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FINANCIAL REPRESSION IN THE LDCS: A Survey of Issues and Reappraisal

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This paper surveys major issues in the financial repression literature. A theoretical discussion of sources of imperfections in capital market and financial repression is presented. Important conclusions from the survey are presented for LDC policy makers in terms of impact on investment and savings variables. Based upon the former, a framework is developed in which a significant link between financially repressive policies and financial 'looting' is highlighted. A heuristic discussion of conditions under which financial 'looting' takes place is provided. The end result, and cost to the economy, is 'paper' investment and concentration of economic power.

I. Introduction

Financial development in any economy will promote growth to the extent that it (i) augments the levels of real saving and capital formation, for any given national income, (ii) raises the productivity of aggregate investment (in terms of efficiency and the nature of the investment made by firms from borrowed funds) by improving its allocation, and (iii) is well-integrated with international capital centres to facilitate national trade and capital flows. Goldsmith (1969) has examined the history of financial development over the past couple of centuries and has reached the general conclusion that the ratio of total financial assets to national wealth rises with the level of economic development since financing

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becomes more complex in relation to production and wealth. A rising ratio of the financial assets owned by financial institutions reflects indirect financing and institutionalization of savings and investments. Thus, in the quantitative sense, financial development is a modern phenomenon beginning with the growth of financial institutions specialising in short-term financing and long-term investment needs separately (as in England) and credit-mobilier types in France and Germany, which incorporated universal financial services during the nineteenth century. Before the nineteenth century, financial development was inhibited by the absence of business enterprise as an entity and consequent limited separation between saving and investment activities by business-type households.

In the context of less developed countries (LDCs), the question of financial intermediation needs to be examined not only in terms of interest rate policies but also in terms of transaction costs. Transaction costs or terms of lending have variables other than interest rate – such as, margin requirements, repayment terms, security or collateral requirements and compensating balances. The fragmentation of the capital market can also arise due to the varying transaction costs with respect to different classes of borrowers.[1]

The integration of fragmented markets is brought about through financial innovations that tend to reduce transaction costs. Different banking systems have varying motivation for financial innovations and attitudes towards risk for different class of borrowers. Thus, one layer of financial repression is related to the exclusion of certain class of borrowers due to higher transaction costs, [Bhatt, (1979)].

In section II, an examination of the sources of capital market imperfections, in a neo-classical theoretical framework, is undertaken. Section III deals with the review of literature on some of the important aspects of financial repression, within the context of LDCs. Section IV, presents a critique of issues discussed in section III, and concludes with suggestions for future research.

II. Perfect and Imperfect Capital Markets in Economic Theory

The individual's plan for saving and investment depends on the rate of interest, productive investment opportunities in the economy and individual preferences. In a perfect capital market, every individual can borrow and lend unlimited amounts at an equilibrium rate of interest. Saving is really an abstention of current consumption, with a view for investment in enhanced future consumption plans. This, obviously, poses

[1] This paper does not address the consequences of fragmentation in financial sector on different classes of bank depositors'.

an economic problem, namely the 'exchange' between present and future consumption over time. In the intertemporal theoretic framework, it is assumed that the consumers and producers in the economy:

(i) have knowledge of all current prices for all dates and all goods, as well as knowledge of all future needs in order to make intertemporally consistent preferences, and

(ii) have the possibility of concluding forward contracts in all input and output markets, for any date.

If money is introduced as one of the goods in the economy and is chosen as the numeraire, we obtain a structure of relative prices over time. In a steady state, when all the relative spot prices are held constant, we obtain a unique rate of interest in an intertemporal equilibrium. The equilibrium market interest rate is equal to the consumer's time preference rate and the intertemporal marginal rate of transformation.

If there is less investment than the optimum dictated by the intertemporal equilibrium, we would have the market interest rate greater than the rate of time preference. As more investment is undertaken, which is really an increased abstention of current consumption, it would result in a rising rate of time preference. At the margin, the present value of the investment (in the net output sense) evaluated at the equilibrium market interest rate would be zero. It needs to be emphasized that the value of investment ultimately lies in the potential consumption into the future it represents and not in itself. Thus, we require the equality of consumer's time preference rate and the market interest rate.

The above analysis hinges on two crucial assumptions: (i) the existence of forward markets for all goods and all dates, and (ii) the future generations' interests are adequately represented in the current forward market, which has a bearing on the intertemporal distribution of goods.

An absence of forward markets implies that individuals will then have to know future prices with certainty. This obviously requires perfect information, and in the next section we will examine the consequences of an aspect of imperfect information in the context of capital markets.[2] However, imperfect information implies that the individuals in the economy would have to form expectations about future prices. If expectations turn out to be incompatible with ruling spot prices in the future, it would be a source of inefficiency.

[2] In this section we are concerned with perfect information in the sense of equality between expected prices and spot prices, at any date. However, in section III, we examine consequences of an aspect of imperfect information in the sense of asymmetry in information sets between two agents. This type of information asymmetry was first explicityly modelled, for the banking sector, by Stiglitz-Weiss (1981). In their paper, Stiglitz and Weiss took into account aspects of incentive problems and adverse risk selection.

The intertemporal theoretic framework presupposes a well-defined set of individuals including future generations. However, the present generation cannot be expected to take into account the interests and preferences of distant generations, which in principle is the concern of a society. Thus, savings generated as a result of the decisions of current savers are likely to be less than socially optimal. This result is obtained due to the possibility that the private marginal rate of substitution would be higher than the marginal social rate of substitution.

Sen (1984) has pointed out that individuals may prefer a state in which every individual saves more than the currently prevailing level of overall savings, as compared to a state when each individual was making private saving decision. This has been referred by Sen as the 'isolation paradox' which arises not due to any inconsistency of values, but due to the differences in the nature of choice involved. However, under the Laissez-Faire competitive equilibrium, the market would fail to generate socially optimal savings because market by its nature cannot offer such collective alternatives. A second-best solution would be for the government to influence social savings-consumption balance of the economy through investment choice i.e., choosing investment projects whose benefits tend to be saved and reinvested rather than consumed.

Feldstein (1964) points out that there would be a divergence between the private investor's internal rate of return and social productivity of capital. Although private investors calculate the project's rate of return net of payments to other factors, but to the society as a whole, the increased factor incomes ought to be treated as a gain. Therefore, the social rate of return on investment may be greater than the private marginal efficiency of capital. Marglin (1963) makes a similar analysis and his operational policy suggestion is that:

> "the government can employ fiscal and monetary policy to induce private enterprise to exploit all opportunities for which the present value of the net benefits to society is positive at the marginal social rate of discount. Appropriate use of monetary operations to ensure plentiful and cheap credit, coupled with subsidies and differentiated tax rates, would make socially desirable opportunities privately desirable as well" (p. 275).

The governments throughout the LDCs have generally followed this policy. However, distribution of income in the economy depends on the distribution of factor ownership and on factor prices. In other words, different distribution of resources among the individuals in the economy can result in different product combinations, which in itself is a different general equilibrium solution.

Economic development began with highly skewed factor ownership

in the economy; the governments in LDCs provided 'cheap' credit, subsidies were provided in the form of overvalued foreign exchange rates, domestic market was carved out for national industries through tariff protection and various tax concessions were offered for setting up industries in the economy.

This resulted in an industrial structure which catered to restricted domestic market (in the sense of 'restricted' effective purchasing power of the individuals in the economy in the absence of any prior redistribution of factor ownership) with industries running at high excess capacity [Winston, (1971); Pasha and Qureshi, (1984)]. The average degree of underutilization of capital also affects the income-saving balance [Hahn, (1965)]. Moreover, it also led to the financial 'looting' (as opposed to Mckinnon's financial repression) both by the public and private sectors industrial firms', whereby the act of investment alone becomes profitable and any return in the post-investment period is incidental. A discussion of this aspect is attempted in section IV.

However, it is not apparent as to how an economy obtains socially optimal savings from the analysis of welfare economics. Does there exist a 'socially optimal deposit rate' which would 'encourage' capital formation and savings? If the socially optimal deposit rate is set higher than the social discount rate, then financial intermediation would break down. If it is set lower than the social discount rate (which in any case is lower than private rate of discount), it would then result in encouraging present consumption. The second-best solution for the government is to influence social savings-consumption balance of the economy through choice of technique in project selection. Socially optimal savings are raised by choosing a lower level of employment in the project design, thereby reducing disposable wage income and thus cutting down on consumption. This approach is recommended when the savings are deemed to be socially sub-optimal. Meanwhile, an LDC government can borrow foreign savings whether at market rate of interest or some kind of international social rate of discount, and analytically its consequences remain unclear. The point is simply that any viable project requires its output to be sold in the economy. If the industrial sector of an economy is constrained by low effective purchasing power, the project is likely to operate at high excess capacity. Herein lies the genesis of any potential foreign debt crisis.

For Keynesian reasons, a myth was developed that a low interest rate policy was vital for rapid industrialization in the LDCs. This emerged from the arguments between the neo-classical and the neo-Keynesian schools which centred around the implications of monetary changes on the structure and amount of investment. The neo-classical perspective establishes the proposition of monetary neutrality on the real variables.

According to the Keynesian framework, monetary variables do have an impact on the real variables via the principle of effective demand, whereby the act of additional investment generates higher levels of aggregate income and hence determines a new equilibrium. For Schumpeterian reasons, the additional investment might also generate changes in production functions (technology), i.e., it may be used to finance changes in production possibilities. If the prevailing interest rate is below the equilibrium rate, then greater profitable opportunities exist for undertaking Schumpeterian investment.[3] The essential issue is to study the effects of cheap money policy on the demand for investible funds in conjunction with supply of funds forthcoming at below equilibrium money rate of interest. In the early seventies, Shaw (1973) and Mckinnon (1973) presented a radically different perspective to the question of interest rate policy as an instrument for increased savings, improving 'quality' of investment and presenting a supply-side perspective towards economic stabilization policies in the LDCs. In the following section, the role of interest rate as an instrument of policy has been examined in the context of financial repression.

III. Economic Theories Concerning Financial Repression

Mckinnon's (1973) explanation of the effect of real deposit rate of interest on savings and investment rests on the assumptions that: (i) all economic units are confined to self-finance, and (ii) investment expenditures are lumpier than consumption expenditures. The relative lumpiness of investment expenditures implies that aggregate demand for money will be greater, the larger is the proportion of investment in total expenditures. Therefore, potential investors must accumulate money balances prior to their investment undertakings. This leads to Mckinnon-I [(1973), p. 59] complementarity hypothesis between money and physical capital, which is reflected in the following equation:[4]

$$M/P = f(Y, I/Y, d\text{-}\Pi)$$

where M/P is the real stock of money (defined as savings + time deposits + demand deposits + currency in circulation), Y is the real gross national product, I/Y is the ratio of gross investment to GNP, and d-Π is the real deposit rate of interest. In the above equation, all partial derivatives are

[3] For a recent survey, from Keynesian perspective, see Milgate, (1988).

[4] I am grateful to an anonymous referee for suggesting the above terminology and drawing my attention to implications of Mckinnon-II.

held to be positive. Mckinnon replaces the substitution effect in the neo-classical paradigm between r' (real rate of return on investment and non-monetary financial assets) and d-Π (real return on money), which is the opportunity cost of holding money.

Shaw's [(1973), p. 62] debt-intermediation view is embodied in the following demand for money equation:

$$M/P = f(Y, c, d\text{-}\Pi)$$

where c is the opportunity cost (in real terms) of holding money. Since the investors are not constrained to self-finance, there is no complementarity relationship. In Shaw's analysis, when the financial intermediation is constrained by financial repression (i.e., interest rates are administratively fixed below their equilibrium levels), investors resort to non-institutional markets for credit. Shaw maintains that financial liberalization (freeing of institutional interest rates) will lead to integration of institutional and non-institutional credit markets, which would result in an expanded financial intermediation between savers and investors. The financial intermediation transaction costs may be lowered due to economies of scale in increased lending, lower information costs and reduction in risk through diversification. Molho (1986) provides an elaboration of the above in technical terms (including an explicit treatment of intertemporal and uncertainty aspects) and shows that the Mckinnon-Shaw propositions are mutually compatible.

Recently, Mckinnon-II has been interpreted as a major modification of Mckinnon-I in the sense that Mckinnon now argues a case for government intervention in the banking sector i.e., imposing a ceiling on loan and deposit rates of interest, [Mckinnon, (1988a), p. 408]. There are number of points to be made. First, I am concerned with the *'fundamental'* determinants and consequences of financial repression. Second, a perusal of Mckinnon-II [Mckinnon; (1988a and b)] suggests that Mckinnon-II is concerned with *'sequentiality'* of liberalization of various sectors in the economy (via., financial markets, trade sector, removal of restrictions on capital flows and exchange rate determination) in conjunction with the macroeconomic stability (as encapsulated in 'lower' and stable inflation rate). In other words, Mckinnon-II is concerned with the dynamic analysis of liberalization strategies. In the financial markets liberalization analysis, based on the experiences of Latin American countries, issues of adverse risk selection, moral hazard, and banking supervision are taken into account. Nevertheless, Mckinnon-II still maintains that interest rates' management, which reflects the true scarcity price of capital, as a desirable policy instrument, cautions economists and

politicians against advocating repressive financial policies, and calls it 'the only game in town' for the concomitant successful economic development [Mckinnon, (1988b), pp. 9, 39, 45]. The policy prescription of government intervention in the banking sector by Mckinnon specifically arises from a consideration of moral hazard in banks (say, due to existence of deposit insurance). However, this policy prescription does not negate the desirability of maintaining positive real interest rate structure which was the main message of Mckinnon-I.

From the policy perspective, the optimal (or desired) sequence of liberalization in different markets is an extremely important issue for liberalization strategies. The experiences of Latin American countries, in particular the financial crisis, dramatically illustrate potential pitfalls in this area. Basically, a grave economic policy error was made in misinterpreting the market clearing rate of interest with the equilibrium rate of interest. Equlibrium interest rate requires equality between supply and demand when all other markets (asset, foreign exchange, labour, and goods markets) are also in equilibrium.[5]. If there is disequilibrium in other markets, then fast price-adjusting markets (such as, credit, foreign exchange liberalized markets) would absorb the disequilibrium of other markets. Therefore, 'high' real interest rates may result from credit market resolution of *other* markets disequilibria. Intertemporal welfare aspects of liberalization policy have been examined by KähkÖnen (1987). Further references in bibliography can be found which discuss Latin American experiences in this framework.

Roe (1979) analyses certain factors like uncertainty and imperfect information, in the context of LDCs, and possible distributional consequences of imperfectly functioning financial markets. Specifically, a two-sectors model is built, in which the sectors are not only differentiated by high and low productivity of capital, but more importantly, the distinguishing features are in terms of one sector (called 'traditional' in the model) suffering from excessive uncertainty and transaction costs disadvantages. As a result, banks' fall in lending to traditional sector exceeds that to the moden sector and the loss of welfare falls disproportionately on the traditional sector. The beneficial effects of improved financial intermediation and the gain in welfare in terms of reduced transaction costs and uncertainty would have little impact under the system of administered interest rates because then such improvements

[5] If the issue of adverse risk selection is taken into account, then banks would achieve a position of loan-rationing equilibrium. Banks would want to avoid adverse selection of potential borrowers because of the fixed nature of interest rate based loans. Any increase in real interest rate charged to any one risk class of borrowers would also increase the probability of default on loans. For details, see Stiglitz and Weiss (1981) and Mckinnon (1988a).

will only increase the excess demand. The policy conclusion is that in order to provide relief to the disadvantaged sector, the banks should be allowed a larger spread between lending and borrowing rates in relation to the disadvantaged sector. Roe points out that there is no theoretical support for the current LDCs arrangement where a low interest rate is perceived to benefit the disadvantaged sector.[6]

Recently, an important contribution has been made by Cho (1984), where endogenous constraint in the credit market, such as imperfect information, is attributed to general hesitancy of the LDCs governments and where partial efficient credit allocation would result even if financial liberalization takes place. The model developed by Cho explicitly takes into account the structure of the capital market which is oriented towards the banking system rather than towards the equity market. It is pointed out that full scale financial liberalization will not be sustainable and substantial development of an equity market is suggested as a necessary condition for successful financial liberalization. If the bank credit is the major source of firm financing, and since several groups of distinguishable borrowers are observed, therefore, under conditions of imperfect information, some groups can be totally excluded from the credit market. This can take place even if the expected returns of the excluded groups of borrowers are higher relative to those groups who are able to obtain credit.

The assumptions of Cho's model are that banks can estimate the expected productivity of firms but heterogeneity comes through riskiness which differs depending on managerial skills, marketing ability etc., which are not easily observable. Firms offering collateral for borrowing are obviously observable. Under the regime of administered interest rates, the banks have a preference over a small number of large firms because banks prescreen their quality. However, there may be firms with potentially high capital productive projects and therefore, creditworthy. Banks have subjective estimate of the probability distribution of the excluded firms' riskiness. The variance in the distribution of riskiness of the excluded

[6] However, the two sectors construct, in the above context, can be employed to explore implicit subsidy to the modern sector, due to 'cheap' bank credit. For example, Snowden (1987) shows the importance of low-cost bank credit for profitability and enhanced capacity to accumulate risk-bearing capital (i.e., additions to equity through retention) for the modern sector, in the absence of developed equity market. The latter effect is dubious in view of discussion in section IV and Roe's [(1988), p. 6], reference to disproportionate allocation of bank credit as distress finance to non-performing debtors. Nevertheless, the paper raises an important policy question as to the effects of 'higher' loan rates for the modern sector. Kapur (1986), using techniques of optimal control theory, traces dynamic path for firms in the modern sector, during various phases of financial markets liberalization. But one must keep in perspective that so-called modern sector's 'high' profitability (relative to traditional sector) partly arises from tariff protection and over-valued exchange rates – the essence of liberalization and reforms is to change these patterns of relative prices.

firms is presumed to be larger either because of the characteristics of the projects and the industry or because of the bank's poor screening ability.

Even the move from financial repression towards an elimination of the interest rate ceilings will partially improve the allocative efficiency, which will still be below the maximum efficiency that an economy can achieve, at a given level of capital formation. Even if the banks are risk-neutral, they will avoid financing new and innovative borrowers, because under debt contracts, borrowers retain the excess of outcome over their loan liabilities, when the investment becomes successful. Banks are, however, restricted to their claim on the principal plus specified interest rate. However, if the project fails, then relatively a greater loss is borne by the lending bank. Therefore, the debt contract financing of firm makes risk sharing impossible. In these circumstances, it may be necessary for the government to intervene in the allocation of credit in terms of reduced interest rates level so as to reduce firms' debt burden, rescheduling and providing finance to the firms in distress. If the government administers interest rate on loans, then ceilings on the deposit rates become necessary in order to secure the banks' profitability.

However, under equity contracts, the problem of adverse risk selection would not occur and government intervention is unnecessary even though shareholders may have asymmetric information and are risk-averse. In pure equity contracts, the expected return to the shareholders is exactly the same as the expected return on the investment project itself. Highly productive borrowers can be financed to the extent that the risks are diversified economy-wide. A well-developed equity market will allow capital to flow efficiently (that is, allocational efficiency, which is said to improve if it results in more output for a given capital formation) according to the firm's expected return. Investors (borrowers) and shareholders (lenders) share in the firm's profit and losses over the whole range of expected return's probability distribution. The economy with substantial equity financing would be less vulnerable to exogenous shocks. In the absence of substantial equity market, the risk-sharing between the savers and the corporate sector would have to be done through the role of government intervention in the form of bank intermediation. As Cho (1984) points out:

> "the analysis should not be taken as a defence for financial repression in developing countries. The purpose is to describe the optimum degree of financial liberalization, given the structure of capital markets, and to suggest the need for fostering equity markets as part of a comprehensive liberalization strategy" (p. 27).

Cho's analysis suggests that a fruitful line of enquiry could be to examine equity financing as an alternative to real positive interest rates in order

to remove financial repression in the LDCs. I have attempted to analyse reasons for 'stunted' securities market in Pakistan elsewhere (Ahmed, 1985).[7] What is not generally appreciated is that a counterpart to financial repression in the banking sector exists in the form of share price repression in the securities market. Essentially, firms are restricted, by government regulations, to offer company shares to the public at the *accounting par value*. In other words, if a firm's share issue commands a premium over the accounting par value (at the time of share floatation), then the firm (and its share issue underwriters) cannot price its shares (including rights issue of shares) according to market considerations. This restriction is not only a disincentive for firms' to go public, but it also leads to extreme volatility in share prices, thereby discouraging potential long-term investors to invest in stock market. This type of restriction becomes necessary in the presence of financial repression in the banking sector, when the objective of the authorities is to divert a share of the bank credit for investment in 'non-marketable' government securities (primarily to close the gap in government budget). Moreover, in an unstable inflationary environment, charging interest payments as operating cost against tax liabilities, results in credit subsidy to the firm which hides real profits. Thus, tax legislation may induce substitution of capital equity for bank credit which could further hamper the growth of the equity market.

IV. Evidence and Extension on Financial Repression

The process of financial repression, through the use of reserve requirements (diverting bank credit for investment in government securities) and to provide cheap credits through specialised banking agencies to preferred claimants, is provided by Mckinnon and Mathieson (1981).[8] In order

[7] Share issues and its timing, share pricing and underwriter's commission in Pakistan requires an approval of the Controller of Capital Issues, Ministry of Finance, even if the share issues' conform to administrative regulations. For an Indian study, in the context of present discussion, [see Krishan (1989); p. 29–40]. The above description of government controls over the securities (or equity) market is valid for the South Asian economies. Lack of relevant information precludes generalization about equity markets in other developing countries.

[8] A lucid political economy type explanation of widespread presence of financial repression in the LDCs and its reverberation throughout various economic structures is provided by Skully-Viksnins [(1987), pp. 5–23], while Roe (1988) discusses internal debt problem (i.e., domestic non-performing debts to the banking sector), in the context of financial repression. World Bank experience suggests that non-performing domestic debts may be eight times the levels actually disclosed by LDCs banks/DFIs. For further details, see Roe and Popiel [(1988), pp. 21–33]. This aspect, in particular, is pertinent to the South Asian economies. For an illustrative Pakistani case, see Guisinger [(1981a), pp. 393-94] and Porter [(1980), pp. 387–400] where interactions between monetary targets, credit plan for the banking sector and its sectoral allocations are analysed.

to measure the presence of financial repression (in the Mckinnon's sense), Fry (1980) econometrically estimated a demand for money equation for seven Asian countries. Vogel and Buser [(1976), p. 41] suggest the ratio of non-monetary to monetary assets as an intuitive index to measure the extent of financial repression, where a severely repressed financial sector would exhibit a higher ratio as compared to an economy where financial repression is low. However, Vogel and Buser [(1976); pp. 36–38] have provided another dimension to financial repression. In the context of mean and standard deviation model,[9] financial repression not only means that the expected (mean) real rate of return is uncertain, but repression can also be taken to mean the increased riskiness of the return on money due to increased variability of inflation rates. This is in line with Shaw's [(1973), p. 118] concern for low variance in the rate of inflation to minimise the risk of holding financial assets. Mckinnon [(1973), p. 63] makes the same point whereby the disposal of individual's income can take place in the form of consumption, real money balances, self-financed investment projects or increased holdings of non-productive inflation hedges as other goods might substitute for money as a store of value or as an inflation hedge. The low expected return on money is the only factor that Mckinnon considers, but the variance (i.e., uncertainty) of this return is an important factor as well. Fry (1980) examining the prevalence of Mckinnon's type of financial repression, suggests that the Asian LDCs (i.e., Burma, India, Korea, Malaysia, Phillipines, Singapore, and Taiwan) have achieved stages of financial development well beyond the phase in which the complementarity assumptions might hold:

> "One would have to look much farther down the development ladder, well below these Asian LDCs, to some of the world's least developed countries in a search for complementarity" (p. 113).

However, a study by Tybout (1983), which examined investment behaviour of Colombian firms, with access and non-access to bank credit, lends credence to Mckinnon hypothesis. Small credit-rationed firms relied on internal funds generation in an attempt to reach desired levels of investment. Before we proceed further, it is important to understand the analytical rationale that is adduced for pursuing cheap credit policy:

> "The capacity of the domestic financial system to offer high real interest rates on deposits depends in the ultimate analysis on the opportunities available to utilize those funds at an equally high real loan rate. But the level of loan rates is governed in turn by the existence of bankable projects yielding a sufficiently high return.

[9] Where the demand for any asset depends on the mean and standard deviation of the return on each asset, and on the covariance between the returns on each pair of assets in the portfolio.

> If such projects fail to be forthcoming due to lack of necessary technical expertise or infrastructural facilities, the financial system must perforce transmit its large accumulated financial liabilities abroad in high-yielding foreign financial assets. Thus, the high real interest rate policy, while helping to financialize savings, does not succeed in contributing to domestic investment and hence to development," [Khatkhate, (1982), p. 691].

The above analysis does not distinguish between cause and effect and thus policy intervention is not targeted as directly as possible on the distortion being dealt with. Khatkhate's analysis suggests that since the distortion is structural in characteristic, therefore the suggested policy intervention in the LDC's banking sector does not remedy the structural distortion.

Firstly, the question of bankable projects, within the LDCs 'institutional' financial context, implies that the project is completely secured by collateral even though the project may have a 'below average' rate of return (in financial and/or economic sense). Secondly, the alleged lack of projects yielding a sufficiently high return is in direct contrast with non-institutional credit markets, generally in operation throughout the LDCs, where curbed rates are certainly higher than the institutional interest rates [Drake (1980), pp. 122–154]. Chandavarker (1971) suggests that the bulk of total credit requirement is provided by non-institutional sector with interest rates ranging from 24 per cent to 50 per cent in Asian countries and only about one-fourth of credit requirement is provided by institutional sector. He cites the evidence of Indian Central Banking Enquiry Commission, which estimated that the share of non-institutional credit sources at about 90 per cent in the 1930s and this ratio had not changed during the subsequent surveys in the 1950s and 1960s despite an impressive growth of institutional banking facilities. The issue is to identify those activities, at least in Asian LDCs, which institutional sector does not find bankable and sufficiently 'high' yielding yet non-institutional credit system can still finance them at 'high' rates of interest. Thirdly, the high or low interest rates' policy recommendations cannot be made without specific reference to a particular economy under study. For example, in case of Pakistan, Guisinger [(1981b), pp. 328–336] estimates that if all the incentive policies were eliminated, the cost of capital to the firms would be raised by 300 per cent! The elements in the calculation included overvalued exchange rate, the obtaining of funds by investors at the institutional rates and accelerated depreciation and tax holidays effects. The study estimated the true opportunity cost of capital at 15 per cent as compared to administered interest rates at 5.74 per cent in 1959-60.[10] In such an environment, which is

[10] Guisinger (1981b) also estimates that if wage capital rental ratio had been reduced by 50 per

quite representative of other LDCs as well, the expressed fear of high interest rates becomes quite meaningless. Lastly, the machinery for identification and evaluation of projects, in the financial and technical sense, have been in existence for around twenty years, in most of the LDCs, and go by the generic name of development financial institutions (DFIs).[11] Basically, the issues to examine are constraints in identification of 'desirable' projects, in the context of induced systematic distortions. The answer seems to lie in the manner in which the institutional mechanism for implementing domestic monetary policy interacts with the objectives of national planning authorities (i.e., the issue of incentive compatibility).

Selective and discretionary credit plans and controls are popular instruments for directing the flow of credit to the private sector (in the so-called priority sectors) which may be at variance with the underlying private sector priorities.[12] The lack of convergence between the objectives of planning authorities and profitable opportunities elsewhere in the economy (as perceived by the private sector) can be attributed to policy environment based on exigent needs of the government (in particular, say, ministries of finance, commerce, and industry). However, in order to fulfill planned investment targets, the government would eagerly seek foreign funds and thus foreign borrowing starts substituting for domestic finance. Roe [(1979), p. 77] points out that as part of a financial liberalization programme, the government would have to concurrently reduce its own expenditure, otherwise the alternatives are inflationary finance or unnecessary dependence on external finance. Thus, in the case of Pakistan, foreign assistance was supposed to have covered over 50 per cent of the total financial planned investment requirements (see, Sixth Five Year Plan, Planning Commission, Govt. of Pakistan; p. 37). At a low level of interest rates, investment finance can be increased through the creation of central bank credit which leads to further growth of bank deposits. Thus, an illusory increased financial intermediation is created even though in real terms no real resources have been created and hence accepting Shaw's

cent and maintained over the eleven years period (ending in 1970-71), employment in Pakistan would have grown at an annual rate of 13.8 per cent.

[11] Tolentino (1988) links the establishment of the DFIs to the supply-led strategy, i.e., providing finance in advance of effective demand. This strategy derives support from Keynesian paradigm, where growth is obtained by stimulating investment through a policy of low interest rates.

[12] Subsequent discussion has been inspired by an apt reminder by Prof. Nicholas Kaldor who states in Economics without Equilibrium: it will require new methods of research that would make greater use of knowledge gained through personal contacts and on the job investigations, and less on the testing of formal models through statistics and econometrics. There is an enormous amount of empirical research going on but it is stifled by operating within the framework of established theory (p-54).

hypothesis of enhanced debt intermediation in the financial system would be erroneous.

There is an intermediate model of investment behaviour between Mckinnon's financial repression, where economic units are confined to self-finance and Shaw's debt-intermediation view, where financial progress takes place through the consolidation of fragmented capital market. I would term this intermediate model as financial 'looting'.[13] The conditions under which financial 'looting' occurs is when the selective and discretionary credit plans are in operation in order to direct bank credit towards government determined priority sectors. The risk and return conditions are often influenced by the government policies and investors generally respond to the incentives created by the government.[14] The priority sectors have often limited domestic market, long gestation period and require high tariff protection. It is also not uncommon to find the government making sudden changes in economic policies upsetting the medium term view of the economy, upon which private sector investment plans crucially depend. Moreover, most of the so-called entrepreneurs in the LDCs are traders-turned-industrialists who are used to making "quick money" through a high turnover in trade i.e., investors in LDCs have generally shorter time horizon.[15] Thus, the priors of these industrial managers are confirmed and maintained.

On the other hand, banks and DFIs performance is usually measured in terms of achieving investment targets in the priority sector. Sometimes, even the credit earmarked for expansion of existing industrial sectors are curtailed in order to make finance available for priority sectors [see, Agarwal, (1989), p. 429, for an Indian example]. In the case of Pakistan, in their eagerness to finance priority industrial projects, the banks are

[13] As I hope to make clear in subsequent discussion, the term financial 'looting' is used to describe the consequences of financially repressive policies on *(ex ante)* investment behaviour. It must not be interpreted, for example, grupos in Chile preparing mis-leading financial statements in order to obtain bank credit, that is financial 'cheating', which is an *ex post* exercise. Cases of financial 'cheating' can be gleaned from the pages of The Financial Times or The Wall Street Journal, that is, such cases can indeed take place in financially liberalized economies. However, the difference between the DCs and LDCs would be reflected in different probability distributions, primarily reflecting the conduct of regulatory authorities, sound banking and company laws and practices. Implicit in the above definition is the idea of separation between government-owned banks/DFIs and sponsors of an industrial project.

[14] By investors', I specifically mean sponsors or equity holders of a registered firm engaged in incremental increases in fixed assets. Note that this definition also includes new entrants (i.e., firms') in the industrial business as well as firms' which may be a part of an industrial conglomerate or group.

[15] There is substantial literature on the above issue, see Altaf (1983), Amjad (1982 and 1977) and White (1972).

prepared to accept equity-debt ratio ranging from 20:80 to 10:90 per cent. Thus, the stage is set for financial 'looting' to occur. The so-called investors prepare a 'fiction' called project feasibility report, where a project is justified not only in terms of rates of return but prospective socio-economic benefits, such as linkages with the rest of the economy, and import substitution arguments are advanced to justify the project. The 'looting' takes place in the form of cost over-runs during the implementation phase of the bank/DFI-financed project, and through over-invoicing of machinery costs of the project and other related civil works [ADB, (1985), p. 370]. It is of course, the subsidiary of the so-called investor which is engaged in the construction and procurement of machinery for the project. Thus, the so-called investor is more than able to recoup original equity investment by the time the project commences commercial production. The presence of financial 'looting' could be predicated on a comparison between *ex ante* total project cost (net of borrowing costs), financed from banking and informal sectors (or curbed credit market), for a given technological level.

Investment in priority sectors provides the investor with further access to institutional credit (i.e., working capital loans). If the project is running at excess capacity or facing difficulties of some other nature, the banks/DFIs often lobby with the government (sometimes in a seemingly conflicting manner), in order to influence and/or change government (fiscal) policies with a view to have a 'favourable' impact on the financial viability of sectoral projects. This is simply due to a high investment stake of the banks/DFIs in the project. Thus, the act of investment alone is made profitable under such circumstances.

The process of financial 'looting' occurs as high private returns are available outside the priority sectors, which provide sufficient incentives to transfer funds from one activity to another.[16] Sankong II (1981; p. 131) refers to financial 'looting' in South Korea in the following words:

> "when bank loans are discretionarily allocated, then many problems would arise. For example, if the action of borrowing money itself is found to be lucrative business, how to use that money efficiently is not an immediate concern, but under such a situation resources cannot be utilized efficiently, and incentives for efficient utilization of resources may be reduced. In this connection, a corresponding social cost may be incurred."

[16] For example, in the context of group principle, where a group is defined as multi-enterprise firm, Leff [(1976), p. 99] points out that: 'Because of the Groups' interactivity capital flows, the concept of "self-finance" takes on a special meaning; cash flow generated in one activity can be used to increase the capital stock in other, widely diverse activities.' In other words, we are referring to fungibility of bank credit in a multi-enterprise firm.

In a similar vein, Ghosh [(1988), pp. 2621-2622] points out that, in the Indian context, with little or zero investment (via the process of financial 'looting') the investor gains control over the entire capital value of the project and thereby it leads to increasing the concentration of economic power. Moreover, the cheap money policy in conjunction with low equity debt ratio also acts to retard the generation of corporate savings.

V. Conclusions

Given the lack of political will to raise government finance directly from the public (by curtailing current consumption), a recourse to inflationary finance and foreign borrowing then becomes necessary. The need for development planning is not questionable. But it is important to recognise that it also leads the banking system to partially bear the burden of public policy. The end result is a stunted financial system; stunted because it is not compatible with fundamentals of competitive economic reality.

This paper has avoided applying empirical (or regression) analysis to validate any one of the above arguments. Most of the bankers in the LDCs do not believe in the interest rates' sensitivity with respect to financial savings. Their view point is not incomprehensible. In the presence of government controls on the banking system, the financial institutions find themselves carrying surplus liquidity, which are invested in low-yielding government securities. The lack of motivation for deposit mobilization on the part of bankers, and the perceived interest rates' insensitivity (and thus construed as ineffective policy instrument) for mobilising financial savings (at the margin) on the part of policy makers is a clear manifestation of an aspect of financial repression. Any regression results that show otherwise are bound to be spurious.[17]

However, an attempt has been made to highlight relevant issues for public policy towards the financial system. In particular, analytically plausible arguments have been developed to illustrate some of the unintended consequences of pursuing financially repressive public policy. This paper questions the validity of industrial planning exercises by the governments. Such exercises are supposed to induce private sector investment in sectoral projects, which are the targets of industrial policy (the so-called priority sectors). To the extent, the use of fiscal policy does not alter relative profitability between alternative investments (in different sectors),

[17] Khan (1989) finds statistically significant positive association between the real rate of return on deposits and aggregate savings, while testing for the existence of financial repression on Pakistani data (for the period 1959-60 to 1986-87). Johnson and Brekk (1989) analyse causes of bank disintermediation. For an analytical model dealing with the consequences of financial repression on depositors' of banks, see Burkett (1986).

financial 'looting' will occur in priority sectors. Such 'paper' investments in priority sectors would constitute unintended consequences of the financially repressive public policy. From policy perspective, further analytical work in this area is of utmost importance.

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