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# ARTICLES

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## *Financing*

# Need for Modernizing Financial Institutions

by Prof Dr Heiko Körner, Hamburg \*

**As the flow of financial aid from the industrial countries may be expected to shrink rapidly as a consequence of their economic difficulties, the developing countries will have to find out possibilities of using their own financial resources more effectively. In this connection the task of modernizing their financial institutions should not be neglected.**

The deplorable state of world economic relations and the bad economic conditions prevailing in most of the western industrial countries in the seventies make the prospects for the developing countries very uncertain. Especially the possibilities of transferring capital from the developed countries to the „Third World“ appear to be seemingly restricted in the coming years.

Sometimes this question is graded down as a matter of secondary importance, if compared with the ever growing problems of employing the starving population in the developing countries. Therefore the developing countries should not worry too much over declining capital resources but intensify their search for new and efficient devices of employment creation.

Indeed a policy of employment creation with the help of labour intensive techniques may be described as capital saving from the point of view of capital-labour ratios or of the monetary cost of investment per head occupied. But the fact remains that the capital cost per unit of output in most cases is comparatively high.

Moreover, the expansion of employment by the use of „appropriate“ techniques also does not save capital in absolute amounts: A certain quantity of monetary capital is indispensable for acquiring the (even simple) tools required and for the building up of the overheads needed. And if in a country employment is to be created in sufficient dimensions to meet not only the needs of the workless up to now existent but also of the growing streams of new entrants into the labour force, an adequate provision with capital arises to be indispensable.

Therefore possibilities must be found out to supplement the fading stream of foreign aid capital by unlocking resources of the developing coun-

tries themselves. This can be done either by squeezing out more savings of the population or by the better use of the existent stock of capital.

### Financial Dualism

In most developing countries we find a large agricultural sector which is separated more or less from the modern parts of the economy. Generally in the agricultural sector pre-industrial methods of production and traditional patterns of behaviour prevail. But the agrarian population often is not a homogenous group: Side by side with large groups living according to traditional patterns there also exists a small sub-group of landlords, owners of large plantations and members of the traditional gentry who all show elements of modern patterns of economic behaviour. This is especially evident under the aspect of the generation and allocation of savings: Usually this sub-group consists of people with high personal income and with correspondingly high savings. This group often behaves also in a modern rational manner vis-à-vis the investment problem.

Therefore it seems appropriate to add this „capitalist“ sub-group to the modern sector of the developing countries. As a consequence there remains in the agricultural sector (defined now in the narrow sense of the word) a group of people with low income and low savings per head. And it seems to be a characteristic feature of this group that most savings occur predominantly in the form of target saving for repayment of loans given by traditional money lenders or for ceremonial and social purposes such as weddings and funerals.

Besides in countries with good natural conditions and marketable surplus production in the agrarian sector, savings for the acquisition of livestock and real estate are also to be found, typically in the form of windfall profits caused by the erratic occurrence of good conditions in the markets for agricultural products. Without doubt this saving can be characterized as being income dependent

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and therefore of a modern type. But it seems to be not of high relevance under the allocational aspect. For this type of saving does not enter the general financial circuit between savers and investors; so saving out of "transitory income" in the agricultural sector does not belong to the general category of modern "financial saving". In the absence of institutions which perform the art of "marrying" savings and investment possibilities the money accumulated by rural savers is invested by the savers themselves directly in real assets of low social productivity: Investment in livestock and real estate can at best be interpreted as a widening of the existing stock of relatively inferior real capital assets. So this semi-modern type of agricultural savings does not fructify in the modernization of the capital stock either in agriculture or in the industrial sector.

It is precisely this semi-modern type of savings which highlights the situation of "financial dualism" described by Myint<sup>1</sup> as a special phenomenon of the general dualism in the developing countries. In this situation, the conventional policy of mobilizing additional savings (following for instance the lines proposed by Kaldor<sup>2</sup>) must be accompanied with vigorous measures favouring the creation of effective and attractive financial institutions which will serve to channel at least the income-induced part of the agricultural saving into the modern parts of the economy or into capital deepening activities ("green revolutions") in the agricultural sector itself.

#### Inefficient Allocational Structure

It is not so much this problem of mobilizing and channelling savings which is relevant to the modern sector of the developing countries. According to W. A. Lewis'<sup>3</sup> celebrated dictum "only capitalists save", the modern sector embraces by definition all high-income and high-saving people in the economy: modern entrepreneurs, traditional petty traders, landlords and sometimes the well-to-do members of the metropolitan group of skilled workers. The problem we are confronted with in this respect is mainly the structure of investment out of savings.

In the modern sector (as defined in the sense mentioned above) the predominant problem arises out of the fact that the allocational structure is often not in correspondence with the principle of the optimal use of scarce resources. For instance, a good deal of savings is motivated by

and channelled to the acquisition of consumer durables. Factors which may be responsible for this phenomenon are the preferences of the savers vis-à-vis investment in competing assets, and the level and structure of incentives for investment into these assets. Unfortunately precise information related to the expectational structure of the savers in the developing countries is a rare thing. We only possess hints that savers in these countries are habitually inclined to invest in real estate or in fast-maturing assets, preferences which are not irrational from the saver's point of view with respect to galloping inflation and/or political unrest. But is this a natural phenomenon? Or could it be that this lack of ability to invest in assets of high social productivity has its roots in the "intervention syndrome"<sup>4</sup> so common in the developing countries?

#### Impact of Foreign Capital

One of the most notorious aspects in this respect is the fact, that governments of developing countries shy away from reforming the ill-structured capital-markets or from intervening in the expectations and preferences of their "capitalists" on the basis of political considerations. The governments prefer instead the more easy task of inviting foreign capital to be invested in modern production lines and often do this with success if the general conditions for the activities of foreign investors are promising.

However, exactly this discrimination between domestic and foreign capital supply is the best way to frustrate domestic savers and to confirm them in their deeply rooted preferences for assets with high private revenue but low social productivity: The long process of learning to invest in highly productive assets and the complementary restructuring of the capital market never begins.

But this is not the full story: This tendency of the developing countries' governments has been in most cases sustained by the inundation with highly subsidized and therefore low cost foreign aid capital. In the recipient countries the advent of this relatively cheap capital, as compared with the original scarcity structures, brings with it interest levels, at least in the official market, which are not attractive for the domestic savers with their unaltered preferences. As a consequence, domestic saving will remain locked in the more traditional lines or will find its way out of the country. This, by the way, could be another explanation why the inflow of foreign capital might deter domestic saving<sup>5</sup>.

<sup>1</sup> H. Myint, *The Economics of Developing Countries*, London 1964.

<sup>2</sup> N. Kaldor, *Taxation for Economic Development* (1963), in: I. Livingstone (ed.), *Economic Policy for Development*, Harmondsworth 1971.

<sup>3</sup> W. A. Lewis, *Economic Development with Unlimited Supplies of Labour* (1954), in: A. N. Agarwala, S. P. Singh (eds.), *The Economics of Underdevelopment*, London 1958.

<sup>4</sup> R. I. McKinnon, *Money and Capital in Economic Development*, Washington, D.C., 1973.

<sup>5</sup> G. F. Papanek, *The Effect of Aid and other Resource Transfers on Savings and Growth in Less-Developed Countries*, in: *The Economic Journal*, 1972.

The very fact that in general the level of interest rates remains artificially low as a consequence of cheap foreign financial aid must not necessarily be detrimental to the effective use of the domestic saving if only the structure of incentives is reflecting the order of social productivity of the various potential assets, as described by the development necessities of the country. Therefore, if governments are not able to induce *interest levels* which reflect the comparative scarcity of capital, government intervention should at least create a *structure of interest rates* in conformity with the social productivities of the respective investment opportunities.

### A Vicious Circle

In fact financial intervention and, as Shaw<sup>6</sup> puts it, "financial repression" has a long tradition in the developing countries. Governments do not hesitate to manage the capital markets according to their political priorities. But often it is not clear whether these priorities reflect also the order of economic productivities. Moreover, governments typically intervene with the help of purely administrative, non-market devices which are highly detrimental to the functioning of capital markets. There are instances in which, in overt neglect of the market mechanism, capital is directly allocated with the help of investment funds, special development banks or appropriate banking regulations. And if in this context governments find it necessary to consult experienced people, these are in most cases the foreign investor or the representative of the large domestic corporations, not the ordinary saver.

In this way the often fragile capital-market will be further emasculated and the aspirations of the savers will be left without consideration. And this again will confirm their traditional behaviour concerning the asset structure of their portfolios.

<sup>6</sup> E. S. Shaw, *Financial Deepening in Economic Development*, New York 1973.

So a vicious circle comes into functioning: If in a certain country income per capita rises and the modern sector expands, there will be also an expansion of savings. But the additional savings are allocated to assets with low social productivity, because capital market imperfections and traditional preferences prevail. To compensate for this, governments induce the import of foreign capital to be invested in modern production lines, capital moreover unduly cheap and often allocated by administrative decisions. This again confirms the traditional attitudes of the savers, so that the domestic saving potential will never be fully available for modern investment purposes.

So the argument winds up to the proposition that even in a situation dominated by the all overwhelming employment problem of the Third World the governments of the developing countries should not neglect the task of mobilizing an adequate amount of capital. As the strong presumption seems to be justified that the flow of financial aid will shrink rapidly as a consequence of the endemic economic weakness of the industrial countries, the possibility for the developing countries of using their own financial resources more effectively arises to be of crucial importance.

### Need for Modernizing Financial Institutions

In this respect the question of how to mobilize new saving remains on the agenda of economic policy. But the paramount problem to be solved lies in the better use of the savings already existent in the modern sector of the developing countries. Therefore the growing problems of employment should not induce the governments to neglect the task of modernizing the financial institutions of their countries. The restructuring of these institutions opens up the possibility of economizing scarce resources and seems to be one of the most important preconditions of the successful implementation of employment expansion policies.

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