The probability of New York's International Banking Zone getting launched was increased considerably at the end of 1980 by the submission of the Federal Reserve Board's proposal to permit U.S. banks to establish International Banking Facilities within the U.S. [Cheng (1981)]. The acceptance of this proposal would be a crippling blow to some of the existing offshore banking centres, particularly those located in the Caribbean.

6. Policies for Effective and Efficient Domestic Resource Mobilisation and Allocation in Small Island Developing Economies

The objective of any financial development programme is to raise both the quantity and quality of investment and, hence, to accelerate the rate of economic growth. The majority of such programmes have, in practice, stressed institution building plans - development banks, stock exchanges, etc. They incur substantial resource costs. However, Khatkhate and Villanueva (1978, p.982) conclude:

> The evidence is strong that the specialized institutions are no panacea for solving the basic problem of credit allocation ....

An appropriate legal framework together with price stability are two basic prerequisites for promoting efficient financial intermediation. The legal framework will determine, in large part, the structure of the financial sector. Khatkhate and Riechel (1980) point out the drawbacks of banking laws which enforce specialisation:

> In developing countries, demand for even basic financial services has often not yet been appropriately articulated. In such situations, it appears desirable to generate through official intervention such special sources of supply that can meet socially desirable, albeit partially dormant, private demand. For this purpose, developing countries have often established new specialized financial institutions to satisfy the previously unmet demand. Operations of such institutions are generally insulated from competition by appropriate legislation and are even given substantial subsidies. Such actions are often defended by arguments that resemble those employed in the infant industry advocacy. However, the efficiency gains expected from such specialized and protected institutions are unlikely to be realized, because the necessary competitive conditions are often absent. In fact, a specialized institution created by special statute often assumes a monopoly position. The establishment of a special institution can be justified only if it will expand the overall size of the financial sector, widen its spectrum of financial services, and reduce the degree of concentration. In order to accomplish these goals, the new institution needs to be broadly based and, after the infancy phase is over, needs to be exposed to competitive forces across the board.
> [Khatkhate and Riechel (1980, pp.504-505)]

> The foregoing analysis suggests that the fragmentation of the financial sector that follows from legislated specialization tends to produce two undesirable consequences: a decline in overall efficiency and an increase in the degree of concentration.
> [Khatkhate and Riechel (1980, p.502)]

Khatkhate and Riechel advocate multipurpose or universal banking, citing the German experience as an object lesson for most developing economies, in particular small ones [Khatkhate and Riechel (1980, pp.481-487)]. Legislative and regulatory changes are required in most of the sample countries, with the notable exception of Hong Kong which already has a universal banking system, to permit multipurpose banking.

Four benefits can be derived by switching from specialised to universal banking: (a) improved economic efficiency; (b) more long-term capital; (c) promotion of entrepreneurship; and (d) greater financial stability. Efficiency can be raised through adoption of a universal banking system which can reap greater

economies of scale, be more responsive to changing demands and, at the same time, exhibit increased competitiveness and reduced concentration [Khatkhate and Riechel (1980, p.493)].

Universal banks can supply both short and long-term capital from resources mobilised directly from savers. Specialised development banks - the only suppliers of long-term funds under a specialised system - invariably get most of their resources from other financial intermediaries, e.g., the central bank. Not only does this create inefficient financial layering, it also results almost always in an acute shortage of long-term investible funds.

Universal banks can be expected and encouraged to promote entrepreneurship, as they did during Germany's industrialisation, by offering packages of credit combined with managerial and technical assistance, much as the World Bank does today.

Finally, multipurpose banks may well be less prone to financial instability than specialised financial intermediaries. Scale economies enable them to acquire more information cheaper, transform more short-term liabilities into longer-term assets and diversify their portfolios to greater extents than can smaller, specialised banks [Khatkhate and Riechel (1980, pp.495-497)].

A move towards universal banking has already started in the Western industrial countries, as well as in a few developing countries:

> .... many other developing countries .... sorely disappointed by a lack of long-term financing for development programmes .... are following the richer world's example. They are going down the path of universal banking.
> [Economist (1981, p.96)]

The major potential danger of universal banking, a system under which financial intermediaries are permitted to acquire equity interests in their borrowers,

lies in the conflict-of-interest issue. However, appropriate legislation can confront this potential problem in advance:

> .... conflict-of-interest situations and the prevalence of excessive market power require legislation, like antitrust laws, oriented toward tackling these problems directly rather than indirectly through a narrowing of the range of activities a financial institution can cover. The possibility that such unsavory practices may recur should not be taken as a pretext to devise a straightjacket of banking legislation that would destroy the responsiveness, flexibility, versatility, and the dynamism of the financial system.
> [Khatkhate and Riechel (1980, p.513)]

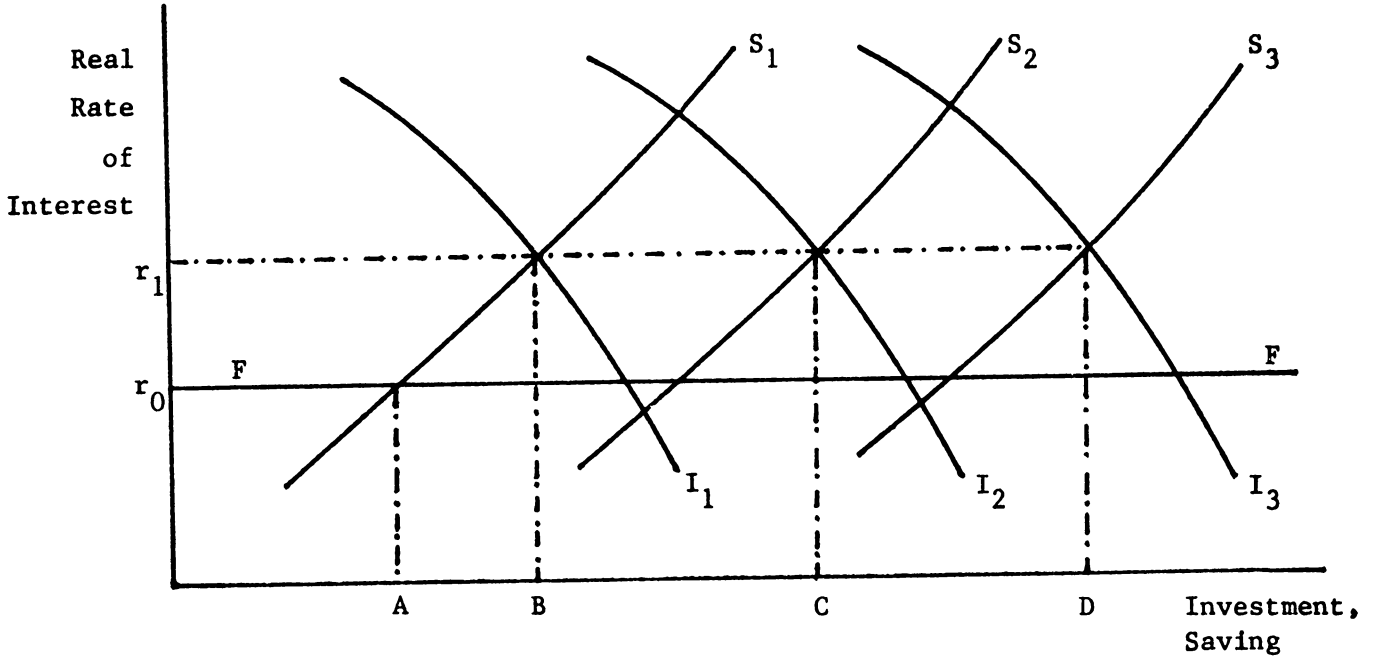
The case for a legislative framework conducive to the development of universal banking is strong. For small island developing economies, the case for encouraging, without discriminatory taxes, large, reputable foreign banks to help develop a universal banking system is even stronger.

Financial development programmes have exhibited a high propensity to collapse in the face of accelerating and increasingly volatile inflation. McKinnon (1973, pp.77-79) and Shaw (1973, pp.119-120) both emphasise low and stable inflation as part of and a prerequisite for financial development. Hence, the foundation stone of any financial development programme in a small island developing economy is control over domestic credit expansion to ensure that an exchange rate policy consistent with low and stable rates of inflation can be pursued. Governments would first have to decide that they are willing to accept the fiscal discipline moderate credit expansion imposes. Then they might give authority and responsibility to the central banks for keeping domestic credit expansion on its noninflationary target.

Financial development and innovation can start once basic financial reform has taken place. Figure 5 shows the objective of financial reform and financial

FIGURE 5

Effects of Financial Repression, Financial Restriction, Financial Reform and Financial Development on Saving and Investment



The saving and investment functions shift upwards and to the right with each step in the programme of financial development. This is achieved by measures which reduce the spread between savers' net returns and investors' gross costs of borrowed funds.

development. Point A is the level of saving and investment under financial repression. The negative real interest rate caused by the ceiling reduces saving to A. Investment can be no greater than foreign saving plus the level of national saving forthcoming at the real interest rate r_0. Low average investment efficiency is anticipated, despite the low quantity of investment.

Point B represents the situation under financial restriction. The interest rate r_1 is the "market" rate, but net returns to savers are well below r_1 and gross costs to borrowers are considerably above r_1. High reserve requirements, taxes on financial transactions and on income from savings, deliberate suppression of certain financial markets, etc., all widen the gap between the net return to savers and the gross cost to borrowers, even in the absence of interest rate ceilings. With interest rate ceilings as well, financial restriction produces a level of saving somewhere between A and B along S_1. This, of course, will also be the level of investment.

Point C is the level of saving and investment achieved after a basic financial reform. Interest rate ceilings have been abolished and the government has accepted the proposition that cheap public finance is likely to impose a high social cost. The government would reduce its seigniorage from the money supply and instead start offering positive real returns on government bonds. Maybe too, some measures are taken to reduce taxes on saving and investment.

Point D is reached only after a fully comprehensive programme of financial development to raise both the quantity and the average efficiency of investment has been implemented. There is now a considerable body of evidence indicating that direct fiscal incentives have negligible or even perverse effects on the level of investment and actually reduce average efficiency [Nickell (1977);

Tanzi (1976); Usher (1977)]. However, financial development implemented in conjunction with liberalisation of fiscal, price and foreign exchange rate policies can itself stimulate investment.

Fiscal incentives have been employed in a number of developing countries not only to encourage investment but also to raise saving propensities. As with investment incentives of this kind, it is not clear that piecemeal fiscal measures to raise saving rates have, in general, been effective. Nevertheless, there is evidence suggesting that saving is sensitive to the net real return on financial assets, as documented above. Income tax lowers the net real return to saving, so reducing saving and investment rates. This, in turn, reduces the capital/labour ratio and labour productivity. Were income from capital not taxed at all, saving would rise and the return to capital would consequently fall. Capital's gross share in GNP could fall substantially. The consumption tax may, in fact, be less regressive than an income tax in the long run. The adoption of a consumption tax could help shift the saving function from S_2 to S_3 in Figure 5 [Boskin (1978)].

An important item in this financial development programme involves paying a competitive return on banks' required reserves. In principle, the reserve ratio can be set at any level - even zero - for purposes of monetary control. However, the magnitude of that ratio should be decided with the objective of parcelling out the lending function efficiently between the central bank and the deposit institutions [Fry (1979a)]. Reserve requirements drive a wedge between returns to savers and costs to borrowers. They lower rewards to savers and raise rates paid by investors, thereby reducing incentives both to save and to invest. Reserve requirements may be viewed as an inefficient tax for this reason, as already pointed out.

Required reserves might earn, say, 85 per cent of the normal short-term loan rate. By exactly how much the rate on required reserves should be below the loan rate involves detailed cost calculations beyond the scope of the present paper. Here, the intention has been simply to explore the concept of a competitive interest payment on required reserves. The reserve requirement tax is reduced to zero if the reserve deposit rate of interest is precisely equal to equivalent commercial bank loan rates less the cost that financial institutions incur in lending and servicing loans.

Who benefits from the refund depends, of course, on the incidence of the reserve requirement tax. Initially, all gains are at the expense of taxpayers. The classic story about this tax refund is that it accrues substantially to depositors who respond by increasing their real demand for deposits. Then economies of scale reduce the unit operating costs of financial intermediation and loan rates to investors can decline. The final outcome is more rapid capital formation and a higher rate of economic growth. Indirectly, all taxpayers benefit. Putting aside implications for the Budget, the optimal monetary policy here is a uniform reserve requirement and a fully compensatory yield on required reserve balances.

A competitive banking system is imperative for financial development. Setting <u>minimum</u> deposit rates of interest has already been suggested as a device which might be used to force uncompetitive banking systems to seek out borrowers in a competitive manner. At the same time, interest rate flexibility has been advocated to prevent falling money demand for exacerbating inflationary pressures created, for example, by monetary accommodation of exogenous supply shocks.

The two proposals could be combined through the introduction of an indexed negotiable certificate of deposit (NCD) of, say, five-year maturity. Banks might

be obliged to offer these NCDs, whose principals would be indexed. At redemption, the face value of the NCD would be adjusted by the cumulative change in the price index adopted. Annual interest payments of, say, 3 per cent would also be adjusted by the same index.

These NCDs may serve three purposes. First, they lengthen the maturity of banks' liability portfolio, so enabling the banks to increase their medium and long-term lending activities without undue risk. Second, trading in NCDs produces a simple market in which experience with a market-determined yield can be gained with minimum risk.

The third function of the NCDs is to stabilise aggregate real money demand in the face of volatile inflation. To understand this point, one might assume that savings can be distributed among four assets - currency in circulation, C, demand deposits, D, negotiable certificates of deposit, T, and unproductive tangible assets held as inflation hedges, A. If C, D, T and A possess just two attributes - return and liquidity - the ranking by return must necessarily be identical to the ranking by illiquidity. In this case, it can be shown that substitution will take place only between adjacent assets [Barrett, Gray and Parkin (1975, pp.505-508)]. This means that the demand for A is determined only by r_A, the real return on A, and r_T, the real return on T. Hence, aggregate real money demand too is a function only of r_A and r_T. Returns on C and D will affect the composition of the money stock, but not the aggregate real demand for money [Fry (1978c)]. Evidently, real money demand can be stabilised by holding just the difference between r_A and r_T constant. This is exactly what the untaxed indexation of NCDs or time deposits achieves [Bhatia (1974)].

Deposit indexation may be a radical reform because it breaches, where they exist, nominal interest rate ceilings. The main benefits of deposit indexation imposed on a noncompetitive banking system are: (a) it stabilises real money demand [Simkin (1978, p.130)]; (b) it forces financial intermediaries to behave competitively in their search for borrowers; and (c) it enables long-term lending to continue under conditions of volatile inflation [Bhatia (1974)].

Loan indexation might also be considered, particularly in high inflation countries. The point of indexing medium and long-term loans is to lengthen their effective maturities. High inflation and concomitant high nominal loan rates reduce effective maturities by requiring borrowers to accelerate repayment of principal. The high nominal loan rates simply compensate for the fall in the real value of the principal outstanding. Hence, they can be viewed in real terms as accelerated principal repayments [Fry (1980c)].

Indexing all deposits or NCDs or time deposits only may cause substantial fluctuations in the currency/deposit ratio, since the difference between the return on currency and the return on deposits will vary with variations in the inflation rate. Monetary control through the cash base can be jeopardised, particularly in developing countries suffering long lags in compilation of monetary statistics. It is possible, however, to stabilise the money multiplier through reserve requirement policy [Fry (1979a)].

The indexed NCDs might be the first step towards the complete abolition, where they exist, of interest rate ceilings. The introduction of indexed NCDs would necessitate the maintenance of positive real rates for <u>all</u> loan rates of interest to prevent "round-tripping," i.e., borrowing at subsidised rates simply to acquire the attractive-yielding NCDs. The primary beneficiary of such tandem

interest rate reform would be small and medium size business enterprises. Indirectly, of course, everyone would gain from the resulting lower rate of inflation and higher rate of economic growth.

The available empirical evidence mentioned earlier not only supports the case for a vigorous and flexible interest rate policy, but also indicates that economic behaviour in most countries is rather uniform. It does, therefore, allow some confidence to be placed in the application of international comparative studies to individual countries in the sample. At the very least, it makes the claim that any of these economies is different in certain important, fundamental respects more difficult to accept. Serious doubt is thrown on statements which pronounce that economic behaviour is insensitive, unresponsive or inelastic with respect to relative prices, be they between present and future consumption, domestic and foreign financial assets, imported and domestic consumer goods, domestic and imported factors of production, and even production techniques themselves.

The optimal interest rate policy would be the abolition of ceilings and the fostering of competition within the financial sector. The proposals outlined above call for large and dramatic changes in most of the sample countries, which may well be unacceptable in their entirety. Nevertheless, it is hope that the evident advantages of some of these measures will sway even the ardent supporters of selective credit policies and interest rate ceilings.