

ECONOMIC ASPECTS OF FINANCIAL INSTITUTIONS  
IN EMERGING COUNTRIES

by

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## ABSTRACT

Financial assets represent evidences of claims against physical assets. Financial institutions are institutions which deal in financial assets. Financial institutions, together with financial assets, compose the financial infrastructure of the nation.

In the first part of this study, the financial infrastructure of the United States is described in terms of what it is and what it does. It was shown that the United States financial infrastructure has undergone an evolutionary process in its development, with the category of nonmonetary financial institutions gaining importance over the category of monetary financial institutions.

The United States financial infrastructure contributed significantly to the nation's economic development through the introduction of indirect external finance. Through the process of financial intermediation, the financial infrastructure is able to collect together domestic savings and allocate them efficiently for productive purposes.

The balance of the study deals with the role of financial institutions in an emerging country, such as Sudan. After showing that financial institutions can

contribute significantly to the process of capital accumulation and thus, economic growth, a framework for a financial system is developed. It consists mainly of private sector financial institutions. Then the government is to supplement the private sector by operating those financial institutions which the private sector cannot perform adequately or at all. More important than owning and operating financial institutions, the government must pursue an economic policy that provides incentives to encourage the growth and development of both the savings process and the appropriate financial intermediaries.

The role of foreign investment is not overlooked. Foreign investment can play a significant role in financial and economic development of emerging countries. These countries should give assurances of security and confidence against measures of nationalization and confiscation.

International financial institutions, such as the World Bank for Reconstruction and Development and the International Monetary Fund are of great help to emerging countries in building their economic and financial infrastructures. It is to their benefit that these countries subscribe to them.

## CHAPTER I

### INTRODUCTION

This chapter of introduction will be concerned with statement and objective of the problem, methodology and organization of the study, and summary of conclusions.

#### Statement and Objective of the Problem

The Sudan, of which the author of this thesis is a citizen, like other emerging countries is facing the problem of economic and social development. The mobilization of all domestic resources available to developing countries to promote economic growth is a major task facing these countries. To improve the standard of living in these countries, it is important to encourage the process of capital formation. To attain this goal, new attitudes toward production, consumption, saving and investment have to be developed.

Although economic development is often discussed in terms of wealth, labor force, output and income, it has to do with savings at some points in the economic system and corresponding accretions of financial assets elsewhere. Accumulation of savings is part of economic growth (Gurley and Shaw 1955).

Accumulation of savings in the process of economic development introduces the role played by financial institutions in economic and social development. With them, institutionalization of savings and investment is accomplished. Financial institutions represent the vehicles for savings. They accumulate funds from savers on one hand and lend them to borrowers on the other hand. This is the process of intermediation. In this process domestic savings are not only becoming productive but also find their way to where they can be most efficiently productive.

In developing countries savings, especially middle-class savings, remain idle most of the time. These countries are facing the problem of the shortage of financial resources for development projects. This shortage is due not only to the fact that the volume of domestic savings is small, but also because domestic savings lacks mobility which directs it to production. A great part of it is hoarded and prevented the chance of being injected into production. To complete the process of capital formation in developing countries, funds must not only be saved, but must be invested. For the transference of savings into production, financial institutions must be well established in developing countries to carry out this function efficiently.

The main objective of this study is to develop a comprehensive idea concerning the role that can be played

by financial institutions in a developing country, such as Sudan, in the process of capital formation. Having done this, a framework for a financial system capable of coping with economic development needs in Sudan will be developed. The financial system developed will be composed mainly of private sector financial institutions. The role of the public sector will be supplementary to that of the private sector. The public sector will operate and control those financial institutions which the private sector cannot do adequately or at all. The only two financial institutions suggested for the public sector to run and control are development banks and pension funds. However the major role of the government toward the financial infrastructure is to pursue an economic policy which is conducive to the growth of financial institutions. Fiscal policy, especially the taxation policy, can be a positive incentive. Public debt can also be managed in such a way as to encourage the growth of financial institutions. It is also the responsibility of the government to give enough security and confidence to private financial enterprises against measures of confiscation and nationalization. By private financial enterprises it is meant domestic as well as foreign institutions. In fact foreign investment also occupies an important position in financial and economic development of emerging countries. Related to foreign investment is the role played by

international financial institutions such as the World Bank and International Monetary Fund in emerging countries.

Having defined the problem and stated objective of the study, the next step will be to show the methodology and organization of the study adopted.

### Methodology and Organization of the Study

To start with, the nature and functions of financial institutions in a well developed financial infrastructure is discussed. Strong emphasis is put on the experience of the American financial infrastructure, because it best reflects the functions carried by financial institutions in a developed economy. Having done this, the study goes further to show the role that can be played by financial institutions in a developing economy, such as Sudan. After demonstrating their function, a framework is developed for the financial infrastructure of an emerging country.

In Chapter II, financial infrastructure, in terms of what it is and what it does, is described. In terms of what it is, a financial infrastructure is composed of financial instruments and financial institutions dealing in these instruments. Financial instruments, which represent evidences of claims against physical assets, are classified into different categories. Financial institutions are classified into different categories. Financial institutions are also classified into two major groups, monetary and nonmonetary,

and the characteristics of each group are shown. In terms of what it does, financial infrastructure is described in terms of their role in the saving-investment and capital formation processes. The last part of Chapter II deals with financial development. United States financial infrastructure is taken as an historical example showing the evolutionary process of financial development, from the colonial period up to the present time.

In Chapter III a description of the individual components of financial institutions is given. The central bank and commercial banks are the category referred to as monetary financial institutions. Their role and functions and organization in the economy are precisely described. The components of the second major category, referred to as nonmonetary financial institutions, are also described one by one. They include: savings and loan associations, mutual savings banks, credit unions, investment banks, insurance companies, pension funds, mortgage banks and development banks.

In Chapter IV economic aspects of financial institutions in emerging countries are shown. A framework is developed for a financial system of an emerging country, such as Sudan. The financial institutions within this framework are mainly private enterprises. The role of the government is supplementary to that of the private sector.

It is supposed to operate and control only those institutions which the private sector cannot perform adequately or at all. However more important than to operate and control some financial institutions, is that the government should undertake an economic policy which is conducive to the growth of the financial institutions. Fiscal policy, especially the taxation policy, is a good incentive. Security against measures of confiscation and nationalization is another incentive.

Foreign investment also occupies a position in the framework developed. I believe foreign investment, especially private, can contribute to the development of the financial infrastructure of an emerging country provided that enough security and confidence are available. International financial institutions are also incorporated into the study. Functions of International Bank for Reconstruction and Development (IBRD) and International Monetary Fund (IMF) are analyzed in such a manner as to make it clear that it is economically advisable for emerging countries to be members of these institutions.

#### Summary of Conclusions

The financial infrastructure of the United States, in its development and growth, has undergone an evolutionary process. Recently nonmonetary financial institutions gained importance over monetary financial institutions. The

financial infrastructure has contributed significantly to economic development and growth of the United States. Now they are the most active and important organizations in the saving-investment and capital formation processes. Almost all domestic savings are channeled through them.

The role that can be played by financial institutions in an emerging country is also significant. They can pool together domestic savings and transfer them into production. The monetary financial institutions are already existing and well developed contrasted with nonmonetary financial institutions. The framework developed for the financial infrastructure of an emerging country is composed mainly of private sector financial institutions. Efforts should be made from the private sector to develop those non-monetary financial institutions which are still infant such as insurance companies. Efforts should also be made to bring into existence some financial institutions in the form of savings and loan associations, mutual savings banks, credit unions. These institutions are directed toward the savings of middle and low income groups.

The government role is supplementary to that of the private sector. It is to control and run those financial institutions which the private sector cannot do adequately or at all. The two financial institutions recommended for government activity are pension funds and development banks.

However the major role of the government is to undertake an economic policy conducive to the growth of private sector financial institutions.

Foreign investment also occupies a position in the framework of the financial infrastructure developed for an emerging country. Those countries should give enough assurances of security against measures of nationalization and confiscation so as to attract foreign investment. International financial institutions are also part of foreign investment in emerging countries. It is recommended that these countries subscribe in them.

## CHAPTER II

### FINANCIAL INFRASTRUCTURE

In this chapter the financial infrastructure will be described in terms of what it is and what it does. Then the development of financial infrastructure will be shown. Lastly United States financial infrastructure will be taken as a historical example of the evolutionary process of financial development.

With respect to what it is, the financial infrastructure of a nation is composed of financial instruments and financial institutions dealing in these instruments. In the first place financial instruments will be described analytically and after that we will come to financial institutions.

#### Financial Instruments

The combination of human labour, capital and natural resources yields durable physical assets which compose the infrastructure of national wealth. Financial instruments represent evidences of claims against physical assets. All financial instruments put together compose the financial superstructure of the nation. The financial superstructure of a nation encompasses a wide variety of financial

instruments that makes it important to classify them into different categories (Goldsmith 1969).

The basis of differences between financial instruments are certain characteristics, such as the basic nature of the contract, the duration, callability, marketability and security of the instrument, the nature of owner and issuer and the level of yield stipulated. The following classifications are recognized.

#### Direct vs. Indirect Securities

Financial instruments may be directly issued by nonfinancial economic units, such as households, business enterprises and governments. Hence primary securities are claims against nonfinancial economic units. Here investors will supply funds directly to issuers. During the early stages of development primary securities take the form of face to face loans. Still they can contribute to the improvement of resource allocation because they allow economic units with promising investment projects to shift resources from others with less productive resources (Gurley 1959).

Financial instruments may also be issued by financial institutions so that borrowers may obtain funds indirectly. It is argued that as a means of raising funds, secondary securities are more efficient than primary securities. This is due to the fact that instruments issued by financial institutions are easier to liquidate than instruments issued

by non-financial economic units. Further, they have the merit of being completely divisible in contrast to primary securities which are normally issued in fixed amounts. Also some secondary financial instruments cannot be issued easily in the form of primary securities, for example, claims against insurance companies (Goldsmith 1969)

### Equity vs. Debt Securities

Equity securities are evidences of fractional ownership in the networth of a business enterprise. They may be common stock or preferred stock. Preferred stock has a prior claim on earnings relative to common stock.

Debt instruments are evidences of claims. Maturity of debt instruments may be on short-term or long-term basis. The distinction between short-term and long-term claims is based on the length of time between deposit and withdrawal or granting and repayment of the loan. Generally claims having maturities of less than one year are regarded as short-term claims, for example treasury bills, while those having maturities of more than five years are considered to be long-term claims, e.g., bonds.

Debt instruments can be further subcategorized into secured debt and unsecured debt. Secured debt includes mortgage bonds and collateral trust bonds while unsecured debt includes debentures and unsecured bonds.

It was mentioned financial infrastructure is composed of financial instruments and financial institutions dealing in these instruments. Having defined and described financial instruments, the next step is to bring financial institutions into the picture. This is done in the following section.

### Financial Institutions

Goldsmith (1968, p. 3) defined financial intermediaries as "financial intermediaries in modern sense of the term are business enterprises most of whose assets are financial rather than tangible and most of whose activities are concerned with financial instruments, such as money, claims and stocks."

Also Pollakoff (1970, p. 16) said, "By their very nature financial intermediaries are middlemen who place themselves between the ultimate lenders and borrowers, offering the former additional choices, in terms of claims against themselves, which such lenders may desire to accumulate while, at the same time, acquiring the IOU's of borrowers at terms more congenial to the latter."

On the other hand, Pyle (1972, p. 2009) in defining financial institutions, stated, "Financial institutions are considered to be firms that supply financial securities and contracts held as assets by other sectors of the economy

and that use the proceeds of these sales to finance liabilities of other economic units."

I think in their general themes, the already stated definitions are almost the same. It may be said that financial institutions are primarily issuers and dealers in debt. They stand between ultimate borrowers and ultimate lenders. They purchase the primary securities of the borrowers and issue claims against themselves. Hence, the assets of financial institutions are mainly claims against nonfinancial borrowers, such as households, business enterprises and governments. On the other hand, their liabilities consist of claims which they create against themselves in the form of indirect securities for the portfolio of the lenders. Inherent within this function, they direct the flow of financial instruments, primarily debt instruments, among nonfinancial units and in that process they often transform the character of funds involved. From this process which involves the holding and transactions in financial instruments, they derive their income. This income is represented by the spread between the rates paid by financial institutions to lending units and the rates paid to financial institutions by borrowing units, i.e., the margin between yields on primary securities and yields on secondary securities accounts for intermediaries' compensation for the special services they offer (Gurley and Shaw 1956).

## Organization of Financial Institutions

Financial institutions may be organized as business corporations as in the case of commercial banks, property, insurance companies, finance and investment companies, or on a mutual basis as in the case of savings banks, savings and loan associations, credit unions, life insurance companies and open-end investment companies.

The main difference between the two types of organization is that corporations are controlled by their shareholders who support management, while mutual organizations have no shareholders.

Instead of being classified on the basis of organization, financial institutions are often classified by their functions as reflected by the characteristics of the financial instrument issued. On this basis, two broad groups are often singled out, namely monetary and nonmonetary financial institutions.

## Monetary vs. Nonmonetary Financial Institutions

The nature and relative importance of financial instruments owned and issued and of financial activities carried often furnish the two most important principles of classification of financial institutions. Monetary financial institutions are financial institutions whose liabilities are a form of money. They supply directly or indirectly some form of money. Hence they affect the supply of money.

They consist of the central bank and commercial banks, the latter being under the direct control of the former.

On the other hand, nonmonetary financial institutions are financial institutions whose liabilities consist of financial instruments other than money. Examples of these institutions are insurance companies, savings and loan associations, credit unions, investment bankers and investment companies. They can transfer money from surplus economic units to deficit units, and hence they can expand the potential amount of credit that may be extended for any given increase in the liabilities of the central bank (Thorn 1958). In Chapter III full account will be given to the individual components of monetary and nonmonetary financial institutions.

Having described financial infrastructure in terms of "what it is," the next step will be to describe it in terms of "what it does". The functions carried by the financial infrastructure are best expressed in terms of saving-investment and capital formation processes.

#### Economic Functions of Financial Institutions in the Saving-Investment and Capital Formation Processes

The accumulation of capital assets is a necessary condition to raise the levels of income and consumption of the community. This process of capital formation depends on the saving-investment process. In every economy the process of capital formation plays a major role in economic development. This is because many current economic objectives like

price stability, high levels of income and employment and high rates of economic growth are closely bound up with the relationship of saving and investment. Given less than full employment, if intended saving exceeds intended investment, national income will fall. On the other hand, when desired investment is greater than desired saving, national income will increase, due to the increasing marginal productivity of capital (Rozenal 1970).

The saving-investment and capital formation processes can be financed internally or externally. It is believed that external finance for these processes is more efficient than internal finance. In the following two subsections the two methods are contrasted.

#### Internal Finance

In a world of saving and investment, but with no financial intermediaries and no surpluses or deficits, the current income for each spending unit will be precisely matched by its investment in tangible assets. In a situation of balanced budgets each spending unit will finance its current and capital expenditures internally. The aggregate expenditures of the economy will be self-financed. Under these circumstances security issues by spending units will be zero or very near to zero. However, under these conditions some profitable investment projects might not be executed because the economic units which owned them lacked

the necessary finance. On the other side, some other economic units might undertake some investment projects which are relatively less profitable because they had enough funds to execute them. In such a world, the saving-investment process would go without financial institutions. Thus under internal finance some investment projects which are relatively profitable may not be undertaken, while other investment projects which are relatively less profitable may be undertaken. To overcome this disadvantage, external finance has to be introduced (Gurley and Shaw 1955).

#### External Finance

Let us now turn to a world of deficits and surpluses. In this world, the spending units, having a surplus in their budgets, are left with excess income over their spending on goods and services. Spending units with deficit budgets permit their spending to exceed their income. They do this by looking for loanable funds. They obtain these loanable funds through the issuance of securities which are equal to their deficits. These securities will be bought by surplus units who will tend to accumulate financial assets equivalent to their surpluses.

Under these conditions for the aggregate spending units, the following relations will hold:

1. Loanable funds supplied equal loanable funds acquired.

2. The increase in net financial assets for surplus spending units is equivalent to the increase of net financial liabilities of the deficit spending units.

It is external finance which maintains the above relations. External finance can be direct or indirect.

Direct External Finance. When external finance is direct, deficit economic units among households, business enterprises and governments will issue debt instruments of their own, they will become debtors. These instruments will be directly purchased by economic units having surpluses and these units will be lenders.

However, obtaining external finance directly is thought to be inconvenient and inefficient because under it the circle of potential borrowers and lenders is small since there is a need for every borrower and lender to find a partner for the same object at the same place and time. These shortcomings are overcome by indirect external finance (Gurley and Shaw 1956).

Indirect External Finance. To transfer efficiently the excess saving of surplus units some financial link has to exist. This is how financial intermediaries come into the sphere of saving-investment and capital formation processes and introduce what is known as indirect external finance. When external finance is indirect, financial intermediaries will stand between ultimate borrowers and ultimate

lenders. They will issue debt instruments of their own represented by secondary securities instead of the primary securities. They have to satisfy simultaneously borrowers who would like to expand their holdings of real assets beyond the limits of their own net worth, and lenders who would like to invest part or all of their net worth in financial assets and with negligible risk of default.

It can be seen that external finance as reflected in financial intermediation separates the functions of saving and investment. This is recognized as helping the accumulation of capital on one hand and increasing investment efficiency on the other hand. Investment efficiency is increased because financial intermediation permits capital saved to be injected in the process of production by those who have the ability to make it most productive. In this way the amount of saving available will be allocated to those investment projects yielding the highest rate of return. Financial assets thus redistribute saving from investment projects with relatively low net productivities to those in which the expected return will be higher. This in turn will lead to an increase in the capital formation ratio to national product. The rate of economic growth will increase assuming the following points hold:

1. The members of the community differ in their ability to combine the factors of production and to utilize

assets acquired by saving or inheritance, in their attitude toward risk and their appraisal on future compared to present utilities.

2. There are economies of scale with a producing unit and there are externalities within the economy (Polakoff and others 1970).

With these assumptions indirect financing through financial institutions permits aggregate output to increase without changes in resources, technology, tastes and attitudes toward risk. Specialization will exist so that some units with less entrepreneurial ability and a higher degree of risk aversion will save more than they invest while others invest more than they save. That is why it is contended that the growth of financial institutions encourages higher levels of saving and investment at each level of income.

However, it is important to note that saving-investment will increase total volume of output only when secondary securities issued by financial institutions are not perfect substitutes for primary securities issued by nonfinancial institutions. In their transference of savings from savers to investors, financial institutions create credit and the savings of the society is given the chance of being highly mobilized to provide for the creation of additional wealth (Goldsmith 1969).

Since the national financial system can tell, to a great extent, the stage of economic development accomplished by a nation, I think it is necessary to state the features which will reflect what stage of financial development a certain nation has reached.

### Development of Financial Structure

Financial development differs from one economy to another. As time goes on some changes will take place in the financial structure of the nation. These changes reflect the national financial development. Some relationship holds between financial structure of a country and its stage of economic growth. Generally speaking more developed financial markets accompany higher stages of economic development. In poor countries financial structures are simple (Rozenal 1970).

Differences in financial development can be in the starting point or in the pace and pattern of development. But it is contended that these differences are not very significant so that it may be said there is only one major path of financial development. Within this basic path two traces of financial development can be singled out. The difference between the two traces is more or less based on the extent to which the government participates in the ownership and management of certain financial institutions. In the countries adopting the first trace virtually all financial

institutions are owned and administered by the private sector except the central bank and social insurance organization; the financial system of the United States of America provides the best example for this. With respect to the second trace many important financial institutions are owned and managed by the government, such as savings banks, development banks and mortgage banks (Goldsmith 1969).

Following the above idea it is always important to distinguish between centrally planned economies and free enterprise economies in the classification of financial structure. In a centrally planned economy the financial structure is missing corporate stock in its financial superstructure and investment bankers, investment companies and trustee organizations among their financial institutions. In these economies government owns and controls financial institutions, consequently claims against the government are predominant.

How far a nation has developed in its financial system will be reflected in many economic activities. With financial development, the central bank will be able to build up its international liquidity, stock of financial assets will have a relative growth over income and buyers and sellers in all markets accumulate average balances of liquid assets. Also with financial development the government dependence on fiscal tools will contract. When

financial structure has reached such an extent of development it is said finance is deepening in the economy. On the other hand, when financial structure is in its early stages of development, it is described as being shallow. When finance is shallow, financial assets earn low real rates of interest mainly because demand for them is low. In addition, shallow finance is accompanied by overvaluation of domestic currency in foreign exchange because the exchange rate of money will not reflect the demand and supply forces for the currency in the free market so much as it will reflect the official exchange rate. This will result in exports being discouraged and imports encouraged. Contrarily, when finance is deep in the economy, the exchange rate of the currency will reflect the real economic prosperity of the country (Shaw 1973).

The financial superstructure development can be measured by the ratio of financial superstructure to real infrastructure of the country. The ratio is calculated by dividing the total value of all financial assets available at a certain date by the total value of all tangible assets and the net foreign balance. For example, if the value of all financial instruments outstanding at a certain point of time is ten billion dollars and the value of all tangible assets is twenty billion and the value of net foreign balance is five billion dollars, then the ratio of financial

superstructure to real infrastructure is 40% ( $10/(20 + 5)$ ) (Goldsmith 1969).

The composition of financial superstructure also describes the financial structure of a nation. It is reflected in the manner in which total financial instruments outstanding are distributed among their main classes and in the corresponding distribution of financial assets among the main sector of the economy. For example, when a country is in its early stages of financial development, its citizens will have more access toward the holding of money than nonmonetary financial instruments. Also, if a greater portion of financial instruments outstanding are industrial, this will reflect that the economy is highly industrialized. In addition the relative importance of the various financial institutions describes the financial structure of the nation. In a well developed financial structure nonmonetary financial institutions will have relative importance over monetary financial institutions. The United States' financial system confirms this point. In the following section the evolution and development of the financial infrastructure of the United States are traced in broad lines as a historical example of the evolutionary process.

United States Financial Infrastructure as an  
Historical Example of the Evolutionary Process

The American financial infrastructure of today is a result of an evolutionary process that started before the formation of the first national government. The changes that accompanied the process were financial responses to the needs of the economy at its different stages of development.

During the colonial period much reliance in capital was put on the western world. Businessmen who came from European countries were mainly dealing in trade between Europe and America. The danger to which trade was subjected necessitated marine insurance and, in response to that need, a merchant called Thomas Willing established, in 1757, the first marine insurance in Philadelphia. Five years before that the first fire insurance was also established in Philadelphia (Krooss and Blyn 1971).

The banks that existed in the colonial period had little of the features of the present day banking. Up to 1740 banks existed mainly in the form of land banks, issuing currency secured by real estate redeemable in the future in commodities. Thus lending was mainly on land and the currency was mainly represented by the note evidencing the debt. As a result it cannot function as a unit of account or a medium of exchange in the modern sense. To overcome these shortcomings, siver banks started to be established by 1740 to

receive notes on silver basis. The notes were to be issued for fifteen years redeemable in silver taking into consideration changes in the value of silver. However, these notes still were not functioning as money and did not circulate freely and smoothly as a currency (Shaw 1951).

In the period that followed the formation of the first national government and until 1815 some significant developments took place in American financial structure. In the following part of this section these developments will be identified and described.

#### The Period 1783-1815

The revolution and the formation of a national government in the beginning of this period opened the door for new types of businesses with less reliance on trade and credit with England. The Americans were thus confronted with the necessity of forming their own financial institutions. In response to the need for capital funds the Bank of North America in 1781 was created in Philadelphia as the first money commercial bank. Other banks followed and by 1790 there were four banks, each chartered by the state in which it was established. Each was issuing its own currency circulating in the country. Each currency was functioning only in its state, and that reduced the velocity of circulation (Krooss and Blyn 1971).

In 1790 the Secretary of the Treasury in a report to Congress pointed out the merits of having a national bank, to increase the country's productive capital and to help the government in borrowing and collecting tax revenues. After much debate, Congress chartered the first national bank in 1791 and it was given most of the powers of the central bank. It was a private bank with the government contributing with only one-fifth of its capital. It was chartered for twenty years. Its share price was to be paid 25% in specie and 75% in government bonds. It was of some help to importers in making their payments because the owners of the bank established some relations with bankers in England. However, the notes were not circulated so widely as to constitute a national currency. Thus many currencies existed as represented by the notes of the national bank and different notes of the various state banks. In 1811 the charter of the first national bank expired and the Congress refused to renew it. For the five years that followed 1811, state banks were expanding and attempting to meet the needs of the system in the absence of a national bank. These shortcomings were especially evident during 1812 War. The notes were issued irrespective of the needs of the economy at that time--the note issue was inelastic with respect to economic needs. The notes started to depreciate especially after the suspension of the gold standard. As a result of those shortcomings, many banks failed and ceased operation (Shaw 1951).

In the period 1783-1815 insurance industry was also undergoing some slow improvements following the British path. In 1812 the first corporate life insurance company was created. The slow progress was due to the fact that most of the population were farmers who did not feel a great need for life insurance. General insurance was also established for the first time in this period in 1792 in Philadelphia (Sweeney 1951).

#### The Period 1816-1836

Being characterized by accelerated innovation this period is significant in the history of financial institutions of the United States. Hoping to get over bank failures mentioned in the preceding period, Congress passed a bill giving charter to the Second National Bank of America. The notes of that bank spread and they almost represented a national currency. By 1826 it was dealing in foreign trade and domestic exchange. It went further and wrote cashiers checks, known as domestic bills of exchange, to persons who wanted to make payments in the distant parts of the country. Also the foreign bill of exchange was given by the Second National Bank of America to persons who wanted to make payments outside the country. The bank came to be the holder of the bulk of silver and gold of the country, and thus it was able to build up its reserves and liquidity. It was

also extending credit to state banks. Its charter expired in 1836 and it was not renewed (Shaw 1951).

In this period commercial banks underwent some reform under the operation of the Second National Bank. Because liquidity problem was one of the main causes of bank failure in the period 1783-1815, commercial banks restricted themselves to short-term obligations represented by their redeemable notes to meet liquidity requirements. State chartered commercial banks continued to issue their own notes. With the absence of a central institution to regulate currency issue with respect to the needs of the economy, the problem of currency inelasticity continued to exist in this period.

Also in this period some new financial institutions evolved. In 1818 the Massachusetts Hospital Life Insurance Company was chartered to be the first life insurance company in the modern sense. However, despite the fact that the number of people insured with it was small in its first years of operation, it was the largest financial institution of its day. It was investing in real estate and personal security of businessmen. To encourage thrift among middle and poor classes, in 1816 a savings bank was established in Philadelphia and a second one in New York in 1819, with the objective of providing a depository for the savings of the poor. It is important to point out that those savings banks

were established by wealthy people and not by the poor people themselves. By 1835 there were fifty-two savings banks with 60,058 depositors holding 10.6 billion dollars in deposits (Krooss and Blyn 1971).

In this period also the first building and loan association was established in Philadelphia in 1831 under the name "Oxford Provident Building". In contrast to savings banks, it was established by the working classes themselves in response to the movement among them that they should save part of their income to finance their homes in cities (Distelhorst 1951)

#### The Period 1836-1869

This period was characterized by accelerated growth of American financial institutions to cope with the new economic conditions. These new economic conditions were represented by the population growth from fifteen million to over thirty million, with more concentration toward urban areas. This population expansion was particularly noticeable in the western part of the country, whose activities were mainly land improvement. The new economic conditions were also represented by the increase in per capita income from \$100 in 1790 to \$400 in 1840. Some technological progress was going on, with telegraph and railroad business starting to grow.

In this period no new financial institutions evolved, instead the already existing institutions were expanding--especially commercial banks. In fact this period was known as the "wildcat banking" which means banks were established everywhere, even in places where wildcats lived. The various banks were issuing different notes and the country was flooded by bank notes. People were losing confidence in them, and as a result many banks failed (Krooss and Blyn 1971).

#### The Period 1860-1890

The effects of the Civil War, which was going on in the beginning of the period, on American finance can be explained in terms of the creation of the national banking system and the innovations in insurance and investment banking industries. This period was known to be a long recession period. In 1861, in an effort to improve the banking system in terms of liquidity and currency, the Secretary of the Treasury suggested to the Congress that the preparation of bank notes should be directed by the federal government and then delivered to banks provided they are secured by the United States bonds. He was considering the merits of having a unified currency nation-wide with a unified security, thus improving the currency and selling government bonds to raise revenue to finance the war. In the 1860's a series of National Banking Acts were passed by Congress providing for:

1. Federal incorporation of banks.
  2. The bank had to deposit with the Treasury of the United States registered bonds in an amount not less than \$30,000 or one-third of its capital stock.
  3. At no time was the note issue to be more than the amount of capital actually paid in.
  4. The notes were to be received at par all over the United States for taxes, public lands, etc.
  5. The bonds were to be held exclusively as security of notes.
  6. The notes were not to be used to procure money to be paid in for capital stock.
  7. A tax was levied on notes of state-chartered banks.
- (Shaw 1971)

In this period the Treasury was thus acting as a central bank. An office under the name "Comptroller of the Currency" within the treasury was established to give charters to banks, and up to 1871 there was no official link between gold and U.S. dollars. However, a national currency to a great deal was created for the whole country. But despite the new organization of banking, some defects remained. The supply of currency was inelastic to economic activities and a central bank in the full sense was absent (Friedman 1963).

In the period 1860-1890 trust companies, investment banking and life insurance also showed continuous growth

with the latter having a faster rate of growth. By that time the investment banking, having established a strong link with the bankers in England, Holland and Germany, was in a position to direct American securities to European capital markets. Investment banking started to specialize in this period (Valentine 1951).

Pension funds started in 1875 in the United States for the first time and consequently they were one of the features of this period (Lüdtke 1961).

#### The Period 1890-1920

In this period the country turned toward specialization and away from agriculture. More attention was given to the national banking system which was facing difficulties. Trying to alleviate these difficulties, much emphasis was put on the inelasticity of the stock of money, and the liquidity problem. Because of these difficulties 243 banks failed during the financial panic of 1907-1908.

In 1913 the Federal Reserve System was created with the purpose to overcome the defects of the national banking system and to protect the public against financial panics. It was proposed that the Federal Reserve System would act as a central bank with all the powers necessary to control the supply of money and consequently to solve the problem of inelasticity of the money supply. The Federal Reserve Act specified that notes issued should be backed 40% by gold

and 60% by commercial paper, and the note issue was to be fixed according to the needs of the economy. With the Federal Reserve System a money market was created for the buying and selling of bills of exchange. Despite the fact that it started operation with the outbreak of the First World War, it was able to correct some of the defects of the national banking system. It was effective in financing the war, especially in marketing the five-year war bond. However, the gold standard tool adopted by the system was inefficient to stabilize the economy to the desired extent (Kemmer 1951, Friedman 1963).

With the introduction of the Federal Reserve System in this period, it was expected that some improvements would be gained by commercial banks. Member banks were required to subscribe in the capital stock of the Federal Reserve System by 3% of its own capital and surplus. To some extent what was expected was realized, and in this period banking spread whereby the number of commercial banks increased from 11,500 to 30,000. In regard to the increasing access of Americans to securities and the fact that the nation changed from a debtor to a lender, the banks were also functioning as investment bankers (Valentine 1951).

In this period some of the already existing financial institutions were experiencing growth and importance while others were declining in importance. Savings and loan

associations continued to grow while mutual savings banks declined in relative importance. Life insurance companies were also growing rapidly supplying the market with funds. General insurance companies, especially casualty, were also growing but at a lower rate. In contrast, inland marine insurance was declining in relative importance because railroads replaced river and water traffic (Krooss and Blyn 1971).

Beside the changes which took place over the already existing financial institutions in this period, some new institutions evolved. In 1909 credit unions evolved under the charter of state law. They were imported mainly from Germany. Also investment companies evolved; their shareholders mainly were other financial institutions (Ludtke 1961).

To sum up, in the period of 1890-1920 a national credit market was created, and the mobility of loanable funds between different regions was improved by the growth of financial institutions thereby facilitating the national allocation of savings. The features of this growth crystallized in the period of the 1920's.

#### The Period of the 1920's

The economy was prosperous in this period. The national product increased from 7<sup>4</sup> billion dollars in 1919 to 10<sup>4</sup> billion dollars in 1929, with industrial achievements having the greatest contribution to this increase. New York became an international money market.

It is logical that the above stated economic conditions would have positive effects on financial institutions. For commercial banks time deposits continued to grow, thus improving the liquidity position of banks. Investment companies continued to grow. Following industrialization, the significance of pension plans was recognized and the volume of dollars which were going into that fund increased. The growth in financial institutions, taken together, during this period is reflected in the fact that while assets of financial institutions comprised 11% of the total national assets in 1900, they comprised 16% of the total national assets in 1929 (Goldsmith 1958)

Unfortunately, this continued growth during the 1920's was interrupted by the disfavorable economic conditions in the depression years.

#### Depression Years 1929-1940

In the depression period, aggregate demand was low, output fell, national product declined, prices deflated and unemployment increased. These conditions adversely affected the financial infrastructure of the nation. In 1929 the stock market crashed. People started to draw their savings out of banks, and to look for real physical assets. Banks' reserves and liquidity were terribly depleted. In 1930 the banking crisis started. The crisis was going on until the president instructed, in 1933, that all banks should close

from March 6, 1933 to March 13, 1933. In the history of the banking system of the United States this week is referred to as "bank holidays". That crisis happened despite the fact that the Federal Reserve System was trying to help banks by undertaking open market purchases on large scale and also by making the discount policy more lenient. Banks were inspected during and after the holiday period. Only those which passed the inspection were allowed to reopen (Friedman 1963).

The period 1933-1935 is a banking reform period. The Banking Act of 1933 established the Federal Deposit Insurance Corporation and depositors in all national banks had their deposits insured up to \$5,000 until 1950. In 1935 another Banking Act was enforced to give the Federal Reserve System power to alter reserve requirements of banks and consequently to improve the money supply elasticity and to control credit effectively. These measures strengthened the banking system which was able to finance 40% of the U.S. war cost during the Second World War (Kemmer 1951, Friedman 1963).

The nonmonetary financial institutions were also affected adversely by the great depression of the 1930's. Several legislative and selective attempts were adopted to let them stand up. In 1933 Congress passed an act for the establishment of what is called "The Home Owners Loan

Corporation". Its main objective was to provide loans on long-term amortized basis to home owners in danger of losing their homes through corporations and to forbid the liquidation of real estate creditors by banks, savings and loan associations and insurance companies. "Federal Housing Administration" was another government agency for home financing enacted by Congress in 1934 to insure mortgages made by private lenders against loss. In 1944 "Veteran's Administration" was enacted to insure loans extended to veterans of the Second World War by private lenders for home purposes (Ludtke 1961).

Investment banking was also regulated by acts to recover from depression. The Banking Act of 1933 required from commercial banks a policy to limit their activities as investment bankers to government and municipal bonds. To prevent fraud in sale of securities, more state and federal regulations were enacted on investment banking. The Security Act of 1933 required that securities subject to this act have to be filed with the Securities and Exchange Commission (Valentine 1951).

In 1937 social security was introduced in the United States to cover those employed in factories, shops, stores, offices and mines. A specific percentage of their wages is deducted to cover their payments to this program. All persons covered by this program must be fully insured. Upon

retirement at 65 or over, the insured person and his dependents will have some income for the rest of his life. Upon the death of the husband, the wife and the underage children will continue to receive the monthly payments (Donaldson 1951).

The efforts which were made, through legislation and direction, to uplift the financial system from the adverse effects of the great depression started to give their fruits in the period that followed the Second World War.

#### The Revival of Innovation--1945 to the Present

Following the Second World War the American economy experienced a continuous growth that fed the growth of financial institutions. With this economic growth a large group of small savers was created. The volume of savings expanded. As an example, gross savings increased from \$30 billion in 1947 to \$200 billion in 1968. By 1965 financial institutions were raising 85% of the funds raised in the credit market. Their assets grew from about \$125 billion in 1940 to over one trillion in 1967 (Krooss and Blyn 1971).

During this period some changes occurred in financial institution. Monetary financial institutions declined in relative importance, and nonmonetary institutions, especially savings and loan associations and insurance companies, assumed a paramount role in the transference of funds from

savers to investors. Table I is a good demonstration of what has been said.

The individual components of the American financial and infrastructure, having undergone the evolutionary process described in the last part of this chapter, have today a well defined role and function.

TABLE I

Ratio of 1952 Assets to 1900 Assets for the  
Individual Components of American Financial Institutions

<u>Individual Component</u>	<u>Ratio of 1952 Assets to 1900 Assets</u>
Mortgage Companies	3.3
Security Brokers and Dealers	5.8
Mutual Savings Banks	10.4
Commercial Banks	18.4
Personal Trust Departments	20.0
Fire and Marine Insurance Companies	21.0
Private Life Insurance Companies	42.1
Savings and Loan Associations	45.9
Casualty and Miscellaneous Insurance Organizations	101.0

SOURCE: Goldsmith, R.W. 1958, p. 69

## CHAPTER III

### DESCRIPTION OF INDIVIDUAL COMPONENTS OF FINANCIAL INSTITUTIONS

In Chapter II it was said that financial institutions are classified into two broad categories, monetary and nonmonetary financial institutions. Within each category there are individual components of financial institutions. In this chapter these individual components will be described in terms of their characteristics and functions, so that the position of each individual component in the financial infrastructure will be determined. The monetary financial institutions will be analyzed first and then nonmonetary financial institutions.

#### Monetary Financial Institutions

Because of its general acceptability in the settlement of all forms of debt, money is distinguished from other financial assets. Money, in the modern sense, is fundamentally composed of currency, coins and demand deposits of commercial banks. The best way to define money is to define it in terms of what it does, i.e., in terms of its functions. The functions of money are:

1. Money serves as a unit of value.

2. It functions as a standard for deferred payments.
3. It is used as a medium of exchange.
4. It functions as a store of value. Money can be held to acquire goods in the future instead of buying them now. (Harvitz 1963)

In terms of these specific functions, money allows efficient allocation of resources. With it economic units having promising economic opportunities can make investment expenditures in excess of their savings by drawing down accumulated money balances. Other economic units with no such promising projects can save above their real investment by accumulating money balances. Thus, some sound economic projects would be undertaken that otherwise would not and other inferior projects that otherwise might have been undertaken can be passed up. In this way money makes it possible for investment spending to be distributed among economic units in a different way from saving (Gurley 1959).

Related to money are monetary financial institutions, which are regarded as those financial institutions which supply directly or indirectly some form of money. They consist of the central bank and commercial banks. The liabilities of monetary financial institutions include money as one major category (Farwell and others 1966).

## The Central Bank

The central bank is basically central to the operation of commercial banks. It conducts for commercial banks the same functions commercial banks conduct for their customers. It holds deposits for them in the form of resources and it also lends to them. This is how the central bank creates credit and lends it to commercial banks. The credit creation takes either one of two forms, central bank notes or created deposits (Kemmer 1951).

Generally speaking, the functions of the central bank include:

1. Government banker. It helps the treasury to manage public debt by arranging for its transference into and out of currencies.
2. Lender of the last resort. When commercial banks or other financial institutions are in need of liquidity under the pressure of the public, the central bank can issue currency notes, lend commercial banks or purchase securities in the market for the purpose of satisfying the demand for liquidity by the public.
3. Note issuance for circulation among the public.
4. Government advisor. It advises the government on:
  - a. Policies to attain domestic stability.
  - b. Policies concerning exchange rates so as to maintain external balance.

- c. Changes in commercial bank holdings of securities and changes in their loans. (Peterson 1951)

The second factor needs more clarification because of its more effective influence on stability. When business activities rise, commercial banks increase their loans and their purchases of securities. As a result money supply increases leading to an increase in the expenditure on goods and services. This trend continues until full employment is reached. Beyond full employment prices are likely to rise. With higher prices, speculative buying increases and the demand for bank credit expands. This will continue until commercial banks' reserves are completely exhausted and at this point the cycle ends. With the decline of business activities, the contrary is true. Commercial banks retire their loans causing a decrease in the money supply and consequently a decline in demand for goods. This trend is brought to an end by such factors as piling up of bank reserve balances, a decline in interest rates, the restocking of depleted inventories and increased exports (Kemmer 1951, Rozental 1970).

It follows that to achieve economic stability, the central bank has to control the money supply. More precisely, it has to influence the extent to which commercial banks can extend credit and expand deposit liabilities and hence influence the money supply. The influence of the central bank on

commercial banks is put into effect through three tools, namely reserve requirements, open market operations and discount rates. Each of these tools will be taken separately to show its effectiveness in influencing economic stability.

Reserve Requirements. By law commercial banks are required to maintain a minimum reserve expressed as a percentage of total deposits. The reserve ratio affects the volume of credit that can be extended. If the central bank wants to take the initiative to let commercial banks expand the volume of credit they can extend, it lowers the reserve requirements. Commercial banks will have excess reserves over the legal minimum and consequently they can lend more. Also, if the central bank wants to take the initiative in letting commercial banks contract the volume of credit they extend, it raises the requirement. Commercial banks will need more reserves to maintain the minimum legal reserve limit. They maintain this by contracting their loans (Boehmler and others 1951).

Open Market Operations. It is also a tool in the hands of the central bank to influence the behavior of banks and other financial institutions. There are two aspects of open market operations: their effects on legal reserves and their effects on the rate of interest. Let us start with their effects on legal reserves. If the central bank wishes to take the initiative in controlling bank credit by selling

securities in the open market, the public will normally buy these securities. The public will pay for these securities largely with bank deposits. This process will result in reserve settlement between the central bank and commercial banks, leading to a decline in reserves of commercial banks at the central bank. Since the liabilities of the central bank constitute reserves for commercial banks, the latter will be compelled to contract credit so as to restore their reserve ratio, particularly if they had no excess reserves. The restoration of the reserve ratio is more likely to take place either by demanding repayment of advances already made where this is possible or by restricting the volume of new advances.

We can now turn to the effects of open market operations on the rate of interest. Open market sales will depress security price and reduce excess reserves. As a result, interest rates rise and potential credit will be reduced. However, when the central bank buys securities in the open market, the opposite analysis applies. The reserve ratio for commercial banks will increase enabling them to increase the volume of credit extended. At the same time security prices rise and interest rates decline. Borrowers can borrow at a lower cost (Harvitz 1963).

However, it is important to point out that there are some limitations to open market operations. Banks may already have excess reserves or they may have highly liquid assets

which can easily be converted into cash. To overcome these limitations, the central bank can use the discount rate as a tool to influence commercial banks' ability to extend credit.

Discount Rates. It is also a tool in the hands of the central bank for the control of credit. A commercial bank confronted with a liquidity problem can sell some of its security holdings. The central bank, by raising reserve requirements or selling securities in the open market, can force commercial banks to rediscount their loans at the central bank, so as to restore their reserve ratio. If the central bank fixes the discount rate above the rate of interest commercial banks receive on their loans, commercial banks will not find it profitable to use the discount window and so will restrict their lending. Conversely, if the central bank fixes the discount rate below the rate of interest commercial banks receive on their loans, commercial banks will find it profitable to obtain funds from the central bank by discounting their loans at the low discount rate. Their reserves will increase which then enables them to extend more loans.

Having described and analyzed the central bank as the backbone of monetary financial institutions, the next step will be to review commercial banks.

## Commercial Banks

In contrast to the central bank, commercial banks deal with individuals. In dealing with individuals, the commercial bank system creates credit. It creates credit in two ways. First, credit is created if a commercial bank accepts a deposit today and promises to repay the depositor when the latter wishes. Second, credit is also created if a commercial bank grants a loan in exchange for the promise of the borrower that he will repay the loan at a certain future time.

Commercial banks differ from other financial intermediaries in the following respects:

1. Commercial banks accept demand deposits while non-bank financial intermediaries do not. Because demand deposits are substitutes for money, they are regarded as part of the stock of money. While commercial banks' lending influences both the quantity and velocity of money, lending by nonbank financial intermediaries influences only the velocity of money. Lending by nonbank financial intermediaries merely activates the existing deposits channelled through them. Hence, commercial banks are unique in their capacity to add to the supply of money and create net additions to the purchasing power of the nation (Thorn 1958, Smith 1959).

2. The lending capacity of a commercial bank depends on its legal reserve as determined by the monetary policy, but the lending capacity of a nonbank financial intermediary is exclusively related to the volume of monetary savings put at its disposal (Pritchard 1965).
3. Generally, a commercial bank is regarded as more liquid than a nonbank financial intermediary. This is because commercial banks, in contrast to nonbank financial intermediaries, operate in the area of short-term lending to a greater extent than do non-monetary financial intermediaries.
4. Commercial banks may benefit more from an increase in the private saving than nonbank financial intermediaries because the public utilizes commercial banks as savings institutions to a greater extent than nonbank financial intermediaries.

It is important to note that there are other authors who think that commercial banks are similar to nonbank financial intermediaries in their role in saving-investment process. According to Gurley (1959), the argument that commercial banks differ from other financial intermediaries is on weak ground. He claims nonbank financial intermediaries also create assets; corporate bonds are created by corporations, savings and loan shares are created by saving and loan

associations. He holds that the analogy that money is different from other financial assets by being accepted as a means of payment is also on weak ground because, by the same token, corporate stocks may be regarded as different from other financial assets by carrying ownership rights.

In his article, "Substitutability of Nonbank Intermediary Liabilities for Money," Lee (1966) claimed that the empirical studies he made confirmed the argument that the liabilities of nonbank financial intermediaries are close substitutes for money. From his analysis he deduced that demand for money is negatively affected by changes in yields on nonbank intermediary liabilities.

While similarities and differences between commercial banks and nonbank financial intermediaries have been a subject of controversy, there is general agreement that commercial banks have been the first financial intermediary to introduce indirect finance. At first banks were concerned with borrowing loanable funds from surplus spending units, issuing indirect securities in exchange. These securities have been the currency and deposits that spending units would prefer to real assets. In their second phase of development, commercial banks became involved in transmitting funds from surplus spending units to deficit spending units. Finally, banks have exchanged direct securities with spending units

that wish to strike a balance in their security holdings between direct and indirect forms (Gurley and Shaw 1955).

Today the main functions of commercial banks in general terms are:

1. To accept deposits for safekeeping and convenience in conducting payment by check.
2. To grant loans and advances of funds so as to meet the needs of individual and business firms. In this process they create money (Farwell and others 1966).
3. Currency and coin inventory for their customers.

The above three functions of commercial banks can throw light on the sources of funds for commercial banks to carry their lending and security purchases activities. Three main sources of funds for commercial banks can be singled out:

1. Sale of stock and notes: This is considered to be the basic source of funds for a commercial bank. The owners of the bank finance this source by purchasing the shares of the bank.
2. The second source of funds for a commercial bank is retained earnings which are ploughed back into the bank operations.
3. Depositors and other creditors: This is the third main source of funds for a commercial bank. Deposits come either from individuals and businesses who

deposit their funds with a commercial bank or from borrowers granted loans by the commercial bank.

Based on the time period between deposit and withdrawal, two classes of deposits may be pointed out.

These are demand deposits and time deposits (Boehmler and others 1951).

- a. Demand Deposits: They are withdrawn by check or payable to the depositor without a previous notice.
- b. Time Deposits: They are deposits that are not drawn by check. Three kinds of time deposits within this class can be pointed out. These are pass book accounts, time deposits-open accounts and time certificates of deposits.
  - i. Pass book accounts consist of funds deposited by individuals or nonprofit organizations. They are characterized by a low volatility.
  - ii. Time deposit-open accounts are based on a signed written agreement between the commercial bank and the depositor. The depositors are mainly business enterprises. The agreement between the bank and the depositor represents an open-end contract, whereby withdrawals are made by a written

request at least thirty days before the withdrawal is put into effect (Harvitz 1963).

- iii. In time certificates of deposits, the depositor is given a certificate showing the amount and date of the deposit, interest paid by the bank and the date on which the funds may be withdrawn.

The ability of a commercial bank to create credit will be related to a great extent to its ability to attract funds from the three mentioned sources of funds. Within this frame, the most significant factors that affect commercial banks' ability to create credit are:

1. Reserves: Commercial banks are required by law to maintain reserves. The idea behind the reserve requirement is to force commercial banks to maintain a reasonable degree of liquidity that will enable them to meet deposit withdrawal. The reserve requirement is also regarded as a device in the hands of the central bank to affect commercial banks' ability to create credit. Once the reserve limit is reached, the bank cannot make more loans. Therefore, the reserve requirement is a factor that affects the ability of commercial banks to create credit.
2. Demand for loans: This is also a factor that affects the ability of a commercial bank to create credit.

Borrowers may not ask for loans and as a result the capacity of the bank to create credit will be restricted.

3. The banks' willingness to make loans: When there are many borrowers applying for loans, the second factor mentioned above will not restrict the capacity of the bank to create credit. However, the problem may be the bank considers the loan applicants as being of substantial risks, i.e., they are not capable to paying back the loans.
4. Liquidity: To provide for liquidity commercial banks may hold highly liquid assets as a secondary reserve. The liquidity problem will also restrict the capacity of commercial banks to create credit (Harvitz 1963).

Up to this point, the functions of commercial banks, the sources from which commercial banks obtain funds to carry out these functions and the factors that affect their ability to carry out their functions have been reviewed. Related to these aspects is how commercial banks obtain their income.

Income is usually derived from work, and commercial banks also derive their income from the work they do, as represented by their functions. Commercial banks derive their income from the interest they receive on the securities they buy, the loans they extend, and the fees they charge.

Their short-term loans enable borrowers to acquire funds for temporary use in business operations. The long-term securities which they buy are a means of supplying funds to finance productive equipment. Thus, a close relationship exists between the depositing and the lending functions of commercial banks. Through the operations of lending and investing, commercial banks put to work funds deposited with them. More important is the fact that by combining deposit function with lending function, they allocate scarce resources of their economic community in such a manner as to direct funds toward the most efficient producers (Boehmler et al 1966).

The last aspect about commercial banks to be discussed is how they are organized. Like other business enterprises, commercial banks are organized in such a manner as to allow them to fulfill their functions appropriately and survive against failure and shocks.

#### Organization of Commercial Banks

There are two main types of banking systems as far as their organization is concerned. These are the unit banking system and the branch banking system.

Unit Banking System. In unit banking systems each of the individual units represents a separate business enterprise. The American banking system provides the best example for this structure of banking. The main advantages of this type of bank structure are:

1. It prevents, to a large extent, monopoly of finance.
2. The unit banking system makes it possible for the locality to finance operations through the savings of the citizens in the same locality (Farwell and others 1966).

Branch Banking. In contrast to unit banking systems, each individual unit in branch banking is not a separate unit but part of a business enterprise. The best example for this type of bank structure is the British banking system. The advantages of branch banking are considered to be the disadvantages of unit banking. The main advantages are:

1. Branch banking is more capable than unit banking of absorbing economic shocks and crises. This is because the depressed branches can be supported by other branches experiencing a boom. The fact that during the depression of the thirties the majority of the commercial banks closed while no single British commercial bank closed, is taken to be practical evidence of this point.
2. Branch banking structure provides for greater concentration of capital and relative lack of competition. This will enable commercial banks under this banking system to extend large loans to big businesses and hence it may result in certain economies.
3. Branch banking structure, being characterized by

interoffice relations, can quicken the transfer of funds and promote the mobility of banking resources.

4. Branch banking can overcome monopoly that may exist with one unit bank in a single community (Boehmler and others 1951).

Despite these advantages, branch banking systems have the following disadvantages:

1. It can foster monopoly.
2. With branch banking there is a feeling that loans advanced to local borrowers are administered by bankers lacking special interest in local welfare and local credit needs.
3. The failure of a large branch bank can terribly affect the whole national banking system and thus cause a widespread disaster.
4. It is difficult for the supervisory authorities to adequately examine the banks.

The analysis of their organization ends up the reviewing of commercial banks, which constitute, with the central bank, one major category of financial institutions referred to as monetary financial institutions. In the remaining part of this chapter, nonmonetary financial institutions will be reviewed.

### Nonmonetary Financial Institutions

Nonmonetary financial institutions are those financial institutions whose liabilities consist of financial instruments other than money. Like commercial banks, nonmonetary financial institutions transfer funds from surplus spending units to deficit spending units and hence they are potential suppliers of loanable funds.

Nonmonetary financial institutions vary greatly as to the character of their assets, liabilities and activities which makes it necessary for a subcategorization among them. This subcategorization includes savings and loan associations, mutual savings banks, credit unions, investment banks, investment companies, insurance companies, pension funds, mortgage banks and development banks.

#### Savings and Loan Associations

Savings and loan associations are institutions designed for the purpose of financing homes. As a result they are concerned with the formation of home ownership. They offer their savings account facilities to the public. They collect savings from the public and reinvest these savings mainly in amortizing first mortgage loans on the security of residential dwellings. Their assets, which consist mainly of first mortgages, reflect their activities. Currently the United States real estate mortgage market

is dominated by savings and loan associations. This reflects the importance of these organizations as a channel through which domestic savings are mobilized (Ring 1972).

It was mentioned that the major portion of the funds available to savings and loan associations are invested in home mortgages. The small portion remaining is invested in the obligations of government treasury securities so as to provide for an immediate source of funds if necessary to meet requests for the net withdrawal of savings.

In most cases savings and loan associations are mutual or cooperative organizations. The members of the associations are the owners who have the power to elect the board of directors. In this way these organizations are controlled by the holders of savings shares. It is important to note that the savings account of savings and loan associations is not a deposit account.

The residual earnings, after the deduction of expenses and after putting aside the reserves, are distributed in the form of dividends (Distelhorst 1951).

Similar to savings and loan associations in purpose and organization are mutual savings banks.

#### Mutual Savings Banks

Mutual savings banks are organized for the purpose of receiving small savings to be invested by the bank to the

best advantage of the saver. Most financial writers regard the original savings banks as philanthropic in nature. They helped people with low incomes by providing them with convenient savings plans and facilities. In this way they promoted the habit of saving among the emerging class of industrial workers, encouraged thrift, and developed positive attitudes toward money and capital (Boehmler and others 1951).

In investing the funds of small savers, mutual savings banks regard safety and availability to savers when needed as of more importance than the rate of interest. For this reason, the mortgage market represents the most important investment outlet to mutual savings banks.

The organizers of mutual savings banks, in addition to providing the initial capital, manage the institutions as trustees. The governing board of trustees for most mutual savings banks is a self-perpetuating body. The daily operations of mutual savings banks are conducted by professional bankers.

As in the case of savings and loan associations, mutual savings banks have no capital stock, as their mutual form of organization implies. Their income, which is earned in the form of interest on investment, belongs to the holders of savings accounts. After deducting operating expenses and keeping aside an adequate amount of surplus for the purpose of meeting possible future losses, the trustee determines

the rate of dividends to be distributed. The distribution is referred to as dividends because it is related to the net earnings of the savings bank and is not a fixed proportion of return which the savings bank is obliged to pay (Distelhorst 1951).

Beside savings and loan associations and mutual savings banks, there is a third subcategory which is organized on mutual basis and represents an outlet for the savings of low or middle income group. This third subcategory consists of credit unions.

#### Credit Unions

Credit unions are mainly consumer credit agencies. Because the average size is small, credit unions are not equipped to provide funds for purposes other than consumer credit. However, in recent years, they have gained more importance as savings outlets.

The incentive to establish a credit union may originate with the employer, employees or combination of the two. A credit union may be formed by workers working in the same industry or workers under the same employer (Ludtke 1961).

Savers' accounts normally take the form of shares. Most credit unions pursue the practice of repurchasing shares on demand and their savings are treated as savings accounts by most members. The members elect officers to operate the credit union.

Because credit unions are mutual organizations, the return on their shares takes the form of dividends. The dividend payout is frequently determined by the vote of membership, after putting aside reserves or guarantee funds (Boehmler and others 1951).

The three nonmonetary financial institutions we have introduced so far are organized on mutual basis. The institutions that follow are organized on corporate basis. One of them is the investment company.

#### Investment Companies

The investment company is a financial institution whose main objective is to collect the savings of many individuals and institutions under the same management by selling them its shares.

There are three main classes of investment companies. These classes are:

1. Face Amount Certificate Companies. Under this class the investor pays a certain amount of money to the company and he is given a certificate showing the date when he is paid his money with the yield on it. It is a rare type.
2. Unit Investment Trust. Here the investment company is organized under a trust indenture, with no board of directors, issuing only redeemable securities. The custodian takes care of the assets and he has to

notify the security holders of all changes in the portfolio. In recent years it has declined in importance (Ludtke 1961).

3. Management Investment Companies. This is the type of investment company which is prevalent today, and almost all investment companies fall under this class. They are further classified into open-end companies. Open-end companies are always ready to sell additional stock to new purchasers; the amount of stock is not fixed. They are non-levered companies. For close-end companies, the amount of outstanding stock is fixed, i.e., the capital of close-end companies is relatively fixed. Hence, they are levered companies (Bellemore 1951).

The funds collected by investment companies from individuals and institutions who buy their shares, are invested in a diversified group of securities, for the benefit of all participants. The investment company buys securities for investment and not for the aim of controlling the company offering these securities. To the individual shareholder, safety of investment undertaken by the investment company is regarded as an important consideration.

The owners of the investment company have the following advantages for entrusting their funds to an investment company:

1. Their investments are managed by a specialized management.
2. Good timing may result in gains to the investor, while bad timing may result in losses. Being an experienced entity, the investment company is capable of solving the problem of timing.
3. Portfolio diversification.
4. Reduced commission expense. (Bellemore 1951)

In regard to these merits, the investment company represents a pool for the savings of many individuals. Since investment companies help individuals who are looking for specialized institutions to entrust them with their savings for safe investment, it is logical to think that specialized institutions are needed to help businesses in obtaining long-term funds. Investment banks are financial institutions that help business enterprises to acquire long-term funds.

#### Investment Banks

An investment bank is a nonmonetary financial intermediary that deals primarily in the sale of new securities. It is an intermediary that assists business enterprises to acquire long-term funds to finance production, distribution and sale of goods and services. When a corporation floats a new security issue to the public, normally it avails itself of the services of an investment bank which buys the issue

from the corporation and then resells it to the public (Van Horne 1968).

In general terms, the functions of an investment bank are:

1. Risk Bearing. When an investment bank buys a security issue, it underwrites the sale of the issue and the issuing company receives a check for the purchase price. At that time the corporation passes the risk of not being able to sell the issue at the fixed price to the investors. By selling the issue at a price above the established price, the investment bank realizes a profit; by selling it at a lower price, it incurs a loss.
2. Selling Securities. The investment bank sells securities to investors and earns a selling concession for this service.
3. Advising. The investment bank advises the issuing company on all aspects necessary to make the issue a successful one, such as timing of the issue, terms of the issue and the offering price.
4. Pricing the Issue. In a negotiated offering, the issuing company and the investment bank fix the price (Farwell and others 1966, Van Horne 1971).

From the foregoing analysis, it can be seen that investment banks are an essential part of the capital markets

affecting the transfer of loanable funds to ultimate users. The efficiency of new issue market affects the availability and cost of capital to ultimate users and, in doing so, influences the level and distribution of real investment, and thus production, employment and income (Friend 1965).

Among the major categories of nonmonetary financial institutions there are some institutions which deal in what is called "contractual savings". These institutions are mainly represented by insurance companies and the institutions dealing in pension funds. Insurance companies will be reviewed first.

#### Insurance Companies

Legally, insurance consists of a contract known as a policy whereby the insurer contracts to indemnify the insured for a loss when the event insured against occurs, provided that the insured pays the agreed upon premium in compliance with the policy terms (Ludtke 1961)

Insurance has been built upon the principle of absorbing the economic shock of loss. It is an institutional device which accumulates funds to meet losses. Insurance improves the economic planning by the substitution of a small definite premium (cost) for the danger of a large loss. The social benefits provided by insurance lie in that they spread risk among a large number of economic units.

Insurance companies are organized either as stock companies, where profits go to the small group of stockholders, or as mutual companies, where profits are returned to policyholders and thus reduce the cost of their insurance.

The general long list of insurable hazards faced by individuals and organizations leads to many types of insurance. Within this context, life insurance companies and fire, property and casualty insurance companies are regarded as the most important types.

Life Insurance Companies. Life insurance companies safeguard against the risk that an individual or organization may lose his earning power. They are regarded as the largest financial institutions after commercial banks. The gathering of policyholders' reserves and annual premiums to provide security against risk creates a large reservoir of funds which make life insurance companies an important source of personal savings for investment. The annual premium paid represents savings and payment for protection (Harvitz 1963).

Life insurance contracts are classified into term insurance, level insurance, endowment insurance and annuity insurance. Each one of them will be described separately.

1. Term Insurance. Term insurance contracts are effective only for specific time periods. The contract may be renewed. It represents pure insurance with no savings aspect. It is commonly used as a security

for mortgages and other kinds of debt or it may be used as a security for temporary protection. The initial cost of term insurance is lower than the cost of other forms of insurance, but the insurer actually pays a higher premium than the annual rate of permanent straight life policy because the rate goes up year after year due to the increase in the chance of death as one grows older. Benefits in term insurance are payable only if death happens within the period specified (Ludtke 1961)

2. Level Insurance. This is also known as whole life insurance. The contract is permanent as long as the policyholder meets the terms of the contract. This type of insurance contract meets the basic needs of life insurance because it provides permanent protection. The benefits are payable at death. The insured is also given the right to receive the cash value saved and also the right to borrow against the cash value from the insurer, or he may transfer the savings into retirement income rather than waiting for a death claim to be filed (Sweeney 1951).
3. Endowment Insurance. This is a plan of insurance that provides for payment of a definite sum of money to the policyholder himself after a fixed number of years if he is still living. If death of the insured

occurs during the endowment period, payment of the face amount is made to a beneficiary. This form of life insurance stresses the savings aspect of insurance because premiums collected and income earned from investment of funds have to be adequate to provide for settlement immediately after the end of the contract period (Ludtke 1961).

4. Annuity Life Insurance. This is a contract purchased by a buyer and sold by the insurance company, whereby the company undertakes to pay a fixed sum periodically for a stated period or, more commonly, for the remaining life of the buyer. Its purpose is mainly to provide an income for the insured when his productive years are over. In this way annuity insurance allows a person to use his capital for living expenses after retirement without running short if he lives longer than he had reason to expect.

So far we have described the nature of the different types of life insurance contracts. More important than this is to show how life insurance companies accumulate funds and mobilize these funds and hence, participate in saving-investment and capital formation processes.

Life insurance companies conduct statistical averages of death age to forecast death rates. This is known as actuarial techniques. Using these techniques, life insurance

companies found that contractual arrangement would last for many years and accumulated savings were left intact until the death of the policyholder. They started to invest the accumulated funds in long-term assets, such as corporate bonds and real estate mortgages. The maturity of assets may be arranged in a manner to match the expected settlement of claims.

Life insurance companies, in their investments, are guided by financial principles of safety, liquidity, diversification and maximization of income. With regard to safety of investment, life insurance companies are more inclined towards real estate investment. Liquidity is maintained so as to meet the usual receipts and disbursement transactions and to provide for unforeseen death and survival benefits, and heavy cash value refunds resulting from policy surrenders (Farwell and others 1966).

Thus, life insurance companies represent a big pool for domestic savings and, as financial intermediaries, they play a major role in saving-investment and capital formation processes.

#### Fire, Property and Casualty Insurance Companies.

Fire, property and casualty insurance companies sell protection against the loss of property. They are not savings institutions in the same sense as life insurance companies. Because the nature of physical risks are uncertain, this

makes it difficult to estimate accurately the timing and size of losses. This stresses the importance of undertaking investments with higher returns by insurance companies.

Some factors govern investment policies of fire, property and casualty insurance companies. The most important of these factors are:

1. State insurance regulations.
2. Diversification to maximize investment income.
3. Liquidity and safety requirements.
4. Incentives to maximize earned income from investment. (Farwell and others 1966)

Thus, although the amount of savings channelled through fire, property and casualty insurance companies is less than the amount channelled through life insurance companies, still these organizations play their role in the transfer of funds from surplus economic units to deficit economic units and in doing so they affect the economic allocation of resources.

It was stated that the institutions which deal in contractual savings consist of insurance companies and pension funds. Having reviewed insurance companies, the next step would be to review pension funds in terms of their role in saving-investment and capital formation processes.

## Pension Funds

A pension fund is an annuity paid to a retired person while he is alive. To this extent, it is the same as an annuity sold by a life insurance company.

Pension funds are accumulated from the contribution of employers and employees. A contributing pension fund is one in which some deductions from the cost of the pension are made from the employee's wage or salary. They may be managed by the employer, employees, through their trade unions or by a life insurance company or a bank. (Rolfe 1967)

Pension funds, after their accumulation, are invested in securities to provide an income for employees when they retire. Generally speaking, pension funds, as contractual savings, have many economic and financial effects. The most significant effects are:

1. Tax effects. The effective tax on pension income is lower because this income is received on a smaller scale after retirement.
2. Pension plans tend to remove mobility of labor, because of the fear of the employee that he will lose his accumulated pension payments if he transfers to another employer.
3. Effects on capital flow. Pension funds invested affect both interest rate and the direction of

- capital flow because they are part of the total demand for securities.
4. Pension funds reduce the supply of money available for immediate consumption and they weight their payments as capital market investments.
  5. In long-run pension plans, funds and other forms of contractual savings provide for the most stable and reliable source of funds. The liabilities and assets of financial institutions dealing in contractual savings are long-term by nature (Boehmler and others 1951).

Thus pension funds have a remarkable role in saving-investment and capital formation processes. Their importance as a pool which receives a part of the community savings is intensified by the fact that pension funds tend to be stable.

There remain two types of financial institutions that will be considered under the major category of nonmonetary financial institutions. These are mortgage banks and development banks. Mortgage banks will be considered first.

#### Mortgage Banks

Life insurance companies and trusts make real estate loans over the entire range of urban land improvements from large office buildings and factories to single-family loans. Life insurance companies and some trusts use mortgage

correspondents because it is impossible to originate mortgage loans and service these loans, which are scattered throughout the country, directly from their offices.

The mortgage bank originates mortgage loans and makes these loans with its own funds. After the loan has been made and the funds disbursed to the borrower, the mortgage bank sells the loan to a permanent investor--a life insurance company or a private trust. The mortgage bank is subsequently required to collect interest and principle payments due on the loan, to see that the borrower keeps the property in good repair and to see that taxes and insurance are paid.

The mortgage bank is typically compensated for its services by selling the loan at a premium plus collecting a fee for servicing the loan (Goldsmith 1969). Thus, the mortgage bank as a financial institution facilitates the transference of funds from savers to investors and in so doing assumes its role in the capital market.

#### Development Banks

Development banks started after the Second World War. The feature that distinguishes a development bank from a commercial bank in lending activities is that the first regards the desirability of the project to be financed and the chance of its future success and contribution to the economy as a major factor, more important than the security offered for the loan (Perkins and Sullivan 1970).

While commercial banks supply short-term and, to a lesser extent, medium-term funds, development banks supply long-term funds. Therefore, its role is expected to be active in those countries where preconditions for natural economic growth are lacking (Jucker-Fleetwood 1964).

Development banks also aim to establish some small and medium-sized industries to be set up for the purpose of providing key industries while helping to train both management and skilled workers. These small and medium-sized industries support large industries by supplying them with day-to-day needs in the secondary sector and breeding for them capable entrepreneurs, engineers and inventors. Thus, development banks as financial institutions also participate in allocating the limited resources of the nation to the sphere of production.

### Summary

In this chapter financial institutions are classified into two broad categories, monetary and nonmonetary financial institutions. The first category supplies, directly or indirectly, some form of money. They consist of the central bank and commercial banks, the first being regarded as the backbone of the financial infrastructure and possibly the economy as a whole.

Nonmonetary financial institutions are those financial institutions whose liabilities consist of financial

assets other than money. Because they vary in the character of their assets, liabilities and activities, they are further subcategorized. This subcategorization includes savings and loan associations, mutual savings banks, credit unions, investment banks, investment companies, insurance companies, pension funds, mortgage banks and development banks.

Both monetary and nonmonetary financial institutions transfer funds from surplus spending units to deficit spending units. In this chapter, the individual components of each category are described in terms of their characteristics and functions in the American financial infrastructure. The purpose behind this is to see how each of them can fit in the financial infrastructure of an emerging country, such as Sudan, as will be clear in the next chapter.

## CHAPTER IV

### ECONOMIC ASPECTS OF FINANCIAL INSTITUTIONS IN EMERGING COUNTRIES

In Chapters II and III the financial system of a developed country, such as the United States, was described in terms of what it is and what it does. This chapter will be concerned mainly with the development of a financial system in an emerging country, such as Sudan, capable of coping with the present and future economic conditions of the country and conducive to the needs of economic growth. This financial system will be composed mainly of private enterprise financial institutions, and then governmental financial institutions take what remains to be done and cannot be done adequately or at all by the private sector. Since the economy is an open one, foreign investment and assistance and international financial institutions are also expected to have a role in the financial infrastructure of an emerging country.

Since economic and social environment represents the framework within which financial intermediaries operate, it is appropriate to first describe economic and social conditions in an emerging country.

Economic and Social Conditions  
of an Emerging Country

In emerging countries the per capita income is typically low; in Sudan it is Ls 35.00<sup>1</sup>. Not only the per capita income in these countries is low, but also the propensity to consume is high among almost all strata of the population. With a low per capita income and a high propensity to consume, it is logical that aggregate savings in developing countries is expected to be too small for the level of investment necessary for a steady rise in productive capacity.

Some other factors contribute to the difficulty of raising the rate of domestic saving at least in the short-run. In developing countries the population growth rate is high and this in turn hinders the increase of per capita saving. Adverse effects on saving are also caused by political instability in those countries. Governments are soon replaced by others. Under these circumstances, no government is expected to formulate and execute any economic plan before it is overthrown. Not only this, but it is also expected that both domestic and foreign investors will be restrained and discouraged to undertake any investment projects.

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1. One Sudanese pound is equivalent to \$2.89.

Also in developing countries product markets are not well established. The size of the available market is not adequate enough to cope with the products that could be produced.

In emerging countries, although towns are growing fast, still the majority of the population live in small villages. With this small degree of urbanization, the traditional sector is larger than the modern sector. In rural areas saving is opposed by a low average education status and knowledge among the population. People are ignorant of the benefits of saving, and they lack the knowledge about banking, stocks and shares. Some people, in these traditional societies, are also restrained from saving by traditional and religious ideas. Even people who are able to save prefer traditional unproductive investments in land, or else they hoard cash or jewels.

Also governments of emerging countries find it difficult to achieve budget surpluses because government revenues are relatively inelastic and because of the increasing pressure on the government to increase its expenditures on services. Owing to low income level, the basis for taxation is narrow, since the majority of the population have incomes almost at the subsistence level and therefore cannot be taxed (Bernstein 1957, Marlin 1970).

To break through the vicious circle some developing countries come to realize that for the stimulation of economic growth, they have to undertake development programs. These development programs generally aim towards expansion of investment to increase agricultural and industrial production. Sudan Government is now executing the Five Year Plan for the Social and Economic Development (1969/70 - 1973/74) for the purpose of raising production in the fields of agriculture and industry. To stimulate domestic savings to contribute in the financing of these development plans, incentives can be provided and efficient institutions established, to mobilize savings and to promote greater willingness among middle class people to pool their savings in these institutions (Okyar 1965).

In the following section it will be shown how the financial system can play a vital role in affecting the willingness of people in emerging countries to save, and hence, participate in saving-investment and capital formation processes.

Promotion of Individual  
Savings by Financial Institutions

For the finance of economic and social development, an emerging country needs to promote and mobilize domestic savings. To increase the willingness of people in these countries to save, saving has to be made more attractive than spending. A well established financial system can play an important role in the promotion of individual savings in emerging countries. This well functioning financial system can promote savings by the establishment of savings institutions which are adequate in number and convenient in location and which offer savings plans and programs possessing a widespread appeal.

In Chapters II and III it was shown how the financial instruments issued by financial institutions are more efficient and attractive as a means of raising funds than primary securities. Financial instruments, compared with primary securities, are easier to liquidate and completely divisible.

Also in those chapters it was described how financial institutions assume their role in the saving-instrument and capital formation processes by introducing indirect external finance. They stand between economic units with surplus budgets and other economic units with deficit budgets. Hence, they stand between ultimate borrowers and ultimate lenders, issuing debt instruments of their own represented by secondary

instruments instead of primary securities. In this way, financial institutions will help in the accumulation of capital, on one hand, and increase investment efficiency on the other hand. Investment efficiency is increased because financial intermediation permits capital saved to be injected in the process of production by those who have the ability to make it most productive. Thus financial institutions redistribute savings from investment projects with relatively low net productivities to those in which the expected return will be higher. Capital formation ratio will be increased and, as a result, the rate of economic growth will be increased.

Hence indirect finance through financial institutions permits aggregate output to increase without changes in resources. Specialization will exist such that some units with less entrepreneurial ability and a higher degree of risk aversion will save more than they invest while others invest more than they save. Thus, the growth of financial institutions can encourage higher levels of saving and investment at each level of income (Gurley and Shaw 1956, Polakoff and others 1970).

In the remaining part of this chapter, a framework for a financial system of an emerging country, such as Sudan, will be set, so that this system is capable of coping with the economic needs of the country at the present and future

times. Within the system, individual components doing specific functions will be described. We will begin first with monetary financial institutions, since they constitute the important part of any financial infrastructure when it is in its early stages of development.

### Monetary Financial Institutions

An important factor for economic development is the establishment of an effective monetary system for the achievement of a stable monetary policy. Within the monetary system we will first look at the role of the central bank and then that of commercial banks.

#### The Central Bank

The central bank of Sudan, "Bank of Sudan," was established in 1960. In developing economies the main functions of the central bank are to indirectly finance long-term development within the economy and to encourage the growth of financial institutions. The critical question that faces the central bank of a developing country is how to contribute to economic development and at the same time maintain internal and external value of the currency (Nevin 1961).

The central bank can contribute significantly to the financing of economic development through policies which induce savings to remain at home and to flow to financial

institutions. These policies have to be directed toward liquidity and return which are considered to be the most significant factors that affect the willingness of investors to invest. The interest rate on savings deposits has to be competitive with alternative uses of funds. In most developing countries, inflationary trends persist which discourage savings from flowing into financial institutions and to overcome this, interest rate on savings deposits have to be high.

In recent years, many central banks in emerging countries have played a major role in mobilizing savings for development through interest rate structures. In 1965 the central bank of Korea raised interest rates on savings deposits to 26% on one-year bank deposits. That reform resulted in an increase in the national savings rate from 7% in 1964 to 16% in 1969 (Brimmer 1971, p. 783).

The policy that the central bank of an emerging country pursues toward commercial banks has important implications. In Chapter III it was shown that the tools of the central banks, in developed economies, used in influencing the ability of commercial banks to extend loans are reserve requirements, open market operations and discount rates. In that part of the study, the manipulation of each of these three tools by the central bank was shown. In emerging countries, central banks normally resort to selective controls

to direct commercial banks' activities. To ensure that commercial banks contribute to economic development, the central bank can adopt selective controls to regulate their lending activities. These selective controls may specify that bank advances to certain sectors should not exceed a particular sum or a certain proportion of all bank advances. Central banks' selective controls may also be in the form of differential discount rates. Here the central bank charges preferential rate on discount or advances against preferred types of paper to increase their lending or to reduce the cost of borrowing to those activities which originally issued these papers (Nevin 1961).

Thus the central bank can be regarded as the backbone of the financial infrastructure. Having described the position of the central bank in the financial infrastructure of an emerging country, the next step is to show the role of commercial banks, since they constitute, with the central bank, the category known as monetary financial institutions.

#### Commercial Banks

In their article of September 1955 (p. 521), Gurley and Shaw said, "A monetary system and especially its commercial banking has commonly been the first significant financial intermediary."

In developing countries, where the financial system is still in its infancy, commercial banks represent the most

important existing financial institutions. They supply short and medium-term funds to the economy, and, in this way, they issue financial instruments to be used for the creation of new wealth.

Commercial banks, by their ability to attract deposits and lend the funds raised to entrepreneurs, create the leverage necessary for economic growth. They have always been the leaders to create a financial superstructure. They have also been the first financial intermediaries to emerge during the development process, as was shown in the historical development of the financial superstructure of the United States.

If savings can find their way to commercial banks, the financial transactions between savers, deposit banks and the borrowers will tend to multiply the financial resources. Financial superstructure created, will promote the ownership of real assets by efficient entrepreneurs. Thus, the creation of more real assets through new investments takes place at a higher rate in an economy characterized by an efficient financial superstructure (Yazici 1965).

In these developing economies, where capital markets are almost absent, commercial banks can fill the gap. They can hold equity of industrial, financial and trading companies. The purchase of equity shares by commercial banks encourages other investors to purchase such shares. To

safeguard against over-investment in equity, commercial banks may set safety limits to their equity holdings through either of the following methods:

1. Equity holdings of the bank should not exceed its own set equity.
2. Equity holdings of the bank should not exceed a percentage of its own equity plus a specified percentage of its time deposits.
3. Equity percentage of a commercial bank should not be more than 10% of its total resources. (Yazici 1965)

In an effort to fill the gap created by the absence of capital markets in emerging countries, commercial banks can also undertake the task of marketing securities of other corporations. They have a large branch office network and a large number of depositors, and hence they can reach savers geographically and personally (Nevin 1961).

To sum up, in developing economies, where the financial infrastructure is still in its early stage of development, commercial banks represent the main financial institutions in existence. For this reason their financial role is expected to be significant. However, since commercial banks tend to restrict their lending activities to short-term and medium-term, the financial infrastructure will be deficient unless some other financial institutions exist to extend

loans on long-term basis. These other financial institutions are nonmonetary financial institutions.

### Nonmonetary Financial Institutions

To satisfy the financial needs of the economy in an emerging country, nonmonetary financial institutions should exist beside monetary financial institutions. In emerging countries, nonmonetary financial institutions are either infant and insignificant or nonexistent at all.

Insurance industry is one class of nonmonetary financial institutions which is existing but with a minor role. While life insurance companies are considered to be the largest financial institutions in the United States, after commercial banks, in an emerging country, such as Sudan, they are regarded as the least significant financial institutions. The reason is that most of the population are traditional farmers who are neither aware of the benefits of life insurance nor feel the need for it. Despite these facts, life insurance companies can be introduced gradually in developing countries. With economic development and urbanization, processes which most of the emerging countries are undergoing, individual insurance buying has to be encouraged. This will create a new method of saving and hence, can provide an avenue for the expansion of the financial system in emerging countries. To reduce the cost

of life insurance, mutual life insurance companies may be formulated in these societies.

In a country such as Sudan, fire, property and casualty insurance companies are more significant than life insurance companies. This is because most of the government property is insured. In addition, the business enterprises, feeling unable to absorb economic losses and damages, find it necessary to insure their property. For these reasons, fire and property insurance companies are encouraged to grow and develop.

Of the existing nonmonetary financial institutions are also investment banks. Commercial banks are now performing the functions of investment banks. As we mentioned, commercial banks have many branches and many depositors. This enables them to sell and market securities issued by other business enterprises. The volume of the issue is usually small, because business enterprises are themselves small. However, as time goes on large forms of business enterprises are expected to exist and, by that time, investment banking business has to undergo some changes. This may necessitate the existence of financial institutions specializing in investment banking business.

Having reviewed the existing nonmonetary financial institutions, the next step is to review those financial institutions which have not evolved yet, but there is a need

for their evolution to fill the gap created by their absence in the financial infrastructure.

In an emerging country, such as Sudan, efforts should be made toward the encouragement of savings among middle and low income groups. Financial institutions, organized on a mutual basis, are recommended for this purpose. Businessmen can organize mutual savings banks for their workers. They have to provide the initial capital and manage these institutions as trustees. In this way they can encourage thrift among workers. The savings of workers pooled in these organizations can be invested to their best advantage. Not only that, but also these savings must be available whenever they are needed by the savers.

Another form of mutual financial institutions that may be organized for the attraction of the savings of middle and low income groups is a class of financial institutions that resembles savings and loan associations in the United States. This is because with the urbanization process an industrial class of workers is also growing. They need to own their own homes. For the purpose of promoting home ownership, savings and loan associations may be formed and managed by the workers themselves. This organization supplies housing to the workers of low and middle income classes, and it can also offer its savings accounts to the public. The savings collected will be reinvested mainly in amortizing

first mortgage loans for the promotion of home ownership as was already mentioned. The security of the loan will be the home itself. Taking into consideration the continuous growth of the industrial sector of Sudan, the future prospects for financial organizations similar to savings and loan associations are quite encouraging.

Another class of nonmonetary financial institutions that may be organized on a mutual basis as a pool for the savings of low income groups is credit unions. These organizations may be formed by workers working for the same industry or for the same employer. In cases where workers are unaware or ignorant of the benefits from such an organization, the incentive to establish a credit union may be originated by the employer. It was mentioned early in this chapter, under the economic and social conditions prevailing in emerging countries, that the propensity to consume is high. Since credit unions provide funds for consumer credit, it is expected that they will have an accepted appeal to the public.

The financial institutions introduced so far in the framework of the financial infrastructure of an emerging country are private sector enterprises. The private sector is well-equipped and hence will adequately fit for the purposes and functions of those institutions. However, this does not mean that the government is entirely excluded from

the financial infrastructure. Within the financial infrastructure, the government is expected to perform in two roles. The first role requires that the government establish and control those financial institutions which cannot or will not be performed adequately or at all by the private sector. The second role requires from the government the performance of economic policy and behavior in such a way as to encourage the growth of private enterprise financial institutions. I will discuss the first role and then proceed to the second role.

#### Government Controlled Financial Institutions

Taking into consideration economic and social conditions, two types of financial institutions are suitable for governmental economic policy. They are already in existence and have been financed by the central government; they are the development banks and pension funds.

Development Banks. In Sudan, as in most other developing countries, commercial banks have greater access to financing trade than other activities. To overcome this deficiency, the Sudan Government established the Agricultural Bank in 1961. The main purpose was to meet the needs of cultivators for substantial amounts of credit at reasonable interest rates and to centralize the government's system of agricultural credit. As a financial institution, the Sudan Agricultural Bank is now providing cultivators

with the necessary credit. This is reflected in Table II which shows advances made by Sudan Agricultural Bank to cultivators during the period 1969-1972.

Also to meet financial needs for industrial development, the Sudan Government established the Industrial Bank in 1962. Table III shows the volume of loans extended by this bank for industrial development during the period 1969-1972.

TABLE II

Advances Made By Sudan Agricultural Bank  
To Cultivators In The Period 1969-1972

(1 Ls = \$2.89)

<u>Year</u>	<u>Amount (in Ls)</u>
1969	1,627,633
1970	2,007,087
1971	3,005,939
1972	3,454,811

SOURCE: Sudan Agricultural Bank

TABLE III

Advances Made By Sudan Industrial Bank  
To Industrial Economic Units  
During The Period 1969-1972

(1 Ls = \$2.89)

<u>Year</u>	<u>Amount (in Thousands of Ls)</u>
1969	116
1970	318
1971	303
1972	294

SOURCE: Sudan Industrial Bank

It is important to note that almost all the amounts of the loans made by both Agricultural and Industrial Banks were made to the private sector, agricultural and industrial economic units, and on a long-term basis. The figures reveal the fact that development banks in emerging countries are important credit institutions for the provision of long-term loans to industry and agriculture. The increase of capital of these institutions can help them to attain their objectives. Thus an emerging country, in considering the development of its financial infrastructure, has to give these development banks enough consideration and recognition (Emery 1970).

Pension Funds and Governmental Insurance. This is a second type of financial activity that fits for the government position in the financial infrastructure. In developing countries the personnel of the public sector is increasing year after year. The building of a wide apparatus of governmental insurance, guarantee and supervision can make institutional savings more acceptable to small savers who are interested in liquidity and safety of their invested savings. For example, in the Phillipines there is what is called "Governmental Service Insurance System." It is a government owned and controlled organization for the provision of retirement annuities, insurance and other services for government employees and insurance for government owned

properties. Membership in the system is compulsory for all government employees. Now "Government Service Insurance System" in the Phillipines is regarded as the largest non-bank financial institution and a major source of long-term credit, particularly for real estate finance (Emery 1970, Rolfe 1967).

However, pension funds and employees' insurance, after being accumulated, should be invested to provide an income for employees when they retire. The regulations and laws preventing these funds from entering the financial markets should be removed (Bernstein 1957).

Having described the first role of the governmental sector in the financial infrastructure, as represented by its financial institutions, the next step will be to introduce its second role as represented by its economic policy.

#### Government Economic Policy as a Tool for the Promotion of Financial Infrastructure

It was said,

...the problem of inefficiency in the financial system cannot be solved by the improvement of financial institutions and policy alone. The improvement of the financial system should be considered together with the measures to improve the related nonfinancial policies. It would be meaningless to push the improvement of the financial system without taking corrective measures on the foreign exchange rate, foreign loan

policy, domestic tax government incentive policy, etc. (Shaw 1973, p. 168)

The above statement shows that the government economic policy is also a tool that can be manipulated to promote financial infrastructure of a developing country. Within economic policy, the tax policy is regarded as one of the most effective factors on the promotion of financial institutions. Most development economists consider tax structure and its level as of great effect in the determination of domestic savings rate. The tax rate on capital gains affects the mobility of capital. A higher tax rate on capital gains makes the owners of properties less willing to sell their properties as prices go up. As a result, capital will flow at a lower rate and this will affect economic development adversely. Therefore, taxation of capital gains at a lower rate can be looked at as an incentive for savings to be invested in financial instruments. Also to encourage savings, dividends may be taxed at a lower rate. Moreover, savings deposited with financial institutions may be tax exempted (Bronfenbrenner, Hayes and Wendt 1965).

Some legislative incentives, with respect to taxation, can be given to encourage domestic capital accumulation in the following ways:

1. Income tax and profits tax relief. The general form is to offer a total exemption from tax for five

years or more to profits of new industries (Nwogugu 1965).

The Sudan Development and Promotion Industrial Investment Act 1972 (n.p.) specifies,

The Minister may exempt an enterprise from business profits tax as follows:

- a. For five years to be calculated as from the date of commencement of production.
  - b. For further five years on the following basis:
    - i. Full exemption from business profits tax, if the profits are within the first 10% of the capital employed by the enterprise.
    - ii. 50% of the rate prescribed as business profits tax, if the profits are within the second 10% of the capital employed by the enterprise.
    - iii. Any profits exceeding 20% of the capital employed in the enterprise shall be subject to business profits tax at the prescribed rates.
2. Relief from custom duties. As an incentive to domestic investment building materials, plant and machinery and raw materials may be fully or partially exempt from custom duties. The same Act mentioned, states:
- a. The Minister may exempt any enterprise or craft wholly or partially from custom and additional duties relating to:
    - i. Machines and equipment which are imported by such enterprise of craft.

- ii. Spare parts, raw materials, quasi manufactured or intermediary materials imported by such enterprise or craft provided they are not available locally in the necessary qualities or quantities.
  - b. The Minister may in exceptional cases extend the concession period for more than five years.
3. Depreciation Allowance. They may be deductible expenses for tax purposes, as an incentive for investment. They may be in the form of initial allowance or accelerated depreciation of the cost of the buildings, plant and machinery.

Another aspect of government economic policy which may affect the growth and efficiency of financial institutions is the policy of the treasury in managing public debt. Public debt in a developing country can be managed through the following principles for the financial system:

1. The central bank has to influence short-term and long-term interest rates in the money and capital markets.
2. The treasury should adjust its own debt operations to the interest rates prevailing in the money market as influenced by the supply and demand for loanable funds through the central bank action.
3. In financing and refinancing debt, the treasury should place the larger part of its obligation with investment and not with liquidity holders.

4. The treasury should maintain a balanced maturity distribution of the debt.
5. The government should undertake the reduction of debt as a long-term policy. (Bechart 1965)

One more important point about the effect of government policy on the financial system remains. The government should provide adequate guarantees to investors against measures of nationalization and confiscation. In most of the developing countries the fear of nationalization and confiscation is the main reason why many people put their savings in banks outside their countries. The guarantees given to investors should be enforced by law. They should also state clearly that there will be no confiscation or nationalization. In the cases where the higher interest of the state so requires, investors must be compensated fairly and quickly.

This point ends up the discussion of the position of the public sector in the financial infrastructure of the nation. However, since the economy of Sudan is an open one, it is expected that it will be affected to a great extent by other economies of the world, especially the strong and developed ones. It is also expected to affect, to a minor extent, other world economies. Therefore, foreign investment is recommended to occupy a place in economic and financial infrastructure of an emerging country, such as Sudan.

The Position of Foreign Investment in the  
Financial Infrastructure of an Emerging Country

In a paper which he presented in a symposium on the development of capital markets, Siddiqui (1965, p. 327) said, "The inadequate formation of capital which characterized the developing countries due to the too modest level of real income causes, on the supply side, a low propensity to save and, on the demand side, a low propensity to invest."

The above statement implies that, in developing countries, the volume of investment is small because the volume of domestic savings is small. The flow of outside funds is regarded as an appropriate instrument for breaking through this vicious circle to fill up the gap in local savings and investments requirements and also the balance of payments problems.

Foreign investment is considered of paramount importance in the promotion of economic development in emerging countries. The flow of foreign capital into a developing country increases the amount of investment that a country can undertake. It also calls for adjustments within the economy so that capital inflow will be used in investment expansion (Bernstein, 1957).

Even if there is enough domestic investment funds, foreign capital is still necessary for developing countries for the importation of equipments and machinery not produced

at home. The resources of developing countries from foreign exchange are scarce and are considered to be a major bottleneck for economic development. The scarcity of foreign exchange can only be met from foreign investment, loans or grants.

Private foreign investments can mobilize domestic savings in many respects. Through the promotion of joint ventures, private foreign investment attracts some of the domestic savings to be used as productive capital. Private foreign investors form joint ventures with domestic investors to produce some commodities formerly imported. This allows for domestic resources to be directed from trade to production.

Also with private foreign investment better management and technology are introduced. Foreign enterprises, which invest their capital in joint ventures in developing countries, bring with them their advanced administrative and financial experience. Improved technology accompanies private foreign investment and is capable of training local labor.

Private foreign investment can also help to alter the socio-financial structure of industrial and business partnership from family or friendship companies into a modern form of capital structure considered to be necessary prerequisites of capital market development. Hence, small

savers gradually begin to buy shares in large joint stock companies open to the public. This results in accumulation and mobilization of savings of the middle class (Aliabadi 1965).

The foregoing account shows that foreign capital can play a major role in the formation of capital markets in emerging countries. However, foreign capital will not flow into developing countries unless some basic requirements are met for its attraction. Some natural resources like water, coal and iron have to be available. There must be adequate transportation facilities and power. Cheap and skilled labor is also needed. These requirements are important since they constitute, with capital, factors of production.

Also a basic requirement and necessity for the attraction of capital is the establishment of confidence in private foreign investors with respect to the security of their investments. This is regarded as the most important factor in the attraction of foreign investment. The fear of nationalization or expropriation of foreign owned enterprises in developing countries without adequate compensation, is considered to be a disincentive to the inflow of foreign capital in a developing country. To remove this fear, assurances of security may be given to foreign investors as follows:

1. Government Policy Statement. Many governments of developing countries have declared policy statements assuring foreign investors that their property will be secured. For the purpose of attracting foreign capital, the federal and regional governments of Nigeria announced:

Our governments have no plans for nationalizing industry beyond the extent to which public utilities are already nationalized, nor do we foresee any such proposals arising. Nevertheless, we are anxious that there should be no doubt in the minds of overseas entrepreneurs that Nigeria will provide adequate safeguards for the interests of investors in the event of any industry being nationalized in the future. Should this occur, then fair compensation, assessed by independent arbitration should be paid. (Nigerian Handbook of Commerce and Industry 1960, p. 230)

2. Legislation. In many developing countries assurances of security given to foreign investors have been put into legislation. In Sudan, the Development and Promotion of Industrial Investment Act 1972 (n.p.) states:

Capital invested in the Democratic Republic of Sudan shall have the following guarantees:

- a. It shall not be subject to sequestration or confiscation save by order of the competent court in accordance with existing laws.

- b. It shall not be nationalized except where the higher interest of the State so requires, and in this case the following principles shall be followed:
  - i. The investor shall be granted fair compensation for the value of his property according to the value thereof current at the time of nationalization.
  - ii. Valuation shall be made within six months of the date of the Order of Nationalization and the transfer of compensation shall take place in yearly part payments made within a period not exceeding five years and in the same currency which was brought into the Sudan for the purpose of the investment.
  - iii. Where any dispute should arise respecting the assessment of compensation, the investor may submit such dispute to an arbitral tribunal to be constituted of one member, representing the investor, and of another member representing the Sudanese Government and of a third member to be President of the Tribunal, who shall be chosen by agreement of the other two members from members of the High Court of Sudan.

3. Property Protection Under Constitutions in Some Developing Countries. The property protection is safeguarded by the Constitution. Article 141 (6) of the Brazilian Constitution of 14 September 1946 says, "The right of property is guaranteed except for the case of expropriation for public necessity

or utility or social interest, with prior and just indemnification in money." (Nwogugu 1965)

As a conclusion it may be said that foreign investment can play a vital role in financial and economic development in emerging countries, if it is given sufficient assurances of security against nationalization and confiscation.

Closely related to the role of foreign investment in emerging countries is the economic and social contributions of international financial institutions.

#### Economic and Financial Role of International Financial Institutions in Developing Countries

For many developing countries, capital inflow in the form of private business is likely to be small. In particular it is not easy to secure private funds in foreign capital markets to finance the construction of transportation and communication facilities, irrigation, power and similar public works. International financial institutions finance such investment for member countries. The most significant of these institutions are the World Bank for Reconstruction and Development (IBRD) and the International Monetary Fund (IMF). By discussing the functions of these institutions, it can be made clear that they can play a significant role in financial and economic development of an emerging country. The functions of the World Bank and how it conducts these functions will be discussed first.

## World Bank for Reconstruction and Development (IBRD)

The IBRD was founded during the international economic conference held at Bretton Woods in 1944 and began operations in June 1944. The main goals of the IBRD are:

1. To help in reconstruction and development through the investment of capital for productive purposes.
2. To help in the promotion of private foreign investment through guarantees or participation in loans and other investments made by private investors.
3. To promote balanced growth in international trade and equilibrium in balances of payments through the encouragement of international investment for the development of the productive resources of members (Boehmler and others 1951).

The IBRD advances loans only to member governments, government agencies and private companies when a member government guarantees the loan. Recently, the bank is turning toward development loans in developing countries. Stresses were placed in financing infrastructural schemes to provide a national basis for economic development. The World Bank usually undertakes the financing of imports and services needed for completion of the project and expects the borrower to undertake local costs. Furnishing technical assistance is also an important concern of the IBRD operation (Farwell and others 1966).

Thus, the World Bank, through these functions, can help very effectively in economic development in emerging countries that are in the stage of building their economic infrastructure and, at the same time, lack the necessary finance needed to attract foreign investment. Therefore, it is economically advisable for emerging countries to be members of the World Bank.

Having discussed the role of the World Bank in economic development, the next step is to discuss the economic role of the International Monetary Fund.

#### International Monetary Fund (IMF)

The International Monetary Fund started operations in March 1947. The major goals of the Fund are:

1. To promote stability in exchange rates.
2. To extend short-term financial aid to members so as to correct temporary deficit in the balance of payments.
3. To promote international trade,
4. To provide machinery for consultation and collaboration on international monetary problems. (Ungren 1951)

The member country pays 25% of its quota in gold and 75% in domestic currency. The member country can borrow up to 25% of the quota in a twelve month period provided that the Fund's holdings of a member currency do not exceed 200%

of its quota. The repayment of the loan has no specific terms and the Fund, with the borrowing country, can agree upon the terms of repayment. Interest to the Fund is payable at 1/2% on average daily balances of a member's quota, when the excess balances are held by the Fund for more than three months. The rate of interest rises by 1/2% with each subsequent year.

Developing countries, who are, in most cases, suffering from deficits in their balance of payments and shortage in foreign exchange, can find a great help from the International Monetary Fund if they subscribe to it.

As a conclusion to this chapter, it may be said that financial institutions can participate significantly in the promotion of economic development in emerging countries. They can encourage savings and mobilize these resources efficiently for productive purposes. A framework for the financial infrastructure of an emerging country was developed. It consists mainly of private sector financial institutions. Of these institutions, the monetary financial institutions are already in existence, and they have crossed the stage of infancy. Therefore, their role in the present is dominant. Nonmonetary financial institutions are still in their infancy. Even those that are in existence, like insurance companies, are still in their very early stages of development. Therefore, additional and continuing effort is

required to promote nonmonetary financial institutions to fill the gap created in the financial infrastructure by their absence. The present and future economic and social development necessitates their existence and contributions.

The public sector position in the financial infrastructure is supplementary to that of the private sector. Public sector financial institutions are those which the private sector cannot fulfill adequately or at all. In this respect, development banks and pension funds are the two financial institutions that suit the financial activity of the public sector of an emerging country, such as Sudan.

The second role of the public sector is to follow an economic policy conducive to the growth of the private sector financial institutions. Fiscal policy, and especially the taxation policy, is a great incentive. Assurances of safety and security of private property against measures of nationalization and confiscation are important factors for the attraction of private investment.

Lastly, foreign investment and international financial institutions hold a position in the financial infrastructure of an emerging country. The flow of foreign investment expands the volume of investment in emerging countries. Through joint ventures with domestic investors, foreign investors can promote the form of private business enterprise. With them, foreign investors bring advanced

technology of the western world. However, a basic requirement for the attraction of foreign investment is the establishment of security and confidence in the minds of the foreign investors for their property. For this purpose, legislations, or even constitutions, in emerging countries have to include definite statements that there will be no nationalization or confiscation of foreign capital.

The World Bank can help in the building of economic infrastructures. The International Monetary Fund can help in solving the problems of deficits in the balance of payments from which most of the developing countries suffer. It is, therefore, economically advisable for emerging countries to subscribe to them.

## CHAPTER V

### CONCLUSION

The financial infrastructure of a nation is composed of financial instruments and financial institutions dealing in these instruments. In the first part of this study, the financial infrastructure of the United States was described in terms of its components and functions, as an example of a well developed financial infrastructure. It was shown that the United States financial infrastructure came to its present stage of development through an evolutionary process. Now the category of nonmonetary financial intermediaries is gaining importance over the category of monetary financial intermediaries.

The financial infrastructure contributed significantly to economic growth in the United States by introducing indirect external finance. By making savers channel their savings through them, they were able to diversify the channels through which loanable funds may flow. They were also able to hold their place in the saving-investment and capital formation processes. They stand between savers and investors, transferring funds from the first group to the

to the second group. In this way they helped the accumulation of capital, on one hand, and increased investment efficiency on the other hand, since they used direct loanable funds to those who are capable of making them the most productive. Thus, it may be said that the financial infrastructure of the United States played a significant role in the pace and pattern of economic development.

In the last chapter, the role of financial intermediaries in economic development in emerging countries was developed, together with a framework for a financial infrastructure. In an emerging country, such as Sudan, to finance economic development we need to mobilize all domestic resources. Financial institutions can serve as a pool for these resources and at the same time they can direct these resources to efficient productive economic units. Therefore, their existence and efficient functioning is important to economic growth.

A framework was developed for the financial infrastructure of an emerging country, such as Sudan, to suit economic conditions at the present time and to respond to economic needs of the future. The system developed consisted mainly of private sector financial institutions. Of these private institutions, monetary financial institutions are already in existence and are well developed compared to nonmonetary financial institutions. The central bank is

considered to be not only the backbone of the financial infrastructure, but also the backbone of the economy as a whole. It is expected to maintain internal and external value of the currency and at the same time contribute to economic development. In an emerging country, such as Sudan, commercial banks are the main financial institutions that receive deposits from savers. They have a network of branches in most of the geographic regions. Therefore, the public is more familiar with them than any other type of financial institution.

The individual components of the category of non-monetary financial institutions are either infant or nonexistent. Because of this fact, the financial infrastructure is expected to be deficient. Insurance companies, though existing, are of a minor role. Insurance buying has to be encouraged especially in urban areas. Efforts need to be made to bring to existence some of the nonmonetary financial institutions directed to the savings of the middle class. Financial institutions similar to savings and loan associations are needed to promote home ownership, especially among the working class of the growing towns. Credit unions are also a form of organization that these classes are expected to respond to positively. The same is true for investment banks.

The position of the government in the framework developed for a financial system of an emerging country is supplementary to that of the private sector. Within this context, the government should own and control only those financial institutions which the private sector cannot evolve adequately or at all. The two financial institutions suggested for government ownership and control are development banks and pension funds. The purpose of the first is to centralize government credit to the big sectors of the economy, such as the agricultural and industrial sectors. The second is required to pool together contributions to pension and social security funds and to make these funds active in the capital market by investing them in some securities. The second role of the government is to pursue a policy which assists the financial institutions grow and develop. Fiscal policy, and especially taxation policy, can be a positive incentive. There can be tax exemptions until economic units pass the infancy stage. Also, imported equipment and raw materials can be taxed leniently in the early age. The government also should give enough confidence and security to investors against measures of confiscation and nationalization. Lack of these measures, historically has caused domestic savings in emerging countries to flee to other, more developed, countries. The way the treasury manages public debt also affects the growth of financial

institutions. It has to be managed in such a way as not to cause inflation, because inflation is harmful to financial institutions specializing in deposit-type savings.

Since most of the economies of emerging countries are open, foreign investment is also expected to have a position in the financial infrastructure. The author wishes to stress his support for the case of foreign investment in his country. I believe it is foreign investment which can modernize the operations of financial institutions. This is because foreign investment brings with it the technology of the western world. It can make joint ventures with domestic investors. The team of experts that comes with foreign investment can provide good management to these institutions. Therefore, the government has to make every effort to attract foreign investment. Efforts have to be made to give foreign investment enough security and confidence against confiscation and nationalization measures. This has to be stated in legislation and in the constitution. Related to foreign investment is the role that can be played by international financial institutions in emerging countries. The World Bank (IBRD) helps to a great extent in the building of the economic infrastructure like irrigation, power, communication and transportation. The International Monetary Fund (IMF) helps to a great extent in solving the difficulties in the balance of payments that most emerging countries

face. Therefore, it is recommended that emerging countries will benefit from subscribing to these institutions.

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