutions tried to the **foreign indebtedness level** (which have included a debt service suspension and the temporary decision not to negotiate with the IMF) actually might have worsened the yearly foreign exchange restrictions, if compared for example, to the case of Chile, which adopted the opposite stance. Very little progress was made on this front. As a matter of fact, the effect of the uncertainty generated by such negotiations on foreign trade and direct investment operations, in all likelihood, reduced the availability of such resources. To compensate, Argentina had to keep the real exchange rate at "higher than necessary" levels, which produced of course additional short-run pressures on the rapidly increasing price level[15].

<u>The Plan Austral.</u>

15A. CONSUMER PRICE INDEX (1970-1987)

(percentage change with respect to previous year)



Inflation eventually reached in Argentina in 1975 almost 700 per cent per year. Late that year, the government of Raúl Alfonsín tried an "unorthodox" anti-inflationary program (the Plan Austral), aimed at practically **stopping the inflation** from one month to the next. To this end, prices were frozen, a monetary "reform" was implemented, wages

[15] It is interesting to notice that between september 1986 and may 1988 (period with available data) the price of the foreign debt documents declined in the case of Argentina from 64 to 28 , while in Chile they moved from 67 to 60 .

were fixed to eliminate undue cost pressures, nominal interest rates were adjusted, and some measures were announced to reduce the public sector deficit and increases in the money supply. The fiscal measures taken, modest to make them politically acceptable, turned out to be obviously insufficient to control the budget deficit to the extend required by the price freeze. In addition, some features of the Plan were attracting foreign resources, and thereby producing an unanticipated increase in the supply of money[16]. As a result, the failure of the program became evident to most economic agents only month after it had been announced. That is, after a sharp reduction in the rate of inflation to about 90 per cent during 1986, it accelerated again, to reach during early 1988 annual levels which even exceeded those of 1976 and 1985.

The failure of the Plan Austral must have convinced the economic team of the governing Radical Party that it had to change its strategy[17]. A similar change, with an even stronger emphasis on free markets and fiscal discipline, was also favored by the Liberal Party, which since the crisis had been constantly gaining popular support. The climate for a reformulation of the economic policy in Argentina can be explained because the results of the strategy applied after the crisis has been discouraging: unemployment, still relatively low, was rising; wages, temporarily higher, fell to their 1980 levels during 1987; the economic growth rate, although still positive, was low and on a declining trend; the savings and investment levels were at an all time low[18]; and only one problem of those generated by the crisis, the high internal indebtedness level, had probably been solved[19].

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16 Lanús de la Serna (1987).

17 It has been reported that Argentina has recently reached an agreement with the IMF. It also has been privatizing some of the larger SOE's. Moreover, the government has announced measures to gradually free some aspects of the financial and international trade markets. It is, however, at this time impossible to judge how deep these liberalizing changes will become.

18 See Statistical Appendix.

19 Baliño, ibid., estimated that during the mid-1982 to end 1983 period borrowers benefitted from the interest fixing scheme at the

Chile: a market economy for a developing country

Chile's economic development record over the long run is only slightly better than that of Argentina. Its per capita income was 50 per cent of that of the USA in 1870, while in 1979 it reached about 29 per cent of the same. However, after the financial crisis of the early 1980's Chile has recovered significantly faster than Argentina and most other Latin American countries. The relatively slow long-run average rate of growth in Chile has been attributed in large part to the results, and effects, of the import substitution economic development strategy applied during 1940-1973[20]. The fast recovery from the recent financial crisis is related to the fiscal discipline and the Social Market Economy presently followed.

Economic policy under Allende

Chile adopted the import substitution economic development strategy package described above in the late 1930's, even before Argentina did so. During the following decades the degree of protectionism and government intervention in the economy increased faster, and became deeper, than in most other Latin American countries, although the process was not necessarily continuous. During the 1960's the intervention got as far as to affect property rights, by way of a land reform[21]. During the late 1960's, since results of the application of the import substitution strategy package were not satisfactory, the population begun to consider other options, both to the right as well as to the left. Then, in 1970, the country elected a marxist socialist president, Salvador Allende, with over 30 per cent of the popular vote. Allende's economic team deepened significantly the protectionist

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rate of 10.8 to 13.4 percent of GDP, while holders of deposits lost the equivalent.

20 Ibañez, P. and Luders, R.J. "Hacia una Moderna Economía de Mercado, diez años de política económica 1973-1983", Política, Santiago de Chile, Noviembre 1983..

21 Over sixty percent of the arable land was eventually expropiated by the land reform process . Owners were paid tax assesment values with long term bonds, wich were sold at the market at a very high discount.

and interventionist policies that had been followed[22]. This, together with the political consequences of his election, and a disastrous macro-economic management, generated a mayor socio-political and economic crisis: during 1973 GDP dropped by 5.6 per cent; the fiscal deficit reached 25 per cent of GNP, and the rate of inflation increased to 353 per cent (which was at that time very high, even by Latin American standards); foreign reserves had all but disappeared; etc. The relatively scarce popular support of the regime dwindled, and when Allende tried to impose some unconstitutional measures, Congress and the Supreme Court in effect invited the military to intervene.

The Social Market Economy

The military opted from the beginning for a market economy. To institutionalize this economy (Social Market Economy) they chose an economic team whose members changed from time to time, but whose leaders were known as the Chicago Boys, because a high proportion of them had been trained at the University of Chicago.

The economic team, lead by Sergio de Castro, who himself operated initially behind the scenes, and between 1976 and 1982 as Minister of Finance, concluded that the import substitution economic development strategy had to be drastically changed. In particular, the role of the state had to be reduced to the bare minimum, that is, to perform those tasks necessary to achieve the common good which the private sector cannot or will not perform. Private initiative, freedom of choice and, initially, increased investment financed with foreign resources, were to be the key elements of the new development strategy.

Between September 13, 1973 and the early 1980's, the past protectionist and interventionist regime was dismantled, to be replaced by a relatively liberal economy. This move enjoyed initially considerable support, because the experience under Allende had been so

22 This included the nationalization and/or management intervention of about 500 medium and large sized industries.

rate, the falling economic activity levels, the rising unemployment levels, the insolvency of business enterprises in the tradable sectors, the relatively slow reduction in the price and wage rate levels,etc. eventually induced the President to accept the resignation of Sergio de Castro as Finance Minister, and soon thereafter, to devalue (May 1982)[25]. The "automatic macro-economic adjustment" mechanism had been abandoned, but, unlike the case of Argentina, the Social Market Economy was going to be saved. This, in spite of the fact that during 1982 real GDP dropped by 14.1 per cent, the unemployment rate increased from 9.0 to 20 per cent (together with a significant increase in the official "minimum" employment program), and real wages started to fall.

Adjustment and growth

During the remainder of 1982 and the following years, the government centered its attention on the foreign resource restriction and the engineering of the recovery of the deeply hurt financial system. The private sector, through the free workings of the markets for goods, labor and credit, was to carry the main burden of the adjustment (profit rates fell dramatically during 1982-1984, and wages dropped steadily up to 1987)[26]. Although some tactical compromises were reached with some sectors (especially in foreign trade), the basic elements of the free market economy were not only retained, but during the last three years actually reinforced (for example, the privatization process has been significantly deepened). Public sector expenses were also temporarily increased, especially in public works, housing and social items, but during the last few years the public expenditure to GDP rate has again been steadily declining[27]. Great care was taken to have the full-employment budget in balance. So much so, that during 1988 a surplus is again likely, in spite of the requirements imposed by the change in the social security system, and

25 Luders (September 1986).
26 See Statistical Appendix.
27 See Statistical Appendix.

the after the crisis transformation of the income tax into something like a progressive expenditure tax at the same rates. As was expected, both of these latter structural changes contributed to increase the traditionally low Chilean savings rate.

The effort to **rehabilitate the financial system** will be analyzed below. At this point it is sufficient to indicate that the rescue operations of most institutions, and the bail out to depositors (and foreign lenders), was not unrelated to the need to ease as much as possible the previously mentioned **foreign exchange restriction**. The strategy to achieve this latter included three key elements: on the one hand, as in Argentina, a "high" real exchange rate policy was adopted to expand exports as fast as possible. This policy required low custom duties, which were so mantained in Chile, in spite of a temporary deviation[28]. On the other hand, renegotiations of the foreign debt with the international banking community took place. Conditions (spreads, new money,etc) of these renegotiations were similar to those of the larger Latin American countries (with the exception of Mexico), in spite of the fact, that Chile's debt as percentage of GNP was the highest[29]. Differing from Argentina, the negotiations with the IMF were seen by Chile as one essential condition to achieve this objective, while fiscal and monetary discipline was not only considered desirable in itself, but also as one element which would aid these negotiations, and therefore help to overcome the foreign resource restriction. Finally, the country increased sharply its credit operations with tne official Washington based banks (World Bank Group, Interamerican Development Bank), operations which had been almost suspended during the 1970's. The strategy followed allowed Chile to expand, after the crisis broke out,

28 Custom duties, wich remained at 10 percent during 1982, were raised, and during 1984 temporarilly reached 35 percent. They have since then been reduced to an even 15 percent. At the same time a ten percent draw-back has been institutionalized on non traditional exports.

29 See various issues of ECLA, " Balance Preliminar de la Economia Latinoamericana".

imports fast enough to grow since 1984 at very reasonable annual rates, and at the same time reduce, during 1986-1988, its foreign indebtedness level as a percentage of GDP and exports[30]. This satisfactory result was perhaps achieved because the strategy adopted generated confidence in the country's ability to solve its foreign resource restraint, and as a consequence, also its development problem, and therefore produced a partial reversal of the capital flight of 1982, as well as a relatively important flow of direct investment[31].

The recovery has been successful on almost all accounts. The solvency of the Chilean financial system has been reestablished[32]. Financial deepening reached record levels, and an interesting institutional capital market is emerging. The success in dealing with the foreign resource restriction has already been noticed. As a result, and also due to adequate and timely private sector adjustments, GDP has been growing around 5 per cent per year since 1984. Fiscal discipline has allowed the inflation rate to remain at rather modest levels, if compared to Latin American standards, and its 1987 level of 21.5 per cent was only slightly higher than the relevant international inflation for Chile. Starting in 1984, employment creation has been impressive, and the unemployment rate (still relatively high) is approaching pre-crisis levels. Of course, salary levels are lower (reflecting the adjustment to the deteriorated terms of trade and the diminished foreign resource flows), but they are now expected to begin to increase, together with the already rising (but still low) net investment levels.

FINANCIAL REPRESSION AND CAPITAL FLIGHT IN ARGENTINA, AND A REASONABLE FINANCIAL DEVELOPMENT IN CHILE

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30 See Statistical Appendix.

31 Debt to equity swaps were 303 million US$ during 1986, and 674 million during 1987, while other direct investments averaged 340 million dollars during the same years.

32 See the section on the chilean financial system below.

Developments of the financial systems of Argentina and Chile were, of course, heavily influenced by the overall economic development strategies adopted. Moreover, specific financial sector policies in the two countries were generally consistent with the basic ideological principles of the overall framework. That is, in Argentina, except for the 1976-81 liberalization period when financial markets were substantially deregulated, during the study period the formal financial system was heavily controlled by the government. Real interest rates in the banking sector were generally negative, and below those to be obtained on foreign assets or in the informal local markets. The system was "repressed", and informal financial operations (including capital flights) became at times very important. Argentinian private holdings of financial assets (in the country and abroad) increased from about 36 per cent of GDP in 1970, to a recent peak of 49.44 per cent in 1982, while monetary assets (the main component of the official financial market) to GDP ratio fell during the same period from about 23 to 13 per cent[33]. Most of the difference in this ratio over time can be attributed to capital flight. According to one estimate foreign currency holdings by Argentinians abroad are estimated to have increased from less than one billion dollars in 1970, to over 17 billion dollars during 1983[34]. Others estimate that today they stand around 30 billion dollars, which would be well over 30 per cent of GDP[35].

In Chile, on the contrary, the financial market was gradually freed after September, 1973 together with the other markets of the economy. Since late 1975 interest rates have been completely free, positive in real terms, and competitive with rates of return on foreign assets. Since the market continues to be regulated in some ways, described later, some informal activity continues to take place. This is,

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33 Arriazu (1988).

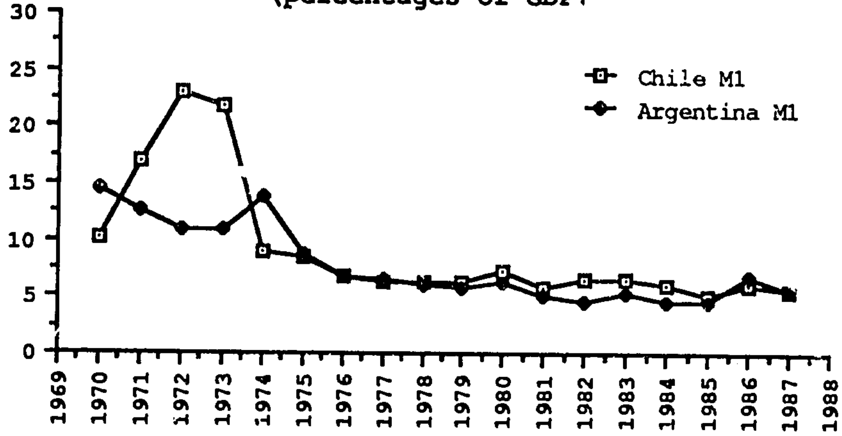
34 Arriazu, <u>ibid.</u>

35 Lanús de la Serna (1987).

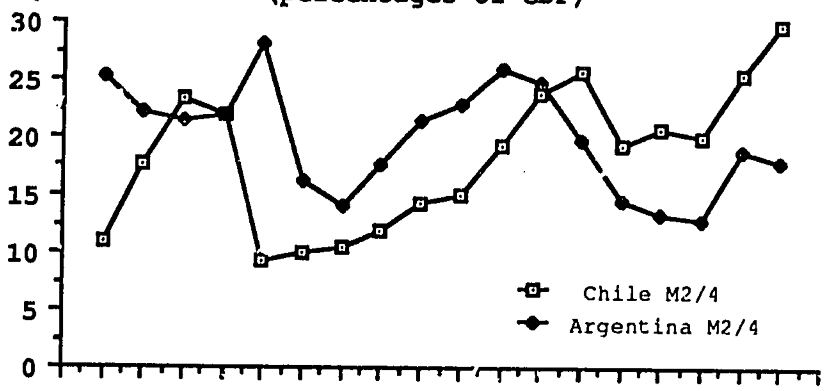
however, relatively insignificant in terms of the size of the formal market.

Next two graphs are shown, representing for Argentina and Chile the relationship between monetary assets (narrowly and broadly defined) and GDP. These relationships are very often used as financial deepening indices. They have a real economic meaning, among other

16. FINANCIAL DEEPENING INDICES: M1
(percentages of GDP)



17. FINANCIAL DEEPENING INDICES: M2 and M4
(percentages of GDP)



reasons because the amounts of money and banking sector credit go hand in hand. The M2 definition of money for Chile comes as close as possible to the M4 definition in the case of Argentina, although it is somewhat more narrow[36]. The sharp increase in monetization in Chile during 1971-1973, the Allende period, is not a reflection of an increase in the demand for money, but instead it is the result of a supply of money shock in a completely closed economy, in which the government allocated goods by coupons at fixed prices.

The M1/GDP indeces in both countries are extremely low, and reflect the high expected alternative cost of holding cash balances (presumably mainly for transaction purposes) in both countries. In Argentina, were deposit interest rates were often very negative, the alternative cost is represented by the loss in purchasing power due to the high inflation rates, and/or the real return on holding foreign assets. In Chile, relatively high and positive deposit interest rates reflect the alternative cost well. These M1/GDP ratios of around 6, compare with values of about 12 for Colombia, Korea and Brazil (also middle income countries), and about 16.5 for Germany and the USA.

On the other hand, the money (broadly defined) to GDP ratios of Argentina (15) and Chile (30) differ of course significantly, as do the financial policies adopted. Chile's ratio is higher than Colombia's (18), but below that of Korea and Brazil (about 40), and far from that of Germany and the USA (70). The improvement in the M2/GDP ratio of Chile from 1970 to the present is significant, and the effect of the financial crisis, and the recovery, is clearly reflected. The data for Argentina leave no doubt about the positive monetization effect of the financial liberalization period (which allowed financial sector credit to increase from 13.9 per cent of GDP in 1975 to 33.2 per cent in 1980), and the depressing results of the interest rate fixing periods[37].

[36] The M2 definition of money in Argentina does not include time-deposits, and is therefore very different from the one in Chile, wich does include those deposits. See the Statistical Appendix.
[37] The temporary increase in the M4/GDP ratio during 1986 and 1987 was short-lived, and due to the Plan Austral.

Some aspects of the evolution of the Argentine financial system during 1970-87

In this section some specific aspects of the financial sector of Argentina are analyzed. The financing of the public sector, interest rates spreads, competitiveness of the system, government control over financial institutions, the effects of the deposit guarantees, and the solvency of the financial system have been selected.

No additional mention will be made of the share market, since in Argentina it is relatively small, and has been declining over the period of analysis. For example, the number of companies allowed to issue public documents has declined from 414 in 1970, to 206 last year[38]. In 1971 it was estimated that the total market value of the outstanding shares was only 3.1 per cent of all financial recorded liabilities in the country[39], while during 1987, only 25 million dollars were monthly traded at the Stock Exchange. This volume is equal to that of Perú, while in Chile (with a total GDP of about 1/3 of that of Argentina) 42 million dollars were traded, and in Brazil the equivalent was about 400 million dollars[40]. Moreover, subscription of new shares as a percentage of GDP are negligible in Argentina. The reasons for this decline are several, and the most mentioned include (a) the variability of share prices (and therefore returns) due to the small size of the market, (b) the lack of stable and explicit dividend policies by most business enterprises, (c) low rates of return of the companies net worth, in relationship to other alternatives, and (d) the lack of institutional investors. In this latter market only insurance companies hold and trade shares, and they have been diminishing ,probably for the same reasons as private investors, their holdings.

38 Artana and Szewack (1988).
39 Tami (1978).
40 Artana and Szewack ,*ibid.*

In Argentina, the financial liberalization of 1977 more or less coincides with the beginning of a steady decline in the savings and investments rates, from over 25 per cent (27 for investment) of GDP, to 15 per cent (16.8) in 1982. This decline continued under the heavily repressed financial system existing since then, and reached 9 per cent (11.6) in 1986. The financial liberalization, coinciding with a heavy inflow of foreign resources which reduced dramatically the price of tradables (including consumer durables), induced and allowed the population (and the government) to increase consumption[41].

The impossible public sector deficit

Financial policies in Argentina are closely linked to the financing of the public sector deficit. This deficit had been of the order of 2.5 Per cent cent of GDP in the late 1960's and early 1970's[42]. Perón increased it to about 14 per cent of GDP during 1975, and since then the Argentine governments have only been able to reduce it temporarily. Fiscal deficits, usually smaller than public sector deficits, closely follow the path of the latter.

Except for 1979-1982, which approximately coincides with the last part of the economic liberalization period, the Argentine governments financed their public sector deficits internally. On average, about half of the needed financing was obtained directly from the Central Bank, and therefore turned out to be inflationary. The remainder was obtained from the financial system, especially from the banking sector, crowding out private sector credit. For instance, between 1970 and 1975, the share of public sector credit, in total financial sector credit, rose from about 10 to approximately 19 per cent, while total credit fell from 25 to 14 per cent of GDP. Between 1980 (the last full year of the financial liberalization) and 1985 (the last year before

41 In Argentina the boom period before the crisis is called the "sweet money time", and this "sweetness" is (wrongly) attributed exclusively to the financial liberalizaton, instead to the capital account opening at the time of the petro-dollar shock.

42 Cavallo and Peña (1983).

the Plan Austral) the share of public sector credit rose from about 15 per cent to almost 24 per cent, while total credit as a percentage of GDP dropped from 33 to less than 19 per cent.Notice that during both of these periods of heavy government intervention in the Argentine financial market, credit to the private sector fell by over 10 per cent of GDP. Interestingly enough, during both of these episodes financial sector credit to the public sector did not even grow relative to GDP[43].

The size of the budget deficits were presumably tolerated because governments gave their short-term economic growth, employment, and wage rate policies priority over fiscal and monetary discipline, and did not have political power to raise tax revenues as required by the expenditure levels. Under those circumstances, voluntary financing of the deficits in the internal financial markets would have implied very high real interest rates, to crowd-out private sector credits. These high interest rates would have been obviously counter-productive to their (short-run) economic growth and employment efforts. The alternative solution: intervene the financial system, fix interest rates at low, perhaps even negative, levels, and allocate credit directly, was coherent with their (short-run) objectives. Moreover, the long-run real effects of such a financial repression was, in spite of lessons from other countries experiences and their own history, always underestimated.

Not so by Martínez de Hoz and his team, who decided to institutionalize a **competitive, apt and solvent financial system**[44]. They needed a mechanism to allocate resources efficiently in the market economy they envisaged, and they also had, to reduce the high rate of inflation, to regain control over monetary policy. As a result of financial repression official monetary assets had fallen to a very low percentage of GDP, and the informal financial sector had grown

[43] That is, financial repression reduced the financial deepenig levels, and therefore the finacial credit to GDP ratios.
[44] Luders (June 1986), pp.52-55.

significantly, generating a very unstable demand for (official) money. The economic team was aware that a smaller deficit was necessary to reduce the rate of inflation, and a considerable effort was made to achieve that. However, the increase in the interest cost to the public sector, produced by the freing of the interest rates, offset a large part of the gain. For example, the public sector deficit, net of the cost of the debt servicing, fell from 11.3 per cent of GDP during 1975 to 1.8 per cent during 1978, but the overall deficit was only reduced by 4 percentage points, to 10.1 per cent of GDP, during the same period[45]. The pressure of the deficit on interest rates, as said, attracted foreign resources, which reduced the credit crunch to the private sector. However, soon after, during the second semester of 1979, interest rate spreads between local and foreign interest rates, computed at the existing "tablita", increased sharply[46], and the government decided to finance its deficit in large part directly abroad, to reduce pressures on the interest rate. The foreign capital inflow increased sharply during 1980 and 1981, but the interest rate spread, did not decline, except temporarily during the first semester of 1980. It became evident that the spread was a risk of devaluation premium. The economic agents estimated that a deficit of the prevailing size could not be financed for very long. The effects of the huge capital inflows to finance the deficit, and the relative price distortions and high interest rate (spreads) generated by this scheme, can probably be blamed for an important part of the financial problems of the business sector during 1980-1982. These, in turn, affected decisively the stability of the financial system.

<u>More on interest rates, and competitiveness</u>

As said, negative real interest explain to a large degree the low financial deepening levels in Argentina. The following graph shows

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[45] Cavallo and Peña, *ibid*.

[46] Luders (June 1986), p.132.

real short-term lending interest rates in that country[47]. These rates were also very variable, and sometimes discriminatory, in the sense that at any given time some groups had access to credit at certain rates, while others had to pay higher rates. For instance, a loan of 100 "real units" in 1 ce 1970, could have become, capitalizing interests, at the end of 1983, anything between 895 or .82 "real units"[48]. The average market rate would have given 122 "real units", while a foreign loan would have implied a debt of 156 "real units", but, if the debtor would have purchased a devaluation insurance which was offered by the Central Bank after the financial crisis , the debt would have only been 1.54 "real units". Something similar would, of course, have happened to the depositors or investors. A foreign deposit would have accumulated to 150 "real units", the average market to 2.21 "real units" (a real loss of about 98 per cent of the initial deposit!), and the best financial investment strategy 359 "real units". Obviously the best strategy is only known after the facts, so that the above numbers give a good idea of the average return (or cost) that might have been expected of operating in the Argentinian financial market, as well as the risks involved. These numbers also suggest the reasons for the huge capital flight.

Another important phenomenon in Argentina is the high interest rate spread (deposits to loans)[49]. These spreads usually reflect the competitiveness of the system, and the efficiency of the institutions operating in it. In countries with high legal reserve requirements and/or high inflation rates, they also include the foregone cost of those reserves. In Argentina, with the financial liberalization of 1977, a Monetary Regulation Account was created at the Central Bank to neutralize the effect of the required reserves on the competitiveness of different types of financial institutions. This account soon was used, by paying interests on reserves required on time deposits, to

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47 Since the second semester of 1982, and up to late 1987 the "regulated " interest rate is dominant.
48 Arriazu (1988).
49 Luders (June 1986), pp.77-80.

control the effect of legal reserves on interest rate spreads. This basic mechanism is still in effect today, and nevertheless spreads continue to be extremely high. For instance, during 1978-80 average interest rate spreads were over 20 per cent per year, while during late 1985 they still averaged 15 per cent for the free segment of the financial market. Several reasons exist to explain these high spreads, but the most important are high operational costs. In countries with developed financial markets, the yearly operational costs to total asset ratio of the commercial banks fluctuates around 2, while for developing countries the average is somewhat higher and has a wider range. For instance, in Colombia and Mexico the ratio reaches almost 5 per cent, while in Malasia it is 1.2 per cent. In Chile, for the larger private banks, this ratio is not different from the average ratio in the USA, and it is only slightly higher for the system as a whole[50]. In Argentina, however, during 1985 it reached 8.1 per cent. The puzzling thing is that Argentina has a very large number of financial institutions, which would lead one to conclude that there must be fierce competition. There are over 300 financial institutions (about 200 banks), with about 5000 offices. That is, there are only 155 thousand inhabitants per bank, while Japan has 780 thousand, Finland 683 thousand, Sweden 590 thousand, Italy 395 thousand, and Germany 235 thousand. Chile, in contrast, has only 40 banks, that is about 325 thousand inhabitants per bank, and competition seems to have forced spreads down close to international levels. There are no good overall explanations for these high operating costs in Argentina[51], except for the fact that free competition among the Argentine financial institutions, and between these and foreign banks, has never prevailed long enough to force severe cost cutting measures.

<u>Financial institution solvency in Argentina</u>

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50 Instituto de Estudios Bancarios "Guillermo Subercaseaux", (1984),"Eficiencia del Sistema Financiero. Una Evaluacion Empirica",pp.53-58.

51 However, there are many very good studies analyzing financial intermediation costs in Argentina.

When Martínez de Hoz and his advisers changed the financial regulations in 1977, they aimed, among other objectives, towards a solvent financial system. Perón had nationalized all deposits, and, until the financial reform, banks were operating for the government when collecting deposits. Although bank loans were legally made at the risk of the banks, at highly negative interest rates, as those prevailing at the time, the possibilities of failures were almost non-existent. The reform of 1977, while privatizing all deposits and eventually (1981) reducing average required reserves to only about 10 per cent, institutionalized a government guarantee of 90 per cent of the value of the deposits, above a fully guaranteed minimum. After the crisis had broken out in September 1982, required reserves of all **existing** types of deposits, were again increased to 100 per cent (in effect, similar to the nationalization under Perón). Interest rates on these deposit and reserve operations were regulated by the authority. Loans were made through rediscounting, at rates and purposes also fixed by the authorities. At the same time, "free" deposits were allowed, that is, at free interest rates, but also without government guarantee. For each institution, the proportion of total operations of these free deposits that was initially allowed was only 3 per cent, and, although the original intention was to let this proportion increase rapidly, in fact it grew relatively slowly until late last year.

During the financial liberalization period, in spite of the existence of the government guarantee, of relatively high real lending interest rates, and a rapidly growing financial system (the number of banks almost doubled between 1976 and 1981), the Central Bank of Argentina exercised little control over banking operations, especially over the quality of the loans. Something similar happened in Chile, where the banking supervising authority (Superintendencia de Bancos e Instituciones Financieras) limited its task to make sure the financial institutions were formally fulfilling their obligations. However, one could argue, in Chile no such guarantee as in Argentina existed, and

Minister de Castro repeated, as much as possible in public, that the government would not bail out any bank that failed, and neither would it aid depositors[52]. In any event, this guarantee might have, and in all likelihood did, introduce in the Argentinian financial system moral hazard, inducing banks to take more risks on their portfolio than socially desirable. There is also some evidence that it allowed fraud. When the crisis broke out during 1980 in Argentina, basically because a significant proportion of the financial sector borrowers were not in a position to honor their commitments, several banks just rose the interest rates to cover their non-performing loans[53]. At the same time they probably engaged in riskier (higher expected return) lending. None of these institutions was able to avoid insolvency, and eventually intervention[54]. The governments of Argentina have, since 1981, implemented several schemes to increase the quality of the loan portfolio of the financial institutions, and thereby improve the solvency of the financial system. The most important of these measures were the already mentioned drastic reduction in the real rate of interest during 1982-1983[55], and the exchange rate insurance mechanism (1981). The process does not seem to be completed yet, contrary to the case of Chile, and continuously financial institutions are intervened or merged under official pressure, and with its aid. There is unfortunately no reliable estimate of the total cost to the government of these rescue operations up to now.

Comments on the liberalization, massive intervention, and rebuilding of the financial system in Chile

At the time the military took over the government in 1973, Chilean financial institutions were practically all state owned, interest

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52 However, it did both each time a financial institution was about to go broke.

53 Arnaudo and Conejeros (1985).

54 Luders (June 1986),pp.93-105.

55 As mentioned, the government fixed the nominal interest rate on loans and deposits, while the rate of inflation was increasing rapidly.

rates were fixed by the Central Bank, credit was allocated as decided by this latter institution, and reserve requirements were extremely high. That is, the financial system was, for all practical purposes, nationalized. Within the market orientation of the new economic policy, the system had to be radically changed, and this was accomplished before 1981. Existing local financial institutions were privatized between 1975 and 1978, in such a manner that they eventually were almost all controlled by local conglomerates known as "financial groups"[56]. New banks, most of them subsidiaries of foreign banks, were authorized to operate, and during 1981, 18 of the 45 existing banks were foreign. A large number of finance companies was established early during the period, although entry into the financial business continued to be regulated by the Superintendencia. The operations different types of depository institutions could perform were gradually unified, but at the same time the variety of operations allowed was enormously diversified, and the system evolved towards "multi-banking". This organization was adopted as one way to increase competition among financial institutions in a country with a relatively small financial market. The almost complete freeing of the international capital flows late in this period, was another way in which competition was introduced into the system. Financial institutions were allowed to allocate credit as they wished, and reserve requirements were reduced to 10 per cent on demand deposits, and 4 per cent on time deposits. As mentioned, no guarantee existed for depositors. In one word, as far as financial systems in market economies are concerned, the Chilean system became probably as unregulated as the most, with the exception of course of the international money centers.

As a result, a very significant financial deepening took place, some financial widening could also be observed (limited by the effect of the very high interest rates, which will be discussed later), and interest rates spreads, initially as high as those in Argentina, fell

[56] Luders (September 1986), pp.94-101.

continously, to average during 1980-81 about 5.5 per cent per year. In spite of these apparently very satisfactory results, during 1981-1982 the system broke down, the government intervened 16 financial institutions (about one third of the total, but among them the largest private commercial banks), and most of the other financial institutions had also high ratios of non-performing loans.

As in the case of Argentina, the reasons for the financial crisis are complex. The level of the interest rates in Chile, much higher than in Argentina, explain probably a large part of the problem. During 1981-1982 they unexpectedly rose to over 30 per cent per year in real terms, as a result of the dollar devaluation speculation described above, and also as a consequence of distress borrowing caused by the crisis conditions themselves. In addition, since about 40 per cent of the loan portfolio of the financial system was expressed in dollars, the sharp 1982 devaluation of the peso suddenly raised dramatically business enterprise indebtedness (the debt to equity ratio of all registered corporations increased from .61 in 1980 to .97 in 1982). On top of this, starting during the last quarter of 1981, and during 1982, economic activity levels of the country plummeted, as reflected in the GDP drop of 14.1 per cent. Not only were, under such conditions, many debtors unable to service temporarily their debts as agreed upon originally, but a large number of them also revised their forecasts (the expected foreign resource constraint of the country implied a reduced output growth rate and a "high" exchange rate; both this factors meant lower gross of debt cash flows and a much higher than originally expected debt service level), and concluded that they were not any more in a position to honor their debt. This implied heavy write-offs (estimated to range anywhere from 2.5 to 4.0 billion US dollars, out of a total asset level of the depository institutions of somewhat over 10 billion dollars)[57] for the financial institutions,

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[57] Luders, R.J. "Auge y Desaparición de los Grandes Conglomerados Chileros 1975-1982" and its anexes ("La Razón de Ser de la Intervención del 13 de Enero ", "Algunas Notas en Torno al Problema del Endeudamiento Interno" and "La Plata ¿Que se Hizo?").Santiago , Chile 1986.For a presentation of the debt capitalization theory, see

which they could not afford with their net worth. Additional reasons for the financial crisis have been given by others. On the one hand, it is argue that the loan portfolio of the financial institutions, weighted heavily in favor of loans to firms related to the owners and originated in the privatizations, had become "bad" during the 1970's. The implicit deposit guarantee (since 1974-75 the government had, in spite of its declared policy, always bailed out the lenders and depositors of financial institutions in trouble), it is said, allowed financial institutions to roll over these bad loans by raising the interest rate level. This would explain the extremely high interest rate levels in Chile, and at the same time, the vulnerability of the financial system to the macro-economic shock of 1981-1982. This hypothesis, appealing to those who are fond of conspiracy theories or give great weight to the moral hazard issue, and which might explain part of the problem, is however difficult to reconcile with the low consolidated indebtedness levels, and the high profit rates, of most financial groups during 1978-1980. Finally, on the other hand, are those that blame the Superintendencia for not having exercised appropriate control over the financial system.

Much has been written about the government intervention of the financial institutions during 1981-1982. Some have critizised the interventions as being perhaps the only important measures taken by the government, which were contrary to the spirit of a free market economy, that had been implemented in Chile almost as a text book case. This would have been correct, if the problem only would have affected one mayor institution, or perhaps a few minor. In fact, this was not so, since the estimated losses of the financial institutions added up to anywhere between 25 and 40 per cent of the loan portfolio. In any event, the interventions were to be definitely temporary, because the government had no intention to change its basic development strategy, although it was willing to correct what it

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Haberger, A.C., "Observations on the Chilean Economy, 1973-1983, Economic Development and Cultural Change, The University of Chicago.,1985.

considered implementation errors. It intervened, instead of letting the financial institutions go broke, because it judged the problem of insolvency to be of such a magnitude, and so widespread, that the whole financial system would have otherwise broken down, with all the implicit real costs, and it might have taken a long time to rebuild it. The problem, it was believed, was no longer a private problem, but a social problem, and it was therefore the governments task to solve it as efficiently and equitable as possible. The government was aware, that the intervention not only avoided (or,in the case of the 1982 intervention, significantly reduced) losses to Chilean depositors, but that it also benefitted foreign lenders. It should, however, be pointed out that at the time of the interventions, balance of payments projections suggested that Chile was going to have to renegotiate its debt, and **obtain naw money**, even under the assumption that only a proportion of the private debtors would be in a position to purchase the foreign exchange to service their debt.

After the interventions, the government took a series of measures to recover the financial system. The solvency of the financial institutions was re-established through a combination of actions which included: (1) the purchase by the Central Bank of bad loans from the financial institutions (program initiated during 1981); according to this program, the benefited institutions have to repurchase these bad loans by applying to it a proportion of future profits; it is expected that it will take some banks several decades to repurchase all their bad loans), (2) the refinancing, at real interest rates of about 6 per cent, of most client loans, which had originally been negotiated at much higher rates; the funds for this renegotiations were provided by the Central Bank, (3) the temporary existence of a subsidized exchange rate to service the debts expressed in foreign currencies, (4) the establishment of capitalization conditions for the purchasers of the banks that were re-privatized, or for the owners of non-intervened financial institutions, and (5) the application of foreign debt papers (which debtors could buy abroad at 60 to 70 per cent of their face value, to which a rationing "tax" was added) to prepay debt[58]. In addition, the government forced financial institutions to make bad loan provisions on the basis of a loan-by-loan evaluation procedure, which was actually began during 1981. Financial institutions also had to reduce its loans to owner related companies to a fraction of their net worth. The banking law was modified, and a 100 per cent reserve requirement was imposed on all demand deposits which exceed 200 per cent of net worth. In exchange, demand deposits are 100 per cent guaranteed by the public sector. In the case of time deposits, no such special reserve requirement exists, nor does any automatic guarantee, but financial institutions can, if they so wish, buy from the government an insurance for their depositors. Moreover, the time deposits of all financial institutions are monthly risk classified by a Commission, and the classification is made public. Finally on this front, the Superintendencia, very aloof in its control in the past, is now exercising strict control over all operations (a computerized network is constantly and directly informing the Superintendencia), and no operation of any new financial institution has been authorized since the crisis. On another front, the intervened institutions were either liquidated, merged or sold. In this re-privatization process great care was take to spread the ownership of the two large banks as much as possible[59] (popular capitalism), and to make sure the new owners of the other banks were economically solvent and had the necessary moral conditions to run a financial institution. Finally, the economic team has managed the macro-economic variables so as to avoid "undue" increases in the real interest rate[60]. This has been achieved through the exchange rate policy, through a constant concern with the control of the level of government expenditures (and deficit), and through the (indirect) management of the investment portfolio of the pension funds. It is important to notice that not even during the financial crisis did the government fix interest

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58 Lanús de la Serna, (1987), "El Saneamiento del Sistema Financiero en Chile".

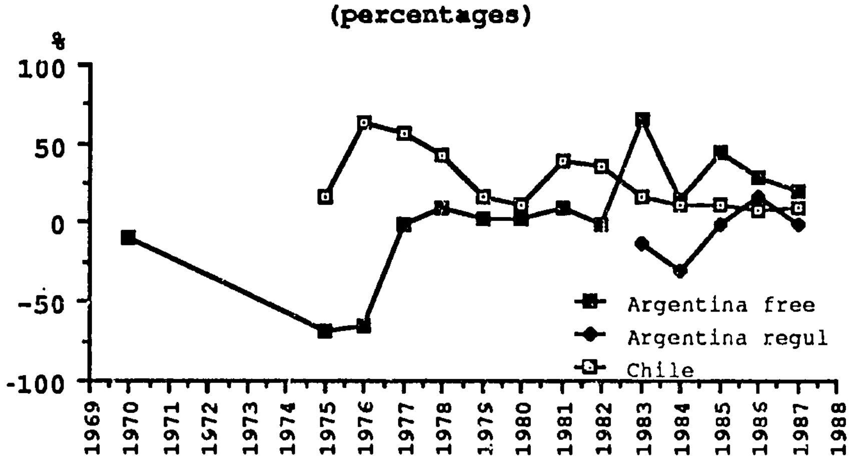
59 Banco de Chile and Banco de Santiago.

60 In relationship to the Libor or Prime rates, and a reasonable risk spread for operations in Chile as compared to the U.S.A.

rates, or allocate credit. Therefore, after the now solvent financial institutions had been re-privatized during 1986-87, the financial system returned basically to its pre-crisis status, but under the surveillance of a considerably more active Superintendencia, and a more explicit deposit guarantee scheme.

Do financial liberalizations and high interest rates go hand in hand?
One of the most puzzling phenomenon of the financial development of Chile was the persistently (extremely) high interest rate, between the moment interest rates were freed, and 1982, when the financial crisis reached its climax[61]. Several econometric studies and/or explanations can be found forthese high interest rates[62], each one applying a

1.8. REAL SHORT-TERM LENDING INTEREST RATE
(percentages)



different model, and all obtaining reasonable results. They are, however, usually based, as they should, on expectation models, and is well known how elusive the measurement of these is. The general conclusion is that a set of factors influenced interest rate levels during those years, among which the following stand out: a sharp increase in the perceived permanent income of the country; increases in real liquidity; at times, distress borrowing, by financial groups, produced by the capitalization of the interest on loans to finance the

61 See Statistical Appendix.
62 See Arellano (1983), Rosende and Toso (1984), Edwards (1984), Corbo et. al (1985), and Harberger (1985).

purchase of privatized (and other) corporations; the, on occasion very strong, exchange rate devaluation expectations; the level of the international interest rate; and the existing (legal and natural) market segmentation between local and foreign financial assets. Of course, the weight of these different factors varied from period to period. The mix was such, that the average **real** interest rate turned out to be, as mentioned, highly positive, ranging from 64.3 per cent in 1976 to about 12 per cent in 1980, and then rising again to over 35 per cent per year during 1981-1982. Such rates are, of ccurse, unsustainable, and the extend of the financial crisis is witness to that fact. In Argentina, although during the liberalization period the government also freed the interest rates, other policies were managed in such a way as to avoid "excessive" increases in the real lending interest rate levels. So much so, that, given their high intermediation costs, deposit rates turned out generally to be negative (although significantly less than during the financial repression periods)[63]. After the financial crisis, the Chilean economic team has also been concerned about the interest rate levels, as one key element of the financial recovery of the financial and business sectors. Since the lower limit of the rates was given by the rates of return on foreign assets (to avoid desintermediation), real interest rates have, since 1983, been highly positive if compared with US rates, but "low" if compared with those prevailing during 1976-1982[64]. That is, if interests are free, the level of the interest rates depends essentially on macro-economic conditions, and therefore a financial liberalization does not have to produce high interest rates. The Chilean experience suggests, however, that the level of the interest rates should be watched while such a liberalization takes place.

The effect of these interest rates on the savings-investment process of Chile is also difficult to explain. Chile has had traditionally

[63] See Luders (June 1986).

[64] The real lending interest rates have ranged from 11.4 per cent during 1984, to 7.48 per cent during 1986. In 1987 they were 9.22 per cent.

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very low savings rates (which of course increase if one includes consumer durables and some social expenditures not included as investment in the National Accounts), and this fact was not even altered by the high prevailing interest rates during 1976-1982. Many explanations have been tried, and the best results are obtained under the assumption that the development process associated with the liberalization raised significantly permanent income, and thereby consumption demand. During the last few years the saving rate is increasing very rapidly, in Chile and during 1987 reached modern times record levels. This increase has been associated with the already discussed pension fund and income tax reforms, in the presence of a interest rate policy which discourages capital flights. Officially recorded investment levels, on the other hand, even if one discounts the effects of the 1975 and 1982-1983 recessions, were relatively low. However, if one corrects for consumer durables and some other items, the rate of investment increased, up to 1981, significantly with respect to pre-liberalization periods. Investment rates since the financial crisis have been low, as in most Latin American countries, to a large extend because a proportion of the countries savings are used to service the foreign debt.

Interesting developments in the Chilean Institutional Capital Market

In Chile the share market is relatively important as compared to Argentina, and, the prospects for a fast growth rate are very good. During 1986, the total value of the shares of the companies traded in the Stock Exchange reached about 30 per cent of total financial liabilities of the country[65]. During 1987 this percentage must have increased significantly, since the real price of shares rose around 20 per cent[66]. In 1986 the value of the shares exceeded by about 20 per cent the value of total time deposits of the commercial banks and finance companies. Moreover, although trading of shares is still a minor percentage of the Stock Exchange business, it has been growing rapidly during the last years, as a result of the institutional

[65] See Table A-4 in the Statistical Appendix.
[66] See Bolsa de Comercio de Santiago, Reseña de Valores, 1988.

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changes to be described below. So much so, that during 1987 the total value of shares traded exceeded by 50 per cent, in real terms, that of the 1980 boom year.

Part of this increase in the trading of shares is of course related to the recovery of the economy, and another part perhaps to the decrease in the real interest rates. Very high interest rates, like those of the first phase of the financial liberalization in Chile, depress share values, and induce borrowers to operate in the short-term market. Suppliers of funds find that market also attractive, because of its low perceived risk. The whole financial market tends to go short, and capital markets become relatively stagnant. For example, during 1975-1980, the depository market developed much faster in Chile than the share market[67].

It is interesting to notice that Chile has, since the last decade, but especially during the last three years, carried out a series of institutional reforms which are changing the picture, and might have considerable impact on the capital market in the future. It has recently created the figure of a Capital Market Agent, in addition to Stock Exchange Brokers, to deal in shares and bonds, and act as a proxy to an investment banker. Already 23 Agents exist, six of them with foreign capital. Also, the government, by changing the law, has in the early 1980's freed the insurance market, and this market has been rapidly growing in volume of business after the crisis of 1980-1982. A number of the most important companies are foreign owned, bringing with them the expertise of investing in the capital market. Mutual Funds, which had hardly developed before the financial liberalization, grew rapidly up to 1982, almost dissapeared during the 1982-1983 crisis, but have made an impressive come-back. Although still small, each one of these latter types of financial institutions has financial assets equal to about one per cent of those of the commercial banks.

More significant are the AFP's (Pension Fund Administrations, which started to operate in the early 1980's), which are private

[67]See Table A-4 in the Statistical Appendix.

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institutions which manage mainly mandatory pension labor force funds on a competitive basis. The AFP's investment portfolio is heavily controlled by the respective Superintendencia (government), but they have been allowed to invest in some selected SOE's shares, besides government bonds and commercial bank deposits. Investments in shares by the AFP's managed funds are still a relatively minor percentage of their total funds, estimated to reach during 1988 about 15 per cent of GDP. Moreover, the funds managed by the AFP's are not yet allowed to invest in shares of private companies, but this is expected to be changed in the future, if the experience with the present investments is favorable. However, some of the SOE's whose shares have been sold to the funds managed by the AFP's were later privatized. This latter process, another of the institutional changes to aid the development of the capital market, has been considerably deepened since 1986, in such a way as to spread share ownership considerably. **Popular capitalism**, the sale of the shares of the largest pre-crisis private commercial banks and of the two largest AFP's, was already mentioned. To this **labor capitalism** has to be added, that is, the sale, by way of special incentives, of shares to the workers of SOE's which are being privatized. And also **institutional capitalism**, the already described sale of shares to the funds managed by the AFP's. Tens of thousands of new share owners have been created over the last three years, and the process will continue, since the government is willing to privatize most of the largest SOE's.

The foreign debt to equity conversions are, interestingly enough, beginning to contribute to the development of the capital market, besides reducing the level of the foreign debt. And this former on two accounts. On the one hand, several foreign commercial banks have engaged in the process of debt conversion, with the explicit objective of later on selling those shares in the local capital market, and in this way return their capital and "interests". On the other hand, the country has recently approved some tax changes to permit the operation in the country of international mutual funds, some of which plan to

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finance their purchases of capital market instruments through debt conversions.

The final structural change, which might be aiding the development of the capital market in Chile, was the reform of the income tax law. Corporate reinvestments are only taxed at a 10 per cent rate. This should induce high income share owners take their profits by way of capital gains, and in the process, spread share ownership.

STATISTICS APPENDIX

TABLE A-1a ARGENTINA: ECONOMIC INDICATORS 1970-1987

	1970	1971	1972	1973	1974	1975	1976	1977	1978
I. REAL SECTOR									
Gross Domestic Product (GDP)(mill.of 1980 dollars)/1	64556.6	66751.5	68220.1	70403.1	74064.1	76290.9	73553.7	78484.2	76346.5
Precentage changes in GDP (rates of growth)/2	2.6	3.4	2.2	3.2	5.2	1.03	-3.3	5.9	-2.8
Gross Investment Rate (percentage of GDP)/2	20.4	20.1	22.5	20.3	19.9	26.1	27.1	27.2	24.5
Gross Savings Rate (percentage of GDP)	20.3/6	21.6/6	21.4/6	22/6	19.7/6	17.3/2	21/1	25.3/1	23.1/1
Urban Unemployment Rate/3	4.9	6	6.6	5.4	3.4	3.7	4.9	2.8	2.8
II. GOVERNMENT									
Central Government Expenses (percentage of GDP)/10	8.1	15.07	19.14	16.85	22.54	21.35	9.37	16.87	19.16
Fiscal Deficit (percentage of GDP)/10	-1.2	-2.4	-4.78	-5.62	-6.15	-10.33	-7.11	-2.77	-3.21
III. MONETARY AND PRICE STATISCS									
Money (M1) (percentage changes)/2				72.7	63.5	90.5	310.8	144.2	145.6
Money (M2) (percentage changes)/2				106.5	73.5	66.3	306.1	256.6	212.7
M1/GDP/7	14.61	12.67	10.82	10.97	13.9	8.8	6.76	6.52	6.08
M4/GDP/7	25.19	22.25	21.34	21.79	28.11	16.09	14.14	17.64	21.44
Consumer Price Index (percent. change Dec.to Dec.)/2	13.6	34.8	58.4	61.2	23.5	182.3	443.2	176.1	175.5
Real Short-term Leading Interest Rate (percent.)/7									
- from 1977 free interest rate in Argentina	-8.79					-68.57	-65.04	-0.37	10
- regulated interest rate in Argentina									
Real Wage Rates (percentage changes)/9						-5.9	-32.7	-1.5	-1.8
Real Wage Rate (1980=100)/9						119.6	80.5	79.3	77.9
Real Exchange Rate/8						0.00026	0.00017	0.00032	0.00027
Terms of Trade (1970=100)/5	100	123.2	123.2	146.2	127.6	100.7	88.9	86.3	79.9
IV. BALANCE OF PAYMENTS									
Trade Balance (millions of dollars)/2	274/5	87	256	1289	714	-549	1153	1852	2913
Exports (millions of dollars)/2	1773	1740	1941	3266	3931	2961	3916	5652	6400
Imports (millions of dollars)/2	1694	1868	1905	2230	3635	3947	3033	4162	3834
Capital Account (millions of dollars)/2	236/5	-55	162	131	-43	-119	-772	739	-62
Foreign Exch. Reserves (less gold)(mill. dollars)/2	130	-341	121	836	-5	-856	1157	1709	1812
Total External Debt (millions of dollars)/4	3875/7					7875/7	8275/7	9678/7	12496

TABLE A-16 ARGENTINA: ECONOMIC INDICATORS 1979-1987

	1979	1980	1981	1982	1983	1984	1985	1986	1987
I. REAL SECTOR									
Gross Domestic Product (GDP)(mill.of 1980 dollars)/1	81829	83329	77395.3	73263.2	74991.8	76742.7	73169.3	77546.3	79097.2
Precentage changes in GDP (rates of growth)/2	6.7	1.8	-7.1	-3.8	2	2.9	-4.7	5.9	2.0/5
Gross Investment Rate (percentage of GDP)/2	23.5	22.7	18.2	16.8	15.5	13.3	11.5	11.6	
Gross Savings Rate (percentage of GDP)	21.1/1	19.6/1	15.5/1	15/1	13.6/1	11.4/1	10.8/1	9.0/1	
Urban Unemployment Rate/3	2	2.3	4.5	4.7	4.2	3.8	5.3	4.6	5.4
II. GOVERNMENT									
Central Government Expenses (percentage of GDP)/10	19.05	20.75	24.93	22.88	28.32				
Fiscal Deficit (percentage of GDP)/10	-2.6	-3.57	-8.15	-7.15	-12.74				
III. MONETARY AND PRICE STATISCS									
Money (M1) (percentage changes)/2	131.4	115.9	53.9	195.7	287.8	522.6	650.2		
Money (M2) (percentage changes)/2	178.9	127.7	91.1	141.9	288.2	564.9	631.3		
M1/GDP/7	5.72	6.31	5.01	4.66	5.3	4.7	4.6	6.8	5.6
M4/GDP/7	22.81	25.87	24.86	19.84	14.5	13.3	12.9	18.7	17.8
Consumer Price Index (percent. change Dec.to Dec.)/2	159.5	100.8	104.5	164.8	343.8	626.7	672.1	90.1	178.3/5
Real Short-term Leading Interest Rate (percent.)/7									
- from 1977 free interest rate in Argentina	3	2.4	8.7	-1.21	65.7	15.4	44.2	28.3	19.6
- regulated interest rate in Argentina					-12.7	-29.8	-1.2	16.8	-1.2
Real Wage Rates (percentage changes)/9	14.3	11.8	-10.6	-10.4	25.5	26.4	-15.2	1.6	-8.4
Real Wage Rate (1980=100)/9	89.5	100	89.4	80.1	100.5	127.1	107.8	109.5	100.3
Real Exchange Rate/8	0.0002	0.00018	0.00023	0.00039	0.00035	0.00034	0.00039	0.00036	
Terms of Trade (1970=100)/5	81.1	94.2	89.1	82.2	79.5	86.4	78.2	66.2	68.4
IV. BALANCE OF PAYMENTS									
Trade Balance (millions of dollars)/2	1782	-1373	712	2764	3716	3982	4877	2549/5	1450/5
Exports (millions of dollars)/2	7810	8021	9143	7625	7836	8107	8396	6849/5	6400/5
Imports (millions of dollars)/2	6700	10541	9430	5337	4504	4585	3814	4300/5	4950/5
Capital Account (millions of dollars)/2	4486	1890	1072	-2335	-2687	8	-183	2121/5	2700/5
Foreign Exch. Reserves (less gold)(mill. dollars)/2	4422	-2669	-3451	-762	-1334	71	2030.3	-555.3	-1064
Total External Debt (millions of dollars)/4	19034	27162	35671	43634	45084	46903	48312	51500	54500

TABLE A-2a CHILE: ECONOMIC INDICATORS 1970-1987

	1970	1971	1972	1973	1974	1975	1976	1977	1978
I. REAL SECTOR									
Gross Domestic Product (GDP)(mill.of 1980 dollars)/1	18997.3	20875.1	20627.6	19533.7	19731	17476.5	18110.4	20100.3	21895.7
Precentage changes in GDP (rates of growth)/2	1.4	9	-1.2	-5.6	1	-12.9	3.5	9.9	8.2
Gross Investment Rate (percentage of GDP)/2	22.2	15.4	4.3	-35.7	21.2	13.1	12.8	14.4	17.8
Gross Savings Rate (percentage of GDP)/1	15.2/8	12.5/8	8.3/8	5.3	20.7	8	14.5	10.8	12.6
Urban Unemployment Rate/3	4.1	4.2	3.3	4.8	9.2	15	16.3	13.9	13.7
II. GOVERNMENT									
Central Government Expenses (percentage of GDP)/10	19.8	26.1	43.48	35.65	33.7	35.01	30.53	32.92	32.39
Fiscal Deficit (percentage of GDP)/10	-2.9	-7.7	-13.04	-6.96	-5.33	0.14	1.37	-1.11	-0.11
III. MONETARY AND PRICE STATISCS									
Money (M1) (percentage changes)/2	52.9	99.3	100.9	264.4	315.5	239.5	216.1	156.7	81.2
Money (M2) (percentage changes)/2	46.1	76.8	101.6	330.8	435.2	297.8	217.5	147.9	99.5
M1/GDP/8	10.2	16.9	23.1	21.8	9	8.4	6.7	6.4	6.2
M2/GDP/8	11	17.7	23.3	22	9.3	10	10.5	11.8	14.2
Consumer Price Index (percent. change Dec.to Dec.)/2	33	19.2	77.3	353.6	504.7	374.7	211.8	91.9	40.1
Real Short-term Leading Interest Rate (percent.)/6						16.02	64.3	56.79	42.22
Real Wage Rates (percentage changes)/7						-4.2	1.4	12.9	6.5
Real Wage Rate Index (1980=100)/7						69.5	70.5	79.6	84.7
Real Exchange Rate /7				55.6	49.5	57	49.6	47.4	50.7
Terms of Trade (1970=100)/7	100	78.2	72	83.3	88.1	53.2	57.1	51.3	49.8
IV. BALANCE OF PAYMENTS									
Trade Balance (millions of dollars)/2	246	73	-161	-13	250	70	653	35	-426
Exports (millions of dollars)/2	1249	997	855	1231	2481	1552	2083	2190	2478
Imports (millions of dollars)/2	941	980	941	1093	1911	1338	1643	2259	3002
Capital Account (millions of dollars)/2	174	-111	-38	-88	-363	-115	263	677	1818
Foreign Exch. Reserves (less gold)(mill. dollars)/2	46	-171.5	-73.9	25.2	-80.2	14.6	349.3	20.9	664
Total External Debt (millions of dollars)/4	2767/9	2746/9	3002/9	3261/9	4026/9	4267/9	4274/9	4510/9	6664

TABLE A 2b CHILE: ECONOMIC INDICATORS 1970-1987

	1979	1980	1981	1982	1983	1984	1985	1986	1987
I. REAL SECTOR									
Gross Domestic Product (GDP)(mill.of 1980 dollars)/1	23877.6	25897.6	27239.5	23674.7	23548.3	24972.4	25581.1	26966.8	28503.8
Precentage changes in GDP (rates of growth)/2	8.3	7.8	5.5	-14.1	-0.7	6.3	2.4	5.7	5.7/6
Gross Investment Rate (percentage of GDP)/2	17.8	21	22.7	11.3	9.8	13.6	13.7	15	16.9/11
Gross Savings Rate (percentage of GDP)/1	12.5	13.7	7.5	-0.4	3.2	5.1	7.6	9.9	13/11
Urban Unemployment Rate/3	13.4	11.7	9	20	19	18.5	17	13.1	12.6/6
II GOVERNMENT									
Central Government Expenses (percentage of GDP)/10	29.3	28.73	30.34	31.2	30.37	31.88	31.55	28.2/9	26.1/9
Fiscal Deficit (percentage of GDP)/10	4.82	5.41	2.59	-0.98	-2.63	-2.97	-2.36	-1.9/11	-0.8/11
III. MONETARY AND PRICE STATISCS									
Money (M1) (percentage changes)/2	60	62.6	23.4	-5.5	28.3	18.9	11.3/9	41.4/9	9.8/9
Money (M2) (percentage changes)/2	76.7	56.5	57	27.3	3.2	25.7	31.6/9	24.6/9	47.2/9
M1/GDP/8	6.2	7.3	5.9	6.5	6.6	6.1	5.0/6	6.0/6	5.5/6
M2/GDP/8	14.9	19.3	23.7	25.7	19.3	20.7	20.1/6	25.4/6	29.7/6
Consumer Price Index (percent. change Dec.to Dec.)/2	33.4	35.1	19.7	9.9	27.3	19.9	30.7	19.5	21.5/9
Real Short-term Leading Interest Rate (percent.)/6	16.6	11.94	38.72	35.14	15.93	11.4	11.04	7.48	9.22
Real Wage Rates (percentage changes)/7	8.3	9	9.1	-0.4	-10.6	0.3	-4.5	1.7	0.6/9
Real Wage Rate Index (1980=100)/7	91.8	100	109.1	108.7	97.1	97.4	93	94.7	95.2/9
Real Exchange Rate /7	44.7	39	39	48.4	52	54.3	61.2	59.8	61.2/9
Terms of Trade (1970=100)/7	53.4	49	38.6	34.4	36.7	34.5	32.3	38.1	40.3/9
IV. BALANCE OF PAYMENTS									
Trade Balance (millions of dollars)/2	-355/1	-764	-2677	63	986	293	850	1100	1080
Exports (millions of dollars)/2	3894/1	4671	3906	3710	3836	3657	3823	4222	5050
Imports (millions of dollars)/2	4218/1	5124	6364	3529	2754	3191	2743	2914	3970
Capital Account (millions of dollars)/2	2141	3216	4799	947	-3168	100	-1281	-1244/9	-937/9
Foreign Exch. Reserves (less gold)(mill. dollars)/2	847.4	1185.7	90.2	-1399.1	221.7	266.2	147	-98.5	157
Total External Debt (millions of dollars)/4	8484	11207	15591	17159	18037	19659	20403	20670	20510

FOOTNOTES - TABLE A.1 - ARGENTINA: ECONOMIC INDICATORS 1970-1987.

1/ Source: Economic Commission for Latin America (E.C.L.A.), Statistical Yearbook.
2/ IMF, International Financial Statistics.
3/ E.C.L.A., Notes on Economics and Development (Federal Capital and Metropolitan Buenos Aires)
4/ Source: E.C.L.A., In addition to the public and private debt with official guarantee, it also includes the non-guaranteed long and short-term with financial institutions which provide information to the B.I.S., and the IMF credits it does not include guaranteed or non-guaranteed credits from other commercial banks, non suppliers credits without official guarantee.
5/ E.C.L.A., Notes and Economics and Development.
6/ Fanelli (1984).
7/ Central Bank of Argentina. M1 includes coins bills and sight deposits
M2 includes M1 and time deposits (regulated) plus free deposits plus adjustable deposit plus public sector bonds
8/ IMF, deflated by the average wholesale price index of each period
9/ E.C.L.A., Notes on Economics and Development, average wages of industrial workers.
10/ IMF, Government Finance Statistics Yearbook.

FOOTNOTES - TABLE A.2 - CHILE: ECONOMIC INDICATORS 1970-1987

1/ Source: Economic Commission for Latin America (E.C.L.A.), Statistical Yearbook.
2/ IMF, International Financial Statistics
3/ E.C.L.A., Metropolitan Santiago.
4/ Source: E.C.L.A., In addition to the public and private debt with official guarantee, it also includes the non-guaranteed long and short-term with financial institutions which provide information to the B.I.S., and the IMF credits it does not include guaranteed or non-guaranteed credits from other commercail banks, non suppliers credits without official guarantee.
5/ Central Government
6/ Central Bank of Chile, Boletin
7/ Source: E.C.L.A., Notes on Economics and Development. Metropolitan, Santiago.
8/ Central Bank of Chile. M1 includes coins, bills and sight deposits
M2 includes M1 and time deposits of Private Sector
/9 Central Bank of Chile.
/10 Government Finance Statistics Yearboob, FMI.
/11 Bank of Boston.

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TABLE A-3: ARGENTINA: CONSOLIDATED BALANCE SHEET OF THE FINANCIAL SECTOR(1)
(Percentages of GDP)

CONCEPT	1940	1945	1950	1955	1960	1965	1970	1975	1980	1984	1985
ASSETS											
Cash	8,8	19,0	1,9	3,0	7,3	2,4	3,0	4,2	2,5	5,2	5,0
Deposits on Account of Central Bank	-	-	27,7	23,6	-	-	-	14,5	-	-	-
Shares	0,2	0,4	0,1	-	0,1	-	-	-	-	-	-
Net Foreign Sector	0,2	-0,3	0,6	1,0	1,4	-0,3	-0,6	-0,7	-3,1	-7,4	-7,2
Credits	47,3	41,3	47,5	44,7	27,0	15,8	25,2	13,9	33,2	18,0	18,8
In Local Currency	47,1	41,1	46,4	44,1	25,1	15,5	24,3	12,8	29,3	12,0	10,3
(To the Public Sector)	(7,2)	(14,3)	(19,5)	(15,8)	(3,7)	(3,7)	(2,6)	(2,6)	(4,5)	(1,4)	(1,7)
(To the Private Sector)	(39,9)	(26,8)	(26,9)	(28,3)	(21,4)	(11,8)	(21,8)	(10,2)	(24,8)	(8,9)	(10,3)
In Foreign Currency	0,2	0,2	1,1	0,6	1,9	0,3	0,9	1,1	3,9	7,7	7,1
(To the Public Sector)	-	-	-	-	-	-	-	-	0,4	2,8	2,8
(to the Private Sector)	(0,2)	(0,2)	(1,1)	(0,6)	(1,9)	(0,3)	(0,9)	(1,1)	(3,5)	(4,9)	(4,3)
LIABILITIES											
Due to the:											
Private Sector	48,9	52,1	25,5	20,1	21,1	11,3	19,8	10,3	23,1	9,8	11,0
(Sight Deposits)	(10,9)	(19,6)	(12,9)	(10,2)	(11,4)	(5,0)	(7,4)	(5,3)	(3,2)	(0,8)	(1,6)
(Time Deposits)	(23,1)	(23,2)	(12,3)	(9,8)	(9,5)	(6,3)	(12,4)	(5,0)	(19,3)	(7,9)	(8,5)
(Mortgage Operations)	(14,9)	(9,3)	(0,3)	(0,1)	(0,1)	(-)	(-)	(-)	(-)	(-)	(-)
(Foreign Currency Deposits)	-	-	-	-	-	-	-	-	(0,6)	(1,1)	(0,9)
Public Sector	1,6	2,6	4,4	5,5	6,8	2,6	3,6	2,7	4,1	1,5	3,8
(Deposits)	(1,6)	(2,6)	(4,4)	(5,5)	(6,8)	(2,6)	(3,6)	(2,7)	(4,1)	(1,5)	(3,8)
Central Bank	0,1	-	41,7	42,9	6,8	3,1	1,9	13,9	2,6	2,5	4,0
Other Operations Due	-	-	-	-	-	-	0,1	0,4	0,8	-	-
Net Worth and Other Net Various Accounts	5,9	5,7	3,0	-6,0	-2,6	1,4	2,2	4,6	1,9	2,0	-1,9

(1) Includes: Commercial Banks, Mortgage Bank, Industrial Bank, Savings Bank (Caja de Ahorro), Finance Companies, Credit Banks (Cajas de Crédito) and Housing Savings and Loan Societies.

SOURCE: Arriazu (1988,.

TABLE A-1: CHILE: FINANCIAL LIABILITIES[1]
millions of December 1986 pesos)

	1961	1965	1970	1973	1975	1978	1979	1980	1981	1982	1983	1984	1985	1986
TOTAL FINANCIAL LIABILITIES	103.291	107.076	108.307	157.516	255.191	1.049.110	1.432.838	2.008.220	1.927.369	1.402.254	1.715.197	1.841.513	2.084.410	2.623.879
PUBLIC SECTOR	16.879	16.059	25.627	45.147	102.808	153.864	178.543	135.371	113.501	116.616	334.062	407.838	452.877	506.505
Central Bank						94.111	119.142	104.559	80.932	45.079	158.030	158.609	294.534	381.085
Treasury						59.753	59.405	30.812	32.569	71.536	176.032	249.229	158.343	125.421
BANKS AND FINANCE COMPANIES	16.517	10.448	14.598	1.263	20.011	397.339	505.552	742.986	1.008.198	996.348	912.487	983.796	1.149.240	1.247.001
Time deposits	15.124	10.055	13.320	1.000	19.355	297.485	351.897	495.761	712.146	660.540	48.111	583.043	702.238	723.861
Bonds (including mortgage)	1.393	393	1.278	263	656	15.689	32.711	84.014	167.013	188.887	206.010	235.221	242.753	250.489
Other						83.164	120.944	163.211	129.040	136.921	658.365	165.528	204.249	272.651
BUSINESS SECTOR	69.567	72.876	30.768	77.497	111.078	464.339	725.621	1.114.699	792.033	792.543	462.092	443.498	481.598	864.163
Bonds and debentures					6.332	4.924	5.967	5.901	10.167	47.418	12.570	42.863	47.463	32.611
Shares of corporations	69.567	72.876	30.768	77.497	86.628	436.226	701.193	1.089.333	745.849	724.078	415.178	400.634	434.135	831.552
Other					11.531	20.199	15.010	15.666	31.820	21.047	4.344			
Cooperative System					6.527	2.990	3.451	3.799	4.197					
SAVINGS AND LOANS ASS.	328	7.693	37.314	33.609	121.294	33.568	23.122	15.164	13.637	6.747	6.557	6.381	6.225	6.210
TOTAL FINANCIAL LIABILITIES/GDP RATIO	5,7	5,2	4,5	5,9	15,2	36,5	46,0	59,8	54,4	62,5	56,8	57,3	63,5	75,4
TOTAL FINANCIAL LIABILITIES EXCLUDING NEW PENSION SYSTEM/GDP RATIO	5,7	5,2	4,5	5,9	15,2	36,5	46,0	59,8	54,1	61,0	53,4	52,3	54,9	62,9
NEW PENSION SYSTEM LIABILITIES/GDP RATIO	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,3	1,5	3,3	5,0	8,6	12,5

(1) December of each year data

SOURCE: Perez (1987).

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POLICY AND INSTITUTIONAL CONSIDERATIONS IN EQUITY MARKET DEVELOPMENT

Draft

Arthur Young

A MEMBER OF ARTHUR YOUNG INTERNATIONAL

Disclaimer: This paper is condensed from a draft report prepared by Arthur Young under contract with the Agency for International Development, Bureau for Program and Policy Coordination. While the report was written by Robert J. Rourke and Flora M. Painter of Arthur Young, the organization and content of the report reflects the contributions of three individuals with considerably more experience in capital markets than the preparers of the report. These three individuals are: George M. Ferris, Jr., Chairman and Chief Executive Officer of Ferris & Company, a regional investment banking firm headquartered in Washington, D.C.; Terrence C. Reilly, of the London Office of Curtis, Mallet-Prevost, Colt & Mosle, and former Director of International Policy and Senior Legal Advisor for International Securities, U.S. Securities and Exchange Commission; and Robert M. Bishop, retired Senior Vice President of the New York Stock Exchange. Collectively, these three individuals have provided advisory services on the development of capital markets in more than 40 countries. While every attempt has been made to capture accurately the experience and opinions expressed by these individuals in their other writings or specific contributions to the report, the authors ask the forbearance of the participants in this conference for any misstatements contained in the initial draft of the report or in this condensed treatment of the report.

POLICY AND INSTITUTIONAL CONSIDERATIONS IN EQUITY MARKET DEVELOPMENT

INTRODUCTION

There is growing recognition among developing country governments that expanding the role of the private sector in economic development is a prerequisite for sustained economic growth, and that equities markets play a crucial role in financing the growth in private investment. Much of this interest can be attributed to changes in the global economy in the last decade, including falling oil revenues, increasing debt servicing costs, and declining demand for traditional exports, which have resulted in reductions in the funds available for development activities. Thus, developing countries must rely more than ever before on their own capital markets to achieve private sector growth and to maintain development momentum and the improvements in the standard of living achieved through the public sector-oriented policies of the past.

The inadequacy of capital markets in many developing countries, however, is a major deterrent to the growth of indigenous private enterprises. Capital markets play a crucial role in economic development by encouraging domestic savings and mobilizing these savings for investment in productive activities. Well functioning and dynamic markets are essential to providing the financing of the capital investment needs of private enterprise and to encourage growth of the private sector.

Private sector initiatives are intimately linked with capital market development efforts. Private enterprises cannot grow significantly without adequate capital markets, and capital markets can only grow and contribute to the development process when there is an active private sector.

The purpose of this paper is to describe specific types of issues and market conditions that affect the development of capital and equities markets, and the barriers that inhibit efforts to mobilize capital through the securities market. The discussion is based largely on the experience of team members in equity markets development in a number of developing and developed countries.

KEY CONSIDERATIONS IN CAPITAL AND EQUITY MARKET DEVELOPMENT

Development of a country's capital and equity markets is part of a broader effort of macro-economic policy and private sector business growth. Economic policies that discourage formation or expansion of private enterprises also impede development of capital markets because they impact negatively the demand for long-term finance. Economic policy, private sector growth, and capital mobilization, therefore, are interrelated conditions, and all three must be considered in any attempts to formulate capital market development policy.

Securities market activities in developing countries tend to consist principally of trading of the limited number of issues available in the market by a small number of investors. Growth of the market, however, requires continual introduction by underwriters of the new debt and equity issues of companies seeking long-term financing. It is this important function that serves to attract domestic savings and provide for a wider distribution of ownership, and that leads to an increase in the number of enterprises and to growth of the private sector. For reasons that will be described more fully in subsequent sections of this paper, the number of new issues offered annually in most developing countries is small relative to the opportunities that exist. This will have to change, however, as LDC governments turn increasingly to the private sector to achieve economic development objectives that the public sector no longer can afford to finance.

1) Business Environment

Development of an equities market is not an end in itself. Equities markets serve the dual purposes of encouraging savings and providing a channel for directing these savings into investments that finance the capital needs of various enterprises. Increased capital permits businesses to expand and create additional jobs and income. Equity market development cannot succeed unless the environment for business supports profitability, growth, and expansion. A favorable climate for business formation and expansion will promote the development of a securities market as businesses seek ways to obtain long-term financing of capital requirements through family resources, internal profit financing, and traditional and other borrowing. Conversely, a securities market will not develop and grow in an environment in which tax policies, regulations, or laws governing company operations discourage formation of new companies or expansion of existing enterprises.

To promote growth of the private sector, the environment--political, economic, legal, and otherwise--must offer business the opportunity to make an adequate return on its investment. Political or economic instability, or inadequate and restrictive laws, increase the risk of investment and raise expectations of the return on investments. Publicly owned companies in this situation will find it necessary to distribute most profits, and even incur losses, in order to meet shareholders' dividend expectations. Privately held companies have no incentive to go public under these conditions, and generally divert their profits to investments in overseas markets, or in unproductive activities such as real estate development.

Lack of meaningful dialogue between the public and private sectors is a common problem in developing as well as developed countries. Private business often complains that the "playing field" for state-owned and private enterprises is uneven because the former have preferential access to credit and are not subject to the same kinds of restrictions as private firms. In addition, businessmen often assert that government dominance of certain sectors of the economy impedes private competition. Excessive government "red tape", favoritism, and corruption are frequently

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blamed for stifling private sector growth. On the other hand, government often mistrusts the private sector and doubts its commitment to contributing to economic growth. As a result, neither party trusts the other and there is little if any constructive dialogue between them.

2) <u>Supply of Securities</u>

One explanation for the undeveloped nature of capital markets in developing countries is that the supply of securities is very limited. While the lack of a market is also related to the demand for securities, there are some specific reasons why companies are reluctant to "go public". These include the following:

a. <u>Pricing</u>

Government intervention in the pricing of equity issues is one of the major impediments to companies going public. The price at which a company can sell its shares is a very important consideration as it determines whether the cost of capital raised through the securities markets is economically attractive or not. In some LDCs, the government might fix the price at which companies and controlling shareholders can sell their shares based on the notion of "par value". In other cases, the LDC government might establish an issue price on the basis of book value, without adequately taking into account current or future earnings potential. In developed markets the price of a share is established in negotiations between the underwriter and the issuing company, and relies heavily on the underwriter's assessment of what the market would be willing to pay given the earnings record and other characteristics of the company.

Interference in the pricing of new public issues not only affects negatively the willingness of companies to go public and therefore reduces the supply of securities, it also places the government in an undesirable position of appearing to be "recommending" an issue at a particular price. In these instances, the government feels obliged to support the issue price by directing its agencies or banks to buy the shares. While this might have an initially positive effect on the market, if the company subsequently stops paying dividends or fails, the government's coffer as well as its reputation will suffer.

The short supply of securities can also create a false sense of demand which might drive prices up to unrealistic values and significantly increase the risk for new or unsophisticated investors. In addition, interference with the pricing mechanism can also lead to the practice of "free riding" whereby the middleman or underwriter of an issue, knowing that the issue is underpriced, buys most of the shares for his own account and issues only a few shares to the public. The middleman then sells his holdings when demand pushes prices up. This provides a substantial profit for the underwriter, but penalizes the public who paid the higher price and the company which received a lower price for its shares.

According to one team member, government involvement in

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pricing of public issues occurs in some 95% of developing countries. One typical example is Kenya, where the government, through the Capital Issues Committee, plays a major role in the pricing of issues in an effort to "protect" the unsophisticated buying public.[1]

Another example is Malaysia where companies are only allowed to issue shares at prices ranging from four to eight times their pretax earnings. According to Dato Malek Merican, Managing Director of the Arab-Malaysian Merchant Bank Berhad, shares are systematically underpriced, increasing the cost of going public and encouraging considerable oversubscription of shares. As a result, an elaborate ballotting system is required to select the successful applicants, "many of whom will sell their shares at considerable capital gains within a few weeks of the public listing."[2]

Indonesia presents still another example of pricing interference. There, public offering prices have been affected by pressure from the Stock Exchange and Danareksa, the national investment and unit trust fund, which "encourage" companies to set low prices.[3] As a result of these and other practices, only 24 companies have listed shares on the Jakarta Stock Exchange since 1977 and there has been no new stock issue on the exchange

[1] George Ferris, Jr., "Kenya: An Action Plan for Capital Market Development and Capital Mobilization" (April, 1987), p. 9.

[2] Dato Malek Merican, in ADB Symposium, p. 136.

[3] Reilly, "Indonesia Memorandum," p. 21.

since 1984.

b. <u>Tax Biases/Disincentives</u>

The supply of securities is also diminished if tax policies make the cost of raising equity funds more expensive than debt finance. Interest on debt, for example, is generally tax-deductible to a corporation, while dividends on shares must be paid out of after tax profits. In addition, stamp duties and other transaction costs are frequently high and discourage the transfer and trading of securities. Excessively high taxes on the capital gains arising from the sale of shares also impede secondary market activity as controlling shareholders prefer to retain their shares and take out profits in dividends or illegal payments.

Tax biases against investment in securities and in favor of deposits in banks also force companies to rely on borrowing from domestic banks or other sources rather than issuing bonds or selling equity interests. When interest received from bank term deposits is tax free, and dividend income is taxable, which is frequently the case in developing countries, banks can obtain funds from depositors at lower rates than companies can obtain such funds through the issuance of securities. The situation is further complicated when one considers that in many developing countries, particularly in those with new or relatively inactive markets, investors are more interested in receiving dividends than in the capital gain from share appreciation. As a result, in order to be competitive with the banks, publicly-listed companies must offer dividend rates that are comparable to the after-tax interest rates paid by the banks. In these instances it is less costly for firms to borrow from banks than it is to issue equity or debt securities in the market. According to the Asian Development Bank (ADB), for example, the 1983 dividend pay-out ratio (total annual cash dividends plus any payments on preferred stock divided by annual company earnings) for 19 listed companies in Indonesia ranged from less than 60 per cent to 120 per cent. According to the ADB, some listed companies even paid more in dividends than they made in profits, a situation that diminished the capital base of the companies.[4]

In many countries tax laws are poorly administered and tax requirements are not enforced rigorously or uniformly. As a result, companies may be reluctant to go public because they are afraid that financial disclosure, required for public offerings, will lead to increased tax assessments by the fiscal authorities.

c. <u>Registration Process</u>

The process of public offering approval is often cumbersome and time-consuming, and can deter companies from going public. Very stringent listing requirements which limit the number of companies that can access the market for equity finance also impede the supply of securities. Very stringent requirements are often applied based upon an unrealistic view that investors in the securities market should not be allowed to take risks. This

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4 Asian Development Bank, <u>Capital Market Development in Selected Developing Member Countries of the Asian Development Bank</u> (1985), p. 45.

view is particulary inappropriate in the context of developing countries since it denies finance to businesses that do not meet the strict standards, at a time when finance is desperately needed and should be encouraged. It also prevents investors who can afford varying degrees of risk from making investment decisions on the basis of their own views about the future profitability of companies. In fact, emphasis on strict listing requirements has declined in developed countries such as England as the importance of allowing--and moreover encouraging--companies to access equity markets to obtain finance for expansion has become more widely recognized.[5]

d. Fear of Losing Control

A common problem in developing countries is that owners of private firms are afraid that going public will weaken their managerial control over the enterprise. This attitude is particularly prevalent in LDCs with numerous family-owned firms. It has been found that even when a company is publicly listed, the majority of its securities are closely held by the original owners, relatives or friends. The controlling shareholders, usually the founders, often prefer to finance the company from internally generated funds or bank loans (possibly through banks that they control). A recent study by the Asian Development Bank found that in several Asian countries, the percentage of "closely-held" shares frequently amounted to 60 per cent to 85 percent. This constitutes a major impediment to the trading of

5 Reilly, "Indonesia Memorandum," pp. 19-20.

securities in the secondary market.[6]

In Bangladesh, for example, where thousands of family-owned enterprises pervade the economy, reluctance to dilute family ownership and control is one of the major impediments to going public. Frequently, even when the company is listed on the stock exchange, few shares are available for trading because most continue to be held by the original owners. Moreover, according to Khursid Alam, former Chairman of the Dhaka Stock Exchange, even when shares are floated in the primary market on a 50:50 basis, the original sponsors frequently purchase additional shares on the market to raise their holdings to some 70-80 per cent. This attitude is largely blamed for the limited availability of shares and the low level of trading in the secondary market.[7]

e. Extent of Government Ownership

The supply of securities is also diminished if the government itself is engaged in business ventures through "parastatal" and nationalized firms. When governments assume responsibility for traditional private sector activities, it stifles the formation of private sector companies and consequently reduces the number of potential issuers of public shares.

f. Inadequate Financial Intermediaries

Developing countries often lack adequate financial and

[6] ADB, Capital Market Development, p.44.

[7] Khursid Alam, in ADB Symposium.

securities intermediaries--brokers, dealers, market makers, and investment and merchant bankers. Merchant and investment banking firms that will underwrite and distribute new issues of securities, or encourage companies to raise funds through public offerings may be non-existent or only marginally effective in bringing issues to the market.

In addition, brokers in LDCs tend to operate with little financial backing or training. There are few if any market makers, to buy and sell securities for their own account to make a market for their customers. In fact, the safeguards which should govern the activities of brokers and market makers generally are not understood or practiced in payment requirements, credit extension, and dealer exposure with the result that doing business with a broker dealer may be viewed as very risky. As a result, distribution of securities is limited and secondary trading activities are few. This issue will be further discussed below in item 6.

3) <u>Potential Approaches to Increasing the Supply of Securities</u>

Actions to increase the supply of securities generally take one of two forms: a) adoption of positive incentives; or b) removal of impediments. Some LDC governments, however, have also resorted to direct intervention in an attempt to encourage an increase in public issues. Some countries require that foreign or joint venture companies go public after a specified number of years as a way of increasing domestic ownership. South Korea, for example, imposes fiscal penalties on companies that do not go public after public authorities have determined that they should.[8] Indonesia, until recently, limited foreign ownership to 49% and required sale of the foreign equity after 10 years.

a. <u>Incentives</u>

Tax incentives are used most often as inducements to encourage companies to go public. Typically, publicly-listed companies are taxed at a lower rate than private or "closed" companies. Relying on fiscal incentives to encourage equity markets development, however, can cause distortions. Most financial market experts agree that discriminatory policies should be viewed as temporary measures. In general, it is preferable to promote equity market development by eliminating existing impediments and distortions so as to put all markets on an equal footing.

There are a number of ways in which to reduce the tax rate for publicly-listed companies below the rate applied to unlisted firms. In Thailand, for example, the corporate tax rate for listed companies is 30% compared to 40% for unlisted ones. In Sri Lanka, newly-listed companies are eligible for a 10% lower tax rate and a five to ten-year tax holiday if they invest in priority sectors such as tourism, exporting, and fishing. Egypt gives a tax incentive to companies which list on the exchanges.

[8] Jonathan R. Hakim, ed., <u>Securities Markets</u>, IFC Occasional Papers. (Washington, D.C.: IFC, 1985), p. 23.

Other incentives might include accelerated rates of depreciation for listed companies for a certain number of years, tax credits or investment allowances for investments in plant and equipment by public companies, concessions on taxes payable in the year after a new public issue of shares is made, and others.[9]

The spectrum of tax incentives that can be applied in equity market development is broad. However, it should be noted that fiscal incentives will be effective only if the taxation system itself is effective and uniformally enforced. Reducing tax rates for listed companies while private companies can evade taxation will not induce companies to go public.

b. Removal of Impediments

More frequently, it is recommended that governments remove the impediments to public offerings that exist in many countries. Some of the actions that would be required to remove common deterrents to public offerings include:

o Liberalize pricing

One of the most important steps to encourage companies to go public is to eliminate government involvement in establishing the price of shares. Share price should be negotiated by the underwriter or sponsoring brokers and the offeror, and should follow the industry practice of giving emphasis to earnings. This assures that profitable businesses will be able to sell their shares at a fair price with the result that the cost of raising equity capital will be competitive with the cost of long-term borrowing. In addition, higher issuing prices will enable the owners to raise larger amounts of funds for future growth without concern about the large dilution of their ownership that would have taken place at the lower prices. In South Korea, for example, growth of the capital market accelerated rapidly in 1973-1974 when the Ministry of Finance

9 ADB, Capital Market Development, p. 49.

liberalized the pricing process.[10]

- <u>Eliminate tax biases against securities and in favor of bank deposits and non-negotiable debt finance.</u>

Companies will not go public as long as the cost of equity funds is greater than debt financing. In addition, proper tax enforcement and auditing is necessary to assure "reluctant" companies that they will not be penalized for disclosing financial information in order to go public. In this regard, it should be noted that tax incentives for companies going public will not be effective if tax laws are poorly administered and tax returns understate income. Under such circumstances, companies will not go public for fear that financial disclosure will reveal deficiencies in their tax statements. This was the case in Indonesia, for example, when the government adopted tax incentives to encourage companies to go public after the Jakarta Stock Exchange re-opened in 1977. By late 1979, only two companies had gone public, even though hundreds of foreign companies were required to transfer majority ownership to Indonesian nationals and were offered tax incentives to go public. One of the main reasons such few companies responded to the fiscal incentives is believed to be the desire to avoid the attendant disclosure requirements in light of a poorly administered tax system.[11]

- <u>Remove "red tape" and loosen listing requirements</u>

In Indonesia, for example, it was recommended that some relaxation be provided to the stringent listing requirements in force in 1986, particularly the requirement that listed companies must have a return on equity (earned profits after tax to shareholders equity) of no less than 10% during each of the two preceding financial years. It was further recommended in both Indonesia and Kenya that one way to accomplish this relaxation but still make it clear that some firms are not "blessed" by the Jakarta Stock Exchange would be to admit companies that cannot meet the listing requirements to trading but not listing.[12]

- <u>Privatization of profitable parastatals</u>

10 George Ferris, Jr., "Further Development of Korean Securities Markets" (April 1973), pp. 4-6.

11 Dickie, "Equity Sharing Policies," p. 91.

12 Reilly, "Indonesia Memorandum," pp. 19-20, and Robert M. Bishop, "Recommendations to the Nairobi Stock Exchange."

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The supply of securities is increased if the government privatizes selected state-owned enterprises by offering shares in these companies to the public. Companies selected for divestiture should be successful ones, in order to attract private investors. In addition, as one team member has pointed out, one of the greatest incentives for individual investors is hearing about others' successful investment experience. Since the stocks and bonds of selected public entities in some countries are already acceptable to the public because of their profitability and stability, privatization of successful state-owned enterprises could have an important ripple effect. The Government of Sri Lanka, for example, has already developed plans to promote development of the securities market through privatization of certain public enterprises. In an effort to augment the supply of securities, Bangladesh has also ennunciated a policy to divest 49% of the shares of public companies, including nationalized commercial banks.[13]

o <u>Introduction of new financial instruments</u>

Financial markets in developing countries often suffer from a lack of variety in investment instruments. Expanding the variety of financial instruments available to present investors with different combinations of risk and return is one way to encourage development of the securities market.

Debt to equity swaps, closed end mutual funds, and securitization of illiquid assets can be used to create new financial instruments, promote new investments, and assist in reducing a country's foreign debt. As such, they present important opportunities to increase the supply of negotiable securities and enhance capital market activity.

4) <u>Demand for Securities</u>

Insufficient demand for securities is a common deterrent to growth of equities markets in developing countries. Some of the same factors that constrain the supply of securities, such as tax biases and inadequate financial intermediaries, also diminish the demand for securities. In addition, ownership of securities is often concentrated in a small segment of the population, the

13 ADB Symposium, pp. 10 and 59.

wealthy few, while the majority hold cash or invest in jewels, land, cattle, and other "hard" assets. The level of financial sophistication in LDCs is generally low, and a large portion of the population might not use banks, much less a broker, to invest what little savings they have. In The Yemen Arab Republic, for example, over 60% of the money supply is in the form of cash outside the banking system. In addition, savers often lack confidence in the financial and political stability of the country, and thus require almost instant liquidity.

The most typical impediments to the growth of demand for securities are:

a. <u>Tax Biases/Disincentives</u>

The demand for securities is commonly restricted by tax systems that encourage deposit of savings in banks or investment in government savings programs. As explained earlier, due to the double taxation of dividends common in developing, as well as developed, countries, investors as well as corporations might pay taxes on dividends. On the other hand, interest received from bank deposits is often tax exempt. In addition, capital gains arising from the sale of securities are often subject to income taxes, which further discourages savers from investing in corporate securities.

b. <u>Insufficient Demand from Financial Institutions</u>

Pension funds (both private and public) are frequently barred from investing in corporate securities either through regulation or tax treatment. Insurance companies usually are subject to similar restrictions or are limited to a small percentage of their investments. In some Central American countries, for example, pension funds are not allowed to invest in capital stock, and insurance companies are often required to invest a large percentage of their funds in government bonds. In addition, mutual funds and other types of investment trusts are non-existent in many LDCs.

c. Lack of Investor Confidence

Growth of equity investments is also constrained by lack of investor confidence in this form of investment. This lack of confidence stems primarily from: distrust of corporate managers; fear of market manipulation; absence of adequate financial information about companies; inadequate accounting and reporting standards; and lack of financial sophistication; fear of government expropriation or irrational regulation of business.

5) Potential Approaches to Increasing the Demand for Securities

Efforts to increase the demand for securities should give attention to the following conditions:

a. Comparative Yield

In countries such as Egypt, Kenya, Indonesia, Sri Lanka, and many other developing countries, most investors are yield conscious and do not think in terms of total return (income plus appreciation). It is important, therefore, that dividends not be placed at a comparative disadvantage to other forms of interest income, such as interest earned on bank deposits, postal savings, and housing bonds. To increase the demand for securities, it is important to place dividend and interest income on an equal footing.[14] This can be accomplished in a number of ways, such as removing or reducing the double taxation of dividends, removing or reducing the capital gains tax, making interest from bank deposits taxable at a comparable rate to dividends, and eliminating other tax disincentives to investment in securities. Thus, any effort to induce increased demand for securities should begin with a review of the tax structure in the particular country to ensure that it does not discriminate against the securities market. The goal in policy dialogue and other efforts should be to ensure a post-tax return on interest income from savings deposits, corporate funds and dividends that adequately reflects the investment risk involved.

Japan, for example, does not have a tax on capital gains from securities transactions. According to Kanju Sugimoto, Associate Director and General Manager of The Nomura Securities Company Limited in Japan, the dramatic increase in the number of individual investors in the country is due almost entirely to the absence of a capital gains tax.[15] Taiwan, Korea and Malaysia also do not have capital gains taxes, and have experienced rapid growth in the size of their securities markets. Securities Industry Association studies in the United States show that

14 Ferris, "Kenya", p. 12.

15 ADB Symposium, p. 75.

reduced capital gains taxation can produce offsetting increases in income tax revenue to the government through accelerated realization of gains.

b. <u>Tax Incentives</u>

Tax incentives can be used to influence the behavior of both borrowers and savers. As discussed in an earlier section, tax policies can influence a firm's choice between different forms of finance such as bank loans or new securities issues. Likewise, fiscal incentives can make equities more or less attractive relative to other forms of savings, thus influencing investors' decisions to allocate their savings among different types of instruments.

Developing, and industrialized countries, have provided a wide variety of tax incentives to stimulate demand for securities. Some incentives have been more successful than others. Among the developing countries, the Brazilian experience is frequently cited as one of the most successful tax incentive plans. Beginning in 1965, the Brazilian government established a series of tax incentives to foster the growth of the securities market by encouraging individuals, as well as institutions, to invest in shares or debentures of publicly-traded companies. One of the most important steps the government took was the creation, through government Decree-Law No. 157, of special mutual funds (known as "157 Funds"). Tax provisions allowed individuals and corporations (currently only individuals) to deduct a proportion of their income tax liabilities as long as the amount discharged was invested in the form of quotas in the mutual funds. To encourage long-term investments, withdrawals from these funds could not begin for at least two years. The mutual funds were in turn required to invest in company securities, particulary new issues, but the government designated the proportion of funds that had to be invested in new issues and that which had to be invested in currently traded shares.

Tax-relief provisions also allowed individuals to offset against income tax a portion of the cost of buying listed stocks or convertible bonds. Another incentive provided for part personal income tax exemption of dividends, and for concessional rates of withholding taxes for shareholders in public companies which undertook steps to widen their equity base.[16] These incentives led to a tremendous growth in individual and institutional demand for securities and produced impressive increases in the volume of shares issued and traded. According to IFC statistics, the number of "open capital" companies--those which have opened their share capital to public subscription--rose from 209 in 1968 to 551 in 1978. In addition, the value of shares traded yearly on the Rio de Janeiro and Sao Paulo Stock Exchanges jumped from US$131 million in 1968 to US$4.818 billion in 1971.[17]

16 Roberto Teixeira da Costa, Brazil's Experience in Creating a Capital Market, Bovespa, Sao Paulo Stock Exchange (1985), pp. 40-43, and P.J. Drake, "Securities Markets in Less Developed Countries," The Journal of Development Studies 13, 2 (January 1977), pp. 85-86.

17 Hakim, "Securities Markets," p. 22.

c. Institutional Investors

Institutional investors such as pension funds, insurance companies, and mutual funds can play a vital role in mobilizing savings and investing those savings. Investment trusts and mutual funds provide advantages, in particular to small investors, through diversification, professional portfolio management, and continuous supervision by professional managers. As exemplified by the experience with the "157 Funds" in Brazil, the provision of tax incentives for investment in specialized investment trusts can provide an important stimulus to capital mobilization for investment in productive enterprises.

Countries have used portfolio composition requirements stipulating that institutional investors must invest a certain percentage of their funds in local equities to stimulate development of the securities market. In 1978, for example, Brazil required that the "157 Funds" invest 80% of the total value of their portfolio in shares or convertible debentures of private Brazilian companies.[18]

d. Favorable Investment Experience

A favorable investment experience is an important stimulus to growth in demand for securities as few things attract new investors more than hearing from friends or relatives of a successful investment. Conversely, word of an unfavorable investment can be detrimental to securities market growth. It is generally recommended, therefore, that in the early stages of

[18] Teixeira da Costa, Brazil's Experience, p. 68.

equity market development only the shares of well-established companies with favorable earnings potential and proven management be made available to new investors. An approach suggested earlier pointed to the merits of pursuing divestiture of successful government enterprises and public distribution of their shares. Public confidence in such companies is generally higher than in newly formed entities. Thus, distribution of privatized companies could do much to stimulate investor interest and demand.

e. Measures to Increase Investor Confidence

A number of steps can be taken to increase investor confidence, including:

- Improving disclosure of material information by companies

Investor confidences rests to a large extent on the ready availability of comprehensive and reliable information on the financial condition of the companies concerned. Without it, the public can not make a proper asssessment of a company's financial position. In this context, it is also important that adequate accounting and auditing standards be established. This issue, however, will be dealt with further in section 11.

Furthermore, an adequate broker infrastructure to analyze corporate information and interpret the results in easily understood language is essential.

- Improving the regulatory and supervisory environment

An adequate and effective regulatory and supervisory climate is essential to dispel or at least reduce fears of market manipulation and other abuses. This implies not only developing a comprehensive system of stock exchange regulations and a body of company law, but also an effective enforcement system for these regulations. Otherwise, the public may feel too exposed to the risk of market manipulation and other abuses, and may decline to invest in securities.

o Establishing professional requirements for securities brokers

Financial intermediaries play an important role in the distribution of securities. As will be discussed below in part 4, brokers in many developing countries lack training and often take no responsibility for their transactions. Professional brokers are needed who can provide advice to their customers on the financial position of a particular company and will take responsible actions on behalf of their customers.

o Providing protection of minority shareholders

Company laws should include provisions to protect the rights of minority shareholders. As a substitute, listed company agreements with stock exchanges can fill in any such gaps in corporate law.

o Educating the public on the benefits of investing in securities

Reluctance to invest in securities often stems from a lack of understanding of the benefits that can be derived from owning securities and of the way the securities market operates. Thus, education of both the general public and investors is vital to increase demand for securities and further development of the market. The securities commission of a particular country in the early stages of development can play an important role in this education process by organizing seminars, printing pamphlets, and publicizing the securities market through the radio and other news media. But, as the securities infrastructure develops, these functions should be taken over by stock exchanges, stock brokers, companies, financial institutions, and trade associations. Financial intermediaries also have a key role in public education. In the United States, for example, investment and brokerage firms have been actively involved in investor education and promotion programs through seminars and other means.

f. Foreign Investment

Foreign portfolio investment can increase the demand for securities and provide a stimulus to securities market development. This issue, however, will be dealt with in more detail in section 13.

6) __Financial Intermediaries__

Financial and securities intermediaries--brokers, dealers, market makers, and investment and merchant bankers--are important participants in a capital market. In the primary market, the role of merchant and investment banking firms is to encourage companies to raise finance through public offerings of securities. In the secondary market, brokers act as intermediaries between buyers and sellers in exchange for a fee. Market makers are dealers who buy and sell securities for their own account, to make a market for customers. Their role is very important to the liquidity of the secondary market. In addition, financial intermediaries can play an important role in the growth of the capital market through education of potential investors and programs to promote ownership of securities.

In many developing countries securities intermediaries are inadequate. Often, LDCs have few if any viable investment or merchant banking firms. The financial sector is generally dominated by commercial banks that play a relatively small role in the capital market, since their lending activities are primarily short-term oriented. In addition, in countries with a Glass-Steagall type of banking system, commercial banks are not allowed to engage in underwriting activities. Other common problems include:

a. __Inadequate capitalization__

In many LDCs, brokers are under-financed individuals, rather

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than properly capitalized firms with branch offices to serve customers and generate business throughout the country.

b. Inadequate training

Often, brokers have little if any training in financial analysis. As a result, they cannot provide investors with sound financial advice and generally act solely as "introducers" between clients, and take no responsibility for securities transactions.

c. Absence of market makers

In some countries, there are no market makers who will buy and sell securities for their own account and in so doing provide liquidity for the secondary market.

d. Excessive or inappropriate regulations

In some countries stock exchange regulations or laws may prohibit brokers from engaging in related activities (such as underwriting). In Indonesia, for example, brokers are not allowed to act as dealers or market makers, only as agents for clients.[19] Because of the low level of market activity that prevails in many LDCs, this policy in effect limits profitability and, therefore, the number of brokers. In addition, there may be limitations on selling prices and underwriting commissions and fees, which may encourage abuses such as "free-riding" and insider-trading. "Free-riding" was a common practice in Brazil, for example, in the early 1970s. In fact, it was the largest source of profit from underwriting activities. The deliberate

19 Reilly, "Indonesia Memorandum," pp. 31-32.

underpricing of issues and market manipulation that occurs with "free-riding" leads both to a substantial reduction in the amount of proceeds from the offering available to the issuing company and significant losses to public investors. Sooner or later, such practices undermine public confidence.[20]

e. Inadequate awareness of comparable institutions in other countries

Often there is little information about the role of financial and securities intermediaries in other countries. As a result, the importance of these intermediaries is downplayed or regulations are adopted that impede the healthy development of such institutions.

7) Potential Incentives to Formation of Financial Intermediaries

Incentives to encourage adequate development of securities intermediaries generally include the following:

a. Ensure legitimate profit-making

It is commonly believed that attracting the highest quality professionals to the investment banking and brokerage community is one of the best ways to protect the investing public. Profitability attracts such individuals, but profits should not come from illegitimate activities such as "free-riding" and insider trading. Thus, it is generally recommended that

20 George Ferris, Jr., "FUMCAP - Securities Aspects: Brazil," 1971, p. 4.

regulations that limit legitimate profit-making in the securities business through the imposition of ceilings on underwriting commissions, brokerage fees, and the like, should be eliminated, or the limits raised to reasonable levels. An appropriate approach is to establish underwriting rates at respectable minimums in the early stages of development of the securities market in order to avoid destructive price cutting, while allowing negotiation between issuer and underwriter. In Kenya, for example, it has been recommended that minimum fees be mandated to preclude predatory competition in an embryonic industry, with final fee-setting left to negotiation between issuers and underwriters. In Kenya, and in Indonesia too, for example, it has also been recommended that brokers act as dealers or market makers, not just as agents for their clients, and that they band together for the purpose of serving as underwriters. Because the level of market activity is often low, this would allow them to increase their profit potentials, thus encouraging a greater number of brokers to participate in the market and engage in broader selling efforts.[21]

b. Government-owned banks should not compete as underwriters

In some LDCs, underwriting activities are undertaken by government owned institutions. In Indonesia, for example, Danareksa is the major underwriter in the country. Its dominant

21 Ferris, "Kenya," p. 17, and Reilly, "Indonesia Memorandum," pp. 31-32.

position in the market effectively stifles development of private underwriters and discourages companies from going public.

c. Provide training to create a professional core of securities intermediaries

As noted above, in many LDCs, brokers and other intermediaries have little or no training in financial analysis. Without adequate training, financial intermediaries cannot create confidence among the investing public. It is essential that brokers are familiar with and understand the financial position of issuing companies such as is provided through disclosure reports, and that they can make recommendations to their customers based on such information.

d. Establish intermediary institutions/branches

Often, it is also recommended that branch offices of brokerage firms be established in important cities outside the main urban center. In India, for example, this approach was pursued to spread interest in securities ownership "to the four corners of India." Financial intermediaries should be encouraged to engage in a broader distribution of securites by offering their securities, as they do in India, to suppliers and customers in outlying areas of the country.[22]

e. Adequate finance

Another important issue is that adequate financing be available for underwriting, market-making and investment activities. It has been recommended in some countries that

22 Reilly, "Indonesia Memorandum," pp. 31-32.

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facilities be established for merchant banks and securities brokers, dealers, market makers and investors to obtain finance for their activities. In Indonesia, for example, it was recommended that a securities rediscount facility and a securities market finance fund or corporation be established for that purpose.[23]

8) <u>Trading Facilities</u>

The purpose of the secondary market is to facilitate trading in already issued securities. Its role is crucial to a properly functioning securities market for two major reasons:

- <u>Liquidity</u>

  The secondary market provides liquidity, so that holders of securities can sell their securities when they see fit;

- <u>Pricing</u>

  The secondary market provides a price-determining mechanism, whereby market participants interact to bring together buying and selling interests both for fair secondary market prices and for use in setting prices on new issues of securities in the primary market.

From the point of view of securities market development, these functions are crucial, because the goal of capital market development is to facilitate mobilization of and access to long-term capital, preferably equity capital, for productive enterprises. Without properly functioning secondary trading facilities, there is insufficient liquidity to attract investors,

23 Ibid., p. 32.

securities can be improperly priced, prices can be more easily manipulated, and securities professionals and insiders may have access to information and opportunities denied to ordinary investors. Unfortunately, once investors have been harmed, they will shy away from the market, thus reducing the amount of savings available for productive investments.

In many developing countries the facilities for trading securities are under-developed or require revitalization. In some cases there is no organized market, and a securities exchange or other organized trading facility must be established for the first time. In other countries, existing market facilities are outdated or dormant, or in some cases they operate as private clubs and are not subject to adequate standards or safeguards.

Efforts to improve or organize secondary market trading facilities must deal with the following issues, among others:

a. Type of Market

A country or company must decide whether the trading mechanism for particular securities should be an auction stock exchange, where all current buy and sell orders represented by brokers are centralized in one physical place or computer system, and exposed to each other and market maker interest to produce the best possible price for each order transacted. Or where there is insufficient infrastructure or trading volume, purely brokered transactions between customers or an over-the-counter trading market may be the only alternatives.

In Kenya, for example, stockbrokers neither conduct an auction nor buy and sell for their own account. They are simply intermediaries for negotiations between buying and selling customers, occasionally represented by other brokers.[24]

Over-the-counter markets are those in which individual security dealers make their own markets buying securities for or selling securities from their own inventories. At primitive stages of development, over-the-counter markets can result in different prices for the same security at the same time by different brokers. With regulation and fast communication between many dealers by telephone or computer, however, over-the-counter markets can compete with auction markets in pricing efficiency and liquidity.

Both types of markets exist simultaneously in the highly developed securities markets, some physical trading floors, some computer networks, some telephone networks. The United States has both the largest auction and over-the-counter markets: the auction market on the computer assisted trading floor of the New York Stock Exchange, and the over-the-counter market through the automated quotation and trading systems of the National Association of Securities Dealers (NASDAQ).

Typically, an over-the-counter market may be developed to supplement trading on the traditional stock exchange and to attract companies that can not meet the stringent requirements of

[24] Robert M. Bishop, "Recommendations to the Nairobi Stock Exchange."

the stock exchange. In the United States, for example, the over-the-counter market developed because many of the smaller companies could not meet the stringent listing requirements and listing costs of the major exchanges. In other environments, smaller companies not suitable for stock exchange listing and auction trading may be traded as unlisted securities on the Exchange as a second tier.

In some countries, an over-the-counter market is effective in establishing an investor base and a secondary market for a company. According to Mr. Kanju Sugimoto, General Manager of the Nomura Securities Company Limited in Japan, "new issues opportunities and secondary market tradings are in a chicken-and-egg relationship." If it is difficult to obtain financing in the equity market because the secondary market is very weak, few companies will want to list their shares. But, with few listed companies, activity in the secondary market cannot pick up. Sugimoto suggests that an over-the-counter market can be used to solve this dilemma. Listing requirements in the over-the-counter market would be less stringent and companies might not be able to obtain the same tax privileges accorded listed firms. However, when the trading volume of such shares became large enough, companies might then move to the stock exchange and comply with its listing requirements.[25] Recently, the government of Indonesia decided to establish an over-the-counter market in order to supplement trading on the Jakarta Stock Exchange, which

25 ADB Symposium, p. 55.

has failed to attract new listings since 1984 and has suffered from a very low level of trading activity. The new market, unlike the Jakarta exchange, will be open to foreign participants and will have less rigorous listing requirements.[26]

b. Market Structure

A country also needs to decide whether trading will be required to occur only on the officially recognized trading facility, or whether trading will also be allowed outside the facility, on the "curb". If trading will only be allowed on the official facility, the question then becomes how to enforce this rule.

c. Efficiency

An important consideration is how to make trading facilities more efficient, productive and useful for securities professionals and investors. A number of issues need to be considered in this regard, including:

- collection and dissemination of information about transactions in the market such as volume, and opening, closing, high and low prices (so-called "market information");
- collection, dissemination, and interpretation of information from issuers of securities traded in the market relevant to buyers and sellers in determining market prices (so-called "corporate information and analysis");
- detection and prevention of fraud and manipulation;
- development of better methods of trading and more modern methods of corporate finance;
- improvements in transfer of certificates and in

26 Intrados Group, Swaps, 2, 2 (February 1988), p. 11.

clearance and settlement (payment and delivery of securities transactions); and

- merchandising and advertising to spread securities ownership among the general population.

d. Government or Private

Another issue is to determine whether the trading facility should be private, with no government involvement, or whether the government should play the primary role in establishing, financing, monitoring, or even operating the facility.

Historically, stock exchanges in most countries were established as private bodies by members wishing to exercise monopoly control over securities trading. As markets grew, the stock exchanges imposed listing requirements, and concerned governments relied on these to protect investors. In addition, many countries, particularly European, imposed restrictions on institutional investors, prohibiting them from investing in unlisted securities. Since the birth of the concept of securities regulation, however, other means of protecting investors have emerged, such as securities laws, disclosure requirements, standard accounting and auditing procedures, among others.

An intermediate condition existed in Jamaica from 1980 to 1988. The government subsidized the private stock exchange by furnishing a trading room and offices in the Bank of Jamaica and a bank officer and six staff members to administer the Exchange.

Currently, the stock exchange in most countries still operates as a private body with formal requirements for listing and membership. A securities commission is generally charged with oversight responsibilities. This is not always the case, however. In Indonesia, for example, a government agency, BAPEPAM administers the stock exchange. One important disadvantage to this is that it is difficult for BAPEPAM, as a goverment agency, to take a private sector point of view, and it is the private sector's profit-making motive that drives a stock exchange. Therefore, in the case of Indonesia, it has been recommended that the BAPEPAM should adopt a more traditional oversight role and allow the private sector to administer the stock exchange.[27]

e. Self-Regulation/Oversight Regulation

The primary purpose of regulation is to assure fair and orderly markets and protection of investors in order to maintain and increase investor confidence. The issue of self-regulation has to do with the extent to which a privately operated trading facility should establish its own rules and regulations and the extent to which government agencies should act as regulators of market participants. Different countries have taken different approaches, ranging from extensive private self-regulation to extensive government regulation. The correct response will depend on local conditions.

In some developing countries, trading facilities are run by government agencies and regulations are set by them. Other countries have adopted the British approach which allows the

[27] Reilly, "Indonesia Memorandum," pp. 10-11.

stock exchange to operate largely on the basis of private self-regulation. Still others have followed the U.S. approach in which trading facilities are allowed to operate as self-regulatory agencies subject to oversight regulation by a government ministry or securities commission.[28]

The challenge is to attain a delicate balance between a system that assures adequate protection of investors and one that does not deter market growth. Inefficient or inappropriate regulation can lead to speculation, heavy damages to investors, and loss of investor confidence. On the other hand, over-regulation can stifle private initiatives and discourage companies from going public.

f. Developmental Duties

The issue here is whether the trading facility, be it a stock exchange or an over-the-counter market facility, should undertake duties to help develop the securities market. The recommendation is generally that it should for the reasons cited in 6) below.

g. Cost

Initial trading facilities in LDCs need not be very expensive. It is not necessary to establish elaborate securities exchanges; simple trading mechanisms can be established that allow flexibility for growth.

9) Developmental and Regulatory Issues

[28] Reilly, in ADB Symposium, pp. 182-183.

An important issue in equities market development is that of regulation and development of the market and the appropriate balance between these two objectives. All too frequently, the focus of government agencies is heavily weighted towards regulation rather than development of the market. As Sir Kenneth Berrill, Chairman of the Securities and Investments Board of the United Kingdom has pointed out, "It is essential not to divorce the objective of developing capital markets from the objective of regulating them: markets which develop without a suitable regulatory framework will not, in the long run, operate as successfully as those which are effectively regulated. Securities commissions, and similar organizations, thus have a dual responsibility, neither of which should predominate at the expense of the other." [29]

In most developing countries, regulatory and developmental policies and procedures require substantial improvement. Some of the more common problems include:

a. <u>Lack of a unified government office for the supervision and development of the market</u>

In many developing countries there is no collective expertise on financial market matters focused in one entity. Generally, responsibility for supervision and development of the capital market is segmented among different government agencies--the Ministry of Finance, the Securities Commission, the Central Bank, etc.--whose roles may overlap or conflict. The result is

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29 ADB Symposium, p. 160.

duplicative, misdirected, and bureaucratic regulations.

Lack of a unified government office for the supervision and development of the capital market was a major problem at the time of the 1979 crisis in Thailand, for example. At the time, regulatory and developmental responsibilities were fragmented among various government agencies. According to Manas Leeviraphan, Director-General of the Fiscal Policy Office of the Ministry of Finance of Thailand, this fragmentation impeded efficient policy formulation with the consequence that no single agency was able to take immediate action to resolve the crisis in the Securities Exchange of Thailand. The crisis had a detrimental impact on investor confidence for years to come.[30] On the other hand, a crisis in Singapore in 1986 was quickly resolved by the Monetary Authority section on capital markets and the Stock Exchange, reopening the exchange after two days of closure.

b. Scarcity of adequate skills

Often, staff do not have the requisite skills to conduct regulatory work or to promote development of the securities market. In addition, the unnecessary duplication that results from having a number of government agencies involved in securities market regulation and development often contributes to the shortage of skilled personnel.

c. Insufficient understanding of the markets

In many countries, existing regulatory bodies are run by

30 Ibid., p. 151.

officials and civil servants who have knowledge of regulation, but lack knowledge of how a market works, and what will develop it. Generally, there are few if any practitioners with a real understanding of how securities markets operate.

d. <u>Lack of authority to enforce regulations</u>

Existing bodies often do not have enough authority or qualified manpower to enforce rules or to promote regulations to develop the market.

e. <u>Inconsistent and outdated regulations</u>

Frequently, regulations are introduced in response to specific problems and on an ad-hoc basis. As a result, regulations are often inconsistent and may even be unenforceable. In fact, some regulations are based on outdated legislation and may be at cross-purpose with goals to develop a securities market.

f. <u>Too much emphasis on regulation and little if any on market development</u>

As explained above, government agencies in charge of securities matters generally focus on regulatory duties, with little if any responsibility for market development. Experience shows that countries like Brazil and Korea, which have taken a developmental approach to capital market growth while at the same time attending to regulation, have been more successful in their efforts to develop the market. In Brazil, for example, associations comprised of merchant bankers, brokers, and institutional investors have been particularly effective in making practical recommendations on how to develop the securities market.[31]

g. Lack of a clear developmental policy

The absence of a clear policy in favor of capital market development can itself be a deterrent to development. In many countries, the absence of a clear government policy to pursue capital market development objectives has led many to believe that the government does not have a sufficient interest in them.

Thus, in order to revitalize and encourage capital market development, it is generally recommended that the government appoint a central capital markets authority or working group to devise an action program for capital mobilization and capital market development and to act as the focal point for analysis and discussion. Such recommendations have been made by team members in a number of countries, including Indonesia, Kenya, and Portugal. The setting up of a central capital markets authority or committee permits a coordinated approach by bringing together available expertise and knowledge. Generally, it is recommended that representatives of the private sector, including merchant bankers and brokers and publicly traded companies, be allowed to participate directly through these committees to provide information on how the securities market works and what companies and investors need in order to participate actively in the market. Representatives of institutional investors should also

31 Reilly, "Indonesia Memorandum," p. 11.

be allowed to participate.[32]

10) Laws Affecting Business Formation

Laws and regulations have substantial impact on the development of securities markets. In many developing countries, prevailing laws and regulations impede the proper functioning and expansion of the capital market. Frequently, laws are based on legal systems, such as the Napoleonic Code, developed in other countries in earlier periods and exert excessive control over private sector activities. In addition, laws generally provide no cohesive approach to securities market development and may even conflict with development objectives.

Company law is generally regarded as the most important law with regard to securities market development. Company law creates the environment for the establishment and operation of companies, and for the issuance of securities. The Asian Development Bank, among others, has found that in many developing countries company laws are usually very rigid and require substantial review and revision.[33] In Bangladesh, for example, the Company Law of 1913 stipulates very little disclosure of financial information. As a result, there is a lack of investor confidence that has contributed to a low demand for securities. According to Khurshid Alam, Former Chairman of the Dhaka Stock

[32] Reilly, "Indonesia Memorandum," pp. 9-10, and Ferris, "Kenya," p. 5.

[33] ADB, Capital Market Development, pp. 68-69, and Reilly, in ADB Symposium, pp. 186-187.

Exchange, Bangladesh's Company Law is outdated and substantial revisions are required to promote capital market development.[34]

A different situation has arisen in Jordan. There, financial market authorities in Amman have been interested in the possibility of establishing mutual funds. The Companies Act of Jordan, however, does not permit the establishment of open- or closed-end investment companies. Therefore, the Companies Act must be amended before Jordanian authorities can proceed with plans to develop mutual funds in the country.[35] On the other hand, Jordanian company law requires that all companies wishing to have limited liability status must go public. This has been the major factor responsible for the rapid development of the securities market in Jordan.[36]

In Indonesia, the Commercial Code is written in Dutch and has remained virtually unchanged in nearly 50 years. To make matters worse, the number of Indonesians who read and write Dutch decreases every year.

Some of the most common problems for securities market development posed by Company Laws in developing countries include

[34] Khursid Alam in ADB Symposium, p. 127.

[35] Benjamin M. Vandegrift, "A Preliminary Assessment of the Development of Mutual Funds in the Kingdom of Jordan" (April 30, 1987), p. 5.

[36] David Gill, "Some Thoughts on the Implications of Different Financial Institutional Structures on Securities Market Development." Paper Presented at the Conference on Las Instituciones Financieras en el Mercado de Capitales en Chile (Chile, 1979), p. 36.

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the following:[37]

a. Restrictions on the potential for securities market development, including limitations on incorporation without specific approvals, restrictions on the issuance of securities, limitation of the public offering price to "par value", restrictions on new share issues to rights offerings, allowance of partially-paid shares and founders shares, restriction on the issuance of corporate bonds and debentures, cumbersome share transfer requirements, and impediments on the issuance of more innovative instruments such as convertible bonds, warrants, and options.

b. Failure to clarify the legal position of certain types of activities such as investment and merchant banking activities, leasing, and venture capital.

c. Failure to provide basic needs for proper market functioning such as disclosure of material information about companies.

d. Inadequate protection for securities holders. This refers to majority control of all actions without due protection of the rights of minority holders.

e. Inadequate administration and enforcement of the law (failure to provide appropriate enforcement powers and sanctions).

[37] Reilly, in ADB Symposium, pp. 86-87 and ADB, Capital Market Development, p. 69.

11) <u>Accounting and Auditing</u>

Adequate accounting and auditing procedures and standards are central to the efficiency and effectiveness of resource mobilization and allocation through the securities market. Without adequate accounting, auditing and financial reporting practices, it is not possible to determine the true financial position and profitability of enterprises. As a result, resources can be misallocated and investors can be misled. Moreover, in the absence of uniform reporting requirements and generally accepted accounting principles, investors cannot make reliable comparisons among different companies. Yet, in many developing countries, financial statements are not governed by legally binding generally accepted accounting principles (GAAP) and audits are not conducted in accordance with legally binding generally accepted auditing standards (GAAS). Some common problems include:

- auditors are not independent of the companies they audit;
- businesses maintain two sets of books, one for the owners, and one for the tax authorities;
- there is no professional body of accountants and auditors to establish uniform principles and standards and to license and regulate professionals;
- there is no private or government authority with the power to impose duties and standards;
- there is a lack of criminal penalties for false certification by auditors.

As discussed earlier in this chapter, the absence of adequate accounting and auditing procedures can affect both the demand and supply of securities. On the demand side, inappropriate accounting and auditing standards discourage savers from investing in securities because they cannot obtain accurate information about the financial position of companies. On the supply side, companies may be reluctant to go public for fear that financial disclosure will result in higher taxes to the company. There is an unfortunate dilemma created in those instances where public companies are audited appropriately while private companies are able to evade taxes.

Recommendations to improve accounting and auditing standards and procedures generally call for the following:

- thorough review of laws and regulations governing accounting and auditing, followed by revision of necessary laws to improve financial reporting;
- provision of training and establishment of licensing requirements for accountants and auditors;
- establishment and enforcement of GAAPs and GAASs, and uniform financial reporting requirements; and
- uniform enforcement of accounting requirements among publicly traded companies as well as private companies of a certain size to remove disincentives to going public.[38]

12) <u>Training</u>

The absence of widespread professional expertise in the securities area is a major constraint to equities market development in many developing countries. As described throughout this paper, most developing countries suffer from a lack of personnel with experience in securities market operations

[38] Reilly, in ADB Symposium, pp. 181-182.

and development. Generally, there are few professional accountants and many securities brokers and other financial intermediaries have little if any training in financial analysis and techniques. Supervisory and regulatory officials also lack experience in securities market development and little is known about experiences in other countries. Therefore, it is important that government officials and private sector representatives receive training in securities market development and operations, market-making, brokerage, regulation, and accounting, among other areas.

It is often recommended that training include courses at training institutes in the major market centers, and that selected candidates be sent to stock exchanges, over-the-counter regulatory organizations, and securities firms in developed countries in order to gain first-hand experience.

All too often, government officials and private sector representatives in a developing country know little about securities market operations in other countries and about the benefits of equities markets to economic development. Therefore, it is often recommended that delegates from both the public and private sectors in one country visit knowledgeable practioners in other countries in order to compare and learn about securities markets developments, regulations, incentives, and benefits. It is more important, however, that these representatives visit securities markets comparable to their country conditions and market development stage, such as Brazil, Singapore, and

Malaysia, than the larger markets of the United States, Japan, or the United Kingdom.

The securities commissions and other supervisory agencies can play an important role in the area of training by stimulating training programs for employees of the stock exchanges and brokerage firms. In addition, they can set professional examinations to set minimum standards for market operators and thus help to increase investor confidence.

13) Foreign Investment

The question of foreign investment must be evaluated in any equity markets development undertaking. In recent years, securities markets have become increasingly internationalized as institutional investors have expanded their horizons in an effort to diversify their portfolios, and as brokerage and underwriting firms have expanded their office networks worldwide. Numerous international mutual funds, unit trusts, and other collective investment vehicles have been established.

Some developing nations are more willing than others to allow foreigners to invest in local securities. The Malaysian, Chilean, Thai, and Philippine markets, for example, are relatively open to foreign investment, while Brazil, India, Taiwan, Korea, and Mexico are accessible through a variety of investment funds. By and large, however, there is still considerable resistance among LDCs to opening their securities markets to foreign investors. The most common impediments are tax and regulatory barriers, including strict limits on repatriation of income, prohibition of majority ownership by foreigners, maintenance of high capital gains taxes, and foreign exchange restrictions.[39]

[39] Swaps, p. 7.

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DRAFT

POLICY PAPER

ON

FINANCIAL MARKETS DEVELOPMENT

U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT

APRIL 19, 1988

DRAFT POLICY PAPER ON FINANCIAL MARKETS DEVELOPMENT

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4/19/88

DRAFT POLICY PAPER ON FINANCIAL MARKETS DEVELOPMENT
EXECUTIVE SUMMARY

Effective financial markets are indispensible to the pursuit of sustained, broad-based economic growth. Unfortunately, financial markets development is one of the most complex areas in the development field. The purposes of this policy paper are to (a) describe A.I.D.'s policy on financial markets development, and (b) provide guidance on the development of A.I.D.'s programs and projects in financial markets.

Whether financial systems are relatively simple or highly complex, they perform the same broad functions and share the same key characteristics.

-- The primary role of the financial system in any economy is to mobilize resources for productive investment. An efficient financial system channels resources to activities that will provide the highest rate of return for the use of the funds. These resources stimulate economic growth; they provide enterprises with the ability to produce more goods and services and to generate jobs.

-- Governments in developing countries can and should facilitate financial markets development and provide a policy and regulatory environment that encourages the appearance of competitive forces, encourages the use of a variety of debt and equity instruments, promotes the growth of different kinds of institutions offering a wide range of financial instruments and services to potential savers and investors, and protects the interests of savers by reducing their risks.

-- Effective financial markets are integrated in two dimensions. Vertically integrated financial systems are those in which the three principal market clusters (formal domestic markets, informal markets, and international markets) are closely linked. Horizontally integrated financial markets are those in which market interest rates typically array themselves around a basic reference rate.

-- Efficient financial markets promote more widespread ownership of assets in a society. A larger number of citizens in a developing country will thereby have an opportunity to participate in, and enjoy the benefits derived from, the growth of their country's economy.

A.I.D. supports developing countries' efforts to develop financial markets. A.I.D. will encourage these countries to (a) design, adopt and implement policies conducive to the development of efficient, deep, and integrated financial markets, relying primarily on market rates of interest and other terms for the efficient mobilization of private savings and allocation of credit, and (b) build and promote competition between viable private, profit-making financial institutions.

A.I.D. can draw upon a broad range of resources to help developing countries build more effective financial markets. Through both the policy dialogue process and project assistance, A.I.D. can be a catalyst for financial liberalization in developing countries. Different countries, depending on their stages of economic and financial markets development, may require different kinds of assistance. The primary policy approaches discussed in the policy paper are summarized below.

-- A.I.D. too often has designed and implemented projects without adequately taking into account broader issues involving the financial systems in developing countries. In addition, many Missions manage a variety of "credit" projects and other financial markets activities simultaneously. Missions contemplating, or maintaining a continued presence in, financial markets activities should prepare a comprehensive financial markets development strategy paper before or in conjunction with pursuing additional financial markets activities.

-- Failure to consider the macroeconomic setting may obscure the forces behind financial developments and lead to inappropriate policy recommendations. Improvements in policies affecting financial markets is an important objective for Missions that are active in the financial markets arena. In those countries in which the macroeconomic policy environment is not conducive to efficient performance of private financial institutions, A.I.D. should (a) urge the host government to adopt more appropriate policies and (b) consider postponing initiation or replenishment of financial markets activities until evidence exists that the host government is prepared to improve the policy environment.

-- Domestic private savings should provide the major source of loan resources for financial institutions. Inappropriate policies inhibit prospective savers from relying on the formal financial system. A.I.D. should help developing countries develop and implement policies to encourage, mobilize, and monetize domestic savings.

-- Over-reliance on directed credit results in often severe misallocations of scarce investment resources which undermines the strength and viability of financial institutions and retards the growth of financial assets. A.I.D. discourages excessive reliance on directed credit. A.I.D. should encourage developing countries to rely on market mechanisms to allocate capital to its most productive uses.

-- In many developing countries, governments hold nominal interest rates constant. During periods of inflation, real interest rates fluctuate with inflation, and will become negative if the inflation rate exceeds the nominal rate. When the outright removal of all statutory ceilings to deposit and lending interest rates is not feasible, A.I.D. should encourage the host government to adopt specific reforms that permit interest rates to adjust (within an acceptable timeframe) to market levels in a deliberate and timely way.

-- In many cases, the existing legal and regulatory framework restricts the growth of financial techniques and limit the ability of financial institutions to maximize their profits by seeking higher yield investments elsewhere. A.I.D. should engage in policy discussions and offer technical assistance, as appropriate, to reduce imprudent, and strengthen prudent, legal and administrative controls on financial institutions, and streamline and simplify the regulatory and supervisory responsibilities of government agencies.

-- Strong institutions are essential parts of effective formal financial systems. Improvements in the institutional framework are a means of attaining the objective of broad-based economic growth. To the extent feasible, A.I.D. should give priority attention to strengthening the private financial system and those private institutions that have a reasonable prospect of being self-sustaining.

-- A.I.D. has been active in helping developing countries improve their financial systems through the provision of credit. A.I.D. will not take an equity position in any private enterprise. The interest rate to be charged on A.I.D. resources to ultimate borrowers (a) shall, at a minimum, be at or near the prevailing interest rate paid on U.S. Treasury obligations of similar maturity at the time of obligating such funds, to the maximum extent practicable, and (b) should not be less than terms prevailing locally or a rate that approximates the opportunity cost of capital in that country. At a minimum, the interest rate to ultimate private borrowers should be significantly positive in real terms, i.e., when adjusted for inflation. A.I.D. funds provided to financial institutions should carry an interest rate that (a) is at least equal to the cost of local, non-concessional sources of capital; (b) approximates the cost of lendable resources of comparable maturities from the local private capital market (if such resources exist); and (c) is based on the appropriate rate to the ultimate borrowers.

DRAFT POLICY PAPER ON FINANCIAL MARKETS DEVELOPMENT

I. INTRODUCTION

Effective financial markets are indispensible to the pursuit of sustained, broad-based economic growth.* Unfortunately, financial markets development is one of the most complex areas in the development field. Policy perspectives differ, often sharply, and the costs of establishing and implementing poor policies are high.

The purposes of this policy paper are to (1) describe A.I.D.'s policy on financial markets development, and (2) provide guidance on the development of A.I.D.'s programs and projects in financial markets.** A.I.D. should promote a system of financial markets that is integrated and relatively undistorted, one that relies heavily on competitive financial institutions capable of effectively mobilizing private savings and of allocating that savings to investments yielding maximum returns.

* A financial system is composed of many financial markets, each offering different types of financial services, serving different sets of customers, and operating in particular geographic areas. Markets can be classified as involving debt instruments, equity instruments, or foreign exchange (or some hybrid involving more than one of these, e.g., letters of credit). The policy approaches and principles described in this policy paper are applicable to the development of all financial markets.

** The policy guidance presented in this paper apply to the use of all A.I.D. resources (DA, ESF, PL 480, U.S.-owned local currency) and, when practicable, host country-owned local currency. References to forms of A.I.D. activities (such as "project" and "program") are used interchangeably in this policy paper. The policies presented in this document should be applied in concert with those in the A.I.D. policy papers on Private Enterprise Development (revised March 1985) and Pricing, Subsidies, and Related Policies in Food and Agriculture (November 1982); the Guidelines on Terms of Aid (revised October 1985); and the guidance contained in cables 1986 STATE 259310 and 259314 on the private enterprise local currency lending program described in sections 106 and 108 of the Food Security Act of 1985. Separate guidance on the Housing Guarantee Program is provided in the Shelter Policy Paper (February 1985).

II. THE FUNCTIONS AND KEY CHARACTERISTICS OF FINANCIAL MARKETS

Low-income economies can only support relatively simple financial systems; more advanced economies require more complex financial systems. The nature and performance of financial systems therefore must be judged in relation to the individual country's level of development. Whether financial systems are relatively simple or highly complex, they perform the same broad functions and share the same key characteristics. These functions and characteristics are discussed below.

A. Mobilizing Domestic Resources

The primary role of the financial system in any economy is to mobilize resources for productive investment. The financial system provides the principal means to transfer savings from individuals and companies to private enterprises, farmers, individuals, and others in need of capital for productive investment. An efficient financial system channels resources to activities that will provide the highest rate of return for the use of the funds. These resources stimulate economic growth; they provide enterprises with the ability to produce more goods and services and to generate jobs.*

Well-functioning and well-developed financial systems encourage savings and allocate resources to higher-yielding investments. Savers can make their surpluses available to investors by, in effect, purchasing financial assets (from a variety of debt and equity claims including entries in a savings passbook from a commercial bank). The financial system mobilizes savings and increases liquidity by providing asset holders with attractive (in terms of yield, risk, and liquidity) financial claims. In the absence of developed financial systems, only investments financed by individual savers or closely-knit groups of individuals would be possible. Many high-yielding investments would not be undertaken and some capital would be invested in activities yielding low returns.

Well-developed formal financial markets offer to savers and investors a variety of short- and long-term savings and investment instruments (often, but not always) through qualified financial intermediaries that enable individuals to make reasonable judgments about the risk and rewards of saving or

* Private enterprises are defined as privately-owned, for-profit business entities. They should be distinguished from private voluntary organizations (PVOs) which are private, nonprofit entities.

investing their funds. These instruments effectively package risk and returns so that individuals who wish to participate in appropriate markets can do so, taking into account their own perceived capacity to accept risk. Individuals are able to borrow funds on terms commensurate with the expected risk and return of the investments they wish to make.

Financial systems transform the size, maturity, and risk characteristics of assets. For example, to reduce their risk, investors who wish to finance the acquisition of long-lived capital prefer to borrow at long term. For similar reasons (to reduce their risk), savers seldom are willing to tie up their funds for the long term. Financial systems mediate, _inter alia_, between the short-term perspectives of these savers and the long-term perspectives of these investors. They do so through (1) direct term transformation of maturities by borrowing short and lending long, and (2) indirect term transformation by buying and selling long-term instruments prior to maturity in secondary markets.

Another way to mobilize domestic resources is through the development of the equity or securities market. Equity financing provides an alternative to debt financing; it also offers new opportunities for investors and for broadening the ownership of economic assets.

In a very shallow financial system, friends, relatives, and moneylenders are the primary sources of external finance. As the system develops, prospective investors increasingly can turn to local financial institutions, national financial organizations and, ultimately, international banks and securities markets for additional funds. Each step leads to a more efficient allocation of capital. The resulting increase in the availability of equity and debt funding will enable developing economies to move towards more balanced capital structures of enterprises.

B. The Role of Government

The growing inadequacy of financial systems as countries develop often leads to government intervention in the financial system. To the extent that government involvement in financial systems is misdirected, the development of efficient financial markets will be inhibited. The costs of inappropriate or excessive government intervention in financial markets are well known. For example, persistent and usually subsidized directed credit programs typically do not adequately reach their intended beneficiaries, limit the access to (and make more costly) credit of firms not in government-designated "priority" sectors, create "moral hazard" on the part of private investors who operate under the expectation that government support will ward off failure, reward inefficient capital-intensive patterns of investment, require administrative burdens most developing countries are particularly ill-equipped to handle, and discourage savings intermediation.

At the same time, government plays a key role in assuring that financial markets operate effectively. Governments in developing countries can and should facilitate financial markets development and provide a policy and regulatory environment that encourages the appearance of competitive forces, encourages the use of a variety of debt and equity instruments, promotes the growth of different kinds of institutions offering a wide range of financial instruments and services to potential savers and investors, and protects the interests of savers by reducing their risks.

The proper role of government is heavily conditioned by one key characteristic of financial markets. Unlike markets in goods and most services (there is a simultaneous exchange of value in any goods market and in most service markets), financial markets involve sale and purchase transactions that are separated in time. In a financial market, the product is exchanged for a commitment (for example, in the savings market, a promise to repay savings deposits plus interest), that is, for a promise to act in the future. Although a certain amount of risk is part of any economic transaction (witness the admonition "caveat emptor"), assessing and coping with risk is the essential component of every financial market transaction.

The nature of the product involved is in large part determined by the personal characteristics of the actors involved in the transaction. Personal judgments of creditworthiness lie at the core of all financial markets. In addition to other political and economic reasons, the crucial importance of personal judgments and the attendant high potential for (1) abuse through, for example, collusion and fraud and (2) expressions of lack of investor and saver confidence in financial markets, have led to different degrees of government involvement in the operations of those markets, depending on the country. The appropriate balance between an emphasis on market-based and administratively determined (government dominated) systems depends upon political, economic, financial, historical, and cultural considerations. The types of policy approaches available could generally be classified in four categories:

(1) "purely" competitive, where government policy is to rely on market forces with limited government involvement even in matters related to supervising, and establishing solvency requirements for, key participating institutions;

(2) competitive but heavily regulated for soundness through extensive use of supervision and solvency rules;
(3) administered market, where government intervenes by allocating finance and structuring institutions, but lets markets set prices within these parameters; and
(4) managed, where government decisions replace market relationships and the enforcement of supervision and solvency policies is minimal.

The mix or balance of policy approaches could differ in a given market through time and among different markets in a given country. Government policies now generally favor administered or managed systems in many of the developing countries in which A.I.D. operates. Recently, however, several developing countries have liberalized their financial markets. They have implemented reforms to reduce the extent of government intervention through inter alia state ownership of banks, directed credit programs, and subsidized interest rates. As a result, financial markets in these countries are less distorted and more integrated; they respond more readily to market signals rather than administrative directives.

C. Efficiency and Depth

Financial markets can be effective to the extent that they are efficient and deep. Governments regulate financial markets to promote efficiency and to avoid excessive volatility. These often are competing objectives.

Efficient financial markets (1) mobilize funds from savings with, at the margin, the lowest opportunity cost (adjusted for perceptions of risk) and (2) distribute those funds to investments which offer, at the margin, the highest potential returns (adjusted for perceptions of risk). Taken together, these are the two characteristics of allocational efficiency. Efficient financial markets also mobilize and allocate funds at minimal cost. This is the characteristic of operational efficiency.

In many developing countries, formal financial markets are shallow: relatively few people have access to these markets, and the range of available financial instruments is limited. A commonly used indicator of financial depth is the ratio of broadly defined money (currency plus demand deposits) to gross domestic product. A low ratio suggests that the financial system is a poor mobilizer of funds; combined with strong demand for funds by the public sector, a low ratio makes credit to the private sector very scarce. The depth of financial markets is a measure of their strength: deep financial markets are inherently less fragile than shallow financial markets.

Shallow, formal financial markets do not adjust well to external shocks without collapsing or displaying excessive fluctuations; they are markets in which, inter alia, severe market gyrations are fairly common, institutions too often collapse, and "secure" instruments are not, in fact, safe havens for savings. Shallow financial markets also are rather easily subject to manipulation. Low-income developing countries, with their shallow financial markets, can be expected to rely relatively more heavily on administrative allocation systems than high-income developing countries.

However, in most of the developing countries in which A.I.D. operates, government policies now appear overly concerned with curbing volatility and inadequately concerned with promoting operational and allocational efficiency. The quest for greater efficiency in the financial markets of developing countries typically means relying more heavily on market forces rather than on administrative controls. There is a risk -- due to heightened market volatility -- involved in the timing and sequencing of introducing liberal reforms. The recent experience of the Southern Cone countries of Latin America is instructive. The main lessons of that experience are:

- financial liberalization should be accompanied by effective supervision of both public and private institutions to avoid fraud, circumvention of sound financial practices, and misuse of funds;

- financial authorities should devalue an overvalued currency before attempting to reform domestic financial markets. Failing to do so will lead to "excessive" borrowing in anticipation of a real devaluation;

- financial authorities should consider carefully the likely effects of rapid reductions in existing interest rate subsidies. Depending on the context, a sudden shift to high real rates may trigger widespread defaults and lead to a collapse of the banking system; and

- financial authorities should pay particular attention to the sequence -- the timing -- of reforms. For example, authorities may wish to liberalize the international current (trade) account before liberalizing the capital account. Otherwise, depending on the context, the result may be destabilizing short-term capital inflows that could stimulate rapid unwarranted appreciation of the domestic currency.

D. Integration

Effective financial markets are integrated in two dimensions. First, integration can be "vertical." Vertically integrated financial systems are those in which the three principal market clusters (formal domestic markets, informal markets, and international markets) are closely linked. Second, integration can be "horizontal." Horizontally integrated financial markets are those in which market interest rates typically array themselves around a basic reference rate.

In horizontally integrated and efficient formal financial markets, the reference rate, typically the inter-bank rate, is the market rate of a short-term, low-risk financial instrument. Such an instrument is easily available to financial institutions. It typically provides the basic liquidity for the formal financial system, and central banks often use it to gauge the tightness of monetary policies.

Two markets sometimes are closely integrated because intermediaries operate simultaneously in both; for example, commercial banks operate in both the savings (deposit) and the loan markets. On the other hand, in most developing countries, the government bond market and the market for housing loans probably will not be very tightly integrated.

Vertically integrated financial systems incorporate informal and international financial markets with formal domestic financial markets. Informal financial markets are especially important in the poorer developing countries in which A.I.D. operates because the size of the informal markets often dwarfs that of the formal markets. In addition, informal financial markets typically are of more immediate concern to A.I.D.'s target population, the poor majority, than are formal markets.

Although knowledge of informal markets, especially those that are urban-based, is limited, informal markets may not be as inefficient as has long been believed. These markets are, however, highly segmented; moneylenders, for example, do exercise spatial monopoly power. Informal financial markets clearly are "interlinked" markets, in that informal financial transactions spill over into transactions in the local land and labor markets (for example, local money lenders often are members of the landed elite and often hire labor at differential rates depending on the indebtedness of that labor). As a result, it is extremely difficult to isolate and analyze the activities that take place within informal financial markets. Assessing the degree to which these interlinked informal financial markets are integrated with formal domestic financial markets is even more difficult.

An effective financial market system also should connect domestic financial markets to international financial markets (and to the related commodity trading systems). The presence of effective financial markets in developing countries will encourage foreign investors to consider providing capital (in the form of both debt and equity) for productive investment. Over time, integration with international financial markets will (1) narrow the differences in the cost of funds between markets in different countries and between different instruments, and (2) spread the risks associated with exchange rate and interest rate fluctuations among a larger number of market participants.

E. Promoting Widespread Ownership

Efficient financial markets promote more widespread ownership of assets in a society. Development of the equity securities market, for example, provides a means of distributing the ownership of securities more widely among the public, which increases the probability that business ownership will not be confined to a small number of wealthy families or to big industrial-financial conglomerates. Another way to build up widespread ownership is the establishment of contractual savings arrangements through pension funds. A larger number of citizens in a developing country will thereby have an opportunity to participate in, and enjoy the benefits derived from, the growth of their country's economy.

III. STATEMENT OF A.I.D. POLICY AND OBJECTIVES FOR FINANCIAL MARKETS DEVELOPMENT

A.I.D. supports developing countries' efforts to develop financial markets. A.I.D. will encourage these countries to (1) design, adopt and implement policies conducive to the development of efficient, deep, and integrated financial markets, relying primarily on market rates of interest and other terms for the efficient mobilization of private savings and allocation of credit, and (2) build and promote competition between viable private, profit-making financial institutions. The primary source of capital for economic growth should be private domestic resource mobilization. Through both the policy dialogue process and project assistance, A.I.D. can be a catalyst for financial liberalization in developing countries.

IV. COMPONENTS OF THE A.I.D. POLICY

A.I.D. can draw upon a broad range of resources to help developing countries build more effective financial markets. Different countries, depending on their stages of economic and financial markets development, may require different kinds of assistance. If that assistance is needed to overcome existing constraints in the policy environment, then that assistance should be designed to help resolve, and not compensate for, those constraints. The policy described in this policy paper is Mission-directed, flexible, and closely guided by detailed and comprehensive country studies. It is expected that Missions will concentrate on policy reforms that emphasize greater reliance on competitive, market-based allocation systems and on project assistance to and through private sector institutions. AID/W will help Missions with technical assistance and other assistance mechanisms where it can.

A. Financial Markets Development Strategy

Missions contemplating, or maintaining a continued presence in, financial markets activities should prepare a comprehensive financial markets development strategy paper before or in conjunction with pursuing additional financial markets activities. This strategy paper should (1) develop a framework for financial markets activities based upon host country conditions and the policy and institutional issues raised in this policy paper, and (2) discuss how existing and proposed A.I.D.-supported financial markets interventions in a country interrelate under this framework.

A review of A.I.D.'s credit projects suggests that A.I.D. too often has designed and implemented projects without adequately taking into account broader issues involving the financial systems in developing countries. For example, A.I.D. often provided credit through public and private development banks, credit unions, and PVOs without exploring the need to mobilize domestic financial resources. A.I.D. projects often implicitly accept interest rate ceilings and administratively determined credit allocation mechanisms as incidental constraints on specific projects. In particular, too little attention may have been paid to the reasons why formal credit was not available.

Many Missions manage a variety of "credit" projects and other financial markets activities simultaneously (involving, e.g., micro-enterprise loans, agricultural credit, mortgage credit, and exchange rate reform efforts). These projects are often channelled through an uncoordinated subset of financial institutions, at a variety of interest rates and conditions. Such efforts may promote a more fragmented domestic financial market than might exist without A.I.D.'s assistance.

Missions should coordinate their efforts in financial markets development with multilateral agencies and other bilateral donors. Multilateral agencies and other bilateral donors are working with many developing countries to help improve their financial systems. Multilateral agencies in particular often are especially well positioned to advocate politically sensitive policy reforms.

B. Policy Dialogue

Improvements in policies affecting financial markets is an important objective for Missions that are active in the financial markets arena. Missions must assess realistically the influence they have in encouraging host country governments to adopt sensitive reform packages. It may be difficult to leverage significant financial policy reforms with sharply limited resources or through a single project affecting only a vary narrow part of the financial system.

Missions should solicit local private sector views to ensure that suggested policy changes are responsive to the needs of the private sector as well as to the requirements of economic efficiency, and encourage a continuing dialogue between government and the private sector. In a number of developing countries, important elements of the business community believe that their governments do not adequately understand their needs and their roles in the development process. Missions may wish to encourage host governments to publicly develop a strategy to promote their financial markets through an appropriate set of policies. Such a commitment, as well as a continuing dialogue on matters relating to financial markets development, may improve saver and investor confidence.

1. Macroeconomic Policies

In those countries in which the macroeconomic policy environment is not conducive to efficient performance of private financial institutions, A.I.D. should (a) urge the host government to adopt more appropriate policies and (b) consider postponing initiation or replenishment of financial markets activities until evidence exists that the host government is prepared to improve the policy environment. If a Mission wishes to initiate or replenish a financial markets activity when the macroeconomic policy framework is inadequate, suitable documentation should clearly demonstrate that the Mission has analyzed the effect of the existing policies on the activity's ability to achieve its purpose. Failure to consider the macroeconomic setting may obscure the forces behind financial developments and lead to inappropriate policy recommendations. Among the policies that may need attention are monetary policy, fiscal policy, exchange rate policy, import and export barriers, credit controls, and access to foreign exchange. The reform of a particular policy should be undertaken carefully and in concert with other actions.

Missions should encourage developing countries to adopt investment policies that attract foreign investors and increase the contribution of foreign and local investment to economic growth. Opening markets to foreign direct investment provides ways for these countries to diversify their economies and increase their capital inflows. A.I.D.'s policies on foreign investment are presented in the Trade Development Policy Paper (July 1986).

2. Encouraging and Mobilizing Domestic Private Savings

A.I.D. should help developing countries develop and implement policies to encourage, mobilize, and monetize domestic savings. A.I.D. should encourage developing countries to eliminate interest rate ceilings, which inhibit capital formation and individual savings and encourage capital outflow, and adopt policies that allow interest rates to fluctuate in response to market forces.

Domestic private savings should provide the major source of loan resources for financial institutions. Inappropriate policies inhibit prospective savers from relying on the formal financial system. Instead, they hold more traditional forms of wealth such as land, animals, jewelry, or gold. The result is an aggregate level of savings less than that which could be achieved given improved financial markets policies. Inadequate information, distrust of large and centralized institutions, and various cultural considerations are other important factors that inhibit savers from relying more fully on formal financial markets.

Empirical evidence strongly supports the assertion that the poor in developing countries save. The poor often rely on informal institutions such as investment clubs, savings societies, and rotating credit associations rather than formal financial institutions such as credit unions and local banks. The informal institutions involved frequently are effective mechanisms for channelling those mobilized savings to productive uses. Mobilization of domestic private savings is dependent on efficient financial markets and profitable uses of the mobilized funds.

Several actions are needed if a savings mobilization effort is to be successful. Two are particularly important. First, effective interest rates paid to savers should be sufficient (normally positive in real terms, that is, adjusted for inflation) to attract an increasing inflow of funds from private savers; artificially low interest rates produce a bias in favor of current consumption and therefore reduce the incentive to save. Second, the services offered by financial institutions must be easily accessible and otherwise attractive to savers.

Combining savings and lending activities of financial intermediaries offers many benefits, and demonstrates the importance of savings to institutional viability. It reduces some costs, including those of establishing creditworthiness, since financial intermediaries will have better information on and be better acquainted with borrowers through their role as savers. Saver-dominated financial institutions also tend to show steady growth in assets and liabilities, lower loan delinquency, and greater efficiency and financial viability. Borrower-dominated financial institutions tend to show higher rates of loan delinquency, poor rates of growth, perennial liquidity problems, and other weaknesses associated with dependence on external sources of funds.

3. Credit Allocation Policies

a. Directed Credit

A.I.D. discourages excessive reliance on directed credit. A.I.D. should encourage developing countries to rely on market mechanisms to allocate capital to its most productive uses.*

Administrative allocation mechanisms are particularly appealing to governments of very low income countries where money markets are typically very shallow and highly fragmented (between geographic regions, urban and rural borrowers, different loan purposes, large and small enterprises, and classes of borrowers). Governments generally pursue these mechanisms because of political, social, or distributional considerations. Over-reliance on directed credit results in often severe misallocations of scarce investment resources which undermines the strength and viability of financial institutions and retards the growth of financial assets. In addition, the allocation of credit may often be compensating for deliberate or accidental inadequacies in the host government's own policy actions.

b. Government-controlled Interest Rates

When the outright removal of all statutory ceilings to deposit and lending interest rates is not feasible, A.I.D. should encourage the host government to adopt specific reforms that

* The "market-determined" or "market-clearing" rate for credit is used throughout this paper, even though its common meaning (the rate at which the supply and demand for credit are in balance with a minimum of government interference) is often not applicable in developing countries where governments exert a great deal of control over financial and related markets.

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permit interest rates to adjust (within an acceptable timeframe) to market levels in a deliberate and timely way.

In many developing countries, governments hold nominal interest rates constant. During periods of inflation, real interest rates fluctuate with inflation, and will become negative if the inflation rate exceeds the nominal rate.

Countries that have consistently maintained positive interest rates and have an adequate number of institutions that issue attractive financial instruments show a higher rate of growth in their financial assets and have deeper financial intermediary systems than countries that have low and/or widely fluctuating levels of real interest on deposits. Positive market-determined real interest rates generally are associated with the development of sound and self-sustaining financial systems.

Interest rate ceilings often are imposed by governments to protect the borrower from "unscrupulous" lending practices. Yet, lending to large numbers of small and widely dispersed borrowers (e.g., small, rural entrepreneurs) normally involves relatively high administrative costs per loan that cannot be passed on to the end-borrower because of the interest rate ceiling. Consequently, it becomes unprofitable for financial institutions to lend to these borrowers.

Imposing interest rate ceilings, no matter how well-intentioned, often results in reductions -- not increases -- in the availability of formal credit for specific target groups. Local financial institutions handling the subsidized credit can be expected to allocate the credit in accordance with their appraisal of risk and profitability for themselves and thereby improve the quality, but not expand the dispersion, of their loans. Subsidized interest rates also encourage greater use of capital-intensive production techniques by making loans for capital equipment less costly, and, consequently, decrease employment per unit of capital employed.

c. Credit Collateral Requirements

A.I.D. should encourage financial institutions to adopt flexible collateral requirements. Financial institutions should also be encouraged to seek alternatives to fixed and high collateral requirements (such as higher interest rates, lending to groups of borrowers, or establishing special small loan windows).

In most developing countries, private ownership and property rights arrangements are important elements in determining the extent of an individual's participation in financial markets. When private property rights exist, an individual has exclusive

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rights to use and derive the income from assets, to transfer the assets voluntarily to others, and to be assured that contracts of exchange are enforceable. The absence of these rights makes it difficult for private enterprises and individuals to obtain the type of collateral required by many financial institutions.

Formal lending institutions (e.g., banks, credit unions, savings and loans, and finance companies) frequently establish loan collateral requirements that effectively direct credit to favored groups of individuals or enterprises. Collateral requirements often are very high (ranging from 150% to 200% in most developing countries) and may be limited to certain types of collateral (e.g., land). Where interest rates are artificially low, collateral acts as a screening mechanism to discriminate among prospective borrowers. High collateral requirements also may be derived from lender concern about political and economic uncertainty and a lack of familiarity with certain potential borrower groups.

4. Legal and Regulatory Constraints

A.I.D. encourages host country governments to review the legal and regulatory framework affecting their financial systems. A.I.D. should engage in policy discussions and offer technical assistance, as appropriate, to (a) reduce imprudent, and strengthen prudent, legal and administrative controls on financial institutions; (b) streamline and simplify the regulatory and supervisory responsibilities of government agencies; (c) establish appropriate accounting standards and comprehensive and uniform financial reporting, public disclosure, and auditing requirements; and (d) improve the capabilities of regulatory bodies to enforce appropriate laws and regulations.

In many cases, the existing legal and regulatory framework is designed to ensure proper banking practices. However, some controls often restrict the growth of financial techniques and limit the ability of financial institutions to maximize their profits by seeking higher yield investments elsewhere. These controls include, *inter alia*, time limits on deposits; maximum amounts for certain deposits; restrictions on the types of institutions that can receive certain types of deposits; entry requirements in the banking sector; requirements for holding government securities; and the requirement that private financial institutions hold substantial amounts of low yielding government securities or maintain high reserve levels.

Legal codes and regulations of developing countries are often inadequate on such issues as security of assets, title to property, transfer of property, taking possession of collateral on loans in default, and sharing ownership of assets. The result is that under existing laws (a) it is often difficult to broaden the range of financial instruments and securities available in the market; (b) there are limits on when and at what price companies can issue securities in public offers (inhibiting public offerings), and interest that can be paid (discouraging savings); (c) securities cannot be easily transferred among holders, and often a company has the power to refuse transfer; and (d) investors have inadequate rights and protections.

Proper government regulation is beneficial to lenders, borrowers, and investors. For example, regulation of securities may increase investor confidence in equity shares. Reasonable standards of investor protection, such as adequate accounting standards and rules of financial disclosure, protect securities investors and are critical to the successful functioning of a capital market. Fair enforcement of contracts protects investors, lenders, and borrowers. Deposit insurance encourages individuals to save and deposit their funds. Responsible regulation of private banking and other financial institutions may remove some of the host government's excuses for nationalization of financial institutions and resistance to privatization of state-owned financial institutions.

It should be recognized also that the judicial and enforcement systems are weak and inadequate to settle disputes. The enforcement of rules and regulations can be just only with a fairly administered adjudicatory mechanism including means of appeal.

5. Tax Policies

As part of their financial markets development strategy, Missions should review their host country's tax structures to assess their roles in the development of the financial systems. Missions should encourage host governments to change restrictive tax laws and adopt tax policies that provide a suitable tax environment for the development of financial markets.

In some countries, tax measures inhibit the development of financial markets and restrict capital formation. For example, some governments impose high tax rates on financial transactions that increase the cost of financial intermediation. Special tax preferences for certain forms of investment discourage savers from investing in those that are not so favored.

A number of tax measures may improve capital formation. These include, *inter alia*, the adoption of lower marginal tax rates for corporations (which promotes economic efficiency and equity investment, and may reduce capital outflows), and for individuals (which encourages savings rather than consumption). In the absence of lower tax rates, numerous measures can be explored that could encourage greater savings and investment. These efforts will involve substantial policy debate, as financial markets development may conflict with other host government goals, such as raising short-term tax revenue.

6. Informal Financial Markets*

A.I.D. should encourage the host government to adopt specific reforms that increase access to formal sources of credit. A.I.D. should sponsor studies on the nature and functions of informal financial markets. As appropriate, those lessons should inform the design of projects and programs involving formal financial markets.

In many developing countries, the common requirements and practices of formal financial institutions make access to credit and other financial services difficult and expensive. As a result, there remain in place often sizeable informal financial markets. These informal financial markets range from the simple savings clubs and the rural credit markets in which local moneylenders and shopkeepers operate, to more complicated urban markets including those involving consignment sales and those typically dominated by merchants supplying raw materials and semi-processed goods to small manufacturers in putting-out systems. They can be national in scope, such as the kerb market in South Korea, or international in scope, such as the Hundi system prevalant throughout South Asia.

Informal financial markets transactions generally take place in an unregulated environment. Some elements of these transactions

* Informal financial markets frequently serve productive enterprises or entrepreneurs in the informal sector. The informal sector refers to those business entities that operate outside formal economic and governmental structures and range in size from the small and labor-intensive enterprise to relatively large and capital-intensive enterprises. They have been characterized as firms that use illegal means (e.g., unregistered or untaxed) to pursue legal objectives (e.g., the production of legal goods and services). Yet, precisely because many regulations specifically exclude small enterprises (e.g., minimum wage and working conditions), to define them as illegal may often be incorrect. Women are widely represented in the informal sector, particularly at the small-scale range of the spectrum.

may be very efficient. They have at best limited connections with monetary authorities (for example, they are not subject to reserve requirements and governments exercise no direct fiscal controls over their activities). However, information of the nature and functions of informal financial markets is woefully inadequate. Important lessons may be derived from careful study of their behavior.

The activities of moneylenders in informal financial markets are often abhorred since interest rates charged in the informal financial markets often are higher and for shorter terms than in the formal markets. Yet growing evidence suggests that the implicit and explicit costs and difficulties associated with formal credit sources often are higher than are the nominally higher costs for funds obtained in the informal markets.

A.I.D.'s assistance to the informal sector has historically been in the form of project-based credit and technical assistance. Although many A.I.D. programs directed at micro-enterprises and informal sector enterprises have demonstrated that these enterprises are reliable borrowers and can be reached cost-effectively, studies have shown that providing credit alone to micro-enterprises only rarely produced self-sustaining gains; increases in income were short-lived.

Informal sector enterprises often face a policy and administrative environment that contains serious market access and entry barriers. Some macroeconomic policies have a negative impact on informal enterprises and serve as entry barriers to the formal sector. These issues should be addressed within the framework of our assistance to the informal sector.

A.I.D. should also continue to encourage formal financial institutions to serve the same clientele served by the informal financial markets. In the process, the more efficient formal markets gradually displace less effective informal markets. The best examples are those involving the extension of formal financial systems to better serve the growing financial demands of small farmers and small scale enterpreneurs. This approach depends for its success on the truth of an assumption that formal financial markets are more effective than informal institutions. Although this assumption is generally borne out over the long run, it may not be correct in some markets in the short run.

To facilitate graduation to commercial borrowing, A.I.D. should foster the involvement of formal financial institutions in the informal system. For example, it may be useful to have a representative from a local private bank involved in an A.I.D.-sponsored informal sector lending program conducted through a

PVO. This might facilitate an informal enterprise's graduatior from the A.I.D. program to commercial banks by increasing the bank's familiarity with the borrower (and much of that segment of borrowers) while establishing a credit history in which the bank has confidence.

C. Institutional Strengthening and Development

Strong institutions are essential parts of effective formal financial systems. The most effective place for A.I.D. to concentrate its resources, after policy reform, is in assistance to financial institutions, including intermediate financial institutions (IFIs). It should be kept in mind that improvements in the institutional framework are not ends by themselves, but only a means of attaining the objective of broad-based economic growth.

To the extent feasible, A.I.D. should give priority attention to strengthening the private financial system (through which A.I.D. resources should be channeled) and those private institutions that have a reasonable prospect of being self-sustaining. It is preferable to expand the capabilities of existing private financial institutions rather than establish new institutions. A.I.D. should encourage well-run, existing financial institutions to add new types of financial activities to their traditional operations rather than create new institutions to accomplish particular development objectives. Diversification allows institutions to overcome the problems of scale associated with over-specialization, especially in low-income countries with small financial markets

Greater attention should be directed to structuring assistance to financial institutions to improve their (a) prospects for viability after A.I.D.'s assistance has been terminated, and (b) operations in ways that would enhance their own financial strength, growth prospects, and contribution to savings mobilization and credit allocation performance. Examples of measures meriting close attention include cost controls, loan application appraisal techniques, reasonable collateral and other safeguards to protect loan contracts, good collection records, business services, and deposit-taking functions.

Missions should be alert to the risks of overemphasizing the supervision of the uses of credit, as this sometimes results in the neglect of potentially more important objectives of credit projects. External assistance, in the form of technical assistance or staff training (rather than capital for making loans) may help these institutions develop their own capabilities.

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In a free market, financial institutions generally organize themselves according to the opportunities they see to meet the different needs of savers and users of funds as well as the changing patterns of savings, fiscal conditions, and institutional arrangements. A.I.D.'s programs and projects should be sufficiently flexible to allow for the disbanding of inefficient entities or the merger of institutions as appropriate. For example, institutions may properly merge or go out of business when there is insufficient market demand to support many separate institutions.

Although particular country situations differ, private sector financial institutions are usually more efficient institutions for channeling assistance to individual private enterprises than public institutions and for mobilizing domestic resources in support of financial markets because they:

- have to depend to a greater extent on their capacity to attract nonconcessionary savings and to engage in new financial activities because of their more limited access to concessionary resources;
- are more innovative in reducing transaction costs and spreading the costs of bearing risks; and
- have been able to better avoid projects of dubious profitability (although sometimes to an imprudent extreme).

On a case-by-case basis, A.I.D. may help to establish new financial institutions (including special purpose institutions) in areas where private institutions have not been established despite a favorable policy environment and other supporting factors. However, A.I.D. should carefully study each situation and weigh available alternatives prior to proceeding with the new entity. Where existing private financial institutions are capable of performing the desired activity, the establishment of a new trust or trust fund to serve as a financial intermediary for on-lending or equity investment should be avoided.

An unwarranted increase in the number of financial institutions can reduce the success of institutional development. Since financial systems in most developing countries are shallow, special purpose institutions could affect adversely the ability of commercial institutions to attract natural clients. The creation of parallel and costly institutional structures should, therefore, be discouraged, particularly in smaller countries.

Before establishing new financial institutions, A.I.D. should review the existing financial system to determine whether:

(a) financial intermediation is being provided at a reasonable cost; (b) financial institutions are providing an appropriate mix of services for market demands; (c) the level of competition among various institutions is adequate; (d) the financial stability and structure of the various institutions is appropriate for their types of financial activities; and (e) experienced management is available.

D. A.I.D. Credit Policy

A.I.D. has been active in helping developing countries improve their financial systems through technical assistance, training, studies, policy dialogue, and the provision of credit. A.I.D.'s credit programs and projects (1) support new development finance institutions; (2) help existing banks expand their traditional short-term lending operations to add medium- and long-term lending; (3) increase the credit resources available for financing priority development activities; (4) eliminate impediments to capital movement among regions or sectors; and (5) open up access to formal credit to disadvantaged borrowers.

1. The Provision of Equity and Grants by A.I.D

As established in section 635(g)(3) of the Foreign Assistance Act of 1961, as amended, and section V.D. of the Private Enterprise Development Policy Paper, A.I.D. will not take an equity position in any private enterprise.* Grants to private enterprises in developing countries are permitted to finance direct training and technical assistance, although such assistance should be programmed in a way that provides competitive access for many enterprises rather than one enterprise.**

Owners' equity is important during the start-up phase of an IFI or other private enterprise as it provides permanent finance

* Section 635(g)(3) of the FAA restricts A.I.D. from directly purchasing equity securities, although A.I.D. does have limited authority to purchase convertible debt securities and may convert them or otherwise obtain equity securities through such means as the enforcement of liens and pledges. Legislative guidance on this subject extends back to the Mutual Security Act of 1954, as amended, and the Development Loan Fund, one of A.I.D.'s predecessor agencies.

** This language refers to private enterprises that are not IFIs. A permitted use for grants to IFIs is discussed in section IV.D.3.a. below.

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with no contractual payments. Owners' equity is the financial stake put at risk by each of the owners, originating from each owner's desire to earn a return on his share of equity higher than alternatives for which he could have used the funds.*

A number of A.I.D. reports have characterized our involvement in IFIs as providing "quasi-equity." The quasi-equity instruments usually referred to, such as debentures, are debt instruments. Any confusion between equity and quasi-equity may have arisen because A.I.D., in the short run, may perform like an owner of equity by insisting that a portion of an IFI's on-lending portfolio (generally the capital available from A.I.D.) contain loans to an A.I.D. target group.

2. Interest Rates to Private Enterprises and Other Ultimate Borrowers

The interest rate to be charged on A.I.D. resources to ultimate borrowers (a) shall, at a minimum, be at or near the prevailing interest rate paid on U.S. Treasury obligations of similar maturity at the time of obligating such funds, to the maximum extent practicable (it should be borne in mind that use of the U.S. Treasury rate is moderately concessional); and (b) should not be less than terms prevailing locally or a rate that approximates the opportunity cost of capital in that country.** If interest rates, collateral requirements, or repayment periods are administratively imposed by the government, the terms agreed to in A.I.D.-supported activities will be part of a planned effort to encourage governments to move progressively toward market terms. At a minimum, the interest rate to ultimate private borrowers should be significantly positive in real terms, i.e., when adjusted for inflation.

A donor, such as A.I.D., has two immediate problems in trying to use its funds as equity. First, a donor's principal motive is not to earn more than an average return on its funds. Second, a donor sees itself as a catalyst to an IFI or a private enterprise, not a long-term member of the board. A.I.D. cannot act as an owner of equity unless it internalizes market-based, entrepreneurial behavior in its involvement in the business entity. A.I.D. would then have to direct its funds to the business entity that offers the Agency the best prospects for the highest return.

** The opportunity cost of capital represents the value of the best alternative use of the capital, or the opportunity that is sacrificed for a particular use of the capital.

Where practicable, the interest rates and associated fees charged to the sub-borrower by an IFI should cover all of the IFI's costs of lending, such as the costs of funds mobilized or borrowed; the normal premiums for the higher risks of term loans or devaluation risks for loans denominated in foreign currency; a loan loss reserve; the administrative costs of providing loans to end borrowers (which usually are high as A.I.D. generally tries to service the credit demands of a large number of small borrowers); any extraordinary costs of non-bank services furnished the sub-borrowers or of supervising the sub-loans; and a reasonable profit margin for the IFI. Interest rates to be charged on A.I.D.'s direct loans to private enterprises should be set within the context of this effort.

Special circumstances for concessional assistance are discussed in section V.D. of the Private Enterprise Development Policy Paper; however, concessional rates should not be used to encourage private enterprises to undertake activities that are not commercially feasible at market rates. If there is little expectation that a needed product or activity is not commercially viable, then Missions should consider the use of a contracting mechanism to one or several firms to undertake the particular activity, rather than introduce new distortions into the financial market.

Experience shows that in countries in which private business is overshadowed by subsidized state-owned enterprises (SOEs), the financial market is severely handicapped and limited. SOEs often consume much of the total domestic credit available. When A.I.D. extends credit to SOEs, loans to SOEs will be at the same rate charged to private enterprises, and are to be provided in the context of the privatization guidance contained in the Private Enterprise Development Policy Paper (section V.F.).

3. <u>The Relationship between Donor Funds and the Cost of Capital to Financial Intermediaries</u>

a. <u>Interest Rates</u>

<u>A.I.D. funds provided to financial institutions should carry an interest rate that (a) is at least equal to the cost of local, non-concessional sources of capital; (b) approximates the cost of lendable resources of comparable maturities from the local private capital market (if such resources exist); and (c) is based on the appropriate rate to the ultimate borrowers. All IFIs (regardless of whether the owners are public or private, joint public/private, or PVOs) should be treated as private enterprises for the purpose of determining interest rates on loans to them because they are selling services in commercial markets and are capable of earning revenue.</u>

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Market-based interest rates on loans to IFIs are an essential component of financial markets development. Historically, A.I.D. projects that provided low interest (or interest-free) loans to IFIs have developed maintenance of capital value problems in later years. These relatively low nominal interest rates were often combined with moderate to high levels of inflation and resulted in negative real rates of interest. Consequently, these projects have built in automatic financial drains. Interest rate subsidies lead to substantial recurrent cost problems. It is difficult to wean IFIs from subsidies.

A financial institution's usual sources of capital for on-lending are equity capital, debt instruments, borrowings from the Central Bank, and retained earnings. The provision of donor funds provides three initial benefits. First, donor funds provide additional capital to a financial system that has little or no access to external funds and cannot meet capital demand with its domestic resources. Second, the addition of donor funds to the capital base decreases the aggregate cost of funds in the economy. Third, donor funding to the financial sector provides new foreign exchange to the Central Bank.

When a donor provides capital to an IFI at terms below that which the IFI must pay to attract depositors, the IFI may deemphasize its acquisition of deposits from local sources and seek to increase its access to additional donor resources as deposits become relatively more expensive At the same time, a relatively large spread between A.I.D.'s loan terms to the IFI and the on-lending terms may enable IFIs to operate profitably with a significant percentage of their loan portfolio in arrears or default, and will reduce the pressure on the institution to expand volume and services. This large spread may reduce the IFI's overall market effectiveness and efficiency, and discourage its aggressiveness in other financial activities. A.I.D. needs to balance this cost against the goal of wanting these IFIs to develop a more aggressive risk profile in their loan portfolios.

A.I.D. needs to make more realistic determinations of the costs of carrying out A.I.D.-required activities when developing credit projects. If it is necessary to make adjustments (concessional assistance) in the terms of A.I.D.'s assistance to the IFI to hedge agreed-upon risk (although not necessarily the total risk) or cover the costs arising from meeting A.I.D.'s programmatic objectives, then the value of the adjustments shall be equal to, but not greater than, the actual costs incurred by the IFI.* This will enable the IFI to cover the costs of A.I.D.-sponsored activities and earn a return that, since it is comparable to other returns earned by the IFI, will not discourage the IFI from pursuing its non-A.I.D. activities (such as deposit-taking).

If the cost of the institution-building activities (such as training of IFI employees) occurs primarily in the early stage of an IFI project, it may make sense to identify such costs as separate components of a project and to finance these with grant funds, rather than have such costs spread over the term of loan repayment. This approach may be preferred if it is desired that the institution-building activities should proceed before the on-lending activities can generate revenues. Another approach is to provide technical assistance to reduce loan transaction costs in the credit delivery system. A concessional loan would not be appropriate for handling long-term differences in transaction costs between loans to different types of end-borrowers.

If the A.I.D. loan to the IFI is to be concessional, then the grant component of the loan should be identified, analyzed, and its value fully reflected in program or project documents. A.I.D. must fully justify, on a case-by-case basis, the use of loan subsidies (and, as appropriate, grants) to IFIs (including PVOs that act as IFIs).

If the spread between the cost of the funds from A.I.D. and the IFI's on-lending rate is too large, then the IFI receives a windfall profit. If the spread is too small, then the IFI will not disburse the funds, or will not disburse them to the clientele targeted by A.I.D. Thus, the interest spread is a critical financial parameter in an IFI project. Missions may wish to consider lending their funds to an IFI at a floating interest rate if A.I.D.'s funds are to be disbursed over a long period of time.

* These costs generally include the costs of analyzing and monitoring loans and maintaining a loan loss reserve. The adjustments to A.I.D.'s assistance generally include grants, reduced interest rates, or extended grace periods. Programmatic objectives may include making credit available to private enterprises that would not be able to obtain formal financing in the absence of A.I.D. support (additionality), encouraging an IFI to provide term loans, or providing services to a borrower that are not normally part of a loan agreement (such as business advisory services). Determining these costs may be a difficult task; Missions may wish to obtain expert assistance to conduct the appropriate analyses.

b. <u>Foreign Exchange Risk</u>

The issue of foreign exchange risk presents a special problem. There are certain situations in which private financial institutions are unwilling to accept dollar loans because of the risk of devaluation. They are also afraid that they will be unable to convert their local currency repayments into dollars because of foreign exchange limitations. There are several ways to deal with this problem.

A.I.D. often utilizes a two-step loan that passes its financing through a host country's government entity (e.g. Central Bank) before the funds are on-lent to ultimate borrowers. The dollar loan is made directly to the government which assumes responsibility for its ultimate repayment and the dollars or the local currency equivalents are then on-lent through the IFI to the ultimate borrowers. This procedure allows internal on-lending arrangements to be structured so that the government can continue to bear all the risk of devaluation, or can pass all or a part of the risk to the IFI and then to the ultimate borrowers. In this two-step process, the interest rate charged to the IFI by the government entity could reflect the real cost of loanable capital to the IFI within that developing country, including the foreign exchange risk. Alternatively, the foreign exchange risk can be shared in varying proportions between two or all three of the participants. It should be noted, however, that in some instances the involvement of the host government in the transaction may discourage private IFIs from participating in the A.I.D.-sponsored activity.

The A.I.D. dollar loan also may be made directly to the IFI. The loan arrangement should be structured to adequately protect the IFI from the high risk of future currency devaluation and to insure the IFI's solvency. Therefore, the credit program should be structured so that all or most of the risk is shifted forward to the sub-borrowers. In high-risk situations this could restrict on-lending to export activities that would earn the foreign exchange needed for repayment.

In both the two-step or direct loan approach, the charges to the end borrower of a loan denominated in local currency may include a contribution to a reserve fund held by the IFI that could be used to offset any deficiency in the local currency loan service receipts in the event of devaluation. Also, in both approaches, the on-lending rate to the ultimate borrower should still be determined by the guidance in section IV.D.2.

Many ultimate borrowers do not require dollars. In these instances, they are unwilling to accept the foreign exchange risk associated with dollars. A.I.D. should utilize local currency financing wherever possible in credit projects.

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c. Parastatal Financial Institutions

Many governments own or control many of the suppliers of finance in their respective countries. Missions should refer to the Private Enterprise Development Policy Paper (sections V.D. and V.F.) for additional guidance on dealing with parastatal financial institutions. The guidance in section V.D. states that "A.I.D. funds provided to financial institutions should avoid introducing government ministries or parastatals into the on-lending approval process where such involvement does not now exist. Furthermore, such projects should seek to extract government ministries and parastatals from the process if they are now so involved."

4. Targetting and Guaranteeing A.I.D. Loan Resources

Targetted credit projects typically enlarge the role of government in financial markets and further distort, or continue to displace, market allocation of capital. Missions should consider such projects (a) after they have determined that there are no policy, institutional, or cultural constraints discouraging the extension of credit to the target group, or (b) as a way of encouraging host governments to correct policy and other constraints where they exist and helping private financial institutions develop some expertise and experience with delivering financial resources to intended target groups (possibly with the concomitant provision of training and technical assistance).

Directed credit projects appear to be attractive mechanisms for assisting A.I.D.'s target groups. However, there is some skepticism over whether targetting of A.I.D. loan resources actually accomplishes its intended purpose.

The fungibility of money makes it difficult, if not impossible, to attribute measurable increases in the output or incomes of targeted borrowers to A.I.D. credit activities. In addition, directed credit activities may contravene efforts designed to improve the market behavior and performance of the financial system and mitigate the likelihood that, over time, A.I.D.'s directed assistance will be replaced by the capability and interest of the indigenous financial system itself to service the needs of the target group. Great care must be exerted to ensure that our assistance is designed in a way that does not discourage or preempt private sector initiative in this area (especially where this initiative has developed without A.I.D. assistance).

Studies have also found that the costs associated with the administration of targetted loans through rural finance

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institutions, for example, are many times larger than the estimated private lender costs for the simpler task of establishing creditworthiness of borrowers. Finally, the time associated with monitoring and recordkeeping for the donor diverts the time and skills of the financial institution's staff away from profit-generating activities.

A.I.D.-sponsored guaranty activities also risk distortions of market forces and the efficient allocation of capital. For instance, A.I.D.'s objective in a guaranty project designed to redirect credit to rural enterprises (covering the extra risks of lending to the target group), usually requires that credit be redirected away from urban enterprises and towards rural activities. This may reduce much-needed investment funds in urban areas where unemployment rates are extremely high.

Yet, guaranties may be appropriate when the general policy and institutional environment is supportive and lenders retain their traditional inhibitions in developmentally important areas (such as encouraging new, higher-risk, longer-term lending, or lowering or changing collateral requirements). Since guaranty programs should facilitate breakthroughs in new lending patterns and are not meant to substitute for unaddressed structural inadequacies in financial markets, the case for their introduction must be well-justified and the size and duration of such programs should be limited.

5. Lending through PVOs and Nonprofit Entities

A.I.D. should rely upon PVOs and non- or not-for-profit groups for lending only when private, for-profit financial intermediaries capable of performing the desired activity does not exist, or when PVOs are used as part of a Mission's financial markets strategy to involve the private financial banking system in on-lending to the target group (in a way that does not discourage or preempt private sector initiative in this area). PVOs or other non- or not-for-profit groups are not to be utilized for making equity investments. PVOs should lend at rates consistent with the guidance stated in section IV.D.2.

Some private voluntary organizations (PVOs) have special advantages in working with micro and small-scale enterprises because the PVOs are flexible and in touch with the poor and their problems. Some PVOs can offer financial assistance to enterprises or individuals not reached by formal sector credit markets and can collaborate with banks and local financial institutions to establish credit systems for those needing small or short-term loans. The use of PVOs and a combination of technical assistance and credit are often effective in reaching A.I.D. target groups such as rural enterprises and women.

Establishing financially autonomous institutions to manage credit, training, and technical assistance programs and projects often is an important component of a good financial markets development project. To the extent that PVOs act as IFIs, they should follow lending and repayment collection practices based on market-oriented and capital preservation principles. In situations where there has been no experience with lending to micro and small-scale enterprises, PVOs can demonstrate to financial institutions how lending to the poor may be profitable. Where feasible, A.I.D.-financed projects should include mechanisms to graduate beneficiary enterprises from utilization of resources provided from PVOs to borrowing from formal sector institutions.

E. Financial Training and Standards Development

A.I.D. should emphasize to a developing country's public and private sectors the importance of (1) adequate training requirements for accountants and auditors, (2) generally accepted accounting principles and auditing standards, and uniform reporting requirements, and (3) a proper balance between self-regulation and public regulation of these matters. A.I.D. also should support efforts to train accountants, auditors, and others involved in finance. Adequate accounting, financial analysis and reporting, and auditing are critical to a properly functioning market-based financial system. Without these skills, it is not possible to determine the true position and profitability of enterprises. Accounting and auditing principles should be standardized and widely accepted.

F. New Financial Instruments and Institutions

As economies develop, credit demands become more complex and the expanding demand for physical capital requires credit that varies by the length of time required (short-, mid- or long-term) as well as the end-use (consumer, investment, risk capital, venture capital, mortgage, etc.). Where delivery and marketing systems and government policies are satisfactory, financial institutions generally evolve to satisfy these more complex needs. However, in most developing countries the strength of demand for different types of credit exceeds the financial sector's capacity to diversify and develop the institutions needed to respond.

As appropriate, Missions should develop and pursue a policy dialogue agenda with host governments that encourages development of capital markets and associated intermediaries, in, for example, equity securities. In most poor developing countries, securities markets are effectively absent and their development is not a high priority. Capital market

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intermediaries (primarily primary and secondary securities markets) are often inadequate for the development of new equity instruments and the transfer of equity shares and bond instruments. Even in some relatively sophisticated countries securities markets are extremely thin: transactions in stocks are negligible; medium and long term bond markets are shallow; and institutional investors are not a major presence. Therefore, capital markets contribute little to savings mobilization and economic growth and limit the country's participation in international capital or equity transfers. In a small number of A.I.D.-assisted developing countries, a sustained effort to develop securities markets may be warranted. Some preliminary work to promote the concept of securities markets development may be useful even in a few other developing countries.

A.I.D. encourages developing countries to develop and utilize new debt and equity instruments for directing scarce capital resources into productive investments. Among the instruments and techniques for mobilizing capital for productive investments that should be explored are commercial paper and bonds, term lending*, debentures, government securities, trade (or supplier) credit, debt-equity swaps, mortgage bonds, agricultural production contracts, variable interest rate structures, and deposit insurance. These and other financial instruments enable the financial market to spread risk among a variety of instruments, thereby reducing exposure to market volatility, and to be more flexible and responsive to the users of financial instruments.

Missions should ensure that the proper policy conditions exist for venture capital activities prior to, or in concert with, the

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* Private lending institutions in many developing countries avoid making long-term loans because they lack access to resources with the longer maturities appropriate for supporting term lending. They also consider such lending to be less profitable or more risky than alternative investment opportunities, and often face an uncertain policy environment. Other major factors that limit the ability of these financial institutions to undertake long-term financing are the institutions' own shallow resource bases; preferences for fast recovery of funds; inexperience with term loan instruments; and limited local markets for large, long-term financial assets. Furthermore, the unreliable accounting practices commonly followed by many private enterprises contribute to the reluctance of commercial financial institutions to extend credit to new and unfamiliar entrepreneurs.

provision of any support to venture capital firms. Funds lent to venture capital firms should be at market rates; grants or equity contributions are not permitted.

In a small number of A.I.D.-assisted developing countries, A.I.D. may wish to explore activities involving venture capital. These activities may wish to emphasize the policy environment. Among the impediments that should be addressed in support of venture capital activities are: (1) the lengthy government approvals process required for the start of new ventures; (2) unfavorable tax laws; (3) failure to give adequate legal recognition to venture capital firms; (4) requirements for court or government approval to merge or sell out the company when successful; (5) absence of an adequately organized or liquid securities market into which the venture capitalist may sell his shares; (6) government control of when public offerings may be conducted and at what price; and, for foreigners, (7) restrictions on repatriation of profits.

An alternative to fixed-rate loans for venture capital activities may be variable-rate loans based on the internal rate of return or equivalent financial performance of the venture capital enterprise. This arrangement would reflect the relatively high degree of risk and uncertainty attendant in venture capital approaches in developing nations, and would avoid burdening the venture with a large fixed obligation that might inhibit risk taking.

ANNEX

GLOSSARY OF FINANCIAL MARKETS TERMS

Asset - Everything a company or individual owns or is owed. The principal asset categories are: current assets, which generally consist of cash and short-term investments, accounts receivable (trade and other), inventories (raw materials, work in process, and finished goods), and pre-paid expenses; fixed assets, which are often expressed as property, plant, and equipment; and intangible assets, which can consist of goodwill, patents, franchises, copyrights, etc., representing rights or economic benefits that are not physical in nature.

Capital market - The financial market that provides long-term debt and "risk capital" (in the form of equity) for fixed or permanent capital formation that enables businesses to be established or to expand their operations. The capital market is composed of the securities market, which offers equity and negotiable funds, and the non-securities market, which provides non-negotiable funds.

Collateral - Assets, receivables, and inventory, or property, plant, and equipment, which are pledged by a borrower to secure a loan.

Commercial paper - Unsecured, short-term promissory notes of large firms. The rate of interest on commercial paper is typically below the prime rate of interest.

Common stock - A type of stock representing the class of owners having a "residual" ownership (equity) of a corporation.

Convertibles - Securities (generally bonds or preferred stocks) that are exchangeable at the option of the holder for common stock of the issuing firm.

Credit controls - Government controls over national money and credit policies, credit and money supplies, and interest rates. These controls can affect the quantity and cost of credit available to domestic and foreign borrowers in the country's capital markets, and can strongly influence the direction of the national economy.

Debenture - A long-term debt instrument issued by a corporation that is not secured by specific property, but instead by the general credit of the corporation.

Equity - The net worth of a business, consisting of capital stock (preferred and common), additional paid-in capital, retained earnings, and, occasionally, certain net worth reserves, and/or adjustments. When used in a financial sense, equity means the value of property beyond the amount that is owed on it. When funds are provided to a business on an equity basis, there is no promise to repay the funds but rather a right to share in the profits of the business. Thus, the providers of funds in the capital market accept the long-term risk that the company will earn sufficient profit to pay interest on its debt and have enough left over to pay dividends on its equity shares.

Exchange rate - The rate at which one currency may be exchanged for another, usually quoted in relation to the U.S. dollar.

Financial intermediation - Financial transactions conducted through a financial institution that brings together savers and those who need capital so that savings can be redistributed into their most productive uses.

Foreign exchange exposure - The loss-of-value risk in converting one currency to another. In developing country markets, for example, converting from "soft" currencies to "hard" currencies is most likely to result in a loss-of-value transaction.

International financial markets - An all-encompassing term that refers to all international or multinational markets for short-, medium-, and long-term securities and loans, forward and swap contracts, financial futures, and foreign currencies.

Lease - A contract between the owner of an asset and a lessee, who makes periodic payments to the owner for the "right" to use the asset. Leasing imposes less current cash drain on a firm than buying; frees capital that can be used for other productive purposes; and is a convenient way to obtain the services of an asset for a short period of time. However, leasing also has an effect on a firm's solvency similar to debt, with a similar effect on the firm's ability to further borrow or lease.

Liability - Obligations of a corporation or an individual. the principal liability categories are: current liabilities, which generally consist of short-term borrowings, accounts payable, accrued expenses, taxes payable, and the current portion of long-term debt; and long-term liabilities, which usually is comprised of long-term debt.

Loan - The transfer of funds from a lender to a borrower that involves a contractual obligation between the borrower and lender that must be repaid irrespective of business performance.

Money market - The financial market that provides short-term working capital loans to enterprises that require funds to manage their current affairs. All of its financial instruments are in the form of short-term, highly liquid debt.

Preferred stock - Stock that has a claim against income and assets before common stock but after debt.

Primary markets - The market in which financial assets (i.e., stocks) are originally issued.

Risk - The probability that actual future returns will be below expected returns.

Risk premium - The difference between the required rate of return on a particular risky asset and the rate of return on a riskless asset with the same expected life.

Secondary market - The "market" in which primary market instruments (e.g., stocks) are traded after they have been issued by corporations in the primary market.

Securitization - The broad process whereby capital financing occurs through securities issuance rather than bank financing.

Subordination - Relegation to a lower-priority in receiving interest and principal; if an issue of debenture is subordinated to other debt, the senior or latter debt is paid the amount due before the subordinated debentures receive anything.

Term loan - A loan provided for an extended period of time, generally with a maturity greater than one year.

Trade credit - Credit on goods purchased by a company from its supplier (also called supplier credit or accounts receivable credit). The use of trade credit brings different types of companies, including many nonfinancial companies, into the credit system and may, in fact, increase a firm's sophistication in the uses of credit.

Trade finance - The financing, usually characterized as short-term, of export-import trade transactions.

Venture capital - Risk capital supplied to small companies by wealthy individuals, partnerships, or corporations, usually in return for an equity position in the firm.

Yield - The annual rate of return on an investment, as paid in dividends or interest. It is expressed as a percentage generally obtained by dividing the current market price for a stock or bond into the annual dividend or interest payment.

A.I.D. supports the use of debt/equity conversion programs as an important financial markets instrument.

Debt/equity conversions, or the capitalization of foreign obligations, are gaining considerable momentum in business and policy circles. A debt/equity conversion (commonly referred to as a debt/equity swap) is essentially, through a series of complex and interrelated steps, a conversion of an external debt obligation into an equity stake in a company.

Debt-equity conversion programs contribute to economic growth in several ways, including the promotion of policy reforms that support growth and investment, and the reduction or containment of immediate foreign exchange debt servicing burdens. Use of debt-equity swaps also has the effect of increasing levels of private investment in productive enterprises, facilitating financial arrangements for privatization, encouraging the return of flight capital, and rebuilding confidence between commercial banks and debtor countries.

The cumulative impact of deby/equity swaps depends on available opportunities for investment in developing countries, the depth of their capital markets and the ability of the local economy to absorb additional credit.