NON-BANK FINANCIAL INSTITUTIONS AND ECONOMIC DEVELOPMENT

Ahmed Kooros*

Unlike Paulus Athena who came full grown out of the forehead of Zeus, the father of gods, the theory of economic development within the framework of capital mobilization and entrepreneurial attitudes has had a long history of evolution. The essence of economic development was first conceived of theoretically by David Ricardo who considered capital formation as the engine of economic expansion.[1] Productivity, or the volume of production, which is enhanced by the augmentation of capital resources, not only determines but actually defines the size of the market-hence supply creates its own market. The classical argument does not, however, overlook the fact that the willingness to save and the incentives to invest govern the supply of capital.

While the willingness to save hinges on a comparison between the rate of interest and the utility per unit of consumption, the incentive to invest will be choked off if the rate of profit per unit of output lags behind the rate of interest including the risk involved in undertaking a given enterprise. The Ricardian theory maintains that in case of free trade, the marginal productivity and hence the return per unit of capital will be high where capital in relation to labour, is scarce. And, of course, conversely. Now, if it were not for risk and other extraneous obstacles, capital would flow from countries where the rate of return on capital is low to areas where the rate is high.

Over one hundred and fifty years have elapsed since this theory was first formulated and yet not much capital has been channelled into the developing countries from countries which

have been fortunate in having fast rates of capital formation. It may be that capital would only flow from a capital-intensive to a labour-intensive country if investment could simultaneously be undertaken in a number of complementary and supplementary industries.

In competition with the classical theory, there has been the Schumpeterian argument which maintains that progress is obtainable through the waves of creative destruction generated by a considerable number of entrepreneurs and their imitators who carry out innovations, putting out new commodities and re-designing combinations of productive factors. The waves of innovations, according to Schumpeter, result, "each time ... in an avalanche of consumers' goods that permanently deepens and widens the disturbance, losses and unemployment.[2]" Schumpeter's Theory, which was intended to outline the contour of the rise and growth of western capitalism, is inapplicable to developing countries since the forces needed to destroy the roots of economic stagnation in developing countries cannot be mobilized spontaneously. It may be that they are to be formed, as in Japan, deliberately and initially by the state.

After World War II, under the auspices of the United Nations, many studies were undertaken to find ways in which the fate of the "backward" countries of the world could be improved. It was, then, accepted that the vicious circle of poverty could be broken by a determined effort on the part of the developing countries and also by the inflow of capital from the capital rich countries to the capital-poor countries. The United Nations has always recommended that the developed and industrialized countries of the world should allocate a given percentage of their GNP to the developing countries. Whether or not this recommendation has been needed is not the issue here.

After the war another suggestion which gained prominence in academic circles and enchanted policy-makers all over the world was embodied in the idea of balanced growth. This advocated a frontal attack in "a more or less synchronized application of capital to a wide range of different industries ... catering for mass production." These industries are to be "complementary in the sense that they provide

a market for, and thus support, each other".[3] The architect of this argument states that the agrarian societies cannot promote their own development by relying on exports of foodstuffs and materials whose price elasticity of demand is usually less than unity, that is, the expansion of export output reduces total revenue. Under the conditions indicated it seems reasonable to conclude that, "economic growth in underdeveloped countries must largely take the form of increased production for domestic markets. "One should expect that this development will tend in the long run to increase rather than impede the expansion of international trade."[4]

With the prevalence and acceptance of this argument came a package-deal which included, among its ingredients, promotion of import-substitution industries,and protection of these industries through tariffs and low interest rate subsidies. It should be mentioned in passing that the industrial development banks have been the engine to generate waves of industrial progress in developing countries. It has been reported[5] that between 1950 and 1967, the developing countries experienced an average annual rate of growth of production of goods and services (GDP) of 4.8 per cent which was considerably faster than the growth rates estimated for the presently industrialized countries in the early stages of their development: 2 per cent in the U.K. between 1770 and 1820, 2.7 per cent in Germany between 1850 and 1880, and about 4 per cent in Japan between 1876 and 1900. Of course, the high rate of population expansion in the developing countries has reduced the per capita income in these countries. It is not easy to relate this high rate of economic expansion to the policy adopted by the emerging nations since the 1950's. The fact remains that if the developing countries wish to remain on the expansion path, they must mobilize capital resources domestically and internationally.

The Pearson Report indicates that in the 1960's about 85 per cent of investment in the developing countries was financed out of domestic savings. While the average savings-income ratio was 15.0 and the average investment-income ratio was 18.0 per cent during 1960-67, the ratios for the industrialized countries were respectively 22.0 and 21.0 per cent. Although the developing countries' present savings and investment ratios lag behind those of the developed countries

the developing countries' present performance in mobilizing saving compares quite favourably with the historical investment rates of about 10 per cent in Europe and the U.S. in the 19th century. The following table gives the saving-income and investment-income ratios for the SEANZA countries in 1968. (The data for India were not available.) Clearly, the higher the savings-income ratio is, the greater will be the potential to grow. Whereas the savings-income ratio indicates the ability to grow, the investment-income ratio reveals the desire to grow. Obviously if the savings-income ratio lags behind the investment-income ratio, part of investment has been financed out of foreign resources.

Table 1: Three fundamental ratios for the SEANZA participating countries[a]

	$\frac{S}{GNP}$[b]	$\frac{1}{GNP}$	$\frac{S}{1}$
Australia	23.9	27.4	0.87
New Zealand	22.5	21.9	1.03
Pakistan	12.3	14.1	0.87
Thailand	24.7	25.3	0.98
S. Korea	19.6	25.5	0.77
Ceylon	15.5	14.8	1.04
Iran	18.2	22.2	0.82
Philippines	15.2	20.5	0.74
Malaysia	19.8	17.7	1.12
Canada	23.7	22.1	1.07
U.S.	15.1	13.7	1.1
U.K.	14.2	18.4	0.77
Japan	21.7	33.8	0.64
Indonesia	2.7	9.2	0.29

(a) Data for all countries are for 1968 except for Thailand where the data are for 1967. *International Financial Statistics*, July 1970.
The letter S stands for national savings.

(b) The rapid rise in the savings ratio in the 1960's and the greater reliance of developing countries on their domestic resources is attributable partly to the expansion of banking and non-banking financial institutions to some extent

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the extension of economic frontiers for profitable reinvestment and finally to the growing ability of governments to collect revenues. What concerns us here is the successful establishment and development of commercial banks, investment corporations, savings and loan associations,corporate financing institutions, stock exchange and other non-bank financial intermediaries which accept primary securities and issue their own securities. What do non-bank financial intermediaries actually do? First, they stimulate and promote parsimony. Secondly, they specialize in allocating savings efficiently to alternative capital projects. By accepting primary securities and issuing their own securities, financial intermediaries promote those primary securities which are efficient. Financial institutions, by offering different financial markets and financial assets, can promote the efficient allocation of saving to investment and encourage saving in securities. The creation of new assets and the services which were hitherto unknown to savers, may tend to reduce the nominal rate of interest (take a mortgage bank for an example). All in all, the remarkable attribute of non-bank financial institutions has, on the basis of experience, been the promotion of saving habits and the channelling of saving funds into investment projects.

Savings institutions which have been most effective in the mobilization of domestic savings are: (1) savings and loan associations; (2) savings departments of commercial banks; (3) credit unions; (4) postal savings; (5) mutual funds; (6) savings banks; (7) unit trusts; life insurance; and finally (8) agricultural credit co-operatives.The Regional Commissions of the United Nations and the World Bank have over a number of years, studied the problems of non-bank financial intermediaries in depth and have issued numerous papers on the subject.

Usually, non-bank financial institutions in developing countries are faced with two formidable problems. First, in some developing countries, people are inherently attached to physical assets such as land, jewelry and gold as the safest securities which would not depreciate in the face of an inflation. Secondly, in countries where industries are family owned firms, new investors, such as a new savings and loan associations, are not permitted to participate. Under these circumstances, financial institutions are to convince the

depositors that in depositing their saving in an institution, they can avail themselves of the services that those institutions are prepared to offer to them.

Experience has demonstrated that savings and loan associations are most effective in accumulating the savings of middle and lower-middle income groups, but are not so suitable for low-income groups. On the other hand credit unions, postal savings systems, and provident funds have been more successful in accumulating savings from the low-income groups. Likewise mutual funds are designed primarily for middle and lower-middle income groups as with savings and loan associations. However, the mutual funds and unit trusts are more sophisticated institutions than the cooperative savings organizations. They are suitable for developing countries which have achieved a degree of industrial development because their basic purpose is to accumulate savings for investment in new and expanding industries. In those developing countries which have a growing industry, mutual funds have been successful.

For predominantly agricultural communities, credit unions, farmers co-operatives, and such organizations as rural electrification associations are the most suitable savings institutions, whereas the savings and loan associations, mutual funds and savings banks are more effective organizations for mobilization of savings in urban communities.

Notes

1. *Principles of Political Economy and Taxation,* 1821.
2. *Capitalism, Socialism and Democracy,* 1950, p. 68; quoted in R. Nurkse, *Problems of Capital Formation,* 1952, p.13.
3. *Ibid.,* p.11.
4. *Ibid.,* p.22.
5. *Partners in Development, Report of the Commission on International Development;* L.B. Pearson, Chairman, pp. 27-28.