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DOMESTIC FINANCING OF INDUSTRY

Submitted by the Government of Greece

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I. INTRODUCTION

1. The scope of the present paper is to discuss some problems related to the mobilization of domestic savings for the long-term financing of industrial development of low-income countries. Although most of these problems are common to nearly every developing country and have been extensively discussed in the past, it may be useful to re-examine them in the light of the experience acquired in the course of the Greek industrial development efforts.

2. The problem of adequate and rational financing of industrial development has three aspects each of which, although closely inter-related with the others, requires specific and independent treatment. In this sense we may distinguish the following three issues. First, the inadequacy of aggregate saving to sustain an adequate volume of over-all investment. This problem, which has been vividly emphasized in the context of the vicious circle of poverty, should hardly be underestimated, especially with reference to the external financing requirements of developing countries seeking to promote industrialization. Nevertheless, in view of the exhaustive treatment of the subject in the past, it would not detain us here. Second, in addition to the inadequacy of aggregate saving to finance over-all

investment there is a greater scarcity of funds available for industrial investment. This is due to the fact that only a relatively small part of aggregate savings is channeled into what may be termed "controlled channels", namely banks and the capital market. Thus, the level and rate of growth of loanable funds to the industrial sector reflect not only the scarcity of aggregate savings but also the fact that the part of total savings which takes the form of bank deposits and investments in securities is highly inadequate. Consequently parallel to bringing about an upward shift in the savings function, it is of equal importance to attract an increasing part of total savings into "controlled channels". The second paragraph of this paper deals with some aspects of this problem. Third, in view of the well-known divergence between social productivity and private profitability in developing countries, the allocation of whatever savings are directed into "controlled channels" cannot be left to be determined solely by the defective interplay of market forces. This means that the monetary authorities of developing countries have the additional task of securing a rational allocation of available and controlable savings and this is the subject of the third paragraph of the present paper.

II. PROBLEMS OF DIRECTING SAVINGS INTO "CONTROLLED CHANNELS"

3. The total amount of savings accruing into "controlled channels" as a percentage both of gross national product and of total gross saving is usually low in developing countries. Among various reasons making for this development we should mention the following: the high propensity of the population to invest in real assets as a result of its sensitivity towards inflation;

the lack of tradition to invest in financial assets and especially in securities; the inefficient working of the capital market; the absence as well as the inadequate development of basic institutions in the capital market, and the lack of information of the public with respect to financial transactions and to existing opportunities for profitable financial investment.

4. The greek experience during the last decade illustrates the effectiveness of a consistent policy of monetary stability in strengthening the flow of savings accruing to "controlled channels". Between 1956 and 1966 the net increase in private bank deposits as a percentage of disposable income rose from 1.7% to 5.0%. On the other hand, issues of new securities rose from zero before 1956 to 0.50% of gross national product during the period 1956-60 and to 1.0% during the period 1961-66.

5. The interest rate policy on deposits and bonds proved, in the greek case, a very effective device to encourage the flow of controlled savings. This policy has been based on the assumption that the allocation of savings between financial and real assets, under conditions of monetary stability, is affected considerably by structural changes in relative yields.

6. The overall amount as well as the structure of controlled savings are of crucial importance regarding their mobilization and use for capital formation in industry. The concentration of controlled savings in highly liquid assets leads to a rapid increase of the overall liquidity and narrows the margins for sound financing of new investment. The accumulation of the larger part of controlled savings into institutions less suited to deal with long-term financing problems (e.g. commercial banks) and the lack of an

organized market for shares hampers the establishment and proper financing of new industrial undertakings as well as the improvement of the capital structure of existing ones.

7. In developing countries controlled savings take usually the form of highly liquid claims against the banking system, whereas the capital market is not sufficiently developed. These developments could be attributed to the same reasons mentioned above in paragraph (3). An additional reason is the shortage of supply of securities appealing to the public. This is due to the family character of most industrial corporations plus the tendency of commercial and other banks to keep a permanent participation in major industrial concerns. The following measures may help to increase both the supply for and the demand of securities and to develop the capital market in general:

a. Tax incentives to strengthen the demand for securities. Securities issued by the public and the private sector should be put on the same footing.

b. Tax incentives to strengthen the supply of first rate securities (special tax exemptions should be confined to those corporations offering part of their equity capital to public subscription).

c. Tax incentives favoring the establishment of large corporations as well as the merging of small undertakings into larger, viable ones.

d. The issue of indexed loans or the provision of other safeguards against inflation.

e. The issue of debentures with participation in profits.

of debentures convertible into shares, and of priviliged shares without voting rights.

f. The conversion of public enterprises (especially public utilities) into mixed companies. The Government may maintain the control of those enterprises and in exchange may guarantee a minimum dividend to private shareholders.

g. The Government and State controlled financial institutions should keep in permanent offer to the general public first rate securities from their portfolio.

h. Private banks should be directed and given tax facilities to liquidate part of their portfolio of industrial securities and play an active role in the capital market.

i. State controlled financial institutions while financing large industrial enterprises should make arrangements to acquire part of their equity capital without interfering with the control of the company.

j. The operation of the overall capital market should be supervised by a governmental body specifically organized for that purpose. The functions of such a body should cover activities like the timing of new issues, the approval for new quotations in the Stock Exchange, the supervision of quoted companies and investment trusts etc.

k. The Government should encourage and facilitate through fiscal and other measures the establishment and growth of institutions such as Unit Trusts, Mutual Funds, Life Insurance Companies etc., the role of which consists in collecting small and medium size savings for investment in securities. Public entities such as social insurance funds and other institutions, should also be given facilities and guidance for investing in the capital market, including both bonds and shares. The establishment of Unit Trusts may help toward this direction.

ka. Foreign firms and other corporations which are granted special privileges should be obliged to offer part of their capital to public subscription.

kb. Measures should be taken to improve the intermediation facilities both in the new issue market (underwriting, distribution) and in the Stock Exchange. The banks should also take over some of those responsibilities.

Kc. The Government should fill existing gaps in the supply of securities by issuing its own securities. Care should be taken, however, of the right assessment of the actual condition on the demand side, in order to avoid overburdening the market at the expense of private issues.

III. PROBLEMS OF ALLOCATION OF FINANCIAL RESOURCES

8. The mechanism of the rate of interest is not effective for the allocation of financial savings according to the priorities set by a consistent industrial development policy. The classical prerequisites to reach a satisfactory equilibrium through the market mechanism are missing far more in the developing economies than they are in the developed ones. Therefore, liberalizing credit transactions in developing countries beyond certain extent would mean waste of resources and inconsistency in respect to the policy of economic development. Selective credit controls in those countries are imperative to channel adequate resources to capital

formation in industry. Furthermore, selective credit controls work more effectively in the less developed countries where financial organization is less sophisticated. Under such conditions the rate of interest keeps to a certain extent its distributive role intra-sectorally but not inter-sectorally. In Greece selective controls contributed a great deal to channeling domestic funds to long-term financing of industry. Thus, commercial banks are obliged to set aside 15% of their total deposits for long-term credit to industry plus another 6% of the increase in their deposits since 1965 to finance the development of small scale industries. Until used, these funds are deposited with the Bank of Greece at an interest rate of 2%. Long-term credits to industry granted through the state and the private investment banks on the other hand are financed out of long-term funds controlled by the monetary authorities. Moreover, the law providing for tax priviliges on securities as well as the law to attract foreign capital favor industrial investments. As a result of this policy the share of total gross investments in the country (except dwellings) financed through organized financial markets rose from 8.26% in 1956 to 35.49% in 1966 on the basis of domestic savings only and from 36.72% to 62.14% including external financing.

9. Commercial banks which collect the major part of total financial savings are not well suited to meet the long-term financial needs of industry. This is due both to lack of speciulization and to liquidity considerations. In Greece we have tried to deal with this problem bearing in mind that it is both institutional and operational. The proliferation of financial institutions cannot always provide the best solution to the said problem, given the shortage of adequately qualified persons to staff new institutions

and the impact therefrom on the cost of money. Given the above considerations, the greek authorities resorted to a combination of the following measures:

a. They established an obligation for the commercial banks to grant long-term loans as we mentioned in paragraph (8.)

b. They encouraged the establishment of three financial institutions specialized in long-term financing. One of these institutions is state-controlled. They also supported the operations of these institutions by providing ample long-term funds controlled by them (i.e. savings of public entities deposited compulsorily with the Bank of Greece).

c. They supported the liquidity of commercial banks through long-term funds controlled by the monetary authorities.

10. A final point is presently in order regarding the inadequacy of self-financing in the industrial sector of developing countries and the ensuing over-borrowing of industrial undertakings. The narrow margins for self-financing and the absence of organized capital market lead most industrial enterprises to a situation of high gearing of capital. This situation is further deteriorated because usually the financing of trade is effected through suppliers' credits, i.e. through the intermediation of industry. Over-borrowing restricts the margins for further expansion of industry and renders entrepreneurs less inflation-minded. Furthermore, it involves an excessive participation of the banking system in risks and introduces a credit bias in favor of the over-borrowed firms.

To cope with problems arising out of insufficient self-financing the following measures may prove useful:

a. The financing institutions and especially those controlled by the State should offer their financial assistance partly in the form of participation in equity capital. The banks may acquire provisionally the respective securities up to the time they could sell them to the public. The banks should also look after organizing joint industrial ventures with foreign capital.

b. Measures to facilitate the direct financing of trade from the banking system (as for example interest rate incentives etc.).

c. The Government can help industrial concerns by undertaking part of their risk. This assistance should be used as an incentive for the full mobilization of entrepreneurs' own capital as well as for the attraction of foreign risk capital. The State assistance could take the form either of participation in the equity capital with an option of the entrepreneurs for repurchase of shares or of a direct guaranty for loans obtained elsewhere. The latter method has been used in Greece in order to assist small industries to obtain loans from the commercial banks.

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