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Characteristics of Finance in the Under-developed Countries

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I. Characteristics of Finance in the Underdeveloped Countries

The common characteristics of the financial systems in underdeveloped countries are:

1. The predominance, in the early stages, of foreign banks and of foreign influence in the financial mathers;

2. The intervention by the national government after the attainment of independence, in the management of the financial systems;

3. Seasonal flucturations of the financial variables dominated by foreign trade;

4. The duality of the money market structure, i.e., the existence of the organized and unorganized money markets, and the state of underdevelopment of both the money and the capital markets;

5. The duality of interest rates; and

6. The lack of the right type of financial institutions, and the state of inefficiency of their activities.

In the following pages, we shall discuss each of these characters in some more details.

1. Commerical banks in many of the underdeveloped countries rested in the hands of foreign international banks with head offices abroad. The commercial banks in these countries have been operated as if they were part of the foreign banks. Their policies have been determined by their head offices according to the latter's financial conditions. In view of this situation of the commercial

banks in the underdeveloped countries, it may be relevant to consider the origional form of the currency system under the sterling exchange standard since the other underdeveloped territories outside this system operate their currency systems similar in principle to the sterling exchange standard. The sterling exchange standard implied that the money supply issued in the overseas territories of the British Commonwealth was in effect the same as the currency circulation within the United Kingdom itself.(1) By definition, this system prevents any exercise by the authorities in an underdeveloped country of using monetary policy with the aim of encouraging internal economic development. Domestic monetary policy cannot be operated through foreign banks that can increase their reserves at any time by acquiring funds from their home offices. The operation of monetary policy in this case always involves a conflict between the authorities (central banks) and the commercial banks, and the commercial banks are made all the stronger in this conflict when they have head offices abroad to back them up. Also, commercial banks in underdeveloped territories, as instructed by the international banks, have tended to concentrate their local lending in industries involved in the cultivation and export of primary products.(2) Moreover, there has been a serious effect on the economy of the underdeveloped territory because savings were channelled away to the metropolitan country in which the banks' head offices were located. Finally, the close

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(1) Edward Nevin, Capital Funds in Underdeveloped Countries, Macmillan & Co., Ltd., London, 1961, p. 6.

(2) Nevin, Ibid., p. 47.

association of the underdeveloped territory with the metropolitan country could be the reason for economic instability in the underdeveloped territory by causing net outflows in depression years and large inflows in boom years.

2. As a result of political independence and a step towards a self government, the emphasis of economic policy shifted towards the development of agriculture and industry within the country itself and the raising of the incomes of its own population. Consequently, there has been intervention by the national governments in establishing new national banks, and in the management of the banking systems. The governments' measures were adapted to insure that the commercial banks and other specialized institutions employ their financial resources in accordance with the government programs.(3)

3. Many underdeveloped countries are export economies, depending only on one or a few agricultural commodities with strong seasonal financial fluctuations. Fluctuations in the world demand for their commodities are usually a major cause of changes in the money supply generated by the credit which the commercial banks are called upon to supply.(4) For the same reason, the demand for loanable

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(3) For example, in Nigeria, no bank can commence business unless it possesses a valid license granted by the Finance Minister after consultation with the central bank. National Bank of Egypt, "A Comparative Study of Banking Systems", Economic Bulletin, Vol. XVII, No. 3, Cairo, 1964, p. 297.

(4) Arthur I. Bloomfield, "Some Problems of Central Banking in Underdeveloped Countries", Journal of Finance, Vol. XII, No. 2, May 1957, p. 194.

funds for marketing the major export crops of the underdeveloped countries fluctuates seasonally, and these fluctuations may also cause seasonal movements in interest rates.(5)

4. In underdeveloped countries the traditional monetary weapons are not effective because of the underdeveloped state of both money and capital markets.(6) The organised money markets in underdeveloped countries are not fully integrated. The size of the money market is too small. However, as the economy develops, the size of the typical business and industrial unit is likely to expand; the amount of self-financing tends to decline, and greater use is made of the money market to finance business operations.(7) The unorganized money markets in underdeveloped countries are even more imperfect. In these markets loans are granted more on a personal basis than in the organized money markets, and the most of the loans granted by the money-lenders and by other noninstitutional sources are unsecured beyond the verbal promise of the borrower to repay. Moreover, loans in the unorganized money markets are often contracted and paid for not in money but in commodities, and the size of the average loans is very much smaller than in the

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(5) U. Tun Wai, "Interest Rates in the Organized Money Markets of Underdeveloped Countries," IMF Staff Papers, Vol. V, No. 2, August 1956, p. 267.

(6) Markets dealing in short-term papers or in cash are usually called money markets. The market for long-term monetary assets is usually called the capital market; more precisely, it is the market for long-term securities. D. Williams, "The Growth of Capital and Securities Markets," Finance and Development, Vol. III, No. 3, September 1966, p. 213.

(7) Wai, op. cit., p. 250

organized money markets.(8) On the other hand, capital markets in the underdeveloped countries operate with high cost and low efficiency because savings available for investments are scarce, and where they exist, they flee to industrialized countries.(9)

5. The interest rate structure of the underdeveloped countries is an unintegrated one and is relatively insensitive to the actions of the monetary authorities. This is related to the fact that most of the money supplies in these countries is currency rather than deposits. There is a wide diversity of rates between organized and unorganized sectors of the money market. Interest rates in the unorganized sector of the money markets are generally much higher than interest rates in the organized market. Interest rates in general are much higher in underdeveloped countries than in developed ones, and the amount of lending at high rates is relatively small in developed ones as compared to that in underdeveloped countries.(10) On the other hand, it has been indicated that interest rates play a lesser role in the underdeveloped countries than they do in the more developed countries in influencing the volume and direction of investment. The availability of credit factor is likely to be more important, relative to the cost factor, than it is in the more developed countries.(11)

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(8) U. Tun Wai, "Interest Rates Outside the Organized Money Markets of Underdeveloped Countries", IMF Staff Papers, Vol. VI, No.1, November 1957, p. 82.

(9) Phillips Perera, Development Finance, Frederick A. Praeger, New York, 1968, p. 81.

(10) U. Tun Wai, "Interest Rates in the Organized Money Markets of Underdeveloped Countries," op. cit., p. 249.

(11) Bloomfield, op. cit ., p. 192.

6. Capital market institutions, such as commercial and investment banks, frequently are dominated by a few wealthy families or interest groups and, therefore, do not appeal to or reach the small saver. Since this large number of savers avoids institutional contact, and since the supply of available institutionalized savings is considerably low compared to the demand for such funds, the result is high borrowing costs.(12) In general, and as has been noted by the International Bank for Reconstruction and Development, the experience of many underdeveloped countries in recent years has shown that there has been:

> "A lack of the right type of financial institutions, and also an excessive diversion of their resources into short-term, often speculative, types of activities, with little contribution to the types of investment most needed by the economy."(13)

II. Sources of Capital Funds for Economic Development

Scarcity of capital is one of the most important obstacles to economic development. Capital accumulation in the underdeveloped countries is low because income per capita is low, and the annual rate of voluntary saving per capita also tends to be low. Thus, saving derives its importance from the fact that its level determines the volume of resources available to realize investment. The description of various types of savings could be divided into foreign (inflow of foreign

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(12) Phillips Perera, op. cit., p. 82.

(13) Statement by the International Bank, Methods of Financing Economic Development in Underdeveloped Countries, United Nations, Department of Economic Affairs, New York, 1949, pp. 92-93.

funds), and domestic savings. Foreign savings include hard loans and private foreign investment; soft loans and loans repayable in the receiving country's currency; and grants. On the other hand, domestic savings include government and private savings. Government savings are the excess of current budget revenues over expenditures. Private savings consist of private business enterprises and household savings. Private business enterprise savings are the accumulated reserves out of previous profits. Private household savings consist of savings used by savers for self financing or lent privately to others; savings transferred to financial institutions; and savings invested in securities. Finally, there is forced savings through inflation by credit expansion and other monetary devices.

Of the three main sectors of the economy--foreign, government, and private--the last one is the most important net saver and accumulator of financial assets. The following few pages illustrate this view.

When development is financed by foreign capital, additional interests or dividends have to be paid to capitalists resident abroad, adding to the present and future costs. In order to transfer the payments, the borrowed country will have to generate an export surplus partly by reducing imports and partly by increasing exports. On the other hand, the external resources, even if they become available in the most desirable forms, are necessary but not sufficient. These considerations do not imply that the underdeveloped country should not use foreign capital as one source of financing development, but they do emphasize the need for accelerated national efforts to meet the requirements of economic development. It has been indicated that foreign aid extended by all nations has generally favored countries with strong political and diplomatic associations,(14) and that industrialized countries are giving increasing assistance to developing countries through the medium of multilateral institutions,(15) which are not exempt from political maneuvering. The large number and disparate make-up of their capital subscribers from time to time permit certain elements to influence their policy decisions and can impede their efficient operation.

In time of peace, governments try to run a budget deficit or surplus for the broad purpose of stabilizing the economy or for the purpose of financing development programs. For the purpose of capital development, savings could be increased through the use of government taxation. But there is always a limit to the proportion of income which could be taken in the form of taxation. Moreover, the difficulties of the aministration involved and the danger of the negative effects on private savings motives, along with the possibility that the governments in underdeveloped countries waste a greater percentage of their capital availabilities than the private sector, are of considerable importance.

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(14) Phillips Perera, op. cit., p. 5.

(15) The formation of the world Bank has been followed by the establishment of many other multilateral institutions such as the International Finance Corporation, the International Development Association (affiliates of the World Bank). The U.N. Development Program, and multilateral but regionally oriented institutions such as the Inter-American Development Bank, the African Development Bank, the Central American Bank for Economic Integration, the European Investment Bank, and the Asian Development Bank, Phillips Perera, op. cit., p. 45.

The experts of the United Nations have indicated:

> "While increasing tax revenue is generally desirable in under-developed countries, such tax increases may result in some diminution of private savings, so that the total sum available for capital development would not be increased by the full amount of the tax."(16)

The report of the U.N. has indicated that taxation should cover at least the current expenditure on normal government services. Borrowing is particularly appropriate to finance government expenditures on productive projects.

Some economists(17) believe in moderate inflation as a method of financing development. All that can be said is that inflation is a dangerous method of finance in the sense that it may cause a misallocation of resources. According to the report of the United Nations:

> "... in view of the inflationary conditions already prevailing in many underdeveloped countries, this must in the general case be considered as a dangerous method of financing."(18)

Direct reinvestment of profits in the business enterprises forms an important part of total domestic savings in the underdeveloped countries, as it does in more developed ones. This source of finance may lose its importance over time. As incomes become more evenly distributed,

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(16) United Nations, Domestic Financing of Economic Development, New York, 1950.

(17) Antonin Basch, Financing Economic Development, Macmillan Company, New York, 1964, p. 5.

(18) United Nations, op. cit.,

and wages gain at the expense of profits,[19] the financing of new investment is likely to depend increasingly on rising household savings.[20] Thus the role of private households is considerably important. Private households in the aggregate have an excess of income over expenditure. They show a tendency to save by acquiring gold, real estate or other real assets instead of depositing their savings in the form of money or liquid assets. What underdeveloped countries need to close the capital gap[21] is to establish a proper structure of their financial institutions that can function and operate within the general framework of the development process. Such institutions must be designed to reach the small as well as the large saver. It is, in fact, the small saver who is the most difficult, but important, to approach.

III. Measures to be Taken by the Central Bank and the Government

It has been indicated that the central bank in the underdeveloped countries should constantly cultivate active business.[22] The central

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(19) A matter which seems to have become a phenomenon of the governments' policies in the underdeveloped countries in recent years under the conditions of relative monetary stability.

(20) David Williams, op. cit., p. 215

(21) The difference between the actual level of investment by developing countries and the amount they must invest to achieve a selected target rate of growth has been termed the capital gap. Phillips Perera, op. cit., p. 68.

(22) R.S. Sayers, "Central Banking in Underdeveloped Countries." National Bank of Egypt, Cairo, 1956.

bank should be a banker to the public, finding out the country's economic potentialities and filling the gaps unfilled by others. It should also be a banker to the government, taking the monopoly position of the administration of the note issue; and it should be a banker's bank, acting as a controller of the financial system. It should be a last resort lender to prevent an internal liquidity crisis and to support the market with adequate loans. It should encourage the growth of sound institutions and check their weakness, be an active banker to the young commercial banks and other financial institutions, and guide them. Moreover, the central bank should stimulate the development of trade and the growth of capital in both industry and agriculture by spreading banking services and facilities. In this matter it should not be against medium-term and long - term lending by the commercial banks, but rather it should supply additional liquidity in case of emergency. Another objective and responsibility of the central bank is that it should seek to achieve and maintain reasonable financial stability through control of the supply, cost, and availability of money.[23] By the use of its various credit-control powers, it would not only prevent the inequities and misuse of resources associated with inflation (or deflation) but also provide a necessary condition for increased saving, for attracting foreign investment, and for promoting more balanced economic growth.

In connection with the central bank's function of insuring that no monetary sickness impeded the progress of industrial and commercial development, it has been indicated that open market operations are too

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(23) Arthur I. Bloomfield, op. cit., p. 196.

narrow or, in some cases, do not exist.[24] The power of the bank rate depends largely on the associated changes in the availability of credit. The imperfection in the market for credit in the underdeveloped countries compels the central banks in these countries to confine themselves to influence credit in particular channels. But, the condition of each bank's control depends upon the circumstances of each individual country.[25]

The distribution of bank credit like the distribution of real resources, should be consistent with the program of development. In this connection it is recommended that most of the funds which are deposited under the reserve ratio requirements should be available to the central bank for medium and long-term investment so that the commercial banks could be organized to contribute to the basic economic development with domestic savings taking the form of bank deposits.[26] As it has been indicated:

> "The authorities will have ensured that as the economic system progresses and develops, and as bank deposits rise with the general growth of incomes, a constant fraction of these additional deposits will continue to occure to the central bank for channelling into development."[27]

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(24) R.S. Sayers, _op. cit._, p. 15.

(25) In case of a conflict between the provision of cheap credit and the need to stimulate private savings, one economist has indicated that the central bank should review the discount rate policy. A. Ali, "Banking in the Middle East", IMF _Staff Papers_, Vol. VI, No. 1, November 1957, pp. 74-75.

(26) Edward Nevin, _op. cit._, p. 56.

(27) Edward Nevin, _op. cit._, p. 62.

Nevin has also indicated that the reserve ratio should be variable, and that the central bank should have the right to change this ratio up to 100 per cent, with respect to bank deposits in excess of a specific point. Another type of control over bank credit, according to Nevin, is the local assets ratio of which the commercial banks are required to utilize a minimum proportion of their deposits in the purchase of local assets of one form or another. In this connection, and in the case of growing time deposits, the commercial banks could be in a position to support part of the long-term requirements of the capital market. In the same manner, the commercial banks could increase the share which is held in the form of the government's securities. It is possible that a higher level of interest rates on time and saving deposits in the commercial banks could attract into the banking system some savings which presently go into landed property, real estates or hoards.(28) This would have a positive effect on capital formation.

The central bank in a developing economy should provide some sort of flexibility in the note issue. In order to provide this flexibility one economist(29) has indicated that the actual reserves must exceed the prescribed minimum. Central banks in such countries could

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(28) One of the economists has recommended a low rate of interest on demand deposits in the commercial banks even if this required a government subsidy program. Emile Despres, <u>A Seminar on Inflation and Economic Development</u>, Economic Growth Center, Yale University, April 22, 1968, (unpublished).

(29) A. Ali, <u>op. cit.</u>, p. 72.

include short-term commercial and agricultural bills as part of their statutory reserves so that they not only provide flexibility in the note issue and in bank credit, but also encourage the development of a bill market.

In many underdeveloped countries, export incomes dominate the internal financial position. In this case the central bank should attempt to moderate the swings of income by checking commercial banks in their natural tendency to accentuate the swings. This depends upon how well the country is provided with banks and other financial institutions adapted to its needs. In this connection Sayers said:

> "The encouragement of the growth of sound commercial banking throughout the economy must always occupy first place on the agenda of a new central bank."(30)

Because of the absence of capital markets in the underdeveloped countries and the limited ability of commercial banks to support agriculture and industry, the governments of these countries should establish special financial institutions for these purposes. The establishment of such institutions should provide a powerful influence on the pattern of financial assets in the market; and hence upon physical investment. Hence the growth of various types of specialized institutions such as Agricultural Banks, Industrial Banks, Building Societies, Savings Banks, Insurance Companies, etc., which are providing the functions of collection and distribution of funds, means the existence of the economies of specialization. As Nevin has indicated:

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(30) R.S. Sayers, op. cit., p. 24.

> "The poorer a country is, in fact, the greater is the need for agencies to collect and invest the savings of the broad mass of persons and institutions within its borders. Such agencies will not only permit small amounts of savings to be handled and invested conveniently, but will allow the owners of savings to retain liquidity individually but finance long-term investment collectively."(31)

The establishment of these institutions should be supported by the government. The government also has its responsibility in allocating the funds of these institutions in accordance with the general program of development.

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(31) Edward Nevin, op. cit., p. 75.