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A country's ability to service debt is now measured in terms of its achieving the level of resource transfer from external capital to fill in the resource gap commensurating with the capital requirements for sustaining its development efforts. The extent of resource transfer, as derived from above equations, can further be compared with the average level of resource transfer for a group of countries in a region. Based on the experience of individual countries, certain policy recommendations can be made in order to maintain an increasing level of resource transfer from external borrowings.

Resource Transfer Analysis for 86 Countries

The table provides the summary data for 86 developing countries regarding their most recent debt servicing experience. The data are being compiled by the World Bank based on the reporting made to it by individual countries. The calculations for the net capital flow and resource transfer per unit of external debt have been made by this author. The data cover the latest available statistics for a period of eight years beginning

1967 through 1974. It may be observed that both the net flow of capital and the net resource transfer as a percentage of external debt committed for the year have been declining since 1967. The extent of net flow of capital has dropped from 74 p.c. in 1967 to 70 p.c. in 1974; whereas the drop in resource transfer has been from 64 p.c. to 55 p.c. during the same period. It is, therefore, significant to note that the percentage of resource transfer has been declining at a faster rate than that of net flow of capital. It leads to the only one obvious conclusion, i.e., the burden of interest payment for developing countries, as a whole, has been mounting at a faster rate which is absorbing the net transfer of resources at a growing pace. As it stands now, it almost takes two dollars of fresh borrowings to materialize one dollar of net transfer of real resources. A situation like this leads to an important area of investigation requiring a better management of external debt by the authorities in developing countries. The scope of this article does not permit incorporating the various policy issues relating to international debt management.

The Role of Capital Markets in Developing Countries

by Bruce Lloyd, London *

Capital markets in developing countries are under increasing political pressure. What solutions are likely to the conflicts and problems that arise over the need to integrate them into exploiting the resources, and fulfilling the needs, of a developing economy as a whole?

This paper is primarily concerned with the problems and prospects of equity investment; that is the issue and market in shares (rather than bonds or debentures) using the generic terms "stock market" or "capital market" in that context. However many of the points mentioned apply with equal validity to wider definitions of a capital market. Such a discussion inevitably involves some consideration of the appropriate place for private and foreign risk capital in the investment programme of developing countries (LDCs).

The final section of the paper examines the areas where the policy of governments can influence the role and effectiveness of a capital market or stock exchange in an LDC.

At the outset it should be emphasised that it is misleading to talk about LDCs as if they are all alike. While they have much in common, there are also significant differences which should become more apparent as this paper progresses. It should also become apparent that many of the points considered bear a remarkable similarity to those experienced in the industrialised world.

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The quantity and quality of investment undertaken by any country is crucial; dominant and orthodox economic theories emphasise capital formation as one of the main factors (if not *the* main factor) in the developmental process.

The Role of Private Investment

One of the first questions that should be asked is what role private investment can be expected to play in the developmental process. Without an active private sector there cannot be a meaningful capital market. Consequently, many of the problems associated with identifying a role for a capital market are essentially concerned with attempting to overcome some of the constraints in finding a positive role for the private sector. That such a role can be found should not be taken for granted. As one commentator said, "The closer identification of private enterprise with the broader aims of the nation and society has been one of the outstanding developments of the 20th century in the richer countries. In many of the developing countries, unfortunately, this identification is still lacking"¹. Somehow private investment (and hence the capital market) must be integrated into a country's development programme. It must be aware of, and respond to, the needs of the population as a whole. Anything less may survive on a temporary basis but, with rising expectations and the repercussions of democratisation, long term stability is dependent on considerable overlap between both private and social objectives and their respective costs. The optimum balance between private and public finance depends on many factors, not least the circumstances of each individual country, and even for a given country this balance can be expected to vary over time.

Domestic sources of finance for development are public and private savings. The level of public sector savings is often limited because of a combination of the inability of governments in LCDs to control public expenditure by reducing ordinary budget deficits, to obtain profits from government enterprises, and to reform the taxation system by widening its scope and improving tax collection. As a result, deficits on ordinary and investment account have to be met by borrowing from the central bank and the private sector either domestically or from overseas. Of the three main sectors of a domestic economy — the public sector, business enterprises, and private households — only households tend to be traditionally net savers. The generally accepted concept of a capital market obviously becomes meaningless when savings are compulsorily controlled, or when investments are determined directly by the government.

The essential function of the capital market is to increase and channel the flow of long term funds according to market criteria. But what are these "market criteria"? Do they necessarily reflect the interests of the country as a whole? If not, why not? And what can be done about any distortions or differences that do arise?

Several other questions also need to be considered before the role and prospects of a capital market within an LDC economy can be properly defined.

☐ Taking the question of savings. Who are the savers? Why do they save? How are their savings used? How can the level of domestic saving be increased? Does the existence of a capital market simply encourage a switch from public to private saving, or is it a switch out of consumption? How can the efficiency of the mechanisms for allocating savings between investment in social infrastructure and productive industry be improved? Do savings flow to the points at which they are most needed? Is there a significant (and potentially dangerous?) gap between private and social priorities?

☐ How can the base of the ownership of industrial and financial assets be broadened? Such broadening of the ownership base is important, not only because it contributes to political and social stability, but also because, if capital is owned too narrowly, this leads to the development of an imperfect market. Capital markets of any kind only operate efficiently over any length of time if the dealings take place between equals or near equals. Under the twentieth century pressures of democracy, it is no longer possible to envisage an active capital market that just involves a small minority of the population, organised in such a way that the interests of that minority are in conflict with those of the majority. Consequently a major priority for the governments of most countries is to find ways of broadening the base of asset ownership within the community and some of the programmes now being considered are discussed in more detail later.

☐ What can be done to overcome the lack of appropriate institutional structures such as pension funds, investment trusts and insurance companies? What needs to be done to improve the information on investment opportunities? What controls are required to prevent the abuses which were so prevalent (in retrospect) in Europe and the US earlier this century?

In theory stock exchanges and new issue markets are designed to attract and channel into more productive sectors of the economy some long-term savings held at present as bank deposits, gold or

¹ Abderrahman Tazi, "The Worldwide Opportunity for Private Capital", Finance and Development, No. 3, 1968, p. 13.

jewellery. But to what extent is this happening? And what are the conditions under which the situation might be improved? Here it is essential to analyse the importance of shifting investments between sectors, industries and companies, and the vital aspect of raising new money, as well as the extent to which government policies alter the balance between saving and consumption. However, it is surprisingly difficult to get the necessary figures to begin definitively to answer these questions. Once created, the growth of the capital market mechanism will depend more on the legal and economic environment affecting securities markets rather than the strictly institutional aspects of stock exchanges.

What is the right "development climate"? Any analysis of this question needs to include a low level of corruption, a reasonably accurate reporting system, and positive attitudes to corporate and personal taxation. Up to a point a country can concentrate on growth, without concerning itself with redistribution, but this is only a very short term expedient, since any government not genuinely interested in the prospects for the poor will sooner or later be confronted with the price of its neglect.

Those who extol the virtues of "market" solutions must be aware of the assumptions on which the theory is based, and the constraints that inevitably arise when attempting to put the theory into practice. An uncritical approach only acts as a catalyst to those who wish to experiment with Marxist solutions.

The Role of Foreign Investment

Before considering the way governments have tried to overcome the problems outlined above, it is useful to mention the role of foreign investment within this process. This is neither the occasion, nor is there time, to go into this subject

in any depth, but it is valuable to discuss certain aspects, as this area is subject to particular controversy.

Foreign investment can offer four overlapping but distinct benefits to an LDC:

- ☐ As an additional source of foreign exchange.
- ☐ As a supplement to the volume of savings (and hence the volume of investment) that can be raised domestically.
- ☐ As a source of technical and managerial expertise.
- ☐ As a channel for exports through associated companies abroad.

These funds can be supplied through either private or public channels, or a combination of both (this paper is only concerned with the problems and prospects of the flow of private funds. During most of the 1960's net private capital flows from countries which are members of the Development Aid Committee of the OECD accounted for 30–40 p.c. of the total net flow of financial resources to developing countries). Unfortunately the inequality between countries provides as many difficulties as the enormous inequalities within countries. The market mechanism has no easy way of adjusting the historical imbalances without running the risk of upsetting the system itself. It is because of the extremes of inequality between nations that the flow of capital into, and out of, LDCs is invariably subject to strict control. In most cases it is inevitable that this will continue until a more equal economic basis for the relationship between the countries concerned is established.

For the borrowing country, private bank loans are an important and legitimate source of development finance, but they are expensive and should only be used if the funds can be properly employed in investments where they cover their cost. As

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V E R L A G W E L T A R C H I V G M B H - H A M B U R G

Paul Krebs correctly emphasised "what LDCs, especially the poorer ones, need is a reasonably regular supply of exceptionally long-term funds (40 years or more) at very low rates. This type of financial assistance normal capital markets cannot provide".² Although, as we shall see later, the indiscriminate subsidy of capital often produces its own counterproductive distortions.

Foreign equity investment is under pressure in almost every country of the world. In Malaysia, for example, Malays account for just over half the population, while Chinese represent 36 p.c. and Indians 10 p.c. But the breakdown of the ownership of the share capital of all limited companies in 1970 showed 60 p.c. foreign owned, 37 p.c. in the hands of the Chinese, other minority groups and the government, and only 1.9 p.c. owned by the largest racial group – the Malays. By 1990 it is the Government's intention that the foreign proportion should fall to 30 p.c. and the Malays should own roughly a similar proportion.³ Such a redistribution programme is ambitious and far from easy, but it is an essential prerequisite for stable and democratic political development.

Even the advanced industrialised countries, long independent and with well developed locally owned private sectors, tend to view foreign investment with mixed feelings.

Stock exchanges in LDCs are often used to effect the localisation of ownership (or as the Nigerians put it, "Indigenisation"). In Nigeria, the 1972 Indigenisation Decree reserved a number of industrial sectors wholly for nationals, while another 22 industrial categories had to sell 40 p.c. of their shares to Nigerians either publicly or privately. As a result there was a spate of new issues and, as the public issue price was controlled, many blue chip international companies were being sold on Price Earnings Ratios of 2–3 and dividend yields of well over 25 p.c., at a time when the overdraft rate was 7–8 p.c. There is, of course, some justification for a programme of expanding local ownership in these countries, but the pressure is now beginning to build up against the uneven local share ownership. Gradually Nigerians have realised that a precondition for a flourishing property owning democracy is to avoid the excesses of a "Mercedes worshipping elite", and the recent Government's review of the Indigenisation Programme emphasises the need for wider ownership of industrial assets.

However, a public listing itself does not necessarily produce a meaningful market in the shares as there are often few, if any, sellers. Again, in the

case of Nigeria, controls prevent the market from rising to anything like an equilibrium point; consequently it is currently used primarily as a vehicle for those forced to sell under the indigenisation legislation.

Interest Rates

The importance of an effective policy towards interest rates cannot be over-emphasised, as it is this that encourages or discourages household savings, as well as establishing the whole balance of financing between private industry and the public sector. "The main point is that a financial market cannot develop properly in a climate where interest rates (after tax) on non-risk investments exceed reasonable returns in the security market where illiquidity and credit risks are also present".⁴

Unfortunately, if controls over interest rates are reduced, it usually means interest rates will rise, which will cause higher industrial costs and the need for higher returns to cover the increased cost of borrowed money – the prime source of investment funds. Ultimately this will lead to a lower level of investment.

In many LDCs, interest rates are artificially held down, often to the detriment of the economic development of the country as a whole, since this causes resources to be switched out of badly needed labour intensive activities. Such a policy frequently results in an overconcentration on industry and prestige projects at the expense of the rural and agricultural sectors. The subsidy of capital that occurs in many countries (often encouraged by international and export credit agencies) can produce a particularly regressive vicious circle, since highly capital intensive sectors tend to be concentrated at the luxury end of the market and the goods produced are consumed by this elite, with the workers in these sectors becoming members of the new industrial elite. This results in the classical development of a dualistic economy, with the prosperous industrial sector flourishing on subsidised capital, while the rural sector is virtually ignored.

Fortunately some of these lessons are being learnt and there now is increasing emphasis on redistribution as well as growth. Redistributive policies inevitably produce many problems, but without a reasonable basis of economic equality there can be no meaningful democracy.

The long term stable development of markets requires their limitations to be identified and overcome. The capital raising function of a capital

² Paul Krebs, "The Private Capital Markets and Developing Countries", *Euromoney*, August 1975, p. 32.

³ "Increased Participation without Nationalisation", Malaysia Supplement, *Investors Chronicle*, 28 November, 1975, p.v.

⁴ David Gill, "South East Asia's Financial Markets – Present and Future: The Role of International Agencies – I.F.C.", p. 11, Conference on South East Asia's Financial Markets, Manila, 7–9 July, 1975.

market in an LDC is likely to be particularly distorted because of the enormous gap between social and private costs, reflected in the vast disparities of wealth and income. It so happens that both democracy and capital markets flourish best in open and reasonably equal societies. This means that in many countries a concerted attack needs to be brought to bear on any vested interest groups, who attempt to use the mechanisms for their own narrow ends. The growing tendency towards democracy in industry and greater equality of wealth (and opportunities) are essential prerequisites for the stable and positive development of a market economy.

Taxation

In many countries, governments attempt to use the taxation system to encourage the development of a securities market and the broader ownership of equities. This often presents many problems as, for example, in Latin America and Iran where in the past they tended to adhere to the Continental European ethos of regarding a public share issue as a sign of weakness next only to bankruptcy, rather than as a symbol of commercial success and sophistication.

There are several ways taxation can be used to assist the development of a capital market. In Brazil individuals can obtain considerable tax allowances for certain investments. While this has many attractions, it must be recognised that the opportunity to take advantage of such a valuable concession is enormously unequal, as only a relatively small proportion of the population actually have enough income to allow them the privilege of being taxpayers.

Another method is for corporate taxation to be varied between "private" closely held companies and companies with a wide ownership who have placed a given percentage of their shares on the market. In Korea, the 1968 Capital Market Promotion Law provided preferential treatment for "open" enterprises in tax and depreciation, restraint on the kerb market and a gradual downward adjustment of bank rates. In addition, the Public Corporation Inducement Law, enacted in 1972, empowered the Government to persuade selected private corporations to sell some of their shares to the public. A similar view was taken in Iran where, as an incentive for family companies to go public, the Government accorded substantial tax benefits to those taking steps towards public listing of their shares. Corporate income tax was scaled down progressively for companies going to 100, then 300, shareholders and for companies selling from 33 p.c. to 49 p.c. of their shares to the public. There were also concessions on capital gains tax.

Of, perhaps, greater long term significance is another aspect of the wider share ownership programme which involves 99 p.c. of several state-owned enterprises being sold to the public. In both cases a substantial element of the new ownership will be transferred to the hands of Iranian workers, as the shares of the various enterprises have first to be offered to their respective employees.

One point that has to be borne in mind is that sudden changes are usually not helpful. For example in Pakistan, the stock market suffered severe price falls and a certain loss of private investor confidence following the introduction of the 1963 budget, which was essentially intended to support the market. One of the measures in that budget was to apply higher tax rates to those companies that did not offer 50 p.c. of their shares to the public. The legislation resulted in a volume of share issues which overwhelmed the market. The lesson that emerged was that the strength of incentives must not be out of balance with the capacity of the market to respond to the consequences.

Speculation, Controls and Institutional Structure

"In some countries the stock markets are more closely akin to gambling dens than investing mechanisms"⁵ or as William McChesney Martin put it in the conclusion of his report on the US Securities System (necessitated by the ravages of the 1969/70 bear market), "if the ills of the (securities) industry and its weaknesses are allowed to survive, they are bound eventually to retard new capital formation. The consequences will not be favourable for the economy".⁶

In today's world the worse the level of corruption and malpractice, the harder it is to achieve long term stability of any particular political system. A market orientated structure has special difficulties with these pressures and governments need to be fully aware of their implications.

In the short term it can be argued that speculative activity encourages new issues and the raising of new capital. During a boom, fed by speculative activity, there is always a rush of new issues to the market. However, whether this speculative activity is conducive to the efficient and orderly raising of new capital over the longer term is another question. There is little evidence to suggest that the opportunity to speculate adds to the financial efficiency of the market over the longer term and this activity can have sufficiently adverse

⁵ David Gill, "South East Asia's Financial Markets — Present and Future: The Role of the International Agencies: IFC", p. 12.

⁶ World Stock Exchanges, Financial Times Supplement, 4 September, 1971.

social consequences for there to be an excellent case for severely controlling those activities that come into the category of speculation.

Many of the stock market booms of recent years have been fuelled by lack of responsible credit control. The prospect of becoming rich almost overnight attracts the over-ambitious *nouveau* middle-class, struggling to emerge out of decades of poverty, to invest in the stock market (apart from the widespread use of lotteries and football pools, there are not many other legitimate channels for rapid financial advancement). Given reasonably favourable economic conditions this leads to a classical boom/slump cycle. As the market starts to rise, wider interest is given to shares as a vehicle for making money; takeovers and self-made millionaires get considerable publicity; the banks are liquid and keen to lend, and the new investor is attracted into the market by a combination of this prospective utopia and a fear that he might miss out while his neighbour becomes a millionaire. The *nouveau* middle-class then use their savings, or worst of all newly borrowed funds, to buy shares — usually close to the top of the market. They are net buyers when the shrewd professionals are selling. As the market falls they have to liquidate their positions to repay their borrowings, hence the market falls even further. One of the paradoxes of the stock market — well learnt by the successful professional — is that in the long run it is much more important to know when to *sell* shares than when to *buy* them.

The above process illustrates the fundamental weaknesses of stock markets, particularly in LDCs. If these weaknesses are ignored, rather than controlled, the enormous booms and slumps (which some would argue are getting progressively more violent) are likely to result in increasing financial and social instability. We should not be complacent that the western world has remained reasonably intact despite the extremes of the last cycle.

The most extreme example of speculative activity in recent years is, of course, Hong Kong, where the Hang Seng Index slumped from a peak of 1775 in March, 1973, down to 150 in December, 1974 — a fall of 92 p.c. in under two years (changes of a similar order also occurred in Brazil between 1970 and 1973).

It is not possible to blame Chinese gamblers for the Hong Kong boom (although they do manage to combine the curious paradox of being shrewd savers at the same time as being fearless gamblers!) for it was effectively fuelled by overseas investors, particularly from the United Kingdom. A study of the causes and consequences of Hong Kong's 1972/73 boom and slump would provide many valuable lessons.

The crisis in Hong Kong was partly precipitated by the discovery of forged stock certificates. As a result some investors then realised that they might be buying worthless paper, which quickly led to panic selling. Early in 1973 the Hong Kong Government began to alter its *laissez-faire* policy and it is now attempting to discourage frauds and to prevent repetition of the exuberance of the earlier boom. A Securities Commissioner and a Securities Advisory Council have been appointed to devise and administer more stringent regulations concerning new issues and share trading. A Securities Exchange Bill is also currently under consideration which would provide more stringent regulations for the trading of stocks and the structure of the market⁷. Nevertheless, the Hong Kong market will probably remain relatively volatile for a number of reasons: the domestic economy is so open that profits are necessarily subject to rapid swings; the steadying influence of large scale institutional investment is lacking; shares are often very tightly held, either by families or other quoted companies; the gambling instinct remains an outlet for excess liquidity to a far greater extent than most places. Many of these problems are common to other parts of the world.

In all parts of the world there is an urgent need not only to encourage savings among wage earners but to ensure that these savings are thoroughly protected. As a result there is an obvious requirement for the strict control and regulation of stock markets, but whether these controls are (and can be) effective is a matter of debate. Controlling a financial market is always easier in theory than in practice.

The trend away from private investors is a world-wide phenomenon. In 1951, private individual investors accounted for 61 p.c. of all the shares listed on the Tokyo exchange. This percentage has now fallen to less than 33 p.c., while institutional shareholders have increased their share of the market during the same period from 35.5 p.c. to 67 p.c. Similar trends have occurred in other countries where the individual has felt himself unable to match the performance of the professional; although the largest proportion of institutional saving is involuntary through pension funds, insurance companies and even workers' contractual savings schemes (these are now in use in Germany, France, Denmark and Brazil). The development of an institutional infrastructure is extremely important to an LDC, but it is essential to bear in mind that industrial workers and other participants in these schemes are generally members of a relatively privileged elite within the country.

⁷ W.F.W. Bischoff, "How the excesses of the Hong Kong stock market are being controlled", *Euromoney*, South East Asia Supplement, May, 1967, pp. 22–26.

One of the most important institutional developments in an LDC is the existence of special development finance companies or development banks. These are usually government backed but are also frequently supported by the local private sector, as well as international agencies such as the International Finance Corporation. These institutions are an invaluable source of equity capital and long term credit that cannot easily be provided by the commercial banks. Several successful institutions of this kind existing together in an LDC economy are another essential prerequisite for the launching and controlling of a capital market, although special problems arise where the market is dominated by institutions.

The need for stability in the broadest sense cannot be over-emphasised. This does not mean resisting change but ensuring that it is allowed to evolve in a reasonable and systematic way. Once the public loses confidence in the market, liquidity declines and the process of collapse begins to feed on itself.

But what controls are necessary for the effective operation of a capital market? Apart from the general economic framework mentioned earlier, there is also the obvious need to establish appropriate regulations and standards covering such things as the rules of conduct of stock brokers, accounting and auditing standards for public companies (also needed for private companies) as "almost without exception in countries where there is poor financial reporting there is a substantial tax evasion... it is perfectly natural that a wealthy industrialist sees no reason to forego voluntarily the financial advantages of avoiding accurate financial reporting."⁸

Information disclosure requirements and other statutory regulations that can effectively control the conduct of companies by establishing enforceable standards of accounting practice and ethics are often missing in many LDCs. All these developments are a necessary precondition of a capital market, but they are far from being a sufficient condition. In fact nearly all the improvements mentioned above need to be made irrespective of the existence of a capital market and, if they are not only being introduced because a capital market is under consideration, this is a fundamental criticism of development priorities.

Although countries are in a position to avoid these pitfalls, it did not necessarily mean they do so, and recent experience tends to show that, unfortunately,

these lessons are only effectively learnt the hard way. For many parts of the world it is questionable whether they will be learnt in time.

Conclusion

This paper has taken a critical approach to the role of capital markets in developing countries. There are no easy answers to the questions raised. It may appear that there has been an over-concentration on the problems and difficulties of successfully operating capital markets in LDCs. This may well be true and, if it is, it can be justified on two grounds. First, these questions have tended to be ignored in past literature on this subject⁹. Secondly, it is only when these problems have been correctly identified and acted upon that we can begin to have any real confidence that the existence and development of a capital market in LDCs will have a noticeable and *positive* effect on the enormous problems that they are facing in trying to match their needs and resources over the remainder of this century.

In certain countries (Iran, Nigeria), the capital market is being used to pursue political objectives. Because of the existence of the enormous inequalities within these economies it is inevitable that some political intervention will be necessary, if the capital market is to fulfil any useful long term function within the social and economic development of the country as a whole. If a capital market is imposed prematurely on a country which has not provided the appropriate overall economic strategy it is likely to act in a socially regressive way and ultimately generate forces that will threaten the underlying stability of the economy itself. The existence of a capital market is no panacea for a developing economy and it is naive and totally unrealistic to believe that, of itself, the existence of such a market will have a significant effect on the efficient allocation of resources, let alone reducing economic inequality or extending industrial democracy.

Without a proper understanding of the limitations of a capital market, they can easily create more problems than they solve. These limitations arise mainly from the distorted nature of the social and economic structure that is invariably associated with the present state of development in many countries. It is only when these imbalances and inequalities are attacked in an effective and coherent way that we can begin to have any confidence that the existence of a capital market will make a positive contribution to the development of the country concerned.

⁸ David Gill, "The World Bank Group's contribution to strengthening financial markets in less developed countries — the increasing potential for geographical diversification", an address to 7th Transworld Investment Seminar.

⁹ David Kleinman, "Why developing countries need better domestic capital markets", *The Banker*, November 1972, pp. 1404–1406.