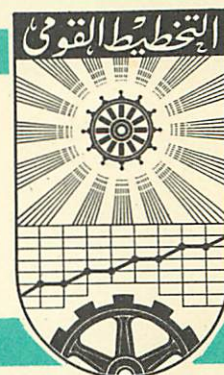


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LIQUIDITY PREFERENCE AND
CAPITAL-FORMATION IN UNDER-DEV-
ELOPMENT COUNTRIES

by

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Liquidity Preference and Capital- Formation in Under-developed Countries

Since the arousal of interest in the economic growth of under-developed countries, writers have dwelt at length on the particular forms in which private wealth is held as a main deterrent to capital formation.⁽¹⁾ The thin productive capital stock on the one hand and large hoards of gold, a high preference for land and residential construction, hoards of valuable consumers' goods and foreign exchange on the other hand are depicted as characteristics which distinguish these societies from industrial countries enjoying the benefits of a rich stock of productive capital.

There is no doubt that the observed forms in which private wealth is held are themselves the effects of basic social and economic features and may, in turn, under certain conditions be inimical to economic development. In fact, they may be explained by a high demand for liquidity accompanied by a particular pattern of asset preferences stemming from the existing political and socio-economic conditions which characterise these countries. The role played by securities in industrial countries as close substitutes of money are taken over by other assets which are considered highly liquid in under-developed societies as there is invariably a ready market for their sale and purchase. The main argument of this paper is that there may be a precautionary and speculative motive for demanding assets instead of money, conditioned by the particular circumstances in existence; and

⁽¹⁾ See, e.g. Charles Wolfe, Jr., Sidney C. Sufrin, "Capital Formation and Foreign Investment in Under-developed Areas", New York, Chapter II.

that the observed asset preferences, via a direct or indirect mechanism may create forces of which the final effect may well be inimical to the growth of national income.

I - Precautionary and speculative motives in under-developed societies

Political uncertainty and instability, strong inflationary tendencies, lack of unemployment insurance or crop insurance may be the basic causes of a high demand for liquidity in terms of the precautionary motive in under-developed societies. In view of the uncertainty involved in the general political and economic milieu, however, national currency is not considered a safe way of remaining liquid; political instability, inflation and depreciation may finally bring to naught the value of cash - balances held for the rainy day. It is pretty difficult to think of a demand for money for precautionary purposes in countries where money is no hedge against any of the structural defects of the economy.

Moreover, incorporated enterprise and the capital market, in addition to other financial institutions which establish a close substitutability between money and the securities, are either non-existent or extremely inadequate. It is, however, highly dubious that in the general atmosphere of uncertainty and unreliability reigning in under-developed societies securities can take the place of other assets which present all the advantages of remaining liquid at a small risk.

One may presume that what is usually considered as "conspicuous consumption" by outsiders, i.e.a. rich display of

precious metals or some valuable consumers' goods, e.g. valuable carpets, the possession of numerous urban dwellings, may be the sheer outcome of a desire for liquidity; the same holds true in the case of the high preference for land which, in most cases, is attributed to the social status it confers on its owners. Hence, certain social attributes of under-developed countries, such as conspicuous consumption or the importance attached to social status, may find an explanation in terms of the particular forms which a high preference for liquidity takes under the circumstances in existence.

In addition to the precautionary motive for demanding assets there may be a speculative motive involved in holding assets⁽¹⁾. Urban expansion as a result of rural exodus and population increase, the changes in the preference attached to certain city sites through time as well as government overhead investments cause considerable changes in urban land values. The same is no less true in the case of agricultural land which appreciates in value as agricultural population increases and as a result of government investments in communication, irrigation etc. Gold prices follow closely the changes in foreign-exchange availabilities and in the general political and economic conditions; and foreign-exchange prices, the export possibilities and the import demand of the country. Devaluation of the national currency as a consequence of domestic inflation and an imbalance in

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A somewhat similar though not quite the same view appears in A.O. Hirschman, "The Strategy of Economic Development", New Haven 1959, P. 20 - 23.

the exports and imports of the country is a far-flung possibility. Moreover, certain import commodities as well can be demanded for speculative purposes: most of the under-developed countries suffer from balance of payments difficulties and have to restrict the imports of certain basic commodities, i.e. consumers' goods or producers' goods from time to time. This possibility in addition to fears of depreciation leads to hoarding of import commodities in expectation of rising prices.

Hence, the basic economic and social features of under-developed countries, presumably, favor the holding of assets and commodities under the speculative motive in expectation of an easy gain and high profitability. Thus, the high preference attached to assets may stem not only from the advantages they present under the precautionary motive but also from the possibilities of high profitability they present under the speculative motive. In the same way as it is difficult to think of a demand for money for precautionary purposes, it is difficult to imagine a demand for money for speculative purposes. Presumably, the money stock is demanded in under-developed countries solely for transactions purposes and for no other motive.

II- The direct impact on investment

The observed asset preferences in under-developed countries are not of interest as a curiosium for social investigators but because they may have a significant impact on investment and national income growth. However, their impact on capital-formation may be either direct, by absorbing a part of productive factors available

or indirect and in a more roundabout way. As the impact varies from case to case, each of the preferred assets will be taken up separately with regard to its possible effects on investments.

Residential construction and certain valuable consumers' goods such as fur coats, carpets etc., in so far as their impact on investment is concerned, can be classified in the same category. A high demand for these items means less productive resources available for investment purposes as they involve a transfer of factors of production to consumption purposes so long as they are produced domestically or imported into the country; (as it may be in the case of such valuable consumers' goods as fur coats or carpets). In fact the overwhelming importance played by residential construction in under-developed countries is clearly depicted by the Turkish case where 2/3 of total private investment are in housing.

Precious metals can be classified together with land under "Non-reproducible assets" so long as they are not produced domestically or imported into the country; though in cases where the high preference attached to these assets results in absorbing productive factors by increasing production or imports they need be classified together with valuable consumers' goods. Now, non-reproducible assets including land and precious metals can only appreciate in value (and not in quantity) in response to a rise in demand. In consequence, they may be expected not to decrease productive factors available for investment purposes. But the mere fact that they may appreciate in value and result in an easy gain and high profitability

diverts entrepreneurial ability from productive investment to dealing in the sale and purchase of these assets. What one observes in under-developed societies is not a lack of entrepreneurial ability but its dissipation in unproductive dealings such as the sale and purchase of land, gold etc. The diversion of entrepreneurial ability to such speculative dealings is definitely inimical to capital formation: first, because the entrepreneur is the organizer of investment activity and secondly, because a high gain in an easy fashion results in a belittling of the rate of profitability on productive investment. Unless the entrepreneur is there to organize investment activity productive resources will remain idle or the state will have to take over his activities; unless the rate of profitability on investments is considered adequate, there is a likelihood that the propensity to consume will remain high as well as the demand for the assets under discussion.

Foreign-exchange, in turn, constitutes again a different category; as capital formation in under-developed countries involves in most cases the purchase of foreign equipment hoards of foreign-exchange constitute an alternative to productive investment and hence a true reduction in the amount of capital goods available for this purpose. Moreover, the argument advanced above for the loss of entrepreneurial ability and the belittling of the profitability of productive investment holds in this case as well where dealing in foreign-exchange yields a high return.

The holding of import commodities in expectation of better price possibilities as import restrictions are imposed or as depreciation is undertaken may have an altogether different impact. In cases where the import commodities are capital goods, hoarding will have the effect of prolonging the gestation period of investments as capital goods will not come onto the market as soon as they are imported. In addition, as a regular flow of capital goods (or spare parts) is prevented the risk attached to productive investment increases, resulting in a decline in their marginal efficiency.

Thus, a high liquidity preference in terms of the indicated assets, either by a transfer of productive factors to consumption or in various other ways may have adverse effects on investment activity. However, aside from their direct effects, they may have an indirect impact on investments via influencing the rate of interest.

III - The indirect impact on investments

To understand the impact of the high demand for assets on interest rates, an investigation into the demand and supply of loanable funds is required.

As the desire for liquidity results in a preference for valuable consumers' goods, for residential construction, i.e. an increase in consumption expenditures, its direct effect is to decrease real saving. Hence, not only a low level of real income per capital but also the desire for liquidity might have a say in low aggregate savings in under-developed countries. To increase the supply of

loanable funds, inflationary sources of finance have to be resorted to.

On the other hand, the demand for loanable funds is strong and stems partly from industrial investments but more so from the sources under discussion, i.e. in order to get hold of land, import commodities, private residences etc. to satisfy the desire for liquidity. The meagre supply of loanable funds and imperfectly competitive markets as well as the high demand results in the establishment of high interest rates. However, the demand for loanable funds arising from the speculative motive can compete and even eliminate the demand arising for industrial investment purposes as the expected rate of profitability on speculative enterprises is much higher. In addition, in under-developed countries where the time horizon of the entrepreneurial class is extremely limited in view of the existing political and economic uncertainty, speculative enterprise is favored not only because of its high profitability but also because it yields a return at short term and permits the individual to remain liquid. Industrial investments requiring long term fixed commitments necessitate the existence of stable conditions over fairly long periods and are not popular with the entrepreneurial class for this reason even if not for others.

High interest rates are actually no panacea for eliminating the speculative enterprise from the market as industrial enterprise will be the first to withdraw. In view of the high elasticity of demand in the upper portion of the marginal efficiency curve with

respect to interest rates, the discouraging effect of high interest rates on industrial investments cannot be ignored. Yet, via their effect on the supply of and demand for loanable funds both the precautionary motive and the speculative motive tend to establish high interest rates in under-developed countries. In cases where the country resorts to inflationary sources of finance to increase the supply of loanable funds, obviously, both the precautionary motive and the speculative motive will be strengthened further to affect adversely industrial investments.

One other feature which emerges from the above analysis is that the velocity of circulation of money in these economies ought to be higher than that in industrial countries. If the money stock is demanded solely for transactions purposes in the former and in addition for precautionary and speculative purposes in the latter it is highly plausible to expect such a difference.

Now, if the velocity of circulation is high and as a result of a slight increase in prices tends to get higher because of an increase in asset transactions, we might have an explanation for the extreme inflationary tendencies reigning in these economies. Inflationary tendencies, in turn, promoting the profitability of speculative enterprise and strengthening the precautionary motive are definitely inimical to capital formation for reasons explained in the paper.

IV - Conclusion

The argument of this paper has been that the high liquidity preference in under-developed societies and the forms it takes may be far from being an innocent neutral social feature but, on the contrary, be a main deterrent to investment activity. Though the tentative explanation given in this paper is in no way adequate to bring to light all the underlying causes or the expected consequences of the observed asset preferences in these economies, we hope at least that the existence of a problems which needs further investigation stands out. This in fact is all that the writer of this paper has tried to do.

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