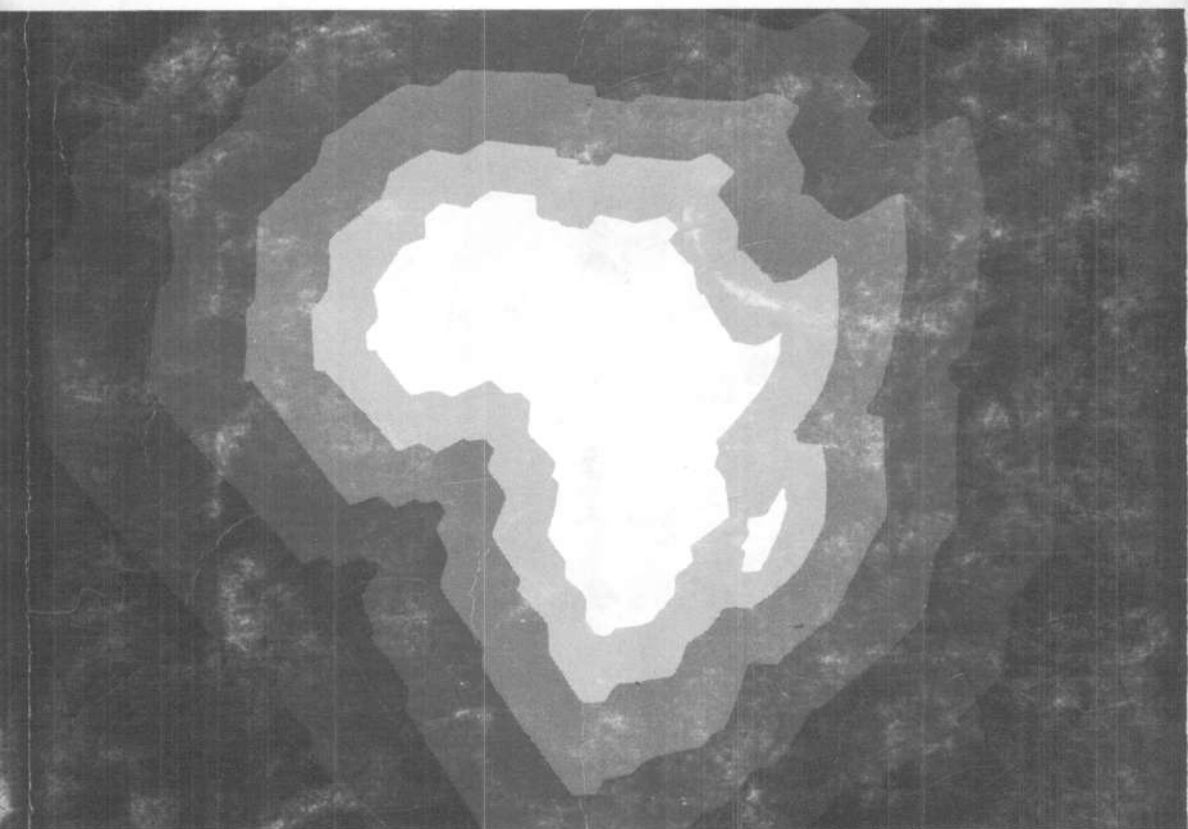


The Credit Markets of Africa Series

Andrea Calamanti

THE SECURITIES MARKET AND UNDERDEVELOPMENT

the Stock Exchange
in the Ivory Coast • Morocco • Tunisia



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Biography

Andrea Calamanti graduated in Economics and Business Administration and is now Professor of Domestic and International Trade at the University of Siena and lecturer at the Banking Division of Bocconi University Business Administration School in Milan.

He is also a member of Finafrica Foundation teaching staff and carried out a number of field studies in several African countries. He is the Author of the following monographs: *Il mercato mobiliare italiano: aspetti strutturali ed evolutivi nel secondo dopo-guerra*, Milan 1978; *Borse Valori, Valori Mobiliari e Attività Bancaria*, Milan 1979.

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16

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FOREWORD

Stock Exchanges and securities markets in general tend in principle to be a field of study confined to « specialists », most of whose work is based on a purely technical approach and is limited to surveys of the structural and operating aspects of these markets.

On the other hand, relatively little attention seems to have been devoted to this field by economists and students of financial and business disciplines, particularly those whose main interests lie in the developing world. As far as economists are concerned, this presumably reflects a widespread academic attitude that the subject is of little import, while the interest shown by students of business methods tends to dwell on the microeconomic aspects involved, and thus is restricted to aspects having a bearing on corporate finance alone.

Furthermore, in this situation the general opinion (with the odd exception) prevailed for a long time even among governments and international institutions, that the creation of a securities market in any developing country would involve considerable difficulty and expense, that action taken to maintain and develop it would be equally costly, and that it would ultimately yield little economic benefit in any case¹.

¹ An example of the relative lack of interest shown in securities markets can be seen from the generalised comments on the contribution they can make to mobilising savings and financing investment made in the study: COMMITTEE FOR ECONOMIC DEVELOPMENT, *How Low Income Countries can Advance their own Growth. The Lessons of Experience*, September 1966, pp. 51-52.

Yet even when a more positive attitude has been taken to the function of stock exchanges in LDCs, analysis has still been very superficial and has concentrated mainly on emphasising the difficulties involved in getting them off the ground (See UNITED NATIONS INDUSTRIAL DEVELOPMENT ORGANISA-

The obvious conclusion in most cases tended to support the idea that it was not worth setting up such a market in the first place.

Is this still widely-held view the result of a lack of interest in the subject and little knowledge of experience gained in certain developing countries? The answer is definitely no. Yet it is likely that these factors have significantly contributed to this attitude.

In any event, it is a fact that in recent years some economists have been showing more interest in ways and means of financing economic development and in the capital market. In this field, securities markets and stock exchanges have received close direct attention², albeit on a limited scale and by only a very small number of people. Such surveys as have been made have in some cases reached conclusions that differ from those reached in the past, and some tend to be more in favour of the creation and strengthening of these markets.

TION, *Domestic and External Financing*, Unido Monograph No. 16, New York, 1969, p. 8). In addition, even the better known and serious studies on the subject e.g. RAGNAR NURKSE, *Problems of Capital Formation in Underdeveloped Countries*, Basil Blackwell, Oxford, 1964, pp. 14-157, despite dealing in a detailed fashion with capital formation problems and drawing interesting conclusions, nonetheless mainly concentrates in analysing the relevant economic factors rather than purely financial factors at play. Also, these studies generally tend to pay little or no attention to the role that can be played by the financial structure, notably a securities market.

² General surveys on the subject include: P.J. DRAKE, *Securities Markets in Less Developed Countries*, in « The Journal of Development Studies », Vol. 13, No. 2, January 1977; RAYMOND W. GOLDSMITH, *The Mobilisation of Domestic Resources for Economic Growth through the Financial System* and CLAUDIO SEGRE, *Capital Markets in Developing Countries: Institutional Problems and Growth Prospects*, both in INTER-AMERICAN DEVELOPMENT BANK, *The Mobilisation of Financial Resources in Latin America*, Lima, May 11-12, 1971; U TUN WAI and HUGH T. PATRICK, *Stock and Bond Issues in Less Developed Countries*, in « International Monetary Fund - Staff Papers », July 1973. Only the first and last of these surveys deal specifically with securities markets, while the other two devote more limited space to the subject.

Three factors appear to have been of special importance in encouraging this shift of interest.

The first of these lies in the failure of *a*) foreign aid policies in the 1950's to solve financial problems associated with capital formation and economic growth, and of *b*) Government fiscal policies in the 1960s that consisted of manipulating taxation on the one hand to build up gross domestic savings and on the other, of public spending on capital projects and allocation of investments through the granting of development loans.

In the 1970's, these failures led some Governments to try out policies aimed at encouraging an increase in private domestic savings, and at fostering the allocation of these savings by developing efficient capital markets³.

The second factor involves the introduction and growing popularity of studies on the cause-and-effect relationships between real economic variables and their financial equivalents⁴. This field has attracted an increasing number of economists⁵ and at the same time has drawn their attention to financial instruments and the markets in which these are used. It is worth noting that some studies criticising the then prevailing monetary theories also played a role in this direction, leading to an innovative approach to the underlying theoretical analysis of economic growth issues⁶.

Finally, in the author's view, interest in the field was certainly aroused at some periods by the favourable trends in secu-

³ See U TUN WAI and PATRICK (1973), *Op. cit.*, pp. 253-255.

⁴ Studies of this kind originate from the survey by R.W. GOLDSMITH, *Financial Structure and Development*, Yale University Press, New Haven, 1969.

⁵ See P.J. DRAKE (1977), *op. cit.*, p. 73.

⁶ These include: RONALD J. MCKINNON, *Money and Capital in Economic Development*, The Brookings Institution, Washington, D.C., 1973 and EDWARD S. SHAW, *Financial Deepening in Economic Development*, Oxford University Press, Oxford, 1973. See also: DEENA R. KHATKHATE, *Analytic Basis of the Working of Monetary Policy in Less Developed Countries*, in «IMF - Staff Papers», November 1972.

rities markets organised in countries such as India, Malaya, Singapore and in particular Brazil⁷ and by certain stock exchanges set up on the initiative of local governments and monetary authorities⁸.

This third set of factors has undoubtedly been of prime importance in encouraging surveys to be made of individual stock exchanges, and, together with the other factors, has stimulated a series of analyses of a more theoretic nature on the role of stock markets in LDCs.

However, despite these developments, research in the latter field is still very limited and at an embryo stage, and consequently deserves more detailed investigation. Regarding surveys of individual stock exchanges it should be noted that there is as

⁷ Studies on the structural features and development of the Indian securities market include KERSI D. DOODHA, *Stock Exchanges in a Developing Economy*, Bombay University Press, Bombay, 1972, pp. 1-26; S.G. PANANDIKAR, *Banking in India*, Orient Longmans Ltd., Bombay, 1966, pp. 173-176. The Brazilian experience is dealt with by RALPH VON GERSDORFF, *Savings, Credit and Insurance in Brazil*, Government Printing Office, Barbados, 1962; HERCULANO BORGES DA FONSECA, *Financial Institutions of Latin America: Their Policies to Attract Savings for Development*, in INTER AMERICAN DEVELOPMENT BANK, *The Mobilisation of International Financial Resources in Latin America*, Lima, May 11-12, 1971, pp. 84-100; SEIKI MAKINO, *Raising Funds in the Brazilian Securities Market*, Institute of Developing Economies, Special Paper No. 3, Tokyo, 1976; WALTER L. NESS JR., *Financial Market Innovation as a Development Strategy: Initial Results from the Brazilian Experience*, in «Economic Development and Cultural Change», April 1974; ALLAN R. ROTH, *Capital Market Development in Israel and Brazil: Two Examples of the Role of Law in Development*, in «Stanford Law Review», June 1967 and U TUN WAI and PATRICK (1973) *op. cit.*, pp. 293-299.

Experience in Malaya and Singapore has been analysed by P.J. DRAKE, *The New-Issue Boom in Malaya and Singapore (1961-1964)*, in «Economic Development and Cultural Change», October 1969 and U TUN WAI and PATRICK (1973), *op. cit.*

⁸ Apart from the countries with an apartheid regime, most existing stock exchanges in Africa were established between 1960 and 1970. The stock exchanges concerned and their year of establishment are listed as follows: a) Kenya (1954); b) Nigeria (1961); c) Morocco (1967); d) Tunisia (1969); e) Ivory Coast (1976).

yet no literature whatsoever on the experience gained in French-speaking African countries with securities markets.

These two points, particularly the latter, have thus led the author to undertake a specific study of stock exchanges in these countries.

This survey is therefore aimed at analysing securities markets in French-speaking Africa. The intention is not merely to describe the structure and evolution of these markets, but to pinpoint the role they can play in a developing economy, the prerequisites needed to bring them into operation, and the basic conditions needed for their development and efficient working in order to attain the objectives they set out to achieve.

It has been felt advisable to deal with these latter aspects in the first part of the survey, which should thus provide an overall framework within which the general problems involved in establishing stock exchanges in developing countries can be placed in focus.

Having pinpointed these problems, the survey will go on to review the markets concerned on a detailed country-by-country basis.

In each case, the analysis will be carried out in three stages, covering

- a) the origins of the securities market and the role attributed to it,
- b) its structural and operating features,
- c) salient developments in its evolution and the results achieved.

An attempt will also be made at each stage to ascertain whether or not the prerequisites for the creation of the market existed, what action, if any, has been taken to ensure its success or maintenance in being, the costs this has entailed, the advantages and disadvantages involved in the operation of the market, its desired goals and the extent to which these can be attained.

A word of warning here: it has not always been possible to give an in-depth analysis of these factors or to check them on a

strictly scientific basis, owing to the lack of reliable figures and accurate detailed information.

Indeed, the shortcomings in this area were such as to call for on-the-spot visits to the countries concerned. While these did not enable all the gaps to be completely filled, they did allow this survey to be compiled and an adequate degree of uniformity to be established between its different sections.

Here, my sincere thanks are due for the help and advice given by the local institutions I visited and the individuals within them I was privileged to meet.

In the Ivory Coast these were: Messrs. Joaquin Aka Koffi of the Abidjan Stock Exchange, Kablan D. Duncan of the Banque Centrale des Etats de l'Afrique de l'Ouest, Casimir Kra Kouvadio of the Ministry of Economy and Finance, Konan Germain of the C.A.A., Jules-Alexander Amani of the Direction des Assurances, Louis Basquez of the Direction Générale des Impôts, Yao Kovakou of the Société Générale de Banque en Côte d'Ivoire, Xavier Laurent of the Banque Internationale pour l'Afrique Occidentale and Quallara Soumgalo of SONAFI; In Tunisia: Messrs. Hamaidi Mohamed Salam of the Tunis Stock Exchange, Khoufi Mohamed Nouredine of the Société Financière et de Gestion, Redieb Abdelkrim and Ruai Sadok of the Banque Centrale de Tunisie and Ben Ismail Abdelaali and Tamar el Abel of the Banque du Sud;

In Morocco: Messrs. A. Ghouti and Bellemlih Abdelilah of the Casablanca Stock Exchange, Mohamed Belkhayat of the Société Nationale d'Investissement, François Asensi of the Banque Marocaine pour le Commerce et l'Industrie, M. Laghmary of the Caisse de Dépôt et de Gestion and M. Moumen and A. Daoui of the Ministry of Finance.

Special thanks must also go to Messrs. Antony Brock, P.K. Djamson and Samuel Morrison of the Central Bank of Ghana, who provided information on the processes involved in setting up the Accra Stock Exchange, which is still under way, and on

the results of visits Mr. Djamson made to Iran and Kenya in 1977 to study those countries' securities markets.

The author naturally takes sole responsibility for the interpretation of developments investigated, the views expressed, and for any errors that may have been made.

PART ONE

**SECURITIES MARKETS AND
ECONOMIC DEVELOPMENT**

INTRODUCTION

As noted in the Foreword, the academic literature on securities markets is somewhat sparse, and what there is tends to be rather sceptical of the contribution these markets can make towards solving LDCs' financial problems and fostering their economic development. This attitude has been reflected in both purely theoretic analyses and in specific case studies, and the general conclusions drawn have not been very favourable to the notion of setting up securities markets in such countries.

This conclusion, shared to varying degrees by economists who have dealt with the subject, has undergone some critical reappraisal in recent years, and some authors held the view that a securities market brings with it a number of benefits sufficient to justify its being established, even in a less-developed environment, provided it is accompanied by appropriate Government policies¹.

Unfortunately, these studies have failed to set in train any significant debate on the subject. They nonetheless deserve interest, and provide the stimulus for a re-examination of the general theme in the first section of this survey, which will look at

¹ Cfr. P.J. DRAKE (1977) *op. cit.* The same author also took a favourable view of setting up securities markets in prevision studies: *The New-Issue Boom in Malaya and Singapore*, (1961-1964), (1969), *op. cit.*, and *Development in Malaya and Singapore*, A.N.U. Press, Canberra, 1969. A similar view was also taken by DOUGLAS GUSTAFSON, *The Development of Nigeria's Stock Exchange*, p. 187, in T.J. FARER, *Financing African Development*, M.I.T. Press, Cambridge, Mass., 1965 in which the Nigerian experience is analysed, albeit without providing any theoretic framework, and based only on Nigeria.

the desirability of setting up securities markets in developing countries, the prerequisites for their establishment, and the outlays involved. This reappraisal is mainly intended to supply conceptual terms of reference for the subsequent analysis of stock markets in French-speaking African countries, and is based on setting the arguments put forward in the most significant existing theoretic studies in perspective against what can be learned in practice from the actual experience of the countries investigated in the survey².

Before embarking on the discussion it will be helpful to define exactly what is meant by the terms *securities market* and *stock exchange*. The securities market is defined as that segment of the financial market in which business is done in securities (primarily shares and bonds) which are negotiable and hence enable an investment to be converted into cash before its term, which is generally medium or long. There are two distinct markets, for shares and for bonds, within any securities market as such, with substantially different functions. The share, or equity, market enables venture capital to be raised by investors taking an interest in the capital of a company, while the bond market enables capital to be raised (or invested) in the form of borrowing (or lending).

Each of these markets is organised into two sections: *a*) the *primary market*, represented by the aggregate of new securities issued over a given timespan and *b*) the *secondary market*, in which securities already in issue are traded.

The primary market thus allows fresh capital to be mobilised and is the expression of the financing issuers can raise by placing their stock with investors, and the terms and conditions on which such funds are taken up. On the other hand, the secondary market provides a vehicle for realising financial wealth invested in securities and the degree to which it works directly

² Consideration has of course also been given to the results of surveys on other countries.

affects the primary market, as it determines to what extent securities are liquid.

The most sophisticated type of secondary market in an organised form is the stock exchange, this being an institution to encourage securities to be traded in one specific place which operates in compliance with formal regulations devised both to protect the interests of investors and to guarantee that all dealings are fully above board.

With these definitions in mind, the term *securities market* will be used in this survey to mean a complete structure of this kind in which it is assumed that a stock exchange or any other form of organised secondary market exists. However, in view of the different roles fulfilled by each segment of the market (primary, secondary, share and bond markets), each such segment will be specified where the meaning is not otherwise clear. The term *securities* will be taken to mean medium-and long-term securities.

1. THE ROLE OF SECURITIES MARKETS IN LESS DEVELOPED COUNTRIES: a) THE PROMOTION OF ECONOMIC DEVELOPMENT

In absolute terms, a securities market fulfils a large number of different functions. In order to assess its ability to perform these functions in LDCs, it will be convenient to classify them into two categories. This section will therefore deal with those functions directly related to the promotion of economic growth, while the other functions will be discussed in the next section.

The interaction between real variables and monetary variables has been closely examined in analyses concerned with the monetary theory of growth, and these analyses have led to disagreements thus generating widespread debate that has led to detailed studies on the subject. The in-depth treatise of McKinnon³ has been particularly useful in this respect.

Further contributions in this direction have been provided by studies based on the theory of growth, which have not been confined to considering money alone, but have drawn attention to the financial structure and activities of banks and non-ban-

³ These include: MILTON FRIEDMAN, *The Optimum Quantity of Money and Other Essays*, Aldine Publ. Co., Chicago, 1969 (Chap. I.); H.G. JOHNSON, *Inside Money, Outside Money, Income, Wealth and Welfare in Monetary Theory*, in «Journal of Money, Credit and Banking», February 1968; D. LEVHARI and D. PATINKIN, *The Role of Money in a Simple Growth Model*, in «American Economic Review», September 1968; R. MCKINNON (1973), *op. cit.*; J.L. STEIN, *Monetary Growth Theory in Perspective*, in «American Economic Review», March 1970 and J. TOBIN, *Money and Economic Growth*, in «Econometrica», October 1965.

king financial intermediaries. In some cases, a very large variety of such intermediaries has been classified and described⁴.

Although the subject has not been developed to the stage needed to draw valid general conclusions, the present state of the art seems to indicate that an efficient financial structure may have the following favourable effects on economic growth:

- i) an increase in the aggregate volume of savings;
- ii) more efficient allocation of the existing stock of tangible wealth, apart from new inflows;
- iii) an increase in the aggregate volume of investment and more efficient allocation of savings among potential investments.

In most cases, these effects have been analysed by reference to the activities of financial intermediaries. It is therefore helpful to ascertain whether and to what extent the existence of a securities market may contribute to each of them.

1.1. *Effects on aggregate volume of savings.*

Those economists who have studied financial deepening are not in full agreement about the effects this exerts on aggregate

⁴ See: RONDO CAMERON, *Le banche e lo sviluppo del Sistema Industriale*, Il mulino, Bologna, 1975, (in particular pp. 9-25 and 424-426) and the Introduction by PIERLUIGI CIOCCA giving an overall review of monetary theories of growth and development as well as a more detailed bibliography; JOHN G. GURLEY and E.S. SHAW, *Financial Aspects of Economic Development*, in « American Economic Review », September 1955; JOHN G. GURLEY and E.S. SHAW, *Money in a Theory of Finance*, Brookings Institution, Washington, 1960; R.W. GOLDSMITH, *Facteurs Déterminants de la Structure Financière*, Centre de Développement de l'Organisation de Coopération et de Développement Economique, Paris, 1966; R.W. GOLDSMITH, *Financial Structure and Development*, *op. cit.*, 1969; R.W. GOLDSMITH, *Capital Markets and Economic Development*, Paper presented to the International Symposium on the Development of Capital Markets, Rio de Janeiro, September 1971; E.S. SHAW (1973) *op. cit.*, and HUGH T. PATRICK, *Financial Development and Economic Growth in Underdeveloped Countries*, in « Economic Development and Cultural Change », April 1967.

savings and its related causes and effects. The latter have mainly been identified as the negative effect of money replacing physical capital in private portfolios, and the positive income effect through the function of production, which is in part offset by the negative income effect arising from the input of physical capital and labour in the production of money and financial services.

In addition to these effects, each of which have been accepted or rejected to varying degrees according to the theoretical approach adopted⁵, other processes have been identified through (which would stimulate the investment unit to increase its cash se the ratio between savings and income.

For instance, in his model, Shaw⁶ while rejecting the substitution effect and emphasising the income effect, contends that an increase in the propensity to save may derive from:

a) greater opportunities for gaining access to credit (which would stimulate the investment unit to increase its cash generation)

b) an improvement in the technical and economic characteristics (yields) of financial assets.

It should be noted that there are two main prerequisites needed to produce these effects. First, the financial instruments available must be acceptable to potential users, or in other words, can be made popular enough to justify their introduction. Secondly, to achieve a positive net effect on income, it is essential for these instruments to absorb a volume of real resources lower than that which their use enables economies to be made in the process of search and negotiation vis-à-vis the pre-existing situation.

⁵ These aspects are dealt with in more detail by MARIO MASINI in his presentation of the Italian translation of E.S. SHAW's study under the title: *Intensificazione dei Processi Finanziari nello Sviluppo Economico*, Cassa di Risparmio delle Provincie Lombarde, Milan, 1976, pp. X-XII and P. CIOCCA, *op. cit.*, pp. XII-XVII.

⁶ Cfr. E.S. SHAW (1973), *op. cit.*, pp. 9-12, 52-57 and 71-77.

I shall deal later on with the question of the real costs attributable to the existence of a securities market, and hence the economisation of resources absorbed by the financial process. In this section, consideration will be given to the effects of a securities market on the propensity to save (points *a*) and *b*)) and an attempt will be made to prove that the first prerequisite exists for securities as a necessary condition for these effects to come into play.

Regarding effect *b*), as briefly stated, this would arise from the fact that the development of the financial system gives a broader range of choice for surplus units by producing financial assets more in keeping with their preferences. As these assets are more attractive in terms of liquidity, yield, risk and possible services offered, they would tend to stimulate the surplus units to reduce spending on consumption in favour of savings⁷, because of the higher returns expected on investment, and the greater opportunities for diversifying asset portfolios on the domestic markets⁸.

In fact, many of these theoretic analyses stress the important role played in this process not only by money but also by liabilities of banking intermediaries (*indirect securities*). It is contended that in an underdeveloped economic and financial environment, the purchase of direct securities, especially if they are long-dated, is likely to be an unattractive proposition for surplus units.

⁷ Savings are also likely to be facilitated by the fact that the availability of financial assets makes it possible for the timing of a savings transaction and an investment transaction by an individual to be separated, thereby doing away with any obstacles that might impede the formation of savings if both transactions had to be simultaneous.

⁸ This represents the development by H.T. PATRICK (1967), *op. cit.*, pp. 183-184, of the assumption put forward by J.G. GURLEY and E.S. SHAW (1960), *op. cit.*, at various stages in their survey (see pp. 47, 49, 55, 196 and 197).

The subject has been taken up again on a different basis by E.S. SHAW (1973), *op. cit.*, Chaps. I and III. See also R. MCKINNON (1973), *op. cit.*

Even so, it would seem that there are no valid *a priori* reasons for not extending to shares and bonds the potential prerogatives attributed to indirect securities or « new assets » provided by the financial system.

In the first place, it is worth noting that such securities are not always primary securities in the true sense of the term, this being the case with bonds issued by financial intermediaries, or where the issuer of a security forms a link in the chain of relationships involved in the savings-investment circuit⁹. Consequently some of the differences between indirect and direct securities may tend to become blurred¹⁰, except of course for those related to services rendered by liabilities which function as a surrogate for money. On the other hand, great store is laid on the importance of distributive techniques¹¹, as well as techniques for intermediation.

Secondly, since the pivot of the whole process has correctly been identified as the attraction new financial assets are liable to exert on surplus units to the extent that, other things being equal, they are encouraged to increase their rate of savings, (and/or formation of financial savings), the most important thing is that

⁹ This is also shown by J.G. GURLEY and E.S. SHAW (1960), *op. cit.*, p. 94.

¹⁰ In such cases, for instance, the existence of some degree of « collectivisation of risk » may be discounted.

¹¹ For instance J.G. GURLEY and E.S. SHAW (1960), *op. cit.*, acknowledge that the monetisation of the economy and the development of intermediation and distributive techniques both have a positive effect on savings and investment. Indeed, on p. 197 of their survey they state that « Distributive techniques get primary securities distributed efficiently from borrower to lender and from one lender to another, through such facilities as dealers and security exchanges. They tend to raise the level of investment and savings by increasing the marginal utility of the last dollar's worth of financial assets to the lender and reducing the marginal disutility of the last dollar's worth of debt to the borrower. At the same time, they tend to increase the efficiency of resource allocation by pitting more investment projects against one another for lenders to examine ».

securities, like any other investment, should respond positively to the following propositions ¹²:

i) can securities in a LDC provide a combination of features in terms of yield, risk and liquidity, that make them equally attractive to, or more attractive than any « new » financial assets? ¹³

ii) assuming they have such features, is there a propensity for surplus units or at least, some kinds of these, to invest in them?

iii) if so, would there be an incentive to siphon off from consumption a proportion of income relatively higher than would be the case in their absence?

Although the third proposition merits considerable attention, its further discussion falls outside the term of reference of this study. For my purposes, it will suffice to note that where development of a country's financial structure in itself brings about an increase in aggregate savings (and investment), this will presumably occur mainly at the time that the economy is becoming monetised or immediately after that stage is reached, and hence will be largely due to the effect of money and indirect securities issued by financial intermediaries.

Yet there is no reason why a similar effect cannot also be exerted at a later stage by securities, which generally represent the « peak » of the pyramid of financial assets in any given eco-

¹² In other words, if the proposition made by E.S. SHAW (1973), *op. cit.*, is to be accepted, the question is to determine at what stage in the process of financial liberalisation and deepening a securities market should be introduced. In this section, the main concern will therefore be to ascertain whether there exist in underdeveloped economies in general the prerequisites needed to establish securities markets. In Shaw's view such markets should be brought into being, albeit at an advanced stage of financial development.

¹³ « New financial assets » are defined as financial assets that represent some innovation vis-à-vis those already in existence on the market. Accordingly, the comparison made in the text implies that in any case such new assets should exert a greater attraction, in the sense of encouraging investment, than existing financial assets.

nomy. Nor it can be contended that securities have a different degree of deepening. In any case, if this process does not occur, given the lack of reliable empirical evidence and confirmed theoretic analysis¹⁴, securities on this basis alone would be on a par with other financial assets. However, it would be of interest to investigate this point further by ad hoc studies of the behaviour of certain categories of individuals when confronted by pressures arising from changes in the financial structure, since

¹⁴ H.T. PATRICK (1967), *op. cit.*, goes into this aspect in considerable detail on p. 184, when he states that «... the major rationale of the stimulus to saving is that with new assets having higher yield, lower risk, and or other desirable characteristics, the return on saving is higher than it was heretofore. With the terms of the trade-off (the exchange ratio) between saving and present consumption relatively more favourable to the former, individuals substitute increased saving for consumption out of current income.

Offsetting somewhat this favourable substitution effect on saving are the effects of increased real income (or wealth) derived from having a wider selection of assets in which to hold wealth. Having the additional alternative to holding financial assets makes an individual better off, and he likely will utilise some of this increased income in the form of consumption. This is especially important where the individual is a target saver. Target saving is a shorter-run characteristic of some rural savers in underdeveloped countries. The (subsistence) farmer wants to be certain of adequate savings to provide for consumption until his next crop is harvested, plus a margin to cover the possibility of adverse crop conditions. However, in the longer run, the horizon of conceivable alternatives expands, targets are raised, and the beneficial substitution effects on saving will probably substantially outweigh offsetting income effects ».

The study referred to by PATRICK (on p. 187), UN ECAFE, *Measures for Mobilising Domestic Saving for Productive Investment*, in «Economic Bulletin for Asia and the Far East, December, 1962, is also of significance, in that it shows that in Asian countries there is a close positive correlation between the increase in the rate of savings versus GNP and the increase in the proportion of savings invested in financial assets vis-à-vis that invested in real assets. However this casual relationship is not explained, and it cannot be ruled out that both the rate of savings and the proportion of savings invested in financial assets are a consequence of the level and rate of economic development.

Finally, it should be noted that at no point in his survey does E.S. SHAW (1973) *op. cit.* to which frequent reference has been made, give any empirical proof of the assumptions he puts forward.

some of these categories may be more influenced than others in how they choose to allocate their income as between consumption and savings, and thus it would be easier to determine just what kinds of financial innovation are likely to be the most effective in this area. The issue is therefore still an open question, and at the present stage of research, it is not possible to comment further.

Turning to the first proposition, namely the potential attraction of securities, it is hard to give a firm reply that would hold good in any context. This is because the three main criteria generally used, liquidity, yield and risk, are not simple intrinsic prerogatives of any given security, but will depend on a set of circumstances on the one hand closely related to the issuer and the terms and conditions on which the security is issued, and on the other, to circumstances of a general nature. The latter would include, for instance, the influence exerted by the degree to which the capital market is unified, its imperfections, whether or not an efficient secondary market exists, the degree of political, economic and monetary stability, the financial structure of enterprises, the interest rate policy adopted by the monetary authorities, the social structure, the level of economic and financial education, and so forth.

These and other aspects will be dealt with in greater detail in a subsequent section covering the prerequisites for the success of a securities market in a developing country on the basis that it is not possible to generalise on this subject without going into specific detail. In other words, in my view, the attitude one should take to the notion of establishing a securities market and the role it can fulfil must be based on whether a number of general and specific conditions exist to an adequate extent, or whether they can be brought into being. Only when this position is ascertained can any significant basis arise for passing judgement.

However, as this analysis should be continued in a systematic order, let us return to the question of the potential attraction

that can be exerted by securities, and confine ourselves for the moment to a judgement based on their terms and conditions and the nature of the issuers on the implicit assumption, which will be put to the test later on, that a set of not unfavourable general circumstances does in fact exist¹⁵. As far as the question of risk is concerned, it must be admitted that where surplus units have little basic grounding in economics and where there is an imperfect market, the element of risk in investing in securities is higher than is the case with other financial assets, which are shorter-dated or can be more easily managed (such as term deposits, which can be redeemed in advance or are subject to interest rate reviews at relatively short intervals). Furthermore, risks of an economic nature tend to intensify, the greater the element of chance in the effective yield that can be earned on investments in securities¹⁶.

It is of course true that in the case of bond issues, the risk element can be attenuated by pitching their issue price, nominal interest rate, and redemption value and terms on similar lines to the term and conditions of long-dated savings deposits. Yet, given the relatively longer life of bonds, this will not guarantee that the risk element will not increase in time, since the resale value of a bond will always be closely dependent on the efficiency of the secondary market in the widest sense. The risk will thus be highest both in recently-established unconsolidated

¹⁵ The simplified terms of reference introduced here, which one would wish to avoid, nonetheless do not affect the validity of the analysis, since the assessments put forward in this section will be dependent on finding the minimum prerequisites and conditions to be indicated in subsequent sections on which final judgement will ultimately depend.

¹⁶ This element of risk is frequently ignored or underestimated in surveys of stock exchanges in LDCs. For instance, this occurs even in the otherwise first-rate study by U TUN WAI and PATRICK (1973) *op. cit.* pp. 285-291, where attention is concentrated on the type of issuer, and above all on the efficiency of the secondary market and speculation, with special reference to the equity sector.

markets not subject to strict supervision and in those bonds whose market price is not supported in any way.

In the case of shares, the biggest risk lies of course in their nature as such, as their prices are highly sensitive to a variety of factors some of which are purely emotional, and as such they are potentially subject to frequent fluctuations. Speculation is a major factor here, but it can be neutralised if the market is properly regulated and carefully supervised¹⁷. Even so, this is not always easy, and it only allows destabilising manoeuvres to be prevented; in achieving this aim, it is also necessary to act with extreme caution so as to avoid depriving the market of a vital prerequisite for it to work properly, namely the support of share prices and the elimination of erratic price movements.

Turning to the issuers, the risks of insolvency will depend on their quality, and these risks will generally tend to be higher with securities issued by private enterprises than with Government securities¹⁸ and those issued by financial intermediaries. These differences still prevail, even if only the largest and soundest enterprises are generally in a position to place securities on the market. In addition, it is difficult to reduce economic risks by having a portfolio diversified by type of issuer, due to the limited choice available. This is a particularly significant point if it is considered that in relatively underdeveloped financial systems, the specialist nature of intermediaries is extremely limited and they generally have little incentive to raise funds by issuing bonds, as savings deposits are a more simple and economic way of raising money from the public.

¹⁷ In the securities markets analysed here, this objective has been pursued with a fair amount of success, although the regulations and supervision employed are of mediocre quality.

¹⁸ Government securities may however entail consolidation risks, and the incidence of these will be closely dependent on the country's past political situation, its future outlook, and the attitude taken to this aspect by its Governments in the course of time. In this respect the Tunisian experience is of interest (cfr. Chapter II, Section 2.1.2 point f.) in the years immediately following independence, and long-term conditioning of the market.

From what has been said, it is fair to conclude that securities have a higher degree of risk than other financial assets (especially money and quasi-money) and that the highest risk lies in bonds issued by private enterprises. Although this risk differential occurs in developed economies as well, it tends to be more marked in LDCs, and among other things will depend on the degree of sophistication achieved by the country's financial structure and distributive techniques.

Given these differentials, it follows that the rate of return on securities should be higher than on other financial assets (especially bank deposits) and should vary according to the type of issuer. However, this may often run counter to the need for enterprises to keep their cost of funding in check, so that they may prefer to borrow money from banks rather than issue bonds¹⁹. Also, Governments themselves may not be keen to pay « attractive » interest rates on their securities, and may prefer to use other types of financing, or impose low interest rates and place their bonds outside the market, i.e., with certain financial intermediaries²⁰.

Finally, there is the question of share yields. Here, I shall confine myself to pointing out that a conflict of interest may arise between a company's policy to plough back its profits into the business, and the investor's desire to receive a return on the money he has invested in the form of a dividend, rather than having to monetise his gains on the market. This however implies the full disclosure by the company to its shareholders of all relevant facts and information, and a secondary market that operates perfectly as far as price formation and marketability is concerned.

¹⁹ This state of affairs was in fact found in all the countries investigated in this survey.

²⁰ This situation was also typical of the countries analysed here. U TUN WAI and PATRICK (1973) *op. cit.* pp. 280-281, also stress its frequent occurrence and the extent to which it restricts the growth of securities markets and acts as a disincentive to the formation of financial savings.

In any case, let us assume for a moment that these problems do not exist, although in reality they are quite common, and let us defer the discussion of the company's costs to a subsequent section.

Given that securities may be objectively « attractive », it is necessary to ascertain whether units in surplus have a propensity to invest in them, above all bearing in mind that investment decisions tend to be subjective by nature, and hence the definition of « objective » attraction is not very apt. This was the second proposition.

In a developing country, and indeed in any recently-established small securities market, there are virtually no institutional investors who manage securities investments on a collective basis in the form of mutual funds and investment trusts. Distributive techniques also tend to be undeveloped. In the absence of bodies which specialise in selling and dealing in shares, this function will be carried out by individual banks, and will depend on their degree of organisation, the extent of their branch network, and their willingness (in many cases very limited) actively to encourage the popularity of securities ²¹.

The result is that where there are no effective organisations for channelling savings into the securities market or for providing individual savers with investment advice, investments in securities are made and managed directly by the surplus units and it is therefore correct to see them in this light.

The first implication of these findings is that access to the securities market will be difficult for small and medium savers, and for any other potential investors who do not live in the immediate vicinity of the main financial centres ²² where the stock exchange, banks and brokers are located.

²¹ Indeed, in all the countries investigated in this survey, except the Ivory Coast, the banking system takes anything but an active role in this field.

²² The geographical concentration of securities ownership has also been noted in other surveys, albeit with varying intensities and based on dif-

This state of affairs prevailed in all the countries we investigated, and if, as seems possible, it is a typical feature of underdeveloped countries, then the number of potential subscribers to shares and bonds would seem to be restricted right from the outset. The number is then likely to be further reduced where wealth is highly concentrated in a few areas which may not coincide with the financial centres in which facilities exist to encourage and facilitate access to investments in securities.

Apart from these objective limitations, which must be taken into account as they themselves pose considerable obstacles, the results of our investigations²³ also point to a number of subjective obstacles to the propagation of securities among potential individual investors. In the first place, many savers, generally, but not necessarily, in the small to medium category are averse to risk-taking, and for them neither the higher yields, nor the potential liquidity of securities is a sufficient attraction in itself. For the more sophisticated of these savers there are (or should ideally be) available, a range of financial assets, such as savings deposits, or interest bearing warrants, which effectively substitute investments in securities²⁴.

Secondly, those individuals more willing to take a risk (usually but not necessarily those with high incomes), while appreciating the advantages of liquidity implicit in marketable securities, are attracted by investments in many cases of a speculative nature²⁵ sometimes in partnership with others in trading, pro-

ferent factors. See, for instance, J.P. DRAKE (1969) *op. cit.* pp. 86-87 and D. GUSTAFSON (1965) *op. cit.* pp. 165-179.

²³ In addition to my actual findings in the African countries covered here, see U TAN WAI and PATRICK (1973) *op. cit.* pp. 257-258 and 277. Although these authors do not provide any empirical evidence to support their assumptions, my own findings fully confirm their theories.

²⁴ In this sense, I fully concur with U TAN WAI and PATRICK (1973) *op. cit.* pp. 257 and 277. However, J.P. DRAKE holds the opposite view (see note 34).

²⁵ The general tendency to speculate by operators with a propensity

perty or other business, with a far higher potential return than that available from investments in shares²⁶. Further disincentives to holding securities arise from a) lack of economic training and inexperience in assessing the value of financial investments²⁷, b) lack of information on the market, c) and an apathetic attitude to any financial investment that calls for a certain amount of commitment in terms of administration and management²⁸. The diffidence shown by many operators to securities can largely be attributed to the interaction of factors a) and b). On the basis of what little information is available on the subject²⁹, this theory is borne out by the fact that those who purchase and hold securities for reasons other than gaining control of a business, in most underdeveloped economies mainly tend to be professional men, bureaucrats and managers rather than entrepreneurs and traders³⁰. These investors then, chiefly

for risk-taking is seen, for instance, in Morocco (see section on the Development of Securities Markets) where experience proves that if such operators were to invest in the equity market, they would do so only in the interests of making a profit in the very short term, after which they would immediately pull out of the market. In the absence of such a prospect, they would not make any investment at all.

²⁶ This is also contended by U TUN WAI and PATRICK (1973) *op. cit.* pp. 257-258, a contention not shared by J.P. DRAKE (1977) *op. cit.* p. 75. See PHILLIPS PERERA, *Development Finance, Institutions, Problems and Prospects*, Preager Publishing, New York, 1969, pp. 302-305, regarding the greater profitability offered by real assets and trading activities in many LDCs, and the other disincentives to investment in securities mentioned in the text.

²⁷ This factor, along with the inclination of savers to invest in the types of asset mentioned in the text, has also been emphasised by E.S. SHAW (1973) *op. cit.* pp. 58-70, in explaining the reasons why, in his opinion, it is better to have a relatively small variety of financial assets in LDCs, inter alia in order to simplify the available choice of units in surplus.

²⁸ Cfr. GEORGE G. MANIATIS, *Reliability of the Equities Market to Finance Industrial Development in Greece*, in «Economic Development and Cultural Change», July, 1971, p. 604.

²⁹ See Chapter II, Section 1.3.1. Regarding the comments in Note 38, see also Sub-sections 3.1 in Sections 2 and 3 in the second part of this survey.

³⁰ DRAKE's analysis of experience in Malaya and Singapore summarised in J.P. DRAKE (1977) *op. cit.*, p. 80 bear out, in that author's opinion, the

come from middle - to high - income groups rather than the wealthy as such; they tend to be fairly knowledgeable about financial matters, and are engaged in professions which do not provide any opportunities for undertaking business in the trading or property sectors. In any case, activities in this sphere are likely to be limited, as many of the people concerned either do not possess adequate funds for the purpose, or, while not averse to risk-taking, are not inclined by nature to business of this type.

In fact, shares in many countries tend to be highly concentrated in the hands of a small number of individuals in the wealthier classes³¹. However, this bears out my observations, in that the shares concerned usually represent controlling interests, which would be the case even if there were no securities market, and anyway do not involve problems of mobilising household savings.

In conclusion, my view is that the opportunities for expanding aggregate savings in LDCs by establishing securities markets will primarily depend on how far the limiting factors described above interact with each other. Given that most of these constraints exist and given that it is difficult to remove them in the short term, the degree of wealth concentration and the size of the socio-economic groups inclined to invest in securities take on

desirability of securities being sold more widely to medium- to low-income groups (domestic servants, gardeners and labourers). To support this proposition DRAKE also refers to the survey of E.A. AROWOLO, *The Developing of Capital Markets in Africa, with Particular Reference to Kenya and Nigeria*, in « I.M.F. Staff Papers », July, 1971 pp. 449-457. In this author's view, however, the information given provides no conclusions other than the fact that investment in certain bond and share issues by private individuals (hence incomplete data not based on stocks held in portfolios) had increased. This does not of course give any reliable indication of the distribution by income group of issues in circulation. The Brazilian experience referred to by U TUN WAI and PATRICK (1973) *op. cit.*, p. 298 is in line with the type of classification I have encountered.

³¹ See Sections 2.3.1. and 3.3.1. (Note 54) in the second part of this survey.

prime importance. These factors largely explain the differences encountered from one country to another in the results that can be achieved by setting up a securities market, not only at the initial stage, but also subsequently.

While the contribution a securities market can make to expanding aggregate savings should be assessed on a case-by-case basis, it is reasonable to contend that in developing countries in general this contribution is fairly modest³².

To be fair, it should be noted that hitherto the possible effects of a securities market have been analysed by reference to the behaviour of the spending unit, whereas the positions of the investment unit and hybrid unit have not been considered.

According to some economists, financial deepening opens up fresh opportunities for investment and greater access to credit, and should therefore be an incentive for such units to save more and enhance their own creditworthiness (thus increasing their cash flow and hence net worth) in order to be able to borrow more money on better terms³³.

I would contend that even in this respect a securities market in backward economies can only play a negligible role. This point will be discussed in more detail later on; for the moment suffice it to say that from the fund-raising viewpoint, most en-

³² Seen in this light, it would appear that even the theories put forward by J.P. DRAKE (1977) *op. cit.*, p. 75 are not wholly in contrast with my own assumptions. In my view, the constraints imposed by a variety of factors must be investigated on a case-by-case basis, even though the opinion expressed in the text is that, on average, the results that can be achieved in LDCs are fairly limited. Therefore, I can accept the proposition of U TUN WAI and PATRICK (1973) *op. cit.*, while not rejecting that postulated by DRAKE.

In any case, SHAW, while recognising the desirability of providing the financial system with a securities market, feels that this is a step which is best undertaken at an advanced stage of development. Indeed, he stresses the obstacles that can arise in relatively underdeveloped economies and also the danger of giving rise to very negative side-effects, cfr. E.S. SHAW (1973) *op. cit.*, pp. 69-71, 92 and 146-156.

³³ Cfr. E.S. SHAW (1973) *op. cit.*, p. 9 and R. MCKINNON (1973) *op. cit.*, pp. 57-65.

terprises have major difficulties in gaining access to the securities market. These are compounded by the considerable reluctance of groups in control of enterprises to expand the shareholder base of such firms by offering shares to the public, and the general preference for bank credit as against money raised through debentures.^{bonds}

Given this situation, one's conclusion is that very little pressure to save is exerted on companies by the existence of a securities market representing a source of finance.

The same applies with regard to investment opportunities that such a market could provide for those enterprises, whose financial management is likely not to be sophisticated enough to include investments in securities. The arguments put forward regarding the spending units are also valid in this area.

1.2. *The effects in terms of more efficient allocation of the initial stock of real wealth and increased financial savings.*

It is reasonable to think that the creation of an efficient financial system may help to accelerate economic growth, particularly in non-industrialised countries, not only by reducing the production factors absorbed in the search and negotiation process (income effect)³⁴ but also by redistributing existing real wealth, apart from new inflows³⁵. The latter effect would arise from the process of change in individuals' portfolios brought about by the supply of financial assets capable of substituting tangible assets hoarded on an unproductive basis.

It is well established that in less developed countries, as a result of lack of opportunities for productive investment, ignorance and the absence of an adequate range of financial assets, a

³⁴ Cfr. E.S. SHAW (1973) *op. cit.*, p. 56 and the bibliography cited.

³⁵ See R. CAMERON (1975) *op. cit.*, pp. 20-21; ERIC L. FURNESS, *Money and Credit in Developing Africa*, Heinemann, London, 1975, pp. 17-20; M. MASINI (1976) *op. cit.*, p. XIX; H.T. PATRICK (1967) *op. cit.*, pp. 178-181 and E.S. SHAW (1973) *op. cit.*

significant proportion of real wealth is siphoned off from the process of savings formation, in the form of foodstuffs, raw and finished materials being stocked in excess of production and consumption requirements, and in the hoarding of precious stones and metals, foreign currency, assets abroad etc.

In some cases, while these assets are relatively liquid and divisible, they nonetheless involve considerable maintenance costs and are highly subject to deterioration and price fluctuation. In other cases, despite being subject to some of these negative factors, assets of this kind are held as a hedge against monetary depreciation. Where this occurs owing to the lack of availability of alternative financial assets, a change could be effected by creating new financial assets, or making those that exist more attractive.

The wider range of investment opportunities that would thus be offered by the financial system, could in fact not only act as a boost to newly-formed money savings, but could also lead to a diversification of portfolios held by individuals. As a result of such tangible assets being progressively substituted by financial assets in the portfolios of spending units and hybrid units, real resources previously tied up simply as purchasing power could be released for productive use. Although some of these resources may be used for consumption, involving a net reduction in aggregate wealth, it is likely that the bulk of these funds will ultimately be transformed into capital goods, both through satisfying the demands of workers engaged in producing them, and through foreign trade³⁶.

It should be noted that the expansion of production and economic growth, as well as activating frozen real reserves, should ideally also contribute to the flow of capital goods from the holders of wealth to businessmen with entrepreneurial abili-

³⁶ Cfr. H.T. PATRICK (1967) *op. cit.*, pp. 179 and 181. The subject is dealt with in briefer terms by CAMERON and PATRICK, in R. CAMERON (1967) *op. cit.*, p. 20.

ties, and on a microeconomic level, to the reinvestment of income in innovatory sectors³⁷. The development of this process, which has rightly been defined as being extraordinary, unrepeatable and of long duration³⁸ will depend to a great degree on the structure and efficiency of the financial system. In effect, despite the fact that the major impetus is likely to occur when the economy is becoming monetised and cash in circulation is becoming enriched with various types of key currencies, considerable potential will probably remain even in those LDCs which are already well on the way to full monetisation³⁹.

This potential is demonstrated by the high volume of precious metals, foreign currencies and or other real assets held to protect individuals' wealth, which could be exploited by offering adequate financial assets.

The question is therefore what role a securities market can play in this process. As I have already shown, it is hard to answer this question in the abstract, nor can empirical analyses be used to produce an answer, as they simply do not exist. While the crux of the problem lies in being able to substitute existing real assets for securities (since for our purposes the substitution of one type of financial asset for another is of negligible importance), I feel the conclusions previously reached on the effects on the propensity of individuals to save can also be applied to this problem.

In relatively undeveloped economic and financial systems, securities are likely to be of interest only to a limited and clearly-defined class of investors, on whose operating potential the propagation of such securities will ultimately depend. Furthermore, if the supply of securities simply leads to a reduction in the volume of deposits held by banks, the benefits inherent in

³⁷ Cfr. H.T. PATRICK (1967) *op. cit.*, p. 181.

³⁸ Cfr. CAMERON and PATRICK, in R. CAMERON (1967) *op. cit.*, p. 20.

³⁹ See experience and surveys mentioned by H.T. PATRICK (1967) *op. cit.*, pp. 181-182 and notes 21 and 22.

reallocation of real wealth will not materialise, and indeed could lead to negative effects in terms of disintermediation.

It does not necessarily follow from this that the existence of a securities market would act as a disincentive to the unproductive holding of real assets, or that it would encourage the reallocation of physical wealth, but it is my view that this influence is small to the point of being virtually negligible in some environments, owing to the reasons set out above.

In other words, I am inclined to think that other kinds of financial asset, notably indirect securities issued by the banking system are more likely to produce the desired results as far as most individuals are concerned, provided their yields are adequate⁴⁰.

At the same time, while on the subject of reallocation of physical wealth into more productive uses induced by the financial structure, I am convinced that developed countries should take a closer look at Schumpeter's theory, and hence give closer attention to the activities of banks that carry out monetary functions. This theory is too well known to call for detailed discussion, but two of its propositions deserve considerable thought.

The first is the special capacity Schumpeter contends that banks have for encouraging the transfer of funds to entrepreneurs (as defined by him) for productive investment⁴¹ by creating credit⁴². Although, for reasons of exposition, Schumpeter tends to overemphasise the distinction between granting (and applying for) credit, on the basis of the purpose for which it is

⁴⁰ Among others, MARIO MASINI, *The Banking System and Savings Policy in Developing Countries*, in A. MAURI (ed.), *Mobilization of Household Savings*, CARIPLO, Milan, 1977, p. 71 and MCKINNON (1973) *op. cit.*, pp. 9-16 and 55-68 discuss the importance of yields in this process.

⁴¹ Cfr. JOSEPH A. SCHUMPETER, *The Theory of Economic Development*, Oxford University Press, New York, 1961, pp. 71-94.

⁴² What Schumpeter defines as the creation of means of payment by credit, which he associates with forced savings, cfr. J.S. SCHUMPETER, *op. cit.*, Chap. 3, pp. 105-115.

to be used, and in demonstrating in what specific conditions such credit is essential for economic growth, there is no doubt that he has fully grasped the basic purpose of the modern deposit-taking bank. However, it still remains to be proved whether the banks are actually inclined to finance innovative activities⁴³.

Here, as research into economic history has progressed, some writers, albeit to a varying extent have come to reject the simplistic contention that banks have failed to finance innovation⁴⁴ and at the same time have pointed to other ways in which bank credit has helped to stimulate industrial development. For instance, Cameron has shown that in some cases, « banks have constantly financed promising technical innovations from their outset » and that in many other cases, this has occurred « unconsciously or at the least, accidentally »⁴⁵. He has also noted that « ... while it is rare for a bank directly to finance a period of experimentation by a new and inexperienced entrepreneur (...), it is fairly common for banks to finance the expansion of enterprises which have already introduced successful innovations, and also for them to finance the adoption of innovations by imitators ». He also loses no time in adding that « it is likely (...) that the

⁴³ Here it should be noted that contrary to what has sometimes been ascribed to him, Schumpeter does not contend that in practice banks are in general particularly inclined consciously to finance innovation. In effect, reverting to what in his exposition he terms operating credit used to finance ordinary trading (operating credit in a circular flow), he states that « ... when in the end all businesses — old as well as new ones — are drawn into the circle of the credit phenomenon, bankers will even prefer this kind of credit on account of the smaller risk it involves. Many banks, particularly of the « deposit » type and also almost all old-established houses, actually do this and restrict themselves more or less to such « current » credit. But this is only a consequence of development already in full swing » (*op. cit.*, p. 104).

⁴⁴ Although starting from a different basis and reaching different conclusions, see the following authors: R. CAMERON (1975), *op. cit.*, (in particular CAMERON and PATRICK's foreword and CAMERON's conclusions) and A. GERSCHENKRON, *Economic Backwardness in Historical Perspective: a Book of Essay*, Cambridge, Mass, 1962.

⁴⁵ Cfr. R. CAMERON (1975), *op. cit.*, p. 23.

majority of technical innovations will have been introduced by sound manufacturing enterprises... » so that « in such cases it is a simple matter for the entrepreneur to obtain finance from a bank without the banker knowing or necessarily bothering to know whether he is financing innovations or not » (*)⁴⁶.

It thus seems reasonable to contend that underdeveloped economies can make beneficial use of the banking system and create a basis on which it can stimulate and accelerate industrialisation and economic growth. In this area, such countries can draw on the experience acquired in relatively more developed economies and the opportunity to « borrow » more efficient banking techniques and adapt them to their own needs.

The second point in Schumpeter's thesis draws attention both to banking activities and the securities market as being complementary to those activities. The question turns on the long-term financing of enterprises, which as he observes, is sometimes effected by short-term credit. Yet, « every entrepreneur and every bank will try for obvious reasons to exchange this basis as soon as possible for a more permanent one, indeed will regard it as an achievement if the first stage can be completely jumped in an individual case »⁴⁷.

In particular, Schumpeter points out that the bank's role here is to make available to the entrepreneur, when shares or bonds are issued, purchasing power created for the purpose, and to place these securities with its customers, thereby substituting incremental means of payment by reserves of existing purchasing power⁴⁸.

By mentioning this point, I do not intend it as an opportunity to review the status of the mixed bank, which has already been the subject of extensive and very useful studies, but I feel that it does offer an opportunity to stress how banks may play a

⁴⁶ *Ibid.*, p. 24.

* Translator's Note: retranslated from Italian version of CAMERON.

⁴⁷ Cfr. J.A. SCHUMPETER (1961), *op. cit.*, p. 111.

⁴⁸ *Ibid.*, pp. 111-112.

vital part in classifying and propagating securities, even though they may not be directly involved in investment financing on a systematic basis. Here it is enough to think of the support they can provide by forming underwriting syndicates, the advice they may give to entrepreneurs as a prelude to securities issues, the credit with which they can support securities dealers, the investment advice and management services they can provide for their depositors and savers in general, and the quite considerable influence they can exert on their choice of investment⁴⁹.

In effect, all these transactions and services should represent one of the essential functions of a commercial bank as such. Any banker worth his salt is fully aware of this and will not make the mistake, which is frequently encountered, of considering intermediation in securities to be a mere deterrent to deposit-taking and credit giving. The famous Italian banker, Raffaele Mattioli pinpointed this aspect with great clarity, when he stated that « the basic function of any bank is to mediate, and to mediate in two complementary directions, i.e. to mediate *a*) between deposits and lending and *b*) between savings and investment. The result of mediation *a*) is credit-giving. The result of mediation *b*) termed « intermediation » in banking jargon — or the buying and selling of currencies and securities on behalf of customers — is to channel savings into the capital market, and complement their integration into the production process by purchasing or subscribing equities, bonds and Government securities ». It is the job of the banker to ensure that these two types of mediation become harmonised and complement each other rather than hindering each other⁵⁰.

⁴⁹ Exemplary in this respect is the support offered by banks in the Ivory Coast towards popularising securities among savers.

⁵⁰ See p. 231 of BANCA COMMERCIALE ITALIANA's 1960 Annual Report. Mattioli drew the attention of the bank's shareholders and the banking world in general to this subject and its implications in a number of BCI's Annual Reports around that period.

In addition, it is worth noting that if commercial banks wish to take an active part in this field without committing themselves directly, they could effectively help to raise capital for entrepreneurs by financing the acquisition of stocks and shares by units in surplus⁵¹. This would avoid many of the problems associated with direct investment in securities, while pursuing the same aims. Indeed, apart from the practical difficulties that might be involved in such business, the banks, while providing finance ultimately used to increase the entrepreneurs' capital and reserves, would be taking on a relatively smaller risk, as their lending would be spread over a broader area and the terms and value of this lending would be well-defined in advance.

However, all this still of course presupposes that entrepreneurs are willing to issue securities and investors are prepared to subscribe to them.

One final consideration needs to be made in this section on the effects of a securities market on savings and the allocation of wealth, namely on capital inflows and outflows in general.

Where capital exports are not primarily motivated by worries about political security but are made in order to earn higher returns on a more diversified portfolio than that available at home, it is reasonable to contend that a local securities mar-

⁵¹ Such transactions have been effected, for instance, at various times in Kenya, and in some cases represented a discreet method of increasing shareholdings. For informative purposes as to how these arrangements worked, it is worth noting that on the occasion of a Dunlop rights issue, two local banks undertook to finance part of the issue by lending to Kenyan nationals 80% of the value of shares they might purchase (up to a maximum number of 500 shares per individual), under a scheme providing for repayment over 18 months. Cfr. HOLGER L. ENGBERG, *The Nairobi Stock Exchange: An Organised Capital Market in a Developing Country*, in «The Journal of Management Studies», March 1976.

Here, it is also of interest to note that the Banque Centrale des Etats de l'Afrique de l'Ouest offered a scheme in 1976 whereby it would refinance the purchase by local investors of the assets of foreign companies located in the West African Monetary Union area (cfr. Chapter II 1.3.1.).

ket could curb the tendency to send money out of the country. However, here again, one should not expect significant results, if for no other reason than the narrow range of securities available on the domestic market. Furthermore, the same objective can be achieved by encouraging a rise in interest rates paid on deposits and other financial assets.

Regarding the inflow of foreign capital it seems unlikely that the development of a securities market will exert any attraction in this respect, as such attraction occurs for other reasons and in accordance with other needs. In saying this, I do not wish to reject or underestimate the positive effects foreign investors may see in opportunities to obtain participation by local businessmen (protection against political risks and other factors) and to cash their investments more easily, albeit gradually⁵², but would simply contend that this is not a determining factor.

1.3. *The effects on the aggregate volume of investment and the allocation of savings.*

This last set of effects through which the financial structure may influence economic growth involves the volume and allocation of investment.

Albeit with sometimes considerable differences in approach, some students of financial theory and less-developed economies⁵³

⁵² The mutual advantages accruing to foreign and local investors from a broad shareholding base are illustrated by E.A. AROWOLO (1971) *op. cit.*, p. 464; D. GUSTAFSON, *Promoting Broader Ownership of Private Securities in the Low Income Countries*; W. DIAMOND, *Development Finance Companies: Aspects of Policy and Operation*, published by the Johns Hopkins Press for the World Bank Group, Baltimore, 1968, p. 28.

⁵³ See R. CAMERON (1975), *op. cit.*, pp. 17-20 and 425-426; VINCENT GALBIS, *Financial Intermediation and Economic Growth in Less-Developed Countries: A Theoretical Approach*, in «Journal of Development Studies», Vol 13, No. 2, January 1977, pp. 64-69; R.W. GOLDSMITH (1969), *op. cit.*, pp. 390-400; R. MCKINNON (1975), *op. cit.*, H.T. PATRICK (1967), *op. cit.*,

contend that an efficient financial system may boost investment and improve its allocation. As regards a potential increase in volume, it is held that this could be stimulated by a variety of factors roughly arising from two kinds of effect, i.e. *a*) the cost effect in the widest sense of the term and *b*) the availability effect. Effect *a*) would arise from the fact that the development of an efficient financial market should lead to a reduction in the cost of funding, including the psychological cost. As has been rightly pointed out, this does not necessarily mean that interest rates would fall in time, since investment demand in LDCs could grow significantly⁵⁴. Also, if interest rates were previously maintained at levels below equilibrium, they could immediately be raised, thus exerting a positive effect on the volume (or allocation) of investment⁵⁵. In effect, this would benefit from the greater availability of investable funds generated by the higher yield obtainable on financial investments, which would tend to discourage direct investment, and, if one assumes that the propensity to consume is not altogether divorced from the real return on household savings, to encourage an increase in savings⁵⁶.

In any case, if one concedes that this latter event is necessary and beneficial, the fact remains that a developed financial structure, by unifying the capital market, ultimately lowers the cost of borrowing by substantially narrowing the range within which interest rates will fluctuate, both in general, and in terms of categories of borrowers and seasonal influences.

The desegmentation of the capital market will also encourage more efficient allocation of resources and an increase in the

pp. 182-185; RICHARD POTTER, *The Promotion of the Banking Habit and Economic Development* in the « Journal of Development Studies », July 1966 and E.S. SHAW (1973), *op. cit.*, pp. 75-77.

⁵⁴ Cfr. H.T. PATRICK (1967), *op. cit.*, p. 184.

⁵⁵ Cfr. V. GALBIS (1977), *op. cit.*, p. 84 regarding the positive effects generated in the volume of investment and allocation of resources.

⁵⁶ This could also tend to siphon funds out of unorganised financial markets into organised ones.

average return they yield⁵⁷. This is because it allows a greater selection of investment opportunities while at the same time fostering a specialist approach by economic units in terms of savings and investment, by relegating investment to the initiative of those businesses with the best entrepreneurial talents.

Yet perhaps the biggest incentive to increasing investment is afforded by the greater availability of funds and greater opportunities for access to capital that development of the financial structure can provide for entrepreneurs, thereby enabling them to borrow more money and achieve economies of scale.

Since the points made above as usual mainly refer to the activities of financial intermediaries, it is worth seeking to assess the contribution which a securities market can make to the growth and efficient allocation of investment.

As to its growth, a fairly simple way to find out whether a securities market can significantly encourage investment in LDCs, is to see to what extent it can facilitate and expand opportunities for access to capital, reduce the cost of borrowing and increase the volume of funds available for lending.

While stressing once again that only rough estimates can be made by reference to general situations, it should be noted that increased access to credit is likely to benefit mainly larger well-established businesses, namely the only kind of business that will be in a position to place its securities without too much difficulty.

It is also likely that as such businesses represent the banks' preferred customers as far as lending is concerned, they will not stand to gain so much advantage from the existence of a bond market⁵⁸ as from an equities market. Yet even the existence of

⁵⁷ See E.S. SHAW (1973), *op. cit.*, pp. 75-76 and V. GALBIS (1977), *op. cit.*, pp. 63-67, who analyses the effects in this direction resulting from an increase in real interest rates towards the point of equilibrium.

⁵⁸ It is of course assumed that existing financial intermediaries would be in a position to provide long-term loans. If this is not the case, one would expect long-term lending by financial intermediaries to become developed at

an equities market will not be of great importance given that many of the businesses concerned, albeit large, have a marked family imprint and/or a very restricted number of shareholders and will tend to prefer to base their growth on internal cash generation or cash contributions from their shareholders rather than offering shares to the public⁵⁹.

A definite sign of the extent to which wider access to capital offered by a securities market is more potential than actual is seen both by the small number of companies that are able to have recourse to the market and their refusal to issue bonds as an alternative to indirect credit, which they consider to be cheaper and easier of access, and also by the reluctance of many companies to expand their equity base and offer shares to the public⁶⁰.

To turn to the possibility of a reduction in the cost of funds, a securities market could contribute to this directly, that is by encouraging the raising of debt capital at lower interest rates than those carried on loans granted by intermediaries, and also indirectly, namely by helping enterprises to achieve an optimal financial structure, which would allow them to reduce the average weighted cost of capital⁶¹.

a stage well before it became popular for enterprises to issue their own long-term securities.

⁵⁹ It should be noted that this tendency may be found even in developed industrial countries, such as Italy, where many companies prefer to avoid coming to the market, and do not use the organised securities market to meet their borrowing requirements.

⁶⁰ All this has actually been found in the countries I have investigated. Similar findings emerge in R.W. GOLDSMITH (1971), *op. cit.*, pp. 20-21; J. LOXLEY, *East Africa Stock Exchanges*, P.A. THOMAS, *Private Enterprise and the East African Company*, Tanzania Publishing House, Dar Es Salaam 1969, pp. 140-146 and U TUN WAT and PATRICK (1973), *op. cit.*, p. 261.

⁶¹ A reduction in the average weighted cost of capital would be likely to occur particularly as a result of the reduction in interest charges an enterprise would obtain by virtue of its strengthened financial position, thus involving the lender institution in a lesser degree of risk. See J.F. WESTON-E.F. BRIGHAM, *Essentials of Managerial Finance*, New York, 1971 Chap. 10.

As to the real scope of these potential advantages, there are various reasons for assuming that they would be pretty modest, if not indeed non-existent, in the presence of financial intermediaries with efficient operating methods.

First, as noted previously, in an underdeveloped economic environment, the risk factor may lead to yields on first-class securities held in the portfolios of surplus units that are high enough to discourage recourse to direct borrowing. Furthermore, the cost of such direct borrowing in terms of small loans in markets that are relatively organised may be significantly affected by the cost of issuing and placing the securities concerned, and by any intervention that may be needed to support their market price.

Secondly, if it is also borne in mind that businesses in a position to sell securities to the public anyway already enjoy privileged treatment from their bankers, it is clear that the advantages in terms of capital cost offered by securities markets may in fact be fairly minimal.

Finally, as to a possible « availability effect », one can rule out the possibility that activation of a securities market significantly increases the volume of finance available to business enterprises because as far as rising debt capital is concerned — and this seems hardly worth repeating — potential issuers already have ready access to indirect credit. At the same time when the question of raising venture capital arises, the limitations to the supply of funds along with the reluctance of many businesses to use this channel for finance lead to the conclusion that, taken as a whole, the effect in question is not of major significance.

It remains to be seen whether the co-existence of a securities market with other financial institutions improves the allocation of savings among various potential investments. Here, a word of warning is due. At the present stage of knowledge, it is not possible to express a firm judgement, since this calls for spe-

cific detailed examination of each market. Without wishing to go into this highly complex subject⁶², I shall confine myself to noting that considerable doubts have been expressed about the ability of securities markets to allocate wealth properly even in developed industrial countries with active stock exchanges⁶³. Hence, it seems fairly safe to conclude that this ability is even more limited in LDCs because of the greater imperfections in their capital markets.

Yet what is of most interest is the finding that as it is impossible to form any definite conclusion as the effects of a securities market on the process of allocation, it is rather oversimplifying the issue to state that « the most that can be said is that since a securities market constitutes an additional avenue of borrowing and lending, the capital market is wider than hitherto and should function more competitively »⁶⁴.

On the contrary, one should consider the possibility that the establishment of a securities market in an undeveloped economy or an economy at the early stages of developing its own long-term financial structure actually tends to increase the segmentation of the capital market and its efficiency in terms of wealth allocation⁶⁵.

In conclusion, and leaving aside the latter issue, my view is that the incentives offered to investments by organised securities markets are, as a whole, of pretty modest proportions.

⁶² Details of the aspects to be considered in seeking to assess the allocative efficiency of stock markets in LDCs can be found in U TUN WAI and PATRICK (1973) *op. cit.*, pp. 258-260.

⁶³ Cfr. W.J. BAUMOL, *The Stock Market and Economic Efficiency*, Fordham University Press, New York, 1965, pp. 182-183.

⁶⁴ Cfr. P.J. DRAKE (1977) *op. cit.*, p. 76.

⁶⁵ SHAW, for example, is firmly convinced that the creation of organised securities markets is unfavourable to the process of allocation, since, among their other negative effects, they lead to an increase in the concentration of economic power (cfr. E.S. SHAW (1973) *op. cit.*, pp. 144-147).

2. THE ROLE OF SECURITIES MARKETS IN LESS DEVELOPED COUNTRIES: b) OTHER FUNCTIONS AND AIMS

In the previous section, attention was concentrated on the contribution that a securities market may provide towards economic take-off in LDCs. Indirectly, I also looked at a large variety of other functions attributable to such a market, such as the raising of capital by business enterprises, liquidity of monetary wealth, the formation and popularity of economic indicators (market prices, yields and so forth) and the selection of more profitable investments for savers.

To complete this analysis of the role played by securities markets and the aims that can be achieved through them, we now have to consider the following aims:

i) encouraging the pursuit of economies of scale, thereby allowing companies to achieve a larger output capacity;

ii) avoiding and opposing excessive concentration of economic power while at the same time providing a basis for achieving a reasonable distribution of wealth and income;

iii) exerting pressure on enterprises to maximise profits and pursue more skilful management policies by using professional managers (and, in the process, stimulating entrepreneurial talents and individual skills);

iv) encouraging the process of placing economic activity in local (or private) hands.

2.1. Contribution to economies of scale.

This aim has already been discussed when I referred to the incentives to investment that a securities market may provide,

and the comments then made may be expanded. Here, I would merely add that this objective in all likelihood does not represent a prerequisite nor is it perhaps even necessary for economic development in countries at the initial stages of industrialisation. Analyses of economic history have indeed proved that the most successful development case-histories have been those in which small businesses played a major role at the take-off stage¹, since by their nature they tend to form an industrial fabric that is agile, flexible and lively. The progressive and selective growth of small businesses also makes it possible to avoid the risks and rigidity inherent in an economy where large businesses are present that have not been the result of gradual and selective development.

Careful thought should thus be given to just how effective the economies of scale offered by big businesses are going to be in comparison with those offered by a widespread base of small enterprises. It follows that greater attention should be devoted to the question of whether it is desirable to foster the growth of certain production units albeit through exclusively financial channels, which may well mean that there is a risk of diverting financial resources away from smaller businesses.

This does not of course mean that one should not encourage some businesses to grow in size. It does however mean that this should be done at the right time, and above all in response to actual needs, preferably at the spontaneous request of the entrepreneurs concerned. At an early stage of development it is more important to consider the quality of the industrial sector, rather than the size of individual production units. This is shown by the fact that many businesses, despite being in a position to raise venture capital without impinging on the controlling interests of the entrepreneurs concerned, prefer to opt for progressive growth based on profits ploughed back into the business,

¹ Cfr. R. CAMERON (1975) *op. cit.*, p. 459 and the essays in this volume.

which may be complemented by direct contributions from their existing shareholders.

In any case, an approach of this kind seems to be in perfect keeping with the lead time needed to acquire the experience and management skills required to run larger businesses (or even merely to exercise the power to choose). It is no coincidence that in a number of countries, including those investigated in this survey, there is a situation, paradoxical though it may seem at first sight, whereby demand for equities, including new issues, frequently exceeds supply.

2.2. The effects of securities markets in terms of concentrating economic power, income and wealth.

It is often contended that the development of a securities market and the widespread placement of equities with investors is essential to avoid an excessive concentration of wealth in the public sector or, at the opposite extreme, in the hands of a restricted clique of private capitalists, as well as representing the basic prerequisite for reasonable distribution of income, and economic power as such². In my view, it is somewhat unrealistic to assume that securities markets per se can achieve these aims in an LDC, nor does there seem to be much evidence to that effect. This view also applies in full measure to developed industrial countries, and the experience gained in such countries proves the point.

In the first place, concentration of wealth, which in turn tends to concentrate economic power, is very likely to form an unbridgeable barrier to wider share ownership. It is therefore an illusion to think that concentration of wealth and power can thus be influenced by a process, the development of which actually requires its removal.

² See D. GUSTAFSON (1968), *op. cit.*, pp. 27-28.

Secondly, it is by no means certain that concentration of economic power can be reduced by broader equity ownership. On the contrary, such concentration may actually be intensified if the increase in shares placed with investors leads to dilution of minority interests, to the extent that the controlling shareholders come to wield power over a relatively higher volume of capital. 20

At this juncture, the idea that securities markets can act to redistribute income and wealth is also discounted. Given that the underlying mechanism involved in this process is not a one-way phenomenon, since equity investments can also result in losses, and that the effects *a priori* are unknown and extremely doubtful, it follows that this is anything but the best way to pursue social objectives based on the redistribution of wealth and income. Finally, for so long as share ownership and share issues are fairly restricted, it is indeed likely that the existing imbalances will be accentuated and that any benefits accruing from the ownership of shares in enterprises will be enjoyed solely by a small circle of individuals belonging to medium- to high- income groups³.

U Tun Wai and Patrick reach similar conclusions when they maintain that the development of a securities market would perhaps not involve these adverse effects if « a country had a vigorous program of wealth redistribution by capital, estate or inheritance taxes ». However they rapidly qualify this by saying that « we know of no market-oriented LDC with such policies »⁴.

³ An indirect confirmation of this assumption and the typical structure of share - and bondholders by income group and issuers by size of enterprise is provided by the experience in Ghana, described by H.L. ENGBERG (1976) *op. cit.*, p. 23.

⁴ Cfr. U TUN WAI and PATRICK (1973) *op. cit.*, p. 260. They also add that in such circumstances a securities market « would enable corporations to change ownership without serious disruption and wealthy taxpayers could diversify their portfolios ».

Even so, in my view, this is more a theoretic hypothesis than a real one (as the authors themselves stress) and however acceptable and convincing it may be, it still does not allay the doubts expressed earlier on about whether this mechanism would work, even where efficient schemes for redistributing income and wealth existed.

2.3. The effects of a securities market on corporate management and as a stimulus to entrepreneurial capacity.

This third set of objectives has a closer bearing on corporate management, to which a broader shareholding base could provide an incentive for improvement in a number of respects. In fact, it may be supposed that where a company goes public, it will be stimulated to earn higher profits and to employ skilled professional management⁵. In addition to making better use of latent entrepreneurial capacity, this would also lead to improved accounting practices, greater profit orientation and more disclosure of information, thus also yielding social benefits.

While it is quite possible that such effects might come about, I am somewhat sceptical about whether firms would also be induced to maximise profits rather than pursuing other goals⁶.

This is because, first, there is no reason to think that, before going public, companies aim at a set of objectives in which the profit motive carries relatively little weight, and secondly because in practice it has been frequently observed that, just when ownership and control become split, the arrival of professional managers leads to other objectives emerging along with profit maximisation. In some cases, these other objectives are based on the personal interests and goals of the new managers.

⁵ Cfr. U TUN WAI and PATRICK (1973) *op. cit.*, p. 260.

⁶ A hypothesis put forward by U TUN WAI and PATRICK (1973) *op. cit.*, p. 260.

2.4. *The contribution of a securities market to indigenisation and/or privatisation of productive activities.*

There remains to be considered one further kind of role securities markets may be called on to play in LDCs, which in general has not been adequately emphasised. This involves the process of indigenisation and/or privatisation of business activity⁷, and is of very considerable interest not only in terms of the scope of these objectives, but also because the processes needed to achieve them may provide an effective way of creating and in the initial stages at least, developing an equities market.

It is a well-established fact that one of the main problems in countries that are highly dependent on foreign capital and other production factors is how gradually to free the business sector from foreign control without seriously jeopardising economic growth. This is clearly a highly complex problem that cannot easily be solved. It calls for intervention on a variety of fronts, a review of which falls outside the terms of reference of this study. I would merely note that one of the ways of indigenising an economic system is, first, to persuade foreign-controlled companies to sell shares at a fair price to local interests under the terms of rights issues reserved for them, and secondly, to encourage a flow of private domestic savings into equity investments.

⁷ In addition to the Ivory Coast, which is examined in this paper (see Section I Part II), the following studies dealing with experience in Kenya and Nigeria are worth consulting regarding the role an equities market can play in the process of indigenisation and privatisation of business activity and the mutual impact this can achieve: E.A. AROWOLO (1971) *op. cit.*, pp. 447 and following; H.L. ENGBERG (1976), *op. cit.*, pp. 13 and 21-22; D. GUSTAFSON (1965), *op. cit.*, pp. 147-149; HON P. MBOYA, *The Role of the Private Sector in Kenyan National Development*, in P.A. THOMAS, *Private Enterprise and the East African Company*, *op. cit.*, pp. 202-203 and G.O. NWANKWO, *Basic Economics, an Introduction for West African Students*, Cambridge University Press, Cambridge, 1977, p. 251, and *Public Participation in the Nigerian Financial Sector*, in «Savings and Development», Finafrica Quarterly Review, No. 3, 1979, pp. 190-191.

Provided it does not entail any particularly coercitive measures, action taken along these lines can yield a number of definite benefits, such as continuity in growth, achieved by avoiding any drastic premature divestment by foreign interests, and a larger degree of control over the firms concerned. Also, a greater slice of profits previously exported will tend to be retained and re-distributed in the country, and so forth.

Of course, such a process involves solely the capital factor and hence requires additional measures aimed at correcting other factors that cause dependence on foreign countries. It also presupposes the formation of a fair-sized volume of private savings, and that surplus units will have a propensity to invest in leading shares.

Yet, apart from the limitations and problems that may arise, which are not worth dwelling on here, it is of interest to note one positive aspect of indigenisation and privatisation of business activity, where this is implemented along the lines described. In effect, it enables one major obstacle to be overcome that frequently obstructs the growth of an equities market, namely the unwillingness of firms to go public. A transfer of shares held by Government authorities and the indigenisation of foreign-controlled companies, would in fact allow a volume of shares in better keeping with absorption capacity of surplus units to be gradually brought to market at the appropriate time.

Even so, this positive aspect should not be overestimated, since the leeway for manoeuvre will be directly dependent on the quantity of securities that the public sector is able to transfer to the private sector, and on the number and size of firms that will stand to benefit by indigenisation. It should also be added that once the equities available run out, any further growth in the supply of shares will rest entirely with the growth of the firms themselves and the degree to which they are willing to go public. In any case, experience in some countries⁸ tends to lend

⁸ The Kenyan experience is discussed by H.L. ENGBERG (1976), *op. cit.*,

credence to the notion that the development of a securities market will to a large extent depend on the variety of other factors discussed in the preceding sections, and that the effect of these processes in themselves is generally fairly limited.

2.5. The effects of a securities market on the conduct of monetary policy.

To complete this review of the role a securities market can play in an LDC, there only remains to be discussed the effects that such a market can exert on the conduct of monetary policy. This is a fairly complex subject and cannot be dealt with adequately without knowledge and detailed analysis of a series of related factors, ranging from the structural and functional features of the economic and financial system, the operating capability of institutions in charge of monetary policy, and so forth.

I shall therefore confine myself to noting two points. The existence of an organised securities market, particularly a bond market may enable the range of financial instruments and intervention procedures available to the policy-makers to be expanded. However, at the same time, such a market may create considerable difficulties in conducting monetary policy, as a result of the possible need to intervene in support of financial market prices⁹ or to achieve aims which may run counter to other ob-

pp. 21-22. In Nigeria, indigenisation was encouraged by two decrees. The first of these, enacted in 1972, required foreign-owned companies to raise local equity ownership to 40%, this being increased to 60% by another decree in 1977 (cfr. « Quarterly Economic Review of Nigeria », 2nd Quarter 1977, The Economist Intelligence United Ltd., pp. 6-9 and 3rd Quarter 1977, p. 9). Regarding the Nigerian experience, see the report entitled *Nigeria in the Financial Times* of 29th and 30th August 1978, in addition to the studies referred to in Note 80.

⁹ E.S. SHAW (1973), *op. cit.*, p. 45 is highly critical of the effects of a securities market on both the conduct of monetary policy and the concentration of economic power, when he says that « The concentration of economic power must increase because only the securities of firms with reliable access to wealth

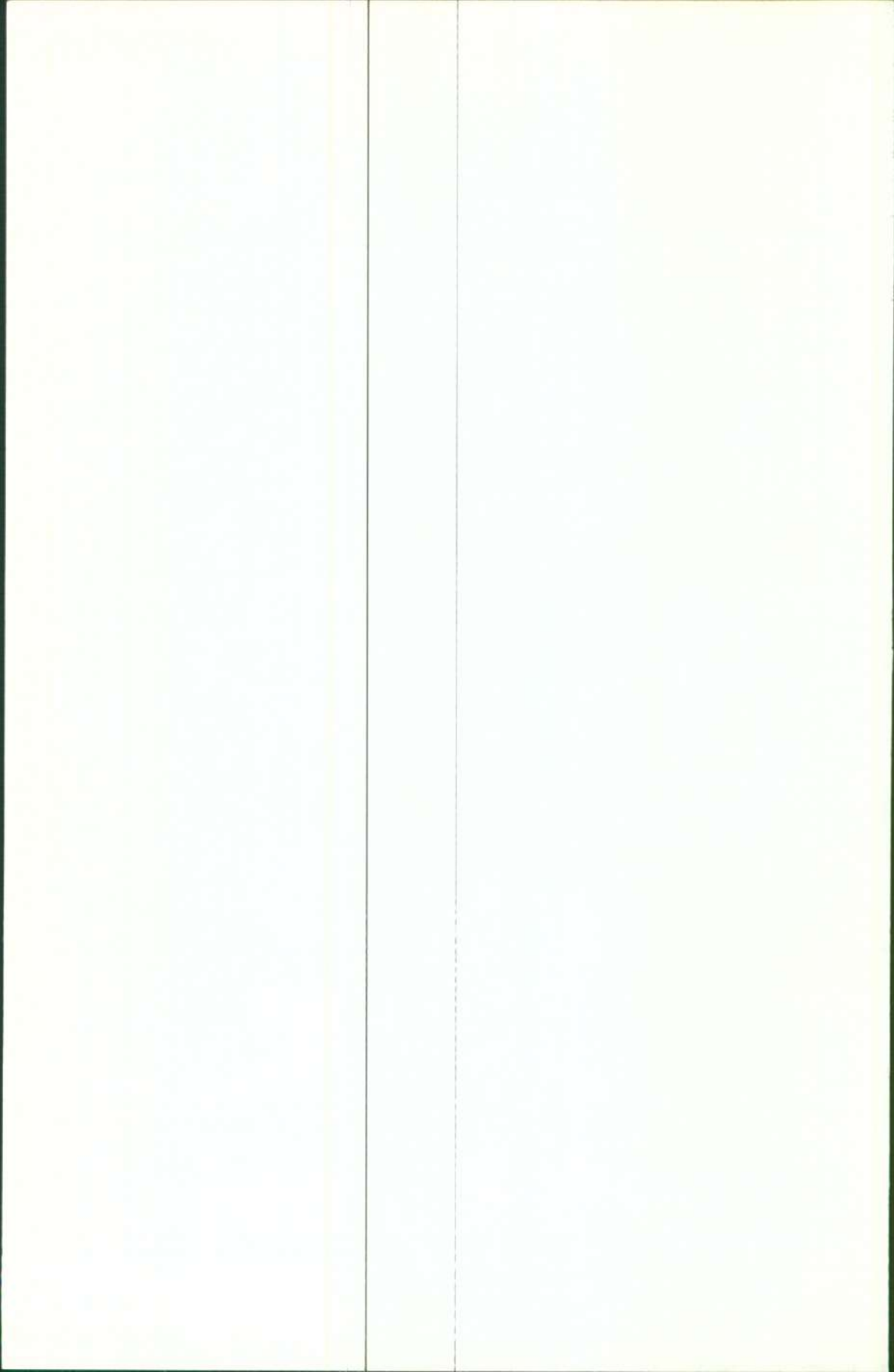
jectives. Careful thought should thus be given to this other aspect and the resulting effects, especially in terms of the scope for action by the central bank in the widest sense, and the relative state of development and stability of the financial market.

On the basis of the points thus far made, one's conclusion is that the creation of a securities market — even if this consists mainly of issuers represented by financial intermediaries — may provide a very limited contribution to economic development in LDCs and to the solution of their financial problems, if indeed it makes any contribution at all.

Even so, given the generalised nature of the analysis and the wide variety of different situations in the less developed world, it cannot be ruled out that a securities market may achieve a fair degree of success in specific countries. In my view however, these are likely to be restricted to but a few cases. Given the limitations in both the supply of, and demand for funds, it seems fair to conclude that, in general, a securities market may yield benefits only where industrialisation is well under way and where there is a fairly well-developed and consolidated financial market.

These are not of course the only factors that have an influence. Other circumstances will also be of prime importance, and in order to develop this analysis, it is desirable to attempt to identify the prerequisites for the creation of a securities market.

and favour can command savers' attentions. Intervention by the central bank to stabilise the equity or debenture market would be one more source of endogeneity in the supply of nominal money ».



3. THE PREREQUISITES FOR THE CREATION OF A SECURITIES MARKET

Two points must be made before seeking to pinpoint the preconditions for a securities market to benefit the financial structure of an LDC.

The first is that it is impossible clearly to identify what these conditions are, and the degree to which they are necessary. Obviously, this is because there are no generally valid rules for defining them, and also because such yardsticks as there may be will vary considerably from one country to another. In addition, as the overall effect is, in the final analysis, what really matters, an accurate assessment of the importance of each prerequisite and its relative degree of significance can only be made by reference to all the prerequisites as a whole and to the different ways in which they are combined in practical reality in each of the countries observed.

The second point is that even where the existence of these prerequisites is established, this does not imply that a securities market will in any event be a success, and exert positive effects, but simply that such a market can be established. In effect, its onward development and the pursuit of its desired goals will be conditional upon a host of other factors, some of which have been indirectly indicated in the preceding section.

Given the foregoing, the circumstances reviewed below should be taken solely as a very rough indication of what are the prerequisites needed to set up a securities market.

3.1. *Adequacy of local businesses in terms of quality and size.*

Despite the very general terms of reference that have been mentioned, it can certainly be said that one absolutely vital precondition is the existence of a fair number of firms in a position to issue shares to the public in the first place and to maintain the supply of such shares. This in turn implies some degree of industrialisation and the presence of fairly large firms. The latter precondition is a matter of course if one considers the requisites in terms of the quality prospective issuers must have in order to gain access to the market and place their shares with the public, quite apart from any limits imposed by regulations.

In fact, it may be objected that the foregoing circumstances are not essential, in the sense the share issues could be concentrated in the hands of certain types of financial intermediary, who would simultaneously be providing the finance needed by the firms, inter alia by acquiring their shares. In my view, however, this is a highly restricted assumption which could be valid for only a limited period, since in the first place, the financial intermediaries concerned would sooner or later be faced with the need to turn over their investment portfolios, and hence transfer to the public the shares they hold. Secondly, if they were to restrict themselves to financing the long-term capital requirements of the firms by lending them money, it is reasonable to assume that funds could be raised through other financial instruments which would satisfactorily meet such requirements, without necessarily issuing securities. Furthermore, in this case, the firms themselves would be fully saddled with the problem of raising venture capital. Thirdly, as the number of such financial intermediaries is extremely limited in LDCs anyway, issuers would be little diversified, if at all.

It is therefore reasonable to conclude that any solution of this kind would be of a highly temporary nature, also for other reasons it is not worth recalling here.

It might possibly be of use in the initial stages of getting a securities market off the ground, in particular, where this had to be achieved by supply lending, that is, steps taken to equip a country's economic and financial system with new financial institutions and instruments before the demand for these from the business community actually made itself felt¹. However, once the initial stage was completed, the market should be able to rely on a broader selection of issuers and adequate inflow of securities on a continuing basis.

Similar considerations apply to the process of indigenisation and privatisation of production. They may represent a useful means of activating a securities market (even where supply-lending is the norm). Yet, as their effects will still perforce be limited to the companies and volume of securities involved, the subsequent growth and fate of the latter will continue to depend on whether the conditions just referred to actually exist.

3.2. *The level and distribution of domestic savings and the skill of people in charge of selecting investments.*

A second set of essential prerequisites lies in the formation of a reasonable volume of domestic savings, especially in the household sector. In particular, the flow of savings must not be sporadic, as is typically the case in many LDCs, and must be adequately distributed among the surplus units. These aspects are closely interrelated, where they do not indeed depend on the level and distribution of income and wealth² and other real factors, which consequently also form other prerequisites.

¹ This is a concept put forward by H.T. PATRICK (1967), *op. cit.*, pp. 174-176, whereby « supply leading » (defined as described in the text and as innovations aimed at getting the financial market to play an active role in economic development) is distinguished from « demand-following », where new financial institutions and instruments are created in response to specific demand by the business community.

² H.B. DA FONSECA (1971), *op. cit.*, pp. 64-67 makes a number of points on the interrelation of income distribution and savings formation and the

It should be noted that the concentration of savings in the hands of middle- to high-income groups is not in itself a handicap to the promotion of, and growth in demand for, securities. Indeed, in terms of quantity, if these groups are large enough, they could actually encourage the achievement of better result vis-à-vis the extreme hypothesis of a situation where savings formation was very widely spread with the emphasis on low- to middle-income groups, who tend to have less economic education, are averse to risk, and in general have a higher liquidity preference.

However, an excessive concentration of savings in the hands of a small number of individuals could pose a severe limit to the growth of a securities market. Moreover, where such a market did exist, it would in all likelihood lead to even greater concentration of economic power as already noted, and would exert a distorting effect on the distribution of wealth.

Subject to the availability of an adequate volume of savings³, a further precondition from the viewpoint of demand for securities is a fair degree of economic education on the part of those in charge of selecting investments and an inclination by them to employ funds in a way in which a premium is not placed on liquidity alone. Further vitally important factors are also the degree to which the economy is monetised⁴, and the growth

limits to expansion of capital markets with reference to Latin America. See also U.N.I.D.O., *Domestic and External Financing* (1967), *op. cit.*, pp. 3-9 and 31-32.

³ The importance of this prerequisite is also shown, albeit from a different angle by GRAEME S. DORRANCE, *The Instruments of Monetary Policy in Countries without Highly Developed Capital Markets* in « I.M.F. Staff Papers », Vol. XII, 1965, pp. 274-275.

⁴ The positive effects exerted by a fair degree of monetisation on the new issues market in Kenya have been stressed by H.L. ENGBERG (1976), *op. cit.*, p. 24. Regarding the possible effects on portfolio selection in various economic sectors see: ANAND G. CHANDAVARKAR, *Monetisation of Developing Economies*, in « I.M.F. Staff Papers », November 1977, pp. 706-708 and A.R. NOBAY, *Manipulating Demand for Money: Discussion*, in M. PARKIN - A.R.

and distribution on a territorial basis of financial intermediaries who can play an essential role in popularising securities in a variety of ways.

Without overlooking or underestimating the special contribution that can be made by institutions such as investment banks, development banks and other specialist bodies of this kind⁵, it is fair to state that the attitude taken by the commercial banks will be critical. In any country, irrespective of structural and functional differences in the banking system, these banks are in a position to provide valuable support for a primary and secondary securities market, owing to their widespread branch networks and extensive relationships with the business community as a whole. Their cooperation is thus essential, especially if it is borne in mind that LDCs are particularly short of institutions specialising in the placement and marketing of securities, and, in any case, such institutions could not base their activities on such transactions alone, in view of the limited returns available on a small turnover.

3.3. *The level and structure of yields on financial investments.*

Along with the circumstances outlined above, a further vital prerequisite, which has a critical influence on demand for securities, is the level and structure of yields on financial investment. These must be differentiated on the basis of the degree of risk and liquidity of each type of investment and they must be formed as a result of the free action of market forces. In other words, yields on securities should not be artificially maintained at below their market equilibrium rates, and should

NOBAY, *Essays in Modern Economics: The Proceedings of the Association of University Teachers of Economics*, London, 1973, p. 338.

⁵ Cfr. H.B. DA FONSECA (1971), *op. cit.*, pp. 96-97; DAVID GILI, *The Role of Investment Banking in Developing Countries*, in « Savings and Development », Finafrica Quarterly Review, No. 3, 1980.

be adequately differentiated from the returns offered on other types of financial asset.

Likewise, no attempt should be made to create an artificial differential in favour of securities, by holding down interest rates on other financial assets. This would lead to a risk of discouraging investments in securities on the one hand, and the formation of financial savings on the other. These aspects should be particularly emphasised in view of the fact that numerous LDCs have for many years pursued such policies, which run counter to the liberalisation of interest rates⁶, and these policies are still fairly widespread.

3.4. *Other political, social and legal factors.*

The final set of prerequisites are defined by Goldsmith as objectives of prime importance, a *sine qua non* for promoting economic growth by mobilising domestic resources⁷, above all, through establishment of a securities market. They are the following:

i) a high degree of long-term political and economic stability

ii) a reasonably stable outlook for the purchasing power of money

iii) a well-established legal framework which reliably regulates corporate activities, the ownership and circulation of securities, and relations between issuers of shares and those who subscribe to them

iv) an equitable and sound tax system.

⁶ Cfr. U TUN WAI and PATRICK (1973), *op. cit.*, pp. 283-284. See also NICOLAS KRUL, *Quelques Aspects de la Collecte de l'Epargne dans les Pays en Voie de Développement*, in « Saggi in onore di Giordano Dell'Amore », Vol. I, Giuffrè, Milan, 1969, pp. 155-160.

⁷ Cfr. R.W. GOLDSMITH (1971), *op. cit.*, p. 36.

The importance of each of these conditions is such as to require no comment. In any case, there is quite a large bibliography which can be consulted ⁸.

Perhaps only one of these factors — monetary stability — calls for a brief discussion dictated by the need to set out the various opinions that are held on the subject. It is often maintained that a stock market can be launched with fair success even in a permanently inflationary situation, if indexation schemes are introduced. Examples of countries are quoted to support this theory, but in fact these are rare exceptions, and no consideration has been given to the side effects and overall implications of such schemes.

In my view, monetary stability is a *sine qua non*, especially at the initial stages of any securities market, whether it be based on equities or bonds. As well as being likely to generate major distortions, indexation would discourage companies from issuing stock, and in all probability would not even stimulate demand for securities. Indeed, it is reasonable to assume that for various reasons including lack of confidence and of economic training on the part of individuals, as well as various barriers of a psychological nature, savers would be more inclined to plump for liquidity rather than investing in long-dated financial assets, even if these were index-linked. In any event, if a system of indexation were adopted that worked completely effectively for investors, the costs for private issuers would be prohibitive, and this would therefore penalise the market in terms of the supply of securities.

Albeit restricted to essentials, the foregoing points made on the prerequisites required to set up a securities market lead me

⁸ See: H.B. DA FONSECA (1971), *op. cit.*, pp. 70-74; R.W. GOLDSMITH (1971), *op. cit.*, pp. 18-21; D. GUSTAFSON (1968), *op. cit.*, pp. 30-32; P. PERERA (1969), *op. cit.*, pp. 79 and elsewhere; C. SEGRE (1971), *op. cit.*, p. 46 and following.

to reaffirm my conviction that such a market would only be viable in a situation where development of a country's economic and financial structure was already in full swing. At the same time, it is clear how very few third world countries are actually in such a situation.

4. MEASURES AIMED AT ENCOURAGING THE GROWTH OF SECURITIES MARKETS

Given the existence of the foregoing prerequisites, the establishment of a securities market, (whether this occurs as a result of demand-following, i.e., on the spontaneous initiative of potential issuers, subscribers or intermediaries specialising in securities dealing, or as a result of supply-leading, namely on the initiative of the authorities and banks), will have to be accompanied by a series of measures aimed at securing its success and growth.

Such measures have been discussed by almost all those who have dealt with the subject, albeit marginally, including those who take a highly critical attitude to the value of securities markets in LDCs. Were it not for the fact that many of the proposals in this area seem figments of imagination and « common sense », rather than closely worked-out ideas, at this stage I would simply confine myself to referring to the bibliography concerned.

However, given this situation, one should attempt to make a brief analysis of the measures most useful in this field, without going into a highly detailed review, for which I shall give the necessary bibliographical references as I proceed.

These measures, the choice of which will depend on a large variety of local environmental factors, should ideally be classified into three categories, according to whether they are aimed at influencing *a*) the supply of securities *b*) encouraging the demand for them, or *c*) the structure, organisation and operations of the new issue and secondary markets.

4.1. *Measures aimed at influencing the supply of securities.*

The main objective of policies of this kind is to stimulate the issue of a sufficiently wide and diversified volume of securities that is in keeping with the market's ability to absorb them.

Assuming that there are no particular difficulties in issuing Government securities and those placed on the market by financial intermediaries, the problem boils down to overcoming the reluctance of private firms to make use of this financing channel¹ a tendency that has been mentioned earlier on.

Intervention here can take three forms: *a*) coercion; *b*) tax incentives and/or penalties; *c*) other kinds of encouragement.

Policies of type *b*) tend to take the form of requiring certain firms more or less compulsorily to issue or circulate their stock among the public. One of the more simple measures in this field consists of automatically listing companies officially on the stock exchange when they reach a given size or have other special features. This is generally perforce accompanied by a requirement to offer to the public a certain number of new or existing shares, so as to ensure actual circulation and market distribution of a substantial parcel of stock.

In comparison with the coercitive measures that have yet to be discussed, this is theoretically a more acceptable step, in that it entails lower costs and less risk. Although it invariably amounts to restricting the companies' freedom of choice, provided it is implemented in such a way as not to impinge on the position of the existing controlling group or work to the financial disadvantage of that group² or the company's operations in

¹ Of course, both financial intermediaries and private firms must have attained a size and importance compatible with the potential prerogatives of going public. These aspects have already been mentioned as prerequisites for the formation of a securities market and hence are not considered as being subject to the policies discussed in this chapter.

² This may be guaranteed by fixing a fair offering or transfer price to the public when the company's shares are first listed and at subsequent stages.

general, it should not give rise to any particular problems. However the possible adverse impact of these measures on corporate growth should not be underestimated, since, if the companies concerned see them as an unacceptable constraint or as a disrupting factor to be avoided at all costs, they may actually be induced to limit the physical growth of their business. This would result in the size of manufacturing units being artificially held down to below its potential.

Can you give some examples

The desirability or otherwise of adopting these policies should thus be assessed very carefully, and in any case they should be implemented in a highly flexible manner so as not to act as a deterrent to growth. In other words, if this policy is to be used, it would be better not to make it a general measure but to restrict it to those firms who were willing to accept it, namely in the form of flotation being made subject to the consent of the firm involved³.

Another coercitive means of expanding corporate share issues would be to impose limits on borrowings from banks or other financial intermediaries. These limits could be based on compliance with given debt/equity ratios in the borrower company⁴, or, taken to the extreme, a limitation on its maximum indirect credit limit.

In the former case, which also applies to « mandatory » listing, an effect would be exerted on the supply of shares. In the latter, the aim would also be to encourage financing in the form of bonds.

Measures of this kind, contrary as they are to financial liberalisation, should be completely ruled out. In the first place, it is by

³ In analysing these specific measures U TUN WAI and PATRICK (1973), *op. cit.*, p. 289 note that « This apparently runs so contrary to concepts of the rights of private ownership in market-oriented economies — concepts that the capital market presumably embodies — that to our knowledge no country has used its regulatory powers in this manner ».

⁴ This hypothesis is considered by J.P. DRAKE (1977), *op. cit.*, p. 84, but he concludes it would not be feasible in practice.

no means certain that their desired objectives would be attained; indeed, they might actually be counterproductive and lead to a build-up in credit negotiations on unofficial markets. Secondly, as well as being difficult to administer, they would have a disastrous effect on the finances and profits of the companies concerned.

Serious doubts also arise about a third type of coercion policy, which consists of requiring foreign companies to issue or transfer to local business interests a certain proportion of their equity. The indirect version of this policy is to place restrictions on such foreign companies borrowing from abroad. Apart from anything else, action of this kind may discourage the investment of fresh foreign capital and lead to the progressive withdrawal of existing such capital.

It might also bring about a reduction in the country's overall resources available for investment, not only if foreign companies are actually restricted in their borrowings from abroad⁵, but also if they are forced to borrow local capital by issuing shares, thereby *de facto* restricting their foreign borrowings anyway.

Steps of this kind should thus be considered permissible only where they form part of a deliberate and carefully thought-out policy of indigenisation. Otherwise, it would be more advisable to encourage foreign companies to place their shares on the domestic market on a voluntary basis, or do so through Government or semi-Government organisations where the companies concerned are the result of joint ventures between foreign businesses and local governments or institutions⁶.

Looking now at fiscal policies aimed at expanding issues by private companies, these are generally directed at reducing the

⁵ See J.P. DRAKE (1977), *op. cit.*, p. 85.

⁶ Cfr. E.A. AROWOLO (1971), *op. cit.*, pp. 463-464 and C. SEGRE (1971), *op. cit.*, pp. 57-58, who deals specifically with the role that can be played by official aid agencies.

cost of funding incurred by certain companies on the securities market, or at penalising those companies which do not raise funds from the market although they are in a position to do so. Tax incentives of this kind can take various forms and involve funds raised through both equities and bonds. They include:

i) corporate income tax rates graded according to whether the company is listed or not, the number of its shareholders, or the extent to which its shares are held by the public;

ii) deductibility (total or at higher rates) from taxable income in respect of dividends or bond interest paid, in some cases discriminating vis-à-vis indirect borrowings;

iii) dividends being taxed at a lower rate than retained profits.

Tax penalisation obviously works in a similar way but in the opposite direction, by raising the rates payable by companies which are being encouraged to go public above those applied to the majority of listed companies.

Without going into further details of the technical aspects of these measures⁷ it should first be pointed out that if a choice has to be made between penalties and incentives, incentives are much to be preferred. Penalisation should be avoided, since as it tends to discriminate in a negative direction, its outcome is unfair treatment, and it may have a serious impact on companies at the receiving end, without producing the result desired.

The same is true of tax rates which *de facto* penalise internal cash generation in the interests of a bigger dividend payout. Here, if it is desired to increase the number of shares in issue, it is not necessary to raise tax on retained profits⁸, since there is the alternative of granting concessions on capitalisation issues taken from reserves. In this way, no obstacles would be placed in the way of self-financing, a vital factor in corporate growth,

⁷ For further details see, inter alia, C. SEGRE (1971), *op. cit.*, pp. 47-48; U TUN WAI and PATRICK (1973), *op. cit.*, pp. 289-290.

⁸ This policy is referred to by C. SEGRE (1971), *op. cit.*, pp. 47-48.

and very similar results would be achieved on a more direct basis, since the decisions involved would be placed in the hands of each company rather than with a large number of potential subscribers.

Secondly, it should be pointed out that even the granting of incentives is of very dubious value. This is because it is difficult to assess whether the company actually meets certain requirements to be eligible for these incentives, such as the number of its shareholders or the number of its shares held by the public, and also because the costs incurred by the community as a whole might outweigh the benefits to be gained. Nor should the possible adverse effects on distribution of income and wealth be overlooked, arising from the fact that the largest companies would stand to benefit most, namely precisely those that in all likelihood already enjoy a privileged position in various other ways. In addition, there is a danger of distorting the mechanisms for allocating savings and of upsetting the capital market, in an environment in which action is generally needed to reduce the segmentation of that market.

Bearing in mind the foregoing points, one's conclusion is that fiscal instruments should not be used to encourage the issue of securities. In any case, where their use is deemed advisable in specific circumstances, they should be as equitable as possible and any distortions should be avoided. The relative costs and benefits involved should also be very carefully evaluated, by reference not to the securities market alone as so often occurs, but to the financial market as an indivisible whole⁹.

To summarise, if private enterprises are to be stimulated to go public, action along lines other than the majority of those mentioned above should be taken, involving measures that do not carry the risk of negative effects that outweigh the results

⁹ The overall approach that must be taken to the financial market and the arbitrary nature of any distinction attempted within it has been highlighted inter alia by GIORDANO DELL'AMORE in *I Mercati Monetari*, Giuffrè, Milan, 1969, p. 23.

they may achieve or that involve any other effects that are hard to predict or measure. The policies that should be adopted should thus aim first at encouraging companies to go public on a voluntary basis, and secondly at facilitating access to the securities market by making the process less onerous. Action here should be geared to providing assistance in preparing and carrying out flotations, and in the development of an institutional framework that is conducive to easy access to the market on a continuing basis, while reducing the costs involved and those incurred in going public in the first place. Such measures principally involve proper organisation of the new issue and secondary markets, which at the beginning of this section were classified for convenience's sake into a category standing on its own. They call for only brief comment, since their choice will be closely contingent on a series of factors, which will tend to vary from one country to another ¹⁰.

These will include, for instance, the structural and functional characteristics of the financial system, the types of intermediary operating within that system, the kind of Government intervention employed and so forth.

I shall therefore confine myself to stressing once again the need to set up organisations that specialise in arranging share issues, or alternatively, to enlist the assistance of commercial banks, which is anyway of crucial importance at various other levels. An important role can also be played by medium-term credit banks, investment banks or other financial service bodies and holding companies controlled by the Government, which among other things can help new enterprises and smaller businesses to come to the market, and keep an eye on their subsequent fortunes by intervening, where appropriate, on the secondary market.

¹⁰ These aspects have been analysed in detail and proposals made inter alia by H.B. DA FONSECA (1971), *op. cit.*, pp. 90-97; D. GUSTAFSON (1968), *op. cit.*, pp. 32-46; L. LOXLEY (1969), *op. cit.*, pp. 149-156; P. PERERA (1969), *op. cit.*, and C. SEGRE (1971), *op. cit.*, pp. 57-59.

The secondary market should also be organised on a formal basis and should include organisations which specialise in securities dealing. The establishment of a stock exchange is thus essential, and where conditions do not exist for securities dealers to transact business profitably, then once again the cooperation of the commercial banks must be sought, while carefully regulating their stockbroking activities¹¹.

Still on the subject of the institutional framework, a further type of intervention, aimed in this case at stimulating the demand for securities, concerns institutional investors. Among these, an especially important part can be played by investment management companies run on a trustee basis for a large number of investors. Such companies provide a useful means of channeling household savings into investments in securities¹². LDCs in which there is a major problem of getting savers to invest in the stock market would certainly stand to benefit from the services of such organisations.

In fact, the volume of business that mutual funds and similar institutions might expect in most LDCs is hardly likely to justify their setting up house spontaneously in such small markets even at a fairly advanced stage of development. In these circumstances, the role of mutual funds should be played by other intermediaries whose activities are already diversified into various sectors, including securities dealing and services provided to issuers and subscribers¹³. Alternatively, in the absence

¹¹ The pros and cons of this « fall-back » solution are discussed in the sections dealing with individual securities markets.

¹² There are no studies of experience in this field in countries with relatively undeveloped financial structures. Even so, a recent book based mainly on experience in the United States is worth quoting, owing to the interesting information it provides and the useful assessment it gives of the role played by institutional investors. This is MARSHALL E. BLUME and IRWIN FRIEND, *The Changing Role of the Individual Investor*, John Wiley & Sons, New York, 1978.

¹³ See D. GILL (1980), *op. cit.*

of private initiatives, it may be appropriate for Government authorities to take on the task of promoting such organisations, in the form considered to be most appropriate and subject to prior analysis of opportunity costs, possibly by making use of existing Government-controlled institutions.

Even so, it should again be pointed out that in markets that are relatively undeveloped from an institutional viewpoint, the commercial banks are potentially best placed to provide such services in terms of both the results that can be achieved, and costs. Needless to say, such banks would have to be willing to play an active role in this field and to support the growth of the securities market. Otherwise, the various alternative solutions proposed would certainly be preferable¹⁴.

4.2. Measures aimed at increasing the demand for securities.

There now remain to be discussed policies aimed at stimulating demand for securities other than those covered in the previous section. These can be classified into two broad categories, according to whether they are directed at institutional or individual investors.

Policies aimed at institutional investors should encourage a demand for funds complementary to that from individual investors, and should not simply result in creating closed financial circuits, thus defeating any attempt to activate a real market as such. In addition, one should avoid the very common mistake of imposing tight controls on the management of portfolios by institutional investors through regulations which *de facto* mean that they can only act as buyers, and thus inhibit them from playing an active role in dealing on the secondary market. Rather, action should be taken to ensure that institutional investors do not

¹⁴ In both cases, these theories are borne out by actual findings in the country-by-country survey.

simply operate as buyers « of last resort », but work on a continuous basis to offset short term market anomalies, and if necessary, to meet possible temporary excesses of demand over supply by selling off securities held in their own portfolios.

As to measures taken to encourage subscription by individual investors, one should first and foremost rule out any coercitive measures, such as any obligation to subscribe to a given volume of securities based on income, or other guidelines. This amounts to nothing short of expropriation, and is impossible to reconcile either with the tenets of the market or the more fundamental principle of free choice. As the few actual known experiments in this field have shown¹⁵, they tend to put all investors right off securities even for a long time after the measures themselves have been abolished.

Guidelines for intervention generally proposed involve policies aimed at increasing the attractions of securities in terms of both liquidity and returns.

On the liquidity front, the central bank or other institutions are usually required to intervene continuously on the market in order to smooth trading and allow securities to be sold. However, it should be noted that there are at least two major limitations to this action, first that it is inadvisable to peg interest rates at rates below the market rate¹⁶, and secondly, and even more important, that it is possible to lose control of the money supply and set off an inflationary spiral. Intervention of this kind should thus be restricted to eliminating erratic movements rather than running against the basic trend of the market. Otherwise, there is a risk of instilling an attitude similar to that of savers and depositors in the business community, and failing to train it how to invest in securities by making it fully aware of the risks involved.

¹⁵ See, for instance, the Tunisian experience referred to in Chapter 2, Part II, Section 1.2.7.

¹⁶ Cfr. U TUN WAI and PATRICK (1973), *op. cit.*, pp. 291-292.

In any case, these practices are open to serious doubt, since as previously noted, they can lead policy-makers (who may not always be highly experienced) into operations that jeopardise orderly growth in money supply.

The granting of tax incentives to investors is also a dubious practice¹⁷, whether these take the form of tax exemption on capital gains from investments or deductions for tax purposes on funds employed in securities, for similar reasons to the doubts already expressed about encouraging issuers. The effect in both cases is to reduce fiscal revenue, or raise other taxes, which may lead to concentrating the fiscal burden in an unfair way, and which runs counter to the precept of treating all types of financial asset in a uniform manner for tax purposes. Furthermore, these policies may distort distribution of wealth and income owing to the fact that most of the beneficiaries (buyers of securities) belong to the wealthier classes. Also, it is very doubtful whether these measures in themselves can encourage investment on the part of middle- to lower-income groups.

Not necessary
Not an
OK

Even so, tax concessions, albeit officially motivated by totally different intentions, are in some cases necessary where there is an inefficient tax system, in order to stimulate investments in securities. In such a situation, the medium- to high-income groups who already have ample opportunities for evasion will not be penalised but given privileged treatment. Where this occurs, exactly the opposite effect is achieved to that ideally intended.

In this case too, the use of fiscal measures should be assessed with great care. They can be used, provided they ensure that uniform treatment is given to all types of financial asset and do not bring about distortions.

On the other hand, what is really necessary if the demand for securities is to be encouraged is a variety of steps designed to

¹⁷ See N. KRUL (1969), *op. cit.*, p. 1161.

improve the economic training of individuals backed by ongoing information on a large scale to assist them in selecting investments. This can be most useful in raising the quality of professional skills in the widest sense among the business community as a whole, irrespective of whether they are surplus or deficit units, and in improving the operation of the financial system. The cost of these measures need not be prohibitive, given the reasonably cheap access Government and other authorities will have to a wide range of media. However, there seem to be no countries in which action of this kind has been taken on a really systematic basis.

Finally, if savers are to be attracted to securities investments, the terms and conditions of issue must be set out in an easily comprehensible fashion, with the emphasis on reducing the risk element.

In conclusion, only a few of the foregoing measures can be recommended wholeheartedly. With many others, serious doubts arise as to cost-effectiveness. A very cautious attitude is thus needed, and the pros and cons of the various effects that may be brought about should be very carefully weighed.

5. THE COSTS AND RISKS INVOLVED IN ESTABLISHING A SECURITIES MARKET IN AN LDC

There are a great many ways in which any given country can mobilise economic surpluses and allocate savings among potential investments. Generally they are classified into two categories, according to whether they give rise to internal or external financing processes. Very roughly, the former category comprises internal cash generation, inflation and taxation, while the latter embraces direct and indirect financing, endowments, along with public sector, private sector and foreign loans.

Gurley and Shaw¹ have drawn attention to certain criteria for selecting saving-investment techniques, and have pointed out that the optimum combination — which forms the basis for a country's financial structure — will tend to vary in space and time, according to various historical, social, economic and environmental factors.

According to these authors, it can be assumed that « the objective of public policy regarding the saving-investment process... is to maximise the capital value of anticipated real consumption. Given a social discount rate, the technology or combination of technologies for eliciting and allocating saving is best which implies highest consumer welfare, counting Government among consumers. The optimal consumption stream has the qua-

¹ Cfr. J.G. GURLEY and E.S. SHAW, *Financial Structure and Economic Development*, in « Economic Development and Cultural Change », Vol. 15, No. 3, April 1967. The criteria for selecting an institutional basis for financial processes are also covered by Shaw in a subsequent study. Cfr. E.S. SHAW (1973), *op. cit.*, pp. 78-79.

lities of equity and stability that conform to a social welfare function »².

Boiled down to the essentials, the optimum combination is that which ensures the most economic input of real resources required by the saving-investment process, whilst providing for the most efficient mobilisation and allocation of savings and stabilising the flow of consumption. In all this, it should be the combination which is most compatible with the ethical principle of equity³.

Gurley and Shaw also maintain that there is an optimum combination of financing techniques for each country at each stage of its development, and that this is achieved when no net yield in terms of the capital value of expected real consumption is obtained when the input of factors represented by the range of techniques is altered. Net yield consists of the difference between gross yield and the factor cost of the contribution that each saving-investment process makes to the well-being of the consumer.

Gross yield can be identified as the effects produced by additional input of resources in the various saving-investment techniques. These effects are: *i*) increases in the savings rate and flow which imply gains in terms of future consumption; *ii*) improvements in the allocation of savings as between alternative investments; *iii*) a reduction in excessive variances in prospective consumption flows; *iv*) changes in the distribution of consumption such as to enhance wealth and income.

On the factor cost side, it should be noted that the productive resources absorbed by each technology give rise to a social cost and an opportunity cost in terms of consumption (measured in terms of capital value), which is waived by diverting resources to other uses. These costs include not only production factors

² *Ibid.*, p. 264.

³ *Ibid.*, p. 267.

absorbed by institutions and financial markets but also those used by savings and investment units in managing their assets and liabilities⁴.

The foregoing concepts should provide terms of reference for decision-making as to how a country's financial structure is to be organised, and hence the actual formation of a securities market. Accordingly, any decision to establish such a market must be preceded by a careful assessment of the costs and gross yield it will generate. This assessment should also take account of the effects of the market on other financial processes, by reason of the substitutive effect between direct financing techniques, indirect financing techniques and internal financing processes⁵. This point is worth making, since the costs and benefits associated with the establishment of a securities market are frequently considered in isolation, while overlooking the impact such a market may have on the activities of each type of financial intermediary and the implications of possible transfers of productive factors from some saving-investment processes to others. It goes without saying that when assessments of this kind involve significant financial innovations, they are anything but simple, and it is reasonable to assume *a priori* that they are only feasible in principle, and that anyway, gradual experimentation will be needed. In any case, this theory needs to be tested in practice.

Nevertheless, it would seem appropriate to put forward some general considerations on the costs and risks involved in setting up securities markets in LDCs. I have confined myself to discussing these two aspects since most of the components of cost and gross yield (in terms of effects on the formation and allocation of savings, the redistribution of wealth, the costs of access etc.) have already been covered in the preceding sections.

⁴ *Ibid.*, pp. 264-265.

⁵ This is of course in addition to the substitutive effect within each group of financing techniques.

Naturally, for these reasons I am fully aware of the very general nature of the views that will be expressed, which, as noted, should rather be deployed along the lines just mentioned.

5.1. *Structure, operating and access costs.*

The first point worth dwelling on here relates to the costs incurred in setting up a securities market. They can be classified into two categories (which are in fact closely interrelated) depending on whether they are involved in *a*) the structure, organisation and operation of the market or *b*) access to it on the part of issuers and subscribers and the administration of their holdings.

Although it is impossible to quantify in the abstract each type of cost, it is reasonable to assume that they will vary according to the kind of measures adopted to encourage the growth of the securities market and the degree to which the prerequisites for its creation exist. As has been shown, such measures can significantly increase costs as a result of the absorption of real resources they bring about and/or the distorted redistribution effects they may cause. The relative presence or absence of prerequisites will directly affect the type and degree of action needed to activate and support the market, as well as influencing the results that can be achieved.

Contrary to views expressed by some authours⁶, my opinion is that if the prerequisites discussed earlier on exist, and if the measures referred to in the preceding section are adopted alone, the overall cost burden need not be very high, for the following reasons.

The initial operating costs will consist of the premises, personnel and equipment used for the stock exchange. If unneces-

⁶ Cfr. E.S. SHAW (1973), *op. cit.*, p. 145. In quoting Shaw, I am merely expressing some reservations about the fact that he considers the direct costs of setting up a stock exchange to be high, whereas I entirely agree with him when it comes to the risks and indirect costs this may involve.

sary frills and luxury are avoided, the cost of premises will be fairly low. Only a few rooms are needed, plus a dealing floor, which can be provided even by the Government at little more cost to the taxpayer than that of a monument. The property will also form a permanent asset, which can be used at any time for other purposes. *yes*

Operating costs in terms of personnel and equipment can also be kept fairly low, particularly if the staff is professionally skilled and efficient. Personnel outlays generally represent the highest of these costs, but need not be excessive, *inter alia* because of the type of service provided to dealers, in terms of compliance with regulations governing the circulation of securities.

The same applies to the equipment needed to run the market, which on the whole is fairly limited, as sophisticated devices are unnecessary and in any case would not be warranted by the generally small volume of trading ⁷.

The foregoing is borne out by the fact that all the stock exchanges investigated in this study are in a position to operate without any Government grant on a self-sufficient basis from commissions received, which are very small and do not represent a significant burden on dealers, even where trading volume is low.

A second set of operating costs involve those incurred in supervision and control. Here again, these are unlikely to be excessive and certainly no more than those required to supervise other financial institutions. In any case, in assessing these costs, the benefits of a general nature accruing from the regulation and careful supervision of companies and other issuers and of transactions on both the new issue and secondary markets should be borne in mind.

⁷ On this point I fully concur with J.P. DRAKE (1977), *op. cit.*, pp. 88-89, who puts forward similar views while criticising the position taken by SHAW referred to in Note 113.

On the other hand, the most onerous costs are likely to be those associated with access to the market by issuers and subscribers, namely those incurred in the placement of and dealing in securities. These require specialist bodies, the establishment of which calls for the absorption of quite considerable resources. However, this aspect should not be overestimated, since these costs can be held in check, if not very substantially reduced by enlisting the cooperation of banks and other financial intermediaries, as mentioned previously. If this is possible, this type of transaction and hence the actual operation of the market can be handled by existing bodies, involving a negligible increase in costs, for so long as the volume of trading does not justify the introduction of specialist organisations.

5.2. *The risk of jeopardising the growth and stability of the financial structure and economic system.* *

In terms of costs, then, the creation of a securities market would not appear to pose any particular problem, always provided that the necessary prerequisites exist and that only the kinds of supportive action mentioned above are used. Even so, it should be pointed out that the picture is incomplete, since it does not take into account the risk which may be incurred, and other aspects such as the impact of the market on mobilisation and allocation of savings, investment outlays, income distribution, reallocation of existing real resources, the concentration of economic power, the control of monetary aggregates, and so on.

These latter aspects have all been fully discussed in the preceding sections and require no further comment. At this juncture, however, it is worth drawing attention to two kinds of risk that can be incurred when establishing a securities market in an LDC.

The first type of risk is highly significant where premature steps are taken to create such a market in an economic and financial environment that is not yet ready for it. This may re-

sult in severely jeopardising the development and stability of the country's financial structure as a whole, as well as considerably delaying the growth of the market itself⁸. In effect, fluctuations in stock prices typical of such markets may well give rise to a negative reaction in relatively naive and immature savers. Where this also leads to them shying off other financial instruments as well, it may cause severe disruption to the country's financial structure as a whole.

In agreement with Shaw⁹ it should furthermore be pointed out that in such circumstances the risk also arises of the Government and monetary authorities attempting to support the market by taking defensive action in a counter-productive and very costly fashion. This could include tax incentives which ultimately benefit only the wealthier classes, artificial constraints on short-term interest rates and intervention to stabilise market prices to the detriment of money supply.

The second type of risk to which attention should be drawn is that implicit in the typical instability of securities markets and the effects of this instability on business activity and fluctuations in economic trends. This is one of the central criticisms levelled against stock markets and joint-stock companies by certain economists (some, but not all, of Marxist inspiration)¹⁰, although their arguments are in many cases dubious.

⁸ This second type of risk has been stressed by ARNALDO MAURI in *Il Mercato di Credito nei Paesi Sottosviluppati*, Giuffrè, Milan, 1966, p. 89, where he states that it is desirable for the development and diversification of the financial structure to occur on a gradual basis in keeping with the process of economic growth.

Views contrary to the premature establishment of stock exchanges have also been expressed (as mentioned in the footnotes to Mauri's study) in publications issued by international organisations, in view of the risks entailed (cfr. DEPARTMENT OF ECONOMIC AFFAIRS, UNITED NATIONS, *Domestic Financing of Economic Development*, New York, 1950).

⁹ Cfr. E.S. SHAW (1973), *op. cit.*, pp. 145-147.

¹⁰ See J.K. GALBRAITH, *The New Industrial State*, Penguin Books, E. MANDEL, *Traité d'Economie Marxiste*, Rene Julliard, Paris, 1962, Vol. I,

Without going into details on this subject, it is enough for the purposes of this study to note that public companies may be severely affected by management changes, and even more so by financing requirements and the need for capital expenditures in relation to their stock market performance. This is notoriously affected by speculation, along with irrational and emotional factors which invariably come to the fore where an assessment has to be made in a climate of uncertainty.

This latter factor tends to generate instability per se and to accentuate fluctuations in manufacturing activity. On this point, it would seem of considerable interest to recall the acute views put forward by Keynes¹¹.

Keynesian economic theory is based on explaining economic cycles in terms of fluctuations in the propensity to consume, of the preference for liquidity, and above all, of the marginal efficiency of capital. The latter, which along with the level of interest rates (albeit with greater efficiency), determines the volume of investment, depends in turn on the availability, or shortage of capital goods, their current production cost, and current expectations as to the yield they may produce¹². The expectations, which play a dominant role in determining the size of the investment in the case of durable goods, are based on a very precarious foundation and are affected by psychological factors and the degree of familiarity with the factors that govern the returns available on any given investment in time¹³.

According to Keynes, securities markets, by virtue of the way in which share prices discount such expectations, or rather the way in which they are formed, make any assessment of the

Chap. VII, Sections 8, 9 and 10; J. ROBINSON, *Economic Heresies*, Basic Books, 1971 Chap. 8, Section 2 and J. ROBINSON and J. EATWELL, *An Introduction to Modern Economics*, McGraw-Hill, London, 1973, Part II, Chap. 8, Section 2.

¹¹ Cfr. J.M. KEYNES, *The General Theory of Employment, Interest and Money*, Macmillan, London 1936.

¹² *Ibid.*, pp. 313-316.

¹³ *Ibid.*, pp. 148-151.

marginal efficiency of capital subject to wide fluctuation, and hence tend to increase the instability of the economic system¹⁴. Indeed he states that « It is of the nature of organised investment markets, under the influence of purchasers largely ignorant of what they are buying and of speculators who are more concerned with forecasting the next shift of market sentiment than with a reasonable estimate of the future yields of capital-assets, that when disillusion falls upon an over-optimistic and over-bought market, it should fall with sudden and even catastrophic force. Moreover, the dismay and uncertainty as to the future which accompanies a collapse in the marginal efficiency of capital naturally precipitates a sharp increase in liquidity-preference and hence a rise in the rate of interest »¹⁵. Both these factors directly affect the volume of investment and cause it to fall¹⁶.

Yet securities markets also tend to accentuate cyclical fluctuations by another route. This additional effect, according to Keynes, arises from the fact that « a serious fall in the marginal efficiency of capital also tends to affect adversely the propensity to consume. For it involves severe decline in the market value of Stock Exchange equities. Now, on the class who take an active

¹⁴ *Ibid.*, pp. 319-320 and 150-151.

¹⁵ *Ibid.*, pp. 315-316.

¹⁶ Regarding investment decisions, Keynes notes that « although the private investor is seldom himself directly responsible for new investment, nevertheless the entrepreneurs who are directly responsible, will find it financially advantageous, and often unavoidable, to fall in with the ideas of the market, even though they themselves are better instructed ». (*Ibid.*, p. 316, Note 1).

He provides the following explanation on this: « In my *Treatise on Money* (Vol. II, p. 195) I pointed out that when a company's shares are quoted very high so that it can raise more capital by issuing more shares on favourable terms, this has the same effect as if it could borrow at a lower rate of interest. I should now describe this by saying that a high quotation for existing equities involves an increase in the marginal efficiency of the corresponding type of capital and therefore has the same effect (since investment depends on a comparison between the marginal efficiency of the capital and the rate of interest) as a fall in the rate of interest ». *Ibid.*, p. 151, Note 1.

interest in their Stock Exchange investments, especially if they are employing borrowed funds, this naturally exerts a very depressing influence. These people are perhaps even more influenced in their readiness to spend by rises and falls in the value of their investments than by the state of their income, and this circumstance, generally overlooked until lately, obviously serves to aggravate still further the depressing effect of a decline in the marginal efficiency of capital »¹⁷.

Similar movements, albeit obviously in the opposite direction, occur at times of expansion.

In brief, then, securities markets may aggravate economic instability by generating fluctuations in the marginal efficiency of capital they produce. These in turn affect the level of investment and increase the propensity to consume. Reverting to the processes whereby fluctuations in economic activity are likely to be accentuated, and in some cases generated, by securities markets, it is of interest to dwell on the reasons which lead Keynes to consider the conditions in which market prices are determined as being extremely precarious, and hence giving rise to violent fluctuations in the marginal efficiency of capital.

Here he notes that « As a result of the gradual increase in the proportion of the equity in the community's aggregate capital investment which is owned by persons who do not manage and have no special knowledge of the circumstances, either actual or prospective, of the business in question, the element of real knowledge in the valuation of investments by those who own them or contemplate purchasing them has seriously declined »¹⁸. « Day-to-day fluctuations in the profits of existing investments, which are obviously of ephemeral and non-significant character, tend to have an altogether excessive, and even an absurd, influence on the market... A conventional valuation which

¹⁷ *Ibid.*, p. 319.

¹⁸ *Ibid.*, p. 153.

is established as the outcome of the mass psychology of a large number of ignorant individuals is liable to change violently as the result of a sudden fluctuation of opinion due to factors which do not really make much difference to the prospective yield »¹⁹.

The presence on the market of professional experts in competition with each other, does not alter this situation in Keynes' view, since « ... most of these persons (Author's note: professional investors and speculators) are in fact, largely concerned, not with making superior long-term forecasts of the probable yield of an investment over its whole life, but with foreseeing changes in the conventional basis of valuation a short time ahead of the general public »²⁰.

Yet even if instability due to speculation is ruled out, there is still, in Keynes' opinion, « the instability due to the characteristic human nature that a large proportion of our positive activities depends on spontaneous optimism rather than on a mathematical expectation, whether moral or hedonistic or economic »²¹.

Accordingly, apart from speculation, securities markets, as well as being precarious for various reasons, such as ignorance on the part of investors of the principles needed to assess corporate profitability, are also unstable because of the psychological factors concerned, and this instability may accentuate cyclical fluctuations.

¹⁹ *Ibid.*, pp. 153-154.

²⁰ *Ibid.*, p. 154. It should be noted that Keynes also felt that speculation did not always prevail over enterprise, defined as predicting the prospective yield on capital assets throughout their life (pp. 138-139). However, he rapidly qualified this by stating that « As the organisation of investment markets improves, the risk of the predominance of speculation does, however, increase ». *Ibid.*, p. 158 and « speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation » (*Ibid.*, p. 159).

²¹ *Ibid.*, p. 161.

In the light of what has just been said, many of the doubts previously expressed about the costs and effects that may be involved in developing securities markets in LDCs emerge with greater force. They should thus be taken into proper account when a decision is being made as to whether to launch such a market, bearing particularly in mind the risk of introducing a further factor of instability into an economic system that may well already be fragile and undeveloped.

This clearly does not mean that one should give up the idea of enriching a country's financial structure with an organised stock market, since if the prerequisites are there, it may significantly facilitate the process of investment ²².

²² Keynes himself reached the following conclusions: « The spectacle of modern investment markets has sometimes moved me towards the conclusion that (one should) make the purchase of an investment permanent and indissoluble, like marriage... For this would force the investor to direct his mind to the long-term prospects and to those only. But a little consideration of this expedient brings us up against a dilemma, and shows us how the liquidity of investment markets often facilitates, though it sometimes impedes, the course of new investment... if individual purchases of investments were rendered illiquid, this might seriously impede new investment so long as *alternative ways* in which to hold his savings are available to the individual. This is the dilemma ». *Ibid.*, p. 160.

CONCLUSIONS

On the basis of this analysis, one may conclude that securities markets cannot make a significant contribution to economic growth in Third World countries. This conclusion is fully confirmed by direct experience in specific countries, with the exception of a very few nations in which conditions are substantially different from those found in the typical LDC. Even here there is no plausible evidence to suggest that their securities markets stimulated economic growth; rather, the success of such markets seems to have been a result of such growth.

Yet this is not the main aspect that it is intended to stress, on which a broad consensus of opinion exists in any case. In the author's view, even where the creation and operation of a securities market is not a very costly process, the risks it can involve make the whole exercise very dubious. Indeed, such a market may seriously jeopardise the growth and stability of a country's financial structure, may introduce factors which tend to aggravate, if not originate economic fluctuation, and may adversely affect the allocation of savings, reallocation of existing real wealth, redistribution of income and the conduct of monetary policy. The importance of these factors and the likelihood of their occurring is such as to lead one to take an attitude which is in principle contrary to the establishment of securities markets in LDCs as a whole. In any event, as U Tun Wai and Patrick¹ have rightly shown, « capital markets are not a necessary condition for economic development », and experience in a variety of countries has clearly borne this out.

¹ Cfr. U TUN WAI and PATRICK (1973), *op. cit.*, p. 300.

Efforts to improve the structure and operation of the financial system, with particular reference to the financing of productive investment should rather be concentrated on a gradual approach, making use of commercial banks and medium- and long-term credit institutions. Consideration can be given to establishing a securities market when economic take-off is already a *fait accompli* and the country is at an advanced stage of industrialisation, always provided that a careful assessment has been made of the costs and risks involved and that the existence of the necessary prerequisites has been proven. ✓