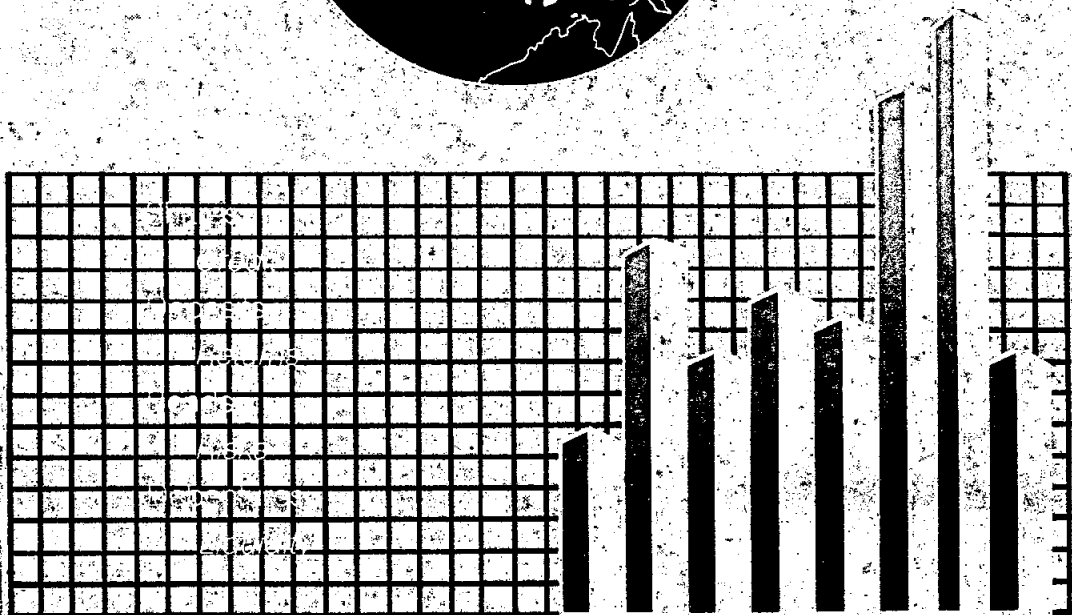
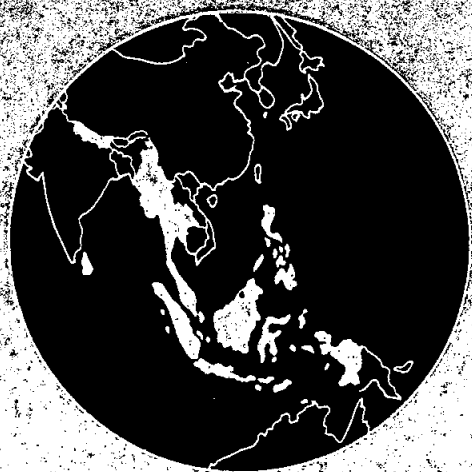


The Development of Capital Markets in the SEACEN Countries

Edited by
NG BEOY KUI



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The South East Asian Central Banks (SEACEN)
Research and Training Centre

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FOREWORD

The international debt crisis in 1982 amidst adverse international environment drew the attention of the SEACEN countries on two policy strategies. The first strategy required a commitment by government to adopt structural adjustment as a development policy to cushion off, albeit partly, the continued adverse international developments in the coming decade. The second strategy advocated a firm commitment by government to further develop the domestic capital market, not only to mobilize more financial resources but also to allocate these scarce resources for productive investment. These two policy strategies tended to complement each other as successful structural adjustment can only be facilitated with a steady flow of medium- and long-term credit on reasonable terms.

As the supply of external capital flow will not come by easily at least in the near future, the development of capital markets becomes an urgent and immediate task for the governments. Any delay in this effort will further widen the existing savings and investment gap, and future economic growth in this region would not be able to meet the challenges of the coming Asia-Pacific Era.

In this regard, the research study on the development of capital markets in the SEACEN countries is timely and most appropriate in terms of focusing the urgent needs of the member countries. The purpose of this research study was therefore directed at examining critically the current problems and issues affecting the development of capital markets in the region. The project was also expected to identify those factors which are crucial for the orderly development of a well-functioning capital market in a country.

The research project is a collaborative effort between the member central banks and The SEACEN Centre. Seven member central banks participated in this project, namely Bank Indonesia, Bank Negara Malaysia, Nepal Rastra Bank, the Central Bank of the Philippines, the Monetary Authority of Singapore, the Central Bank of Sri Lanka and Bank of Thailand. Each member central bank made available at least one researcher in preparing the respective country studies which form the contents of Part II. The SEACEN Centre in this respect wishes to express its sincere gratitude to the participating member central bank for their close co-operation and strong support in bringing this project to a successful completion.

The SEACEN Centre for its part co-ordinated the whole project. In this regard, Mr. Ng Beoy Kui, Research Economist, was responsible for the whole research design and the co-ordination among the country

researchers. He edited the country chapters and also prepared an overview on the development of capital markets in the SEACEN countries. The overview chapter forms Part I of the study.

At various stages of the Project, Mr. Ng was kindly assisted by his research assistant, Mrs. Wong Yoke Mei, who tirelessly provided necessary research support and proof-read most of the chapters. The manuscript was typed by Miss Chew Hong Yng with occasional assistance from Miss Jayanthi Devi. Mr. Ng is also grateful to the Publications Committee for its editorial and publication assistance.

The views expressed in this volume, however, are those of the authors and should not in any manner be ascribed to the institutions or individuals whose assistance is duly acknowledged herein.

Vicente B. Valdepenas, Jr.
Director
The SEACEN Centre

Kuala Lumpur
February 1989

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LIST OF ACRONYMS

(in alphabetical order)

PART I: OVERVIEW

AWAS	: <i>Advance Warning and Surveillance</i>
BAPEPAM	: <i>Badan Pembina Pasar Uang dan Modal (Capital Market Executive Agency)</i>
BAPINDO	: <i>Bank Pembangunan Indonesia</i>
BKPM	: <i>Investment Coordinating Board</i>
KLSE	: <i>Kuala Lumpur Stock Exchange</i>
MAS	: <i>Malaysian Airline System</i>
MISC	: <i>Malaysian International Shipping Corporation</i>
NIC	: <i>National Insurance Corporation of India</i>
NIDC	: <i>Nepal Industrial Development Corporation</i>
PDIC	: <i>Philippines Deposits Insurance Corporation</i>
SES	: <i>Stock Exchange of Singapore</i>
SESDAQ	: <i>Stock Exchange of Singapore Dealing and Automated Quotation</i>
SET	: <i>Securities Exchange of Thailand</i>

PART II: COUNTRY STUDIES

INDONESIA

BAPEPAM	: <i>Badan Pembina Pasar Uang dan Modal</i>
BAPINDO	: <i>Bank Pembangunan Indonesia</i>
BKPM	: <i>Investment Coordinating Board</i>
BNI	: <i>Bank Negara Indonesia</i>
BULOG	: <i>Badan Urusan Logistik</i>
KIK	: <i>Kredit Investasi Kecil</i>
PUM	: <i>Team Persiapan Pasar Uang dan Modal (Team on the Preparation of Money and Capital Markets)</i>
SBI	: <i>Sertifikat Bank Indonesia</i>
SBPU	: <i>Surat Berharga Pasar Uang</i>
Tabanas	: <i>National Development Savings Scheme</i>
Taska	: <i>Insurance Savings Scheme</i>

MALAYSIA

AMF	: Arab Malaysian Finance
AWAS	: Advance Warning and Surveillance
CIC	: Capital Issues Committee
FIC	: Foreign Investment Committee
KLSE	: Kuala Lumpur Stock Exchange
MASA	: Real Time Reporting System
NEP	: New Economic Policy
PTM	: Panel of Takeovers and Mergers
RIIAM	: Research Institute of Investment Analysis Malaysia
ROC	: Registrar of Companies
SCANS	: Securities Clearing Automated Network Services
SSE	: Singapore Stock Exchange.

NEPAL

ADB/N	: Agricultural Development Bank of Nepal
APROSC	: Agricultural Project Services Centre
CGC	: Credit Guarantee Corporation
EPF	: Employees' Provident Fund
ISC	: Industrial Service Centre
LIC	: Life Insurance Corporation of India
NABIL	: Nepal Arab Bank Ltd.
NBL	: Nepal Bank Ltd.
NIB	: Nepal – Indosuez Bank
NIC	: National Insurance Corporation
NIDC	: Nepal Industrial Development Corporation
NGB	: Nepal Grindlays Bank
NRB	: Nepal Rastra Bank
NSC	: National Savings Certificate
POSB	: Post Office Savings bank
RBB	: Rastriya Banijya Bank
SEC	: Securities Exchange Centre
SFDP	: Small Farmers Development Project
SMC	: Securities Marketing Centre

PHILIPPINES

AGSD	: accredited government securities dealers
ALF	: Agricultural Loan Fund
ATMs	: Automated Teller Machines
CALF	: Comprehensive Agricultural Loan Fund
CB Bills	: Central Bank Bills
CBCIs	: Central Bank Certificates of Indebtedness

DBP	: <i>Development Bank of the Philippines</i>
DOSRI	: <i>Directors, officers, stockholders, and related interests</i>
FCDUs	: <i>foreign currency deposit units</i>
GSIS	: <i>Government Service Insurance System</i>
LBP	: <i>Land Bank of the Philippines</i>
Metrex	: <i>Metropolitan Stock Exchange</i>
MkSE	: <i>Makati Stock Exchange</i>
MSE	: <i>Manila Stock Exchange</i>
NAGSD	: <i>National Association of Government Securities Dealers</i>
NBOBs	: <i>Non-bank quasi-banks</i>
NG	: <i>National Government</i>
NOW accounts	: <i>Negotiable Orders of Withdrawal</i>
OBUs	: <i>offshore banking units</i>
OTC	: <i>Over-the-counter</i>
PAB	: <i>Philippine Amanah Bank</i>
PDBs	: <i>private development banks</i>
PDIC	: <i>Philippine Deposit Insurance Corporation</i>
PNB	: <i>Philippine National Bank</i>
PSBs	: <i>Premyo Savings Bonds</i>
SEC	: <i>Securities and Exchange Commission</i>
SES	: <i>Supervision and Examination Sector</i>
SGBs	: <i>specialized government banks</i>
SSLAs	: <i>stock savings and loan associations</i>
SSS	: <i>Social Security System</i>

SINGAPORE

ABM	: <i>Asian Bond Market</i>
ACU	: <i>Asian Currency Unit</i>
ADM	: <i>Asian Dollar Market</i>
CDP	: <i>Central Depository Private Ltd.</i>
CPF	: <i>Central Provident Fund</i>
DBS	: <i>Development Bank of Singapore</i>
EBM	: <i>Euro-Bond Market</i>
GLC	: <i>Government-Linked Companies</i>
HDB	: <i>Housing and Development Board</i>
MAS	: <i>The Monetary Authority of Singapore</i>
NASDAQ	: <i>National Association of Securities Dealers Automated Quotation</i>
NOL	: <i>Neptune Orient Lines</i>
OTC	: <i>Over-the-counter</i>

POSB	: <i>Post Office Savings Bank</i>
PUB	: <i>Public Utilities Board</i>
SECOMS	: <i>Stock Exchange Communications System</i>
SES	: <i>Stock Exchange of Singapore</i>
SESDAQ	: <i>Stock Exchange of Singapore Dealing and Automated Quotation</i>
SIA	: <i>Singapore Airlines</i>
SIC	: <i>Securities Industry Council</i>
SSRI	: <i>Singapore Securities Research Institute</i>
TAS	: <i>Telecommunication Authority of Singapore</i>

SRI LANKA

AICC	: <i>Agricultural and Industrial Credit Corporation</i>
BOC	: <i>Bank of Ceylon</i>
CBA	: <i>Colombo Brokers' Association</i>
CBSL	: <i>Central Bank of Sri Lanka</i>
CDs	: <i>Certificates of Deposits</i>
CFCA	: <i>Control of Finance Companies Act</i>
CSE	: <i>Colombo Securities Exchange (Gte) Ltd.</i>
CSEL	: <i>Colombo Stock Exchange Ltd.</i>
CSMB	: <i>Ceylon State Mortgage Bank</i>
DFCC	: <i>Development Finance Corporation of Ceylon</i>
EPF	: <i>Employees' Provident Fund</i>
ETF	: <i>Employees' Trust Fund</i>
FCBUs	: <i>Foreign currency banking units</i>
FIAC	: <i>Foreign Investment Advisory Committee</i>
GCEC	: <i>Greater Colombo Economic Commission</i>
GRSs	: <i>Government rupee securities</i>
MBSL	: <i>Merchant Bank of Sri Lanka</i>
MLA	: <i>Monetary Law Act</i>
MLCF	: <i>Medium- and Long-Term Credit Fund</i>
NCP	: <i>National Credit Plan</i>
NDB	: <i>National Development Bank</i>
NOW	: <i>Negotiable Order of Withdrawal</i>
NSB	: <i>National Savings Bank</i>
NYSE	: <i>New York Stock Exchange</i>
PMB	: <i>People's Merchant Bank</i>
SBA	: <i>Share Brokers' Association</i>
SE	: <i>Securities Exchange</i>
SMIB	: <i>State Mortgage and Investment Bank</i>

THAILAND

ATS	: <i>Automatic Transfer System</i>
BAAC	: <i>Bank for Agriculture and Agricultural Cooperatives</i>
BIBOR	: <i>Baht Interbank Offered Rate</i>
BOT	: <i>Bank of Thailand</i>
BSE	: <i>Bangkok Stock Exchange Co. Ltd.</i>
EFT	: <i>Electronic Fund Transfer</i>
FCs	: <i>finance companies</i>
IFCT	: <i>Industrial Finance Corporation of Thailand</i>
GHB	: <i>Government Housing Bank</i>
GSB	: <i>Government Savings Bank</i>
MLR	: <i>minimum lending rate</i>
MOR	: <i>minimum overdraft rate</i>
SET	: <i>Securities Exchange of Thailand</i>
SIFO	: <i>Small Industries Finance Office</i>

PART I: REGIONAL OVERVIEW

CHAPTER 1

The Development of Capital Markets in the SEACEN Countries¹

NG BEOY KUI

I. INTRODUCTION

A. Background

Capital investment is essential for the acceleration of economic development. The SEACEN countries² therefore, need a steady supply of medium- to long-term capital funds for productive investment. In this respect, capital market plays a crucial role in mobilizing a constant flow of savings and channelling these financial resources for expanding productive capacity in these countries. This financial intermediation process, in particular the term transformation of short-term savings into long-term investment funds, requires a well-functioning and efficient capital market to facilitate the process.

Since the second oil shock in 1979/1980, the over-reliance of many SEACEN countries on external debt finance has evidently become precarious. The debt situation deteriorated further in the early 1980s as interest rates increased significantly while the U.S. dollar appreciated sharply. As the external debt problem became disproportionately serious, the governments in these SEACEN countries then took various steps to resolve the increasingly difficult debt situation by resorting to among others, a severe cut in government expenditure, and an active promotion of exports to increase their debt-servicing capacities.

1. The views presented in this overview chapter are strictly those of the author and do not necessarily reflect those of The SEACEN Centre or its member central banks and monetary authorities.

2. The SEACEN countries comprise Burma, Indonesia, Malaysia, Nepal, the Philippines, Singapore, Sri Lanka and Thailand. The central banks and monetary authorities of these countries are currently sponsoring activities of the South East Asian Central Banks (SEACEN) Research and Training Centre. For this study, all central banks except the Union of Burma Bank participated in the project.

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The basic issues underlying this external debt problem are of two types; one calls for a long-term structural adjustment in the economic structure and the other calls for a rapid development in their domestic capital markets to mobilize domestic savings such that investment in the productive sectors would not be penalised in the process of servicing the external debts.

This project attempts primarily to address the second issue which is of current interest to the central banks and monetary authorities in the SEACEN region. However, a long term structural adjustment also requires parallel capital market development to meet its critical financing needs, not only in terms of adequate but also timely scarce financial resources at the cheapest cost of fund.

B. Objectives of the Research Project

The basic objective of this research study is to examine critically the basic problems and issues encountered in the process of developing the capital markets and identify factors which are crucial for the development of well-functioning capital markets in the SEACEN region.

The study also reviews the past efforts made by the SEACEN governments in developing their capital markets. This will enhance a deep understanding for the present situation of the existing capital markets in the region.

Finally, the study also intends to look into various financial and monetary implications which may arise in the process of developing the capital markets.

C. Scope and Organization of the Study

For the purpose of this study, capital market is broadly defined to embrace all forms of borrowing and lending with maturities of one year and above. This definition does not clearly delineate the boundary between money market and capital market. For instance, commercial banks may mobilize funds with maturities of less than one year and on-lend these short-term funds for long-term lending for corporate investment or purchases of houses. Even then, the above definition is still useful and workable. For the purpose of this study, the capital market may be divided into two broad categories, i.e., the securities market and the non-securities market.

The term "securities markets" denotes the markets for those financial instruments, financial claims and financial obligations which are readily transferable in the secondary markets such as stock exchange, over-the-counter markets and unlisted securities markets. The securities in this

instance, include basically shares, debentures, bonds, etc., issued by private corporate sector as well as the bonds, bills, debentures and stocks issued by government and public authorities.

The non-securities markets, on the other hand, refer to markets for financial instruments, financial claims and financial obligations created by financial institutions mainly in the form of deposits and loans. Other forms include hire-purchase, leasing, insurance premiums and claims, pension funds, employee contributions to social securities, etc. In these markets, a wide-range of financial intermediaries are involved in performing the financial intermediation function and savings-investment process.

The emphasis of this study is to examine the development of capital markets to meet the private capital needs of the SEACEN countries. However, off-shore banking which is distinct in character and therefore, requires in-depth separate study will not be covered in this research. The Asian dollar market and the Asian bond market are in this instance outside the scope of this study.

This study is a collaborative project of the member central banks and The SEACEN Centre. Under this collaborative arrangement, the researcher of the member central banks and monetary authorities undertook the respective country studies while The SEACEN Centre served as the co-ordinating agency and conducted an overall analysis based largely on the country studies. In this project, Bank Indonesia, Bank Negara Malaysia, Nepal Rastra Bank, the Central Bank of the Philippines, the Monetary Authority of Singapore, the Central Bank of Sri Lanka and the Bank of Thailand participated in this project. The scope of the study is therefore limited to seven countries and excludes Burma. The time frame of the study covers a period of 16 years from 1970 to 1985 (both years inclusive).

The project comprises two parts. Part One is an overall analysis of the country studies. Apart from drawing inferences from the country studies, the overview chapter also includes those aspects which have not been adequately covered by the country studies. Part Two contains all the country chapters which are contributed by the researchers nominated by the member central banks and monetary authorities.

As a matter of convenience, the term "central bank" also includes monetary authorities, where appropriate.

II. OVERVIEW OF THE CAPITAL MARKET STRUCTURES

The primary function of capital market is to mobilize adequate financial resources to be channelled for productive investment to generate

CAPITAL MARKETS

economic growth. The more efficient the capital market the more financial resources would be mobilized in an efficient way. At the same time, these resources would be efficiently channelled to the productive sector to promote economic development. In view of the important role of the capital market, the SEACEN countries in the past two decades or so had directed their effort towards the orderly development of their capital markets.

In their attempt to develop the capital markets, two broad strategies were generally adopted. The first was to mobilize domestic savings by setting up various savings institutions, apart from promoting branch expansion of the existing commercial banks. The second strategy was to ensure that the priority sectors, in particular the agricultural sector and the small enterprises sector, were provided with adequate finance at reasonable cost. However, the capital markets in the SEACEN countries in general are still not well developed as to ensure a steady flow of medium- and long-term funds for productive investment.

The capital markets in most of the SEACEN countries are not well-developed because these markets still lack the required depth and breadth, and constant government support in terms of budgetary appropriation and other assistance is usually needed to ensure their smooth operations. The markets are not deep enough as secondary markets, especially the securities markets in many SEACEN countries are still dormant. As to the breadth of the market, the governments are still the major participants in the capital markets whereas the private agents play only a limited role in financial intermediation.

A. Need for Capital Market Development

As a result of the underdeveloped nature of the domestic capital markets, financial resources cannot be adequately mobilized to finance economic development. The governments in the SEACEN countries have no alternative but to step in to set up basic institutional framework, supply and guarantee investment funds as well as channel funds in the manner the national priorities dictate.

In order to sustain the momentum of economic growth in the next few decades, the SEACEN countries will have to develop their capital markets such that medium- and long-term investment funds will be forthcoming in an adequate and timely way to finance economic growth and programmes for structural adjustment. In the past, these medium- and long-term investment funds were raised in the domestic capital market mainly by commercial banks, savings institutions, and in certain SEACEN countries, through contractual savings schemes.

However, these resources were not adequate to sustain the increasing demand arising from the rapid investment growth. The demand for investment funds were inevitably satisfied by external loans. This was particularly evident after the first oil crisis in 1973/74 when a large number of the SEACEN countries had to foot substantial imported oil bills. At the same time, foreign loans were on easy terms in the 1970s but on variable interest rate basis. Most of the SEACEN countries borrowed heavily from the private international capital market to fund their infrastructure projects and investments of various public enterprises. By the late 1970s, world interest rates rose precipitously coupled with a sharp appreciation of the U.S. dollar. These two new developments resulted in high debt servicing problem encountered by a number of the SEACEN countries. The problem turned to crisis proportions as world recession with declining commodity prices also sets its motion in this most unfortunate time. The over-reliance on external debt by many SEACEN countries then was painfully evident (see Table 1.1). At the end of 1985, five SEACEN countries had their external debt outstanding as a proportion to their GNP exceeding 40 per cent while the other two countries had their ratios ranging from 12 per cent to 24 per cent. In terms of debt-service ratios, Indonesia and Thailand registered a high ratio of 25 per cent. Malaysia, the Philippines and Sri Lanka had lower ratios but still exceeding 14 per cent. Only Singapore had no debt servicing problem while the magnitude of debt problem for Nepal is still manageable.

Table 1.1 DEBT PROFILES OF THE SEACEN COUNTRIES

1985	Gross External Debt Outstanding		Debt Servicing Ratio	Average Annual Growth Rate
	U.S. \$ Billion	% GNP	(Debt Servicing/ Gross Exports)	1981 - 1985
Indonesia	35.8	44.9	25.2	11.4
Malaysia ¹	17.0	58.9	15.8	33.3
Nepal	0.6	24.0	4.0	22.3
Philippines	26.2	80.6	19.5	8.4
Singapore ²	2.1	11.6	2.4	6.2
Sri Lanka	3.5	61.1	14.7	12.9
Thailand	17.5	46.7	25.4	16.1

¹ Figures from Bank Negara Malaysia, Annual Report, 1986.

² Excluding private non-guaranteed debt.

Sources: The World Bank, *World Debt Tables, External Debt of Developing Countries*, 1986-87 Editions.

Bank Negara Malaysia, *Annual Report*, 1986.

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The Asian Development Bank (1986) had noted that "over the next decade, the developing member countries will not be able to (i) fund public capital expenditures, especially for public enterprises, through government allocations, because of their budgetary constraints; (ii) expect an increased flow of foreign commercial loans, because of the recent debt crisis experienced by some developing countries; and (iii) rely on increasing supply of external funds from multilateral institutions and bilateral agencies, because of the budgetary uncertainties in the developed countries". In view of these pessimistic prospects, the SEACEN countries will have to put in more effort to develop and improve their domestic capital market structure.

Equally important is the more fundamental need for capital market development arising from the national aspiration to promote rapid economic and financial development and hence raising the standard of living of its respective populace. This aspiration to better standard of living becomes intensely earnest as the SEACEN countries are generally considered as developing countries. Except Singapore, the rest of the SEACEN countries had their per capita income below U.S.\$2,500 (see Table 1.2). In fact, five out of the seven countries under study had their per capita income less than U.S. \$850. In the meantime, economic growth for the SEACEN countries had slowed down significantly in the period 1981-85, as compared to the performance in the period 1971-80.

Moreover, most SEACEN countries are relatively open economies with heavy dependence on the export of a few primary commodities.

Table 1.2 PER CAPITA GNP AND REAL GDP GROWTH

Country	Per Capita GNP (US\$)			Average Annual Real GDP Growth (%)	
	1970	1980	1985	1971-80	1981-85
Indonesia	78	473	530	8.0	4.5
Malaysia	359	1,634	2,050	8.0	5.1
Nepal	77	135	160	2.0	3.9
Philippines	192	730	600	6.3 ^a	-1.1 ^a
Singapore	923	4,492	7,420	9.1	6.7
Sri Lanka	180	271	370	4.7	5.0
Thailand	180	699	830	6.9	5.0

^a Refers to GNP at 1980 prices.

Sources: International Monetary Fund, *International Financial Statistics*, January 1988.

International Monetary Fund, *International Financial Statistics*, Supplement on Economic Indicators, 1985.

The World Bank, *World Tables*, Second Edition, 1980.

The structural problems of the economies together with the persistent deficits in the balance of payments in a number of SEACEN countries had called forth the urgent need for structural adjustment. Both the urgency to sustain economic growth and the need for rapid structural adjustment point to the need to develop further their domestic capital markets, more so in view of the unfavourable international environment as envisaged by the Asian Development Bank earlier.

On the other hand, the need to develop the financial sector was also a concern to the SEACEN countries. The prevalence of financial dualism in almost all the SEACEN countries in varying degrees had resulted in credit rationing, adverse selection, and the expansion of informal financial markets in the region. It is hoped that the broadening and deepening of the capital markets will help, to a significant extent, in removing this dualistic financial structure and ensure a steady flow of medium- and long-term investment fund to promote and sustain economic development.

B. Savings and Investment Performance

The International Development Strategy for the Third United Nations Development Decade states in paragraph 23:

“The acceleration of production in the developing countries will require that gross investment reaches the level of about 28 per cent of gross domestic product by 1990. The developing countries, therefore, must fully mobilize their domestic financial resources. To this end, for developing countries in general, gross domestic savings should be increased to reach about 24 per cent of gross domestic product by 1990. The developing countries that have a savings ratio of less than 15 per cent should make vigorous efforts to raise it to 20 per cent as early as possible. The countries that have or will soon have a savings ratio of 20 per cent should raise it significantly during the Decade”.

Against the savings target of 24 per cent, Malaysia and Singapore have already overshot the target by having average savings ratios of 34.4 per cent and 43.8 per cent respectively for the period 1981-85. Indonesia, the Philippines and Thailand, however, reached an average of about 20 per cent during the same period while Nepal and Sri Lanka lagged behind, registering average savings ratios of 10 and 13.4 per cent respectively (see Table 1.3).

While the seven countries differ greatly in their capacity to mobilize savings, their levels of domestic savings can be considered as relatively high as compared to Korea and Taiwan. Except for Nepal and Sri Lanka, the SEACEN countries had achieved a reasonably high level of

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Table 1.3 AVERAGE DOMESTIC SAVINGS RATIOS IN THE SEACEN COUNTRIES (Per Cent of GDP)

	1971-75	1976-80	1981-85
SEACEN Countries			
Indonesia	19.3	25.6	21.3
Malaysia	25.7	33.8	34.4
Nepal	4.5	8.1	10.0
Philippines	22.7	24.8	21.1
Singapore	20.0	34.0	43.8
Sri Lanka	11.8	15.3	13.4
Thailand	22.1	21.0	18.1
Korea	18.8	26.5	18.8
Taiwan	31.0	33.9	31.8

Sources: International Monetary Fund, *International Financial Statistics*, various issues.
The SEACEN Centre, Economic Survey Questionnaire replies from member central banks.

economic and financial development over two and a half decades. The higher income growth and the expansion of their financial sectors had contributed significantly to the relatively high level of domestic savings. While there is no detailed data on the sources of domestic savings, it seems that the major component of domestic savings comes from household savings, as most of the SEACEN countries run government budget deficits for most of the time. The corporate sector as a whole, on the other hand, is traditionally a deficit unit. The deficit in the corporate sector is often met by funds through government budgetary appropriations, central bank refinancing facilities or borrowings from a wide range of financial institutions in the respective countries.

As to the investment ratio, both Malaysia and Singapore again far exceeded the target of 28 per cent, while Sri Lanka was already on the target (see Table 1.4). Indonesia, the Philippines and Thailand still lagged behind by about 4 percentage points and is expected to achieve the target by 1990. Nepal may have to expand its investment activities further to be closer to the investment target in 1990.

Compared to Korea and Taiwan, the SEACEN countries as a whole have a consistently high level of investment. In most cases, the investment ratios were higher than the savings ratios such that foreign savings were required to supplement domestic savings to finance the sustained level of investment activities in the region. A significant portion of these investment came from public investment. Private investment were particularly important in Malaysia, Singapore and Thailand but not in

Table 1.4 AVERAGE INVESTMENT RATIOS IN THE SEACEN COUNTRIES (Per Cent of GDP)

	1971 – 75	1976 – 80	1981 – 85
SEACEN Countries			
Indonesia	18.6	21.5	24.8
Malaysia	24.4	26.1	35.9
Nepal	8.3	12.2	17.7
Philippines	24.3	30.1	23.7
Singapore	41.3	40.6	47.3
Sri Lanka	15.7	22.7	27.6
Thailand	23.7	26.4	23.1
Korea	26.6	30.2	24.0
Taiwan	30.4	31.3	23.6

Sources: International Monetary Fund, *International Financial Statistics*, various issues.
The SEACEN Centre, Economic Survey Questionnaire replies from member central banks.

other SEACEN countries. The major focus in the future should be directed at increasing productivity of these investment to generate economic growth.

As the SEACEN countries emphasized investment, the investment ratios had been higher than the savings ratios, resulting in consistent resource gaps to be filled by foreign savings (see Table 1.5). Both Nepal and Sri Lanka encountered serious average gaps of 7.7 per cent and 14.2 per cent respectively during 1981-85. The main issue encountered by these two countries was the relatively low domestic savings mobilization effort. While Sri Lanka had managed to achieve reasonably high investment growth, Nepal still lagged behind in their investment activities. In fact, domestic savings was only adequate to cover slightly more than half of the investment between 1971-85. On the other hand, both Malaysia and Singapore did not suffer from a resource gap because of their relatively high savings rates. While investment spending had generally exceeded savings in Singapore over 1965-84, the resource gap never constituted a problem for Singapore because of its strong economic performance and steady capital inflow from abroad. Moreover, this gap had also been declining over the years. In fact, since 1985, gross national savings has surpassed gross fixed capital formation in Singapore, indicating that a resource gap no longer exists in Singapore. For the other countries like Indonesia, the Philippines and Thailand, continued effort should be directed at reducing the resource gap by encouraging more resource mobilization to sustain increasing investment activities.

Table 1.5 SEACEN COUNTRIES: RESOURCE GAPS

	Savings – Investment Gap ¹			Savings – Investment Ratio ²		
	1971-75	1976-80	1981-85	1971-75	1976-80	1981-85
Indonesia	0.7	4.1	– 3.5	1.04	1.19	0.86
Malaysia	1.3	7.7	– 1.5	1.05	1.29	0.96
Nepal	– 3.8	– 4.1	– 7.7	0.54	0.66	0.56
Philippines	– 1.6	– 5.3	– 2.6	0.93	0.82	0.89
Singapore	–15.3	– 6.6	– 3.5	0.63	0.84	0.93
Sri Lanka	– 3.9	– 7.4	–14.2	0.75	0.67	0.49
Thailand	– 1.6	– 5.4	– 5.0	0.90	0.79	0.78

¹ Derived from subtracting investment ratio from savings ratio.

² Savings as a percentage of investment.

Sources: International Monetary Fund, *International Financial Statistics*, various issues.
The SEACEN Centre, Economic Survey Questionnaire replies from member central banks.

The increasing resource gaps at the turn of the 1980s had in fact, resulted in severe debt problems for a number of the SEACEN countries. Gross external debt over GNP ratios had reached more than 40 per cent for Indonesia (44.9 per cent), Malaysia (58.9 per cent), the Philippines (80.6 per cent), Sri Lanka (61.1 per cent) and Thailand (46.7 per cent in 1985). The heavy reliance on external loans also resulted in high debt servicing problem for a number of the SEACEN countries.

C. Existing Capital Market Structures

The capital markets in many SEACEN countries are characterized predominantly by their dualistic nature. On the one hand, there is a fairly modern financial sector with its capital market providing the necessary financial services. On the other, there exists side by side a fairly large informal financial sector (except Singapore) also providing both short- and long-term capital funds to the private sector, especially the informal sector (see Ng, 1985). While the formal financial sector comprises a wide range of financial institutions, such as commercial banks, development finance institutions, specialized banks³, savings banks and contractual savings institutions, the informal counter-part is also characterized by a heterogeneous group of lenders namely moneylenders, landlords, input suppliers, provision shops, rotating savings and credit associations, pawnshops as well as friends and rela-

3. These specialized banks include mainly merchant banks, investment banks, finance companies and leasing companies which provide specialized financial services.

tives with their "usurious" and "exorbitant" rates of interest. In fact, over the last two decades or so, the governments of the SEACEN countries had adopted several measures to eradicate the informal financial sectors. These measures include legal restrictions on money lenders and pawnbrokers, development and expansion of formal financial institutions, implementation of supervised credit programmes, imposition of interest rate ceilings and usury laws as well as selective credit control. Despite all these efforts, the informal financial sector continues to exist and even stages a comeback in the rural areas (Agabin, 1983).

The mobilization of financial savings by the formal capital market institutions in the SEACEN countries is relatively successful as compared to its informal counterpart. This is because the governments in this region have implemented several policy measures to encourage savings. One of the measures adopted is the rapid expansion of commercial bank branches and savings bank offices especially the post-office savings bank. The other is the enforcement of compulsory contractual savings schemes such as employees provident funds and various pension funds. Financial innovations such as automatic teller machines and new financial instruments were also introduced in recent years to attract more savings. Securities exchanges were also established to encourage bond and equity financing. However, the informal financial sector has not been a successful fund mobilizer, especially for medium- and long-term capital funds. Most of the funds are generated either from the lenders' past savings or borrowings from the formal financial sector. Only the rotating savings and credit societies do mobilize funds from their members. Financial intermediation of this sector is reduced to a minimum.

As to the allocation of capital funds, again the informal financial sector is less active than its formal counterpart in long-term financing. This is mainly because of the short-term nature of its funds and term transformation is not possible in the informal sector as flows of fund is not as steady as in the formal financial sector. Still a significant portion of the borrowings from the informal financial sector is directed to financing capital investment such as purchase and improvement of farm lands, purchase of livestock and poultry, purchase of residential houses and investment in business enterprises in the urban areas (see Ng, 1985).

Aside from the dualistic structure in the capital market, the formal capital market is also characterized by the unbalanced development between the securities and non-securities market. The non-securities markets in all the SEACEN countries are more dominant and well developed than their counterparts in the securities sector. The non-securities market comprises well-established financial institutions espe-

cially commercial banks, development finance institutions, specialized banks, savings banks, and contractual savings institutions. They issue a wide variety of non-negotiable financial instruments to facilitate financial intermediation and term transformation. Money and foreign exchange markets are also developed to complement and supplement the capital market. Regulatory and supervisory framework were well instituted to minimize vulnerability in the non-securities market.

Five major factors accounted for the well-established non-securities markets in the region. The first is the relative ease in developing the non-securities market rather than the securities market. This is because the legal framework for the non-securities market in most of the SEACEN countries has been instituted for a relatively long time whereas the legal framework for the securities market, especially the regulatory and supervisory aspects, is still rudimentary or fragmented in most instances. Secondly, the governments of the SEACEN countries were concerned with low savings rate and much effort has been directed at mobilizing savings by expanding commercial bank branches, instituting post office savings banks and introducing contractual savings schemes such as provident and pension funds. Thirdly, the governments of most SEACEN countries were also concerned about the inadequate finance for the priority sector, especially the agricultural sector and the industrial sector which had been neglected by the profit-oriented commercial banks. As a result, development finance institutions were set up to provide medium- to long-term finance for the priority sector. Fourthly, the introduction of the Green Revolution in the 1950s and 1960s in many SEACEN countries had led to the establishment of supervised credit programmes under which agricultural credit were readily provided by development finance institutions at subsidized interest rates. Of these, Masagana 99 in the Philippines, the BIMAS programme in Indonesia and the Short-term Padi Production Schemes in the Muda River and Kemubu Irrigation Region in Malaysia were some of the supervised credit programmes which have gained prominence in the SEACEN region. Finally, securities markets tend to be less active in those SEACEN countries where private sector plays a relatively lesser role than the public sector. This is because the public sector has easy access to government financing while the private sector find equity and bond financing rather cumbersome and costly as compared to direct lending from the non-securities market which is more well established.

The other prominent feature of the capital markets in most SEACEN countries is the visible government ownership in both financial institutions and public enterprises. For instance, in Indonesia, five

states and 26 provincial government banks account for the major share of commercial bank businesses; the development finance institutions are basically government institutions; insurance businesses are mainly operated by government firms; there is a large state owned investment trust to regulate share prices in the Jakarta Stock Exchange; and even the pawnshop operation is the monopoly of the government. Moreover, public enterprises are a common scene in the Indonesian economy. In Nepal, the same features prevail. The government is the major shareholder in two of the four commercial banks. The development finance institutions such as the Agricultural Development Bank and the Nepal Industrial Development Corporation are wholly owned by the government. The government also has a major stake in the Employee's Provident Fund and the National Insurance Corporation. The corporate sector is also dominated by public enterprises which depend significantly on the government budgetary appropriation. Sri Lanka also exhibits the same phenomena as in Indonesia and Nepal, but to a lesser degree. The two large government-owned institutions dominate the financial system, accounting for about 75 per cent of total bank credit outstanding in 1985. The National Savings Bank, the State Mortgage and Investment Bank, the National Development Bank, the Capital Development Investment Corporation and the Employees' Provident Fund are owned by the government of Sri Lanka. Public enterprises also permeate the mainstream of economic activities in the country.

In Malaysia, Thailand and the Philippines, government ownership in their commercial banks is relatively less important and mainly through indirect shareholding associations. However, the development finance institutions such as Bank Pertanian (the Agricultural Bank of Malaysia) in Malaysia, the Development Bank of the Philippines, the Bank for Agriculture and Agricultural Co-operatives in Thailand are mainly owned by the respective governments. Although public enterprises play a significant role in these countries, the private sector in general dominates the economic scene. As for Singapore, the Central Provident Fund and the Post Office Savings Bank are statutory bodies, while the other financial institutions are operated by private enterprises. Private sector also dominates the economy, with a number of public enterprises controlling some key sectors.

The active government participation in equity ownership in both financial and corporate sector in the SEACEN countries has several implications on the development of the capital market. Firstly, with the exception of Singapore, the increasing burden of budgetary appropriation for these state-owned enterprises has resulted in heavy debt bur-

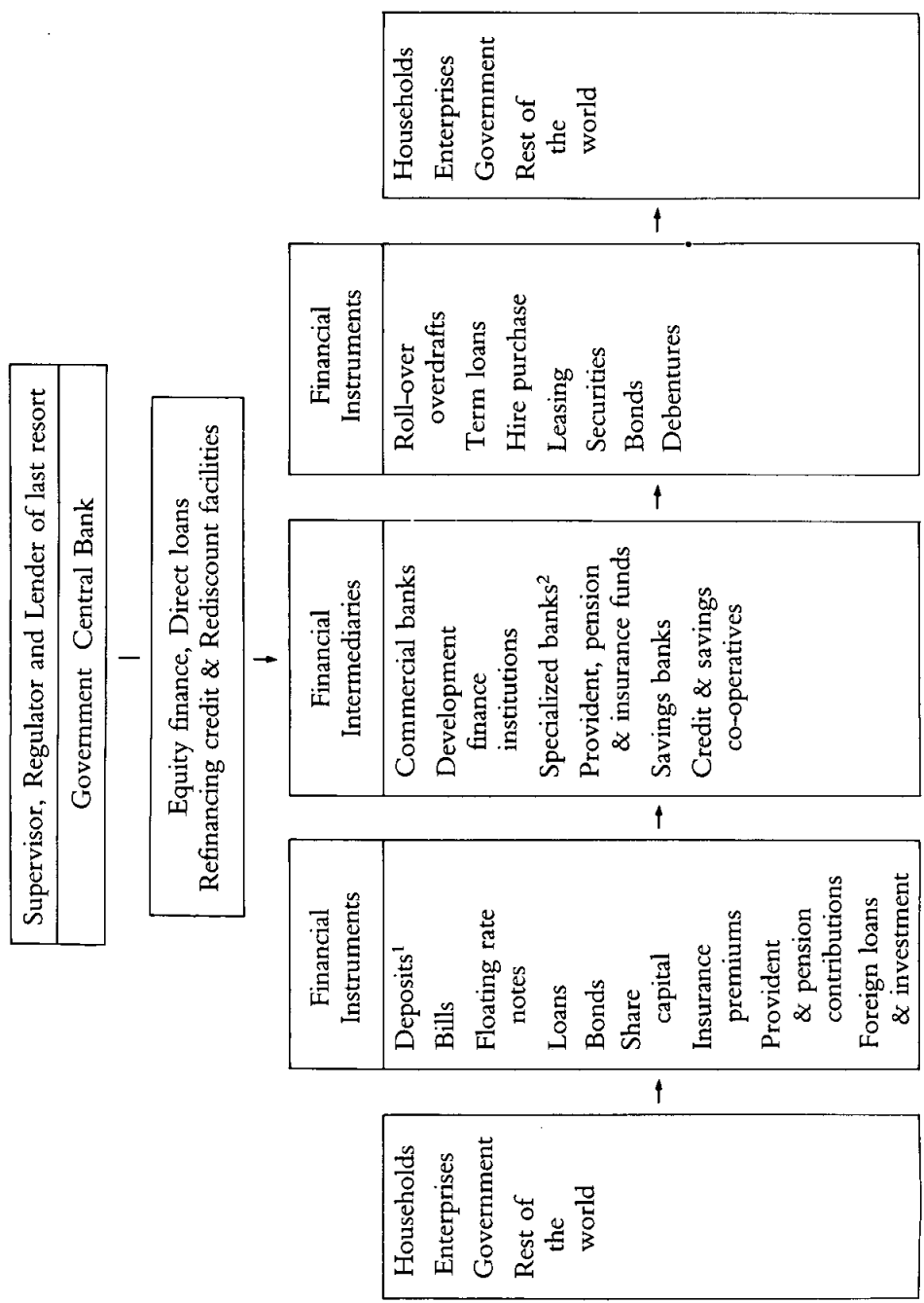
den, especially external debt servicing problem. Secondly, the easy access to government finance by the financial institutions especially through refinancing schemes such as those in Indonesia, Sri Lanka and Nepal had resulted in their poor performance in savings mobilization by these institutions. The same easy access to government credit by the public enterprises also exert detrimental effects on the capital market, especially the securities market, by reducing the supply of securities to the public. To make things worse, these public enterprises (except those in Singapore) are in general not performing satisfactorily, rendering the privatization process at a lethargic pace in certain SEACEN countries.

1. Non-securities Market Structure

The non-securities market operates through a range of financial intermediaries, notably the commercial banks, development finance institutions, specialized banks, contractual savings institutions, and savings banks. In the SEACEN countries, the commercial banks mobilized a significant share of savings but channelled their funds mainly for short-term financing. Development finance institutions were mostly established by the governments to provide medium- to long-term lending. Most of their funds came from the governments or external loans from multilateral institutions or private international capital markets. Specialized banks may or may not be involved in savings mobilization but their activities are directed at a narrow range of specialized financial services, such as underwriting, hire purchase, block discounting or leasing. Contractual savings institutions are common in the SEACEN countries; they provide social security or insurance especially to the employees. They mobilize a substantial amount of forced savings and redirect a large portion of their funds to finance government budgetary operations. They are the captive sources of government securities except in Indonesia where government securities are non-existent. Savings banks are equally well-established in the SEACEN countries. The objectives of these savings banks are two-fold; to mobilize savings from small savers and to inculcate savings and banking habit among the common folks especially those in the rural areas. In order to reduce administrative costs, these banks often make use of the existing facilities of post office network in the respective countries.

The financial intermediaries, as shown in Figure 1.1 mobilized their savings through a variety of financial instruments. They also obtain funds from the governments and central banks through direct equity finance, refinancing facilities, direct loans, and rediscounting facilities.

Figure 1.1 SEACEN COUNTRIES: NON-SECURITIES MARKET STRUCTURE



¹ Includes certificates of deposit.
² Includes mainly merchant banks, investment banks, finance companies, credit foncier companies, and leasing companies.

These funds were then channelled through a set of financial instruments to a wide range of borrowers in the households, corporate, government and external sectors. Most of these instruments used in savings mobilization and loan operations by these financial intermediaries are non-negotiable.

In the SEACEN countries, central banks and commercial banks dominate the non-securities market. As indicated in Table 1.6, the combined assets of central banks and commercial banks in each country have shares ranging from 54.8 per cent (Singapore) to 85.2 per cent (Indonesia) of the total assets of each respective financial system. This reflects the important role of both central banks and commercial banks in the capital markets of the SEACEN countries. However, there is one striking feature in the capital market structure; the respective share of central bank in total assets varies widely from country to country, ranging from 9.9 per cent in Malaysia to 36.4 per cent in Nepal. It seems that the more well-developed the financial system, the lower will be the share of the central bank in total assets. For instance, both Malaysia and Singapore have a relatively well-developed financial sector and their respective central bank's share was less than 15 per cent. For countries like Indonesia and Nepal, where the financial systems are far behind the former two mentioned, the respective shares of the central banks reached as high as 36 per cent for both countries. In the case of Sri Lanka and Thailand, their shares were in the middle range, accounting for 25 per cent and 18 per cent respectively. As for the Philippines, it is surprising to note that the Philippines also has a relatively higher central bank share of 33 per cent, considering the fact that the Philippine financial system is comparable to many developed industrialized countries in terms of number of financial institutions and a variety of financial instruments available there. This may be due to the occurrence of foreign exchange and financial crises in recent years and also the "shallow" character of the non-securities market in the Philippines.

Central banks and monetary authorities play a significant role in the development of non-securities markets in the SEACEN countries. These institutions are development oriented and are involved actively in the financial development of the countries. One of the most important role played by the central banks in the region is institution building. As a major supervisor and regulator of the non-securities market, the central banks promote commercial banking especially through encouraging branch expansion.⁴ Central banks have helped to set up

4. In the case of the Philippines, the establishment of new branches/other banking units in areas considered overbranched has been suspended since late 1984 in order to correct observed imbalances in the distribution of banking facilities.

Table 1.6 SEACEN COUNTRIES: SHARE DISTRIBUTION OF FINANCIAL ASSETS

	Indonesia		Malaysia		Nepal		Philippines		Singapore		Sri Lanka		Thailand	
	1970	1985	1970	1985	1970	1985	1970	1985	1970	1985	1970	1985	1970	1985
Central Bank	47	36.2	20.8	9.9	61.9	36.4	19.5	33.4	9.0	14.0	36.0	24.8	36.4	18.2
Commercial Banks	48	49.0	38.4	45.0	28.2	44.2	45.6	37.6	71.5	40.8	35.0	49.6	52.6	57.1
												(37.5) ^a		
Development Finance Institutions	5	4.6	1.1	2.5	6.0	9.6	12.2	12.8	n.a.	n.a.	2.0	2.3	2.3	5.3
Contractual Savings Institutions	-	3.4	27.2	19.5	4.0	9.7	5.4	2.4	9.7	15.8	18.0	11.9	-	1.5
Specialized Finance Institutions	-	1.3	4.6	16.2	-	-	0.0	3.5	6.0 ^b	4.0 ^b	1.0	2.8	-	11.0
Savings Banks	-	2.0	5.5	3.3	-	-	3.1	2.0	0.8	5.6	8.0	8.6	8.7	6.6
Others	-	3.4	2.3	3.6	-	-	14.1	8.3	3.0	19.8	-	-	-	0.4
												(12.1) ^c		
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

^a Excludes FCBU's

^b Finance companies

^c Refers to FCBU's

Source: The SEACEN Centre member central banks.

finance institutions to complement commercial banking activities. Apart from providing equity finance in a number of cases, they also provide refinancing and re-discounting facilities to commercial banks and development finance institutions. This is especially so for countries like Indonesia, the Philippines, Sri Lanka and Nepal where refinancing is extensive, covering a wide range of sectors. For instance, in Indonesia, Bank Indonesia provides refinancing under the general liquidity credit and long-term investment fund. These refinancing facilities were essentially subsidized credit with low interest rates channelled through state banks in order to achieve certain development objectives. After the deregulation in June 1983, the refinancing amount was reduced drastically and directed only at certain priority sectors. In 1982, total credit provided by Bank Indonesia constituted about 50 per cent of total credit of the banking system, but its share had declined significantly to 37.4 per cent in 1986, reflecting the drastic cut in refinancing.

In the Philippines, rediscounting policy which had evolved from a simple, unitary rate system in the 1950s, designed initially as a tool for liquidity control, to an increasingly allocative and complex structure in the 1960s up to mid-1980 was rationalized and made more market-oriented in November 1985 to enhance its use for liquidity management. By end-1986 outstanding loans under the re-discounting scheme had declined from P19.1 billion at end-1982 to P7.6 billion.

In Sri Lanka, the Central Bank implements five major refinancing schemes, namely the Comprehensive Rural Credit Scheme for agriculture; the Pre-shipment Credit Scheme for preshipment export financing; the Rediscounting Scheme for non-traditional export financing; and the Medium- and Long-term Credit Fund for a wide range of sectors. The interest rates offered to lending institutions range from 1.5 per cent to 4 per cent while the rates for borrowers range from 7 per cent to 12 per cent depending on the type of refinancing schemes.

For the other SEACEN countries such as Malaysia, Singapore and Thailand, there also exist refinancing schemes mainly to promote exports through subsidized interest rates. But the scale of operations is not as large as those in Indonesia, Sri Lanka and the Philippines.

Apart from refinancing facilities, the central banks also participate in some of the development finance institutions, either through equity finance, direct lending or refinancing.

Central banks in the region also implement policies that affect the non-securities market directly. These include policy such as selective credit controls, interest rate ceilings and discount operations. Selective credit controls and interest rate ceilings are aimed at directing credit to certain priority sectors, often at subsidized interest rates. Discount

operations is one of the money market activities by the central bank to provide “cushioning” to liquidity squeeze encountered by banking institutions. At the same time, such operations help deepen the capital market by evolving an active secondary market in the process.

2. *Securities Market Structure*

The securities markets in the SEACEN countries are much less developed than the non-securities markets. The securities traded in this market are generally negotiable and hence can be traded in the secondary market. These securities can be in the form of equity such as shares and stocks, debt instruments such as corporate bonds and government securities or equity equivalents such as convertible bonds or debentures. The securities market, for the purpose of this study is divided into equity market and bond market. Within each of these markets, there are primary and secondary markets. Primary market is the market in which new issues of securities are issued and offered by issuers including government and private companies. These securities can be offered by public floatation or private placement. The secondary market, on the other hand, comprises mainly the stock exchange, over-the-counter market, or direct dealing. These markets deal with old issues and the purpose is to provide liquidity and investment opportunities to investors.

The two markets in the SEACEN countries are mutually reinforcing. While the primary markets constantly supply new securities to the overall market, the secondary markets, on the other hand, provide liquidity cushioning to investors by involving trading of old issues. A market is considered to have “breadth” when there is a constant flow of funds going into both the primary and secondary markets, involving a large number of investors and speculators. The market is considered to have “depth” when there is an active secondary market with continuous quotes of securities prices. Of the SEACEN countries, the securities markets of Malaysia and Thailand, can be considered as generally “broad” but not “deep” enough. The Singapore market, however, is deep enough to be used for portfolio diversification by many international investors. As for the other SEACEN countries, their markets are rudimentary and fragmented.

The basic components of institutional framework in the SEACEN securities markets comprise mainly the regulatory and supervisory bodies, the stock exchanges, securities brokers, securities dealers, securities issuers, underwriters, portfolio investors and speculators. The

institutional structure is set out in Figure 1.2. The primary issue market is conducted through specialized financial institutions such as investment banks, merchant banks, brokers, dealers and even central banks. The underwriters in the SEACEN countries are mainly merchant banks or investment banks. However, in Indonesia, underwriting activities are conducted largely by P.T. Danareksa, a state-owned investment trust company, while in Thailand, underwriting business is conducted largely by securities and finance companies.

In terms of regulatory and supervisory framework, some countries follow the British model, emphasizing self regulation, while others model after the U.S. Securities and Exchange Commission, monitoring and overseeing both the primary and secondary markets. Malaysia, Singapore and Sri Lanka use modified versions of the British model while Indonesia, the Philippines and Thailand follow more closely the U.S. model. On the other hand, Nepal has yet to evolve a complete regulatory and supervisory framework.

For some of the SEACEN countries, the stock exchange has a long history, while in others it is a new phenomenon. Still others have several stock exchanges in the early years, but closed down to leave one or two exchanges later. At the end of 1986, only Malaysia and the Philippines have two stock exchanges. The stock exchanges in Indonesia, Nepal and Thailand are owned by the government. For Singapore, Malaysia, the Philippines and Sri Lanka, the stock exchanges are owned by private companies but subject to close supervision by the government (see Table 1.7). The membership of these exchanges varies substantially both in terms of numbers and composition. In Malaysia and Singapore, the membership is limited to stockbroking firms; some are corporatized while others are not. Malaysia has the largest number of members (53) while Singapore has a smaller number of members (24). In the Philippines, the two exchanges have more or less the same number of members (45 for Manila Stock Exchange and 48 for Makati Stock Exchange) which are mainly stock-broking firms. In Indonesia, there are 27 members, comprising nine development finance institutions including Bank Pembangunan Indonesia (BAPINDO), commercial banks, brokers, dealers and investment companies. In the case of Thailand, the Securities Exchange of Thailand (SET) has 30 members, comprising 25 finance and securities companies and 5 securities companies, which hold licences from the Ministry of Finance to act as brokers and to handle the securities trading in the SET. Sri Lanka has the smallest number of members (7) comprising mainly brokers-dealers.

The trading practices in these SEACEN stock exchanges can be categorised into two types; the open cry system and the call over

Figure 1.2 SEACEN COUNTRIES: STRUCTURE OF THE SECURITIES MARKET

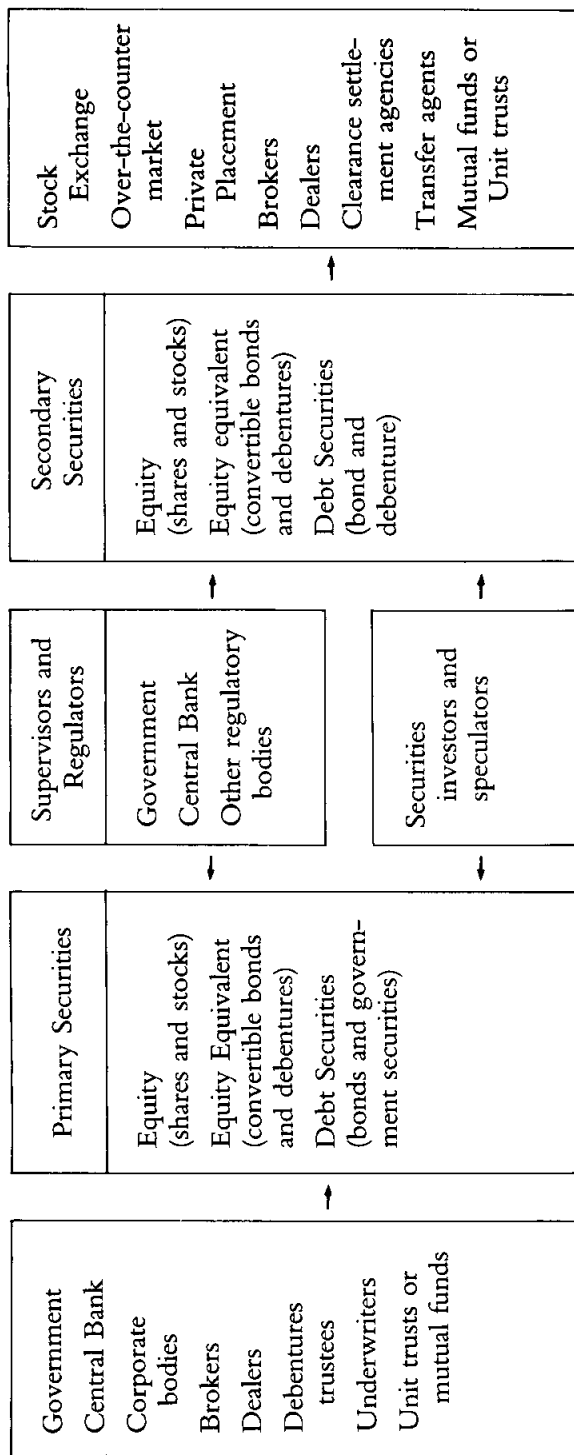


Table 1.7 SEACEN COUNTRIES: BASIC DATA ON STOCK EXCHANGES

	Name of Stock Exchange	Year Established	Exchange Ownership	Number of Member Firms (1986)	Regulatory or Supervisory agency	Number of Companies listed (1986)
Indonesia	Jakarta Stock Exchange	1977	Government	27	Capital Market Executing Agency	24
Malaysia	Kuala Lumpur ¹ Stock Exchange (KLSE)	1973	Private with government supervision	53	Capital Issues Committee Foreign Investment Committee Panel of Takeover and Mergers	301
Nepal	Securities Exchange Centre (SEC)	1983	Government	n.a.	Ministry of Trade & Industry	22
Philippines	Manila Stock Exchange	1927	Private with government supervision	45	Securities and Exchange Commission	154
	Makati Stock Exchange	1963	Private with government supervision	48	Securities and Exchange Commission	
Singapore	Stock Exchange of Singapore (SES)	1973	Private with government supervision	24	Ministry of Finance Monetary Authority of Singapore	317
Sri Lanka	Colombo Stock Exchange	1985	Private	7	Securities Council	169
Thailand	Securities Exchange of Thailand (SET)	1975	Government	30	Ministry of Finance	98

¹ The other stock exchange is the Bumiputra Stock Exchange which provides trading of shares owned by indigenous people, mainly the Malays and other indigenous people in Sabah and Sarawak of Malaysia.

system. Malaysia, the Philippines, and Thailand adopt variations of open cry system while Indonesia and Sri Lanka use a call-over system. The trading system employed in Singapore is a sophisticated version of the open cry system. The system was computerized in 1982 with the introduction of electronic trading boards. However, all trading must still be executed on the floor. Margin trading is allowed in Malaysia, the Philippines, Singapore and Thailand but under close supervision. Insider trading is strictly prohibited in all the SEACEN countries.

In terms of listed companies, Malaysia and Singapore have the largest members of companies (301 and 317 companies, respectively). Most of these companies are cross listed in both exchanges. In terms of size of the market, Singapore has the highest percentage of stock market capitalization to GDP ratio among the SEACEN countries (192 per cent). This figure is even higher than the percentages for Japan (86.2 per cent) and Korea (13.9 per cent). Malaysia also recorded a high market capitalization ratio of 89.9 per cent. In absolute terms, Malaysia and Singapore have relatively active markets. However, the turnover value as a percentage to market capitalization for the two countries is relatively modest (5.2 per cent for Malaysia and 9.4 per cent for Singapore, as indicated in Table 1.8) as compared to Japan (56.5 per cent) and Korea (80 per cent).

Thailand has a relatively active stock market. Although the exchange has 98 listed companies with a market capitalization of U.S.\$956.2 million or 6.8 per cent of GDP, the annual turnover value is relatively high, about 33.2 per cent of the total market capitalization. In fact, the stock exchange in Thailand has launched an offensive move to attract foreign portfolio investors through the establishment of the Bangkok Fund and Thailand Fund in recent years.

The Philippine stock exchanges also have a fairly large number of listed companies (154) but their market capitalization ratio (as a percentage of GDP) was only 9 per cent in 1986, reflecting the prevailing political and economic difficulties in the country. Annual turnover value as a percentage to market capitalization was 27.8 per cent, which was considered the second highest among the SEACEN countries, after Thailand.

Sri Lanka also has a large number of listed companies (169) but most of the shares of these companies were not actively traded as indicated by a low share of turnover value to market capitalization (0.2 per cent). The market capitalization ratio was equally low, as most of the listed companies were relatively small. The big companies in Sri Lanka are mainly public corporations which are not listed in the stock exchange.

The Jakarta stock exchange in Indonesia, is almost dormant, with only 24 listed companies. The market capitalization ratio was negligible

CAPITAL MARKETS

Table 1.8 SEACEN COUNTRIES: SELECTED INDICATORS OF SECURITIES MARKETS

1986	Indonesia	Malaysia	Philippines	Singapore	Sri Lanka	Thailand
Number of listed companies	24	301	128	317	165	98
Market Capitalization (U.S. \$ million)	2,295.6	24,987.8	2,021.0	39,175.2	17.1	2,880
Annual turnover value (U.S. \$ million)	8.2	1,305.0	562.7	3,675.0	... ^c	956.2
Turnover/Market Capitalization (per cent)	0.4	5.2	27.8	9.4	0.2	33.2
Average P/E ratios (per cent)	9.0 ^a	26.4	3.8	36.7	n.a	12.9
Average dividend yield (per cent)	16.1	3.5	16.8	6.2 ^b	n.a	4.0
Stock Market Capitalization/GDP (per cent)	0.1	89.9	9.0	192.0	5.0	6.8

^a Refers to 1983 figure

^b Refers to 1985 figure

^c Negligible, about 0.03 per cent

Sources: Bryan de Caires, *The G.T. Guide to World Equity Markets 1987*. London: Euromoney Publications and G.T. Management, 1987.

(0.1 per cent of GDP) and the turnover was equally discouraging (0.4 per cent of market capitalization). The market is really inactive mainly because of strict government control over the stock exchange activities. P. T. Danareksa national investment trust is authorized by the government to intervene in the stock exchange to ensure price stability. To the investors, the only gain from participation in the stock exchange is the dividend yield which is set to be at least 10 per cent per annum. The stock exchange market also encountered fierce competition from the non-securities market whose interest rates have been deregulated since June 1983.

Finally, Nepal has the smallest stock exchange which is in the process of evolving into a full-fledge stock exchange. Only 22 companies were listed thus far mainly because the larger companies which are mainly public enterprises are not listed in the exchange.

The investors profile in the securities markets of the SEACEN countries, as indicated in Table 1.9, is characterized by the dominance of individual investors. As a result of this dominance, speculative activity is evident in Malaysia and Thailand. Institutional investors are only

Table 1.9 SEACEN COUNTRIES: INVESTORS PROFILE IN THE SECURITIES MARKET

Indonesia	: Institutional investors (P.T. Danareksa, 40 per cent, insurance companies, 20 per cent, banks and other institutions, 10 per cent). Individual investors, 28 per cent. Foreign investors limited.
Malaysia	: Individual investors including nominee companies, 50 per cent. Investment companies, e.g., Permodalan Nasional Berhad, pension funds and state economic development corporations, 20 per cent. Merchant banks, insurance companies and other institutional investors, 27 per cent. Foreign investors, 2 per cent. Have set up Malaysian Fund to attract foreign investors.
Nepal	: Mainly individual investors.
Philippines	: Individual investors dominate. Institutional investors include mutual funds. Foreign investors allowed.
Singapore	: Individual investors dominate. Institutional investors include pension funds, insurance companies, mutual funds and unit trusts. Foreign investors invest either directly or through investment funds such as DF ASEAN Trust, GT ASEAN Hong Kong Growth Fund.
Sri Lanka	: Mainly individual investors.
Thailand	: Individual investors dominate. Institutional investors, lesser role. Foreign investors, 7 per cent. Have set up Bangkok Fund and Thailand Fund to attract foreign investors.

Sources: Bryan de Caires, *The G.T. Guide to World Equity Markets 1987*. London: Euromoney Publications and G.T. Management, 1987.

active in Indonesia and have a share of about 70 per cent. The low profile of institutional investors in the securities market is mainly due to the restrictions imposed on large institutions to invest in stock and shares. For instance, in Malaysia and Singapore, their employee provident funds and insurance companies are required to invest a major portion of their investible funds in government securities. Commercial banks are also not allowed to hold shares up to certain percentages. Secondly, unit trusts or investment companies in the SEACEN countries are still not as well developed as those in the developed countries such as the United Kingdom and the United States. The stock market in Singapore is presently dominated by large domestic institutions (including the local banks and insurance companies) as well as foreign institutional investors seeking international diversification. This represents a significant change from the situation a few years ago.

Foreign portfolio investors were generally not encouraged in the past. In fact, some countries in the SEACEN region require foreign companies to set aside a certain percentage of shareholding to local investors. In Singapore, foreign ownership of listed companies is restricted by the authorities in the case of local banks. The foreign ownership restriction was mainly the result of the apprehension of foreign control over domestic companies. In the wake of global securitization in recent years, a number of the SEACEN countries have set up funds to attract foreign investors while others encourage domestic companies to be listed in stock exchanges in the developed countries. Malaysia and Thailand have set up investment funds to attract foreign investors and they have achieved a certain degree of success thus far.

III. THE DEVELOPMENT OF NON-SECURITIES MARKETS

The development of the non-securities market in the SEACEN countries has been rapid since the turn of the 1970s. The 1950s and 1960s saw the emergence of the modern financial system. During the two decades, there was a rapid expansion of both commercial banks as well as savings banks, in particular the post office savings banks. The introduction of the Green Revolution in the late 1950s had led to the establishment of development banks and the implementation of supervised credit programmes. However, with the turn of the 1970s, the emphasis was on the financing of the industrial sector which became an engine for growth in a number of SEACEN countries. Industrial finance institutions were set up to provide medium- to long-term loans to promote industrial development. The whole approach towards financing was more of supply-led philosophy, rather than demand-pull type.

The financing of government budget deficits depend very much on issuing of government securities. Commercial banks, savings banks and contractual savings institutions were required by law to purchase these government securities as part of the portfolio investment. In a number of the SEACEN countries, interest rates on government securities were deliberately set lower than the market rates to obtain cheap finance for the government. As a result, the government securities market was not only narrow but also shallow in its structure. In recent years, some SEACEN countries had made effort to develop their secondary markets by issuing short-term government securities with competitive market rates. This measure may help to broaden and deepen the government securities market in the long run.

Before the 1970s, the non-securities markets in the SEACEN countries were characterized by interest rate restrictions, selective credit

control, government ownership of financial institutions, segmentation between formal and informal market as well as segmentation within the formal market. Over the years, such features have become less distinct, as deregulation and internationalization of banking and finance proceeded at a rapid pace since the early 1980s. The international debt crisis in 1982 and failures of several financial institutions in the region had also sparked the momentum for further financial reforms and the tightening of supervision and regulation of the financial sector. The development of the non-securities markets in the SEACEN countries will proceed with more challenges in the years ahead.

A. Mobilization of Domestic Savings

In the SEACEN countries, there is a distinct pattern in the institutional arrangement for financial savings mobilization. The commercial banks, the savings banks and the contractual savings institutions are entrusted with the responsibility to mobilize savings, while the development finance institutions concentrate on medium- and long-term financing, especially the financing of priority sectors. The specialized banks, on the other hand, deal with specific financial services and savings mobilization become less important in their operations.

In Indonesia, commercial banks play the most important role in savings mobilization, as compared to other financial institutions. Of these, state commercial banks have the largest number of branches and mobilize savings in both urban and rural areas. There are also three savings banks but their savings mobilization effort has been minimal. Other deposit-taking institutions include village banks and rural banks. Their savings mobilization performance is less encouraging. Compulsory savings institutions are less well developed in Indonesia, as compared to their counterparts in Malaysia and Singapore. However, efforts have been made to introduce an employees' provident fund in 1985 to encourage more savings.

In Malaysia, deposit-taking institutions include commercial banks, finance companies, merchant banks, the National Savings Bank, the Agricultural Bank of Malaysia and a host of savings co-operatives. Of these, both commercial banks and finance companies are the two largest savings mobilizers, accounting for 69.3 per cent and 18.7 per cent in 1986. The National Savings Bank accounted for only 2.3 per cent in the same year, despite its wide post office network. The contractual savings institutions are very well developed in Malaysia. This partly explains the high savings rate in Malaysia. The most important provident fund

is the Employees' Provident Fund, covering about one third of the total population.

In Nepal, the four commercial banks dominate savings mobilization activities. The Agricultural Development Bank is also allowed to take deposits to complement its agricultural financing activities. The Employees' Provident Fund was established as early as 1962 but its coverage is limited. Only the National Insurance Corporation of Nepal (NIC) is involved in the insurance business. The postal savings scheme was only introduced in 1976. As a result, the commercial banks with their wide network of branches became the largest deposit-taking institutions.

Unlike Nepal, the Philippines has a wide range of deposit-taking institutions. Of these, the most important savings institutions are still the commercial banks, accounting for 83 per cent of the total deposits mobilized by the financial institutions (excluding the Central Bank of the Philippines). Other important deposit-taking institutions include savings banks, private development banks, stock savings and loan associations, specialized government banks and rural banks. Provident and pension funds, however, play an insignificant role in savings mobilization in the Philippines.

The Central Provident Fund, which is a compulsory employee savings scheme, is the centrepiece of savings mobilization in Singapore. The provident fund contributions make up about one third of the national savings. Commercial banks, finance companies and the Post Office Savings Bank are the most important deposit-taking institutions in the country.

In Sri Lanka, commercial banks as a group are the most important savings institutions with a wide network of branches. Next in importance is the National Savings Bank, followed by finance companies. The contractual savings schemes under the Employees' Provident Fund and the Employees' Trust Fund have been set up to provide both social security to members and mobilize savings to finance government expenditure. Unlike Singapore and Malaysia, the pension funds in Sri Lanka play a lesser role in savings mobilization due to its limited coverage.

As in other SEACEN countries, commercial banks in Thailand accounted for the largest portion of deposit mobilization (73 per cent of total deposits) among the financial institutions. Finance companies, through the issue of promissory notes also mobilized a large amount of deposits (7 per cent). Other deposit-taking institutions are government savings banks, savings co-operatives and the Government Housing Bank.

The above cursory survey indicates that commercial banks in the SEACEN countries are the most important deposit-taking institutions. The relative importance of commercial banks in the financial system is shown in Table 1.10. However, most of the deposits are mainly of short-term nature. There is, therefore, a tendency for the commercial banks to avoid liquidity risk in financing short-term loans. The contribution of commercial banks toward the development of the non-securities capital market can be enhanced provided that term transformation can be facilitated. In the SEACEN countries, the term transformation process is facilitated by several means, especially the provision of facilities for liquidity management by the commercial banks. Of these, the most important facility is the access to money market, in particular the inter-bank money market, the discount market and the lender-of-last-resort facilities provided by the central banks and monetary authorities. Swaps and repurchase agreements are also used by commercial banks for liquidity management. In recent years, the commercial banks in the SEACEN region have also resorted to liabilities management. This is particularly so for foreign banks which encounter geographic restriction in branching and also limited access to the secondary money market. These banks have introduced various financial innovations to attract more savings such as the introduction of negotiable certificates of deposit, the automatic teller machines and NOW accounts.

To facilitate term transformation in some SEACEN countries, there is a need to inject public confidence in the banking system. In this case, the central banks and monetary authorities in the SEACEN countries have been entrusted with the responsibility to supervise and regu-

Table 1.10 SEACEN COUNTRIES: RELATIVE SIZE OF COMMERCIAL BANKS (per cent)

As at end 1985	Assets of Com. banks	Deposits of Com. banks	Loans of Com. banks
	Assets of Fin. system	Deposits of Fin. system	Loans of Fin. system
Indonesia	49.0	93.7	90.1
Malaysia	45.0	55.2	68.2
Nepal ¹	44.2	98.2	42.9
Philippines	37.6	52.1	47.8
Singapore ²	47.5	41.2	63.5
Sri Lanka	49.6	66.5	57.8
Thailand	57.1	72.9	72.3

¹ Refers to 1986 figures.

² Excludes the central bank.

Source: The SEACEN Centre member central banks' annual report, various issues.

late the banking institutions. Legal and regulatory framework have been tightened in recent years, following a number of bank failures in several SEACEN countries. Only the Philippines has a deposit insurance scheme provided by the Philippines Deposits Insurance Corporation (PDIC). Apart from the implementation of the lifeboat scheme and merging policy, Thailand also set up the Financial Institutions Development Fund to rescue problem financial institutions. In the case of Malaysia, the central bank resorted to changing shareholding structure and reorganizing the management to rescue problem banks, apart from introducing a series of bank legislation such as Finance (Banking and Financial Institutions) Act, 1986 and Essential (Protection of Depositors) Regulations, 1986 to strengthen the supervisory and regulatory framework (see SEACEN Centre, 1985 and Bank Negara Malaysia, 1986).

Term transformation can also be strengthened by deepening the financial market. A case in point is the development of a secondary mortgage market in Malaysia in 1986. The purpose of the market is to resolve the growing risk of funding mismatch by both the commercial banks and finance companies. On the one hand, the bulk of the deposits mobilized by the two institutions are mainly deposits having maturities of less than 18 months. On the other hand, housing loans to individuals already accounted for 13.5 per cent of the total outstanding loans for the commercial banks and 16 per cent for the finance companies at the end of 1986. A significant portion of these housing loans have maturity periods of 10 to 25 years. Such "borrowing short and lending long" mismatch will have serious repercussion on the stability of the financial system in the long run. The establishment of the secondary mortgage market which the primary lenders can "securitize" their large holdings of mortgage loans and sell off these holdings to long-term investors, is to eliminate both the liquidity and interest rate risks. The market will then help to encourage the commercial banks and finance companies to continue to provide more end-financing to house buyers (Bank Negara Malaysia, 1986).

The SEACEN countries also adopted various strategies to mobilize savings in the last 15 years. Of these, five main strategies seem to be most common in many SEACEN countries but the focus may vary from country to country. The five strategies are:-

- increase in accessibility of savings facilities through institution building and branch expansion;
- the assurance of positive real interest rates;
- the provision of tax incentives;
- the establishment of contractual savings scheme; and,
- the introduction of financial innovations.

In the early years of development, most of the SEACEN countries concentrated on institution building and then followed up with branch expansion to provide savings facilities to all savers in both rural and urban areas. Apart from commercial banks, most of the SEACEN countries set up savings banks to mobilize small savings. Most of these savings banks are owned by the government, making use of the existing facilities provided by an extensive network of post offices. As noted earlier, commercial banks are relatively successful savings mobilizers because of their wide network of branches which were encouraged by the governments in the SEACEN countries to expand, especially in the rural areas. The post office savings banks, sometimes called the National Savings Bank, are relatively less successful in terms of the amount of savings mobilized. However, they cater to the special needs of small savers. Non-bank financial institutions such as finance companies and merchant banks in Malaysia, savings co-operatives in Thailand, thrift banks and rural banks in the Philippines are also involved actively in mobilizing funds. Usually, they offer higher interest rates and longer office hours to their customers. However, their savings mobilization efforts are still not comparable to those of the commercial banks. A notable exception is the Post Office Savings Bank in Singapore.

As to the degree of accessibility to savings facilities, Table 1.11 indicates that except Indonesia and the Philippines, the other countries have achieved an increase in accessibility in terms of number of persons served per office. Singapore has the greatest accessibility, followed by

Table 1.11 SEACEN COUNTRIES: ACCESSIBILITY TO SAVINGS FACILITIES¹
(Population per office, in thousands)

	1975	1980	1984
Indonesia	22.76	24.47	28.14
Malaysia	11.91	9.40	8.65 ^a
Nepal ²	n.a	58.00	45.70
Philippines	17.51	12.78	13.15 ^a
Singapore	6.0	5.2	4.5
Sri Lanka	12.97	11.18	9.67
Thailand	n.a	19.65	16.88 ^b

¹ Refers to savings facilities provided mainly by commercial banks and non-bank financial institutions.

² Refers to population per commercial bank offices only.

^a Refers to 1986 figures.

^b Refers to 1985 figures.

Source: The SEACEN Centre member central banks' annual report, various issues.

Malaysia and Sri Lanka. Indonesia and Nepal have the largest number of persons served by each office. The other countries like the Philippines and Thailand fall in between.

Before 1975, interest rates in most of the SEACEN countries were administered and set at low levels. The purpose is to provide cheap finance for economic development. Having experienced rapid inflation in the second half of the 1970s, a number of the SEACEN countries took steps to liberalize the interest rate system. The objective of this liberalization was to provide a greater role to market forces in determining the interest rates, and thereby to relieve financial depression in the financial system (McKinnon, 1973 and Shaw, 1973). Such liberalization of interest rates at least ensures positive real interest to savers so that they are encouraged to save more. Singapore liberalized its interest rates as early as 1970 while Malaysia freed the interest rates for finance companies in 1974 and for commercial banks in 1978. Sri Lanka also liberalized its interest rates in 1977 to a significant degree. The Philippines started its liberalization in 1981 with all interest rates restrictions on bank deposits being abolished. On the other hand, the amendment of the usury law in 1980, provided more flexibility to the Thai authorities to adjust the interest rate ceiling in line with economic conditions. Indonesia also introduced a major financial reform in June 1983, after which interest rates were freely determined by commercial banks. In Nepal, its interest rates are basically determined by commercial banks themselves since 1986 to pave the way for further financial reforms in the future.

As a result of interest rate liberalization and low inflation rate in recent years, real interest rates in all the SEACEN countries except for Nepal have been positive (see Table 1.12). The empirical studies conducted by the Asian Development Bank on 14 Asian developing countries which include a number of the SEACEN countries, indicate that "higher real deposit rates of interest and increased accessibility of depository institution branches in rural areas have raised national savings rates directly" and "higher real deposit rates of interest have raised financial savings substantially" (Asian Development Bank, 1985). This empirical result shows that real positive interest rates can be an effective tool in mobilizing financial savings.

The provision of tax incentives to encourage more savings has been used in the SEACEN countries mainly for discriminatory purposes rather than as an incentive for increased savings. For instance, income tax is exempted on interest income earned from deposits with the National Savings Bank in Malaysia (up to a maximum limit of M\$30,000). But deposits with commercial banks and other deposit-

Table 1.12 SEACEN COUNTRIES: REAL INTEREST RATES¹
(end of period)

	Indonesia		Malaysia		Nepal		Philippines*		Singapore		Sri Lanka		Thailand	
	12-m TD	SD	12-m TD	SD	12-m TD	SD	12-m TD	SD	12-m TD	SD	12-m TD	SD	12-m TD	SD
1971	21.09	15.23	3.11	0.68	7.22	4.71	-0.12	-0.13	3.41	0.98	-1.18	-1.42	5.63	2.17
1972	-6.20	-6.20	2.08	0.10	-6.20	-8.38	-0.01	0.02	-0.05	2.17	0.72	0.48	-1.65	-4.87
1973	-9.73	-9.73	-8.63	-10.74	-8.98	-11.09	-0.08	-0.09	-20.26	-22.68	-8.52	-8.73	-10.98	-13.89
1974	-11.41	-11.41	-2.68	-4.91	-6.89	-9.44	-0.18	-0.21	-3.80	-6.88	-5.29	-5.52	-8.32	-11.29
1975	-3.93	-1.42	6.33	4.35	5.50	-0.92	0.03	-0.01	6.64	4.33	6.33	4.35	8.45	0.10
1976	0.70	3.33	3.56	1.64	9.09	2.75	0.01	-0.02	6.91	5.10	4.88	2.93	4.45	1.06
1977	0.18	2.86	1.14	-0.28	-0.19	-3.75	0.00	-0.03	-0.82	-2.56	13.19	5.51	-0.83	-4.04
1978	2.06	7.68	2.40	0.96	10.04	6.11	0.03	-0.00	3.32	1.56	-1.71	-8.38	0.19	-3.06
1979	-14.17	-9.45	1.71	0.19	-2.67	-6.14	-0.05	-0.07	0.23	0.95	0.26	-4.97	-5.13	-8.18
1980	-6.92	-1.79	1.77	-1.03	1.21	-2.40	-0.04	-0.08	4.29	3.32	-3.69	-8.51	-2.92	-6.36
1981	1.53	7.12	2.12	-1.56	0.96	-2.65	-0.00	-0.03	-1.31	-2.26	3.21	-3.55	0.62	-2.94
1982	-1.00	4.45	4.56	1.24	0.63	-2.95	0.03	-0.00	6.25	5.59	15.75	8.63	9.92	6.03
1983	5.90	2.77	5.72	2.81	2.83	-0.82	0.04	-0.00	5.33	4.83	2.88	-5.35	9.07	5.21
1984	1.00	5.41	8.95	5.70	10.30	6.90	-0.22	-0.27	5.85	5.55	11.52	5.12	12.84	9.33
1985	10.26	10.26	6.33	4.85	-0.26	-3.34	-0.03	-0.10	4.17	4.47	16.26	11.82	7.45	5.52
1986	5.31	5.31	5.52	4.54	-1.14	-3.34	0.11	0.08	4.77	4.56	4.49	2.66	5.51	5.51

¹ The figures are calculated from the following formula:

$$R = \left[\left(t_t - \frac{\Delta p}{P} \right) / \left(1 + \frac{\Delta p}{P} \right) \right] \times 100 \text{ where } R \text{ is real interest rate, } t_t, \text{ nominal interest rate and } p, \text{ the price level indicated by consumer price index.}$$

12-m TD: Time deposits with maturity of 12 months SD: Savings deposits

Sources: The SEACEN Centre, Economic Survey Questionnaire Replies, various years.
International Monetary Fund, *International Financial Statistics*, various issues.

*Data from the Central Bank of the Philippines.

taking institutions are subject to a withholding tax of 5 per cent. This kind of discriminatory treatment applies to most of the SEACEN countries.

With the rapid development of telecommunication and computer technology, various financial innovations were introduced in the non-securities markets in the SEACEN countries. The purpose of these innovations is two-fold. One is to enhance banks and non-bank financial institutions' competitiveness in mobilizing savings. For instance, certificates of deposit were introduced in many SEACEN countries to attract short-term savings. NOW accounts were introduced in the Philippines while interest computation was calculated on a daily basis to attract more savings in Malaysia and Singapore. In certain SEACEN countries, financial institutions also offered various types of benefits to depositors, including the provision of insurance coverage, the easy access to credit and occasionally longer office hours on certain days to their customers.

The second purpose of financial innovations is to circumvent the existing laws and regulations. For instance, foreign banks are restricted in geographic branching. One way to circumvent this restriction is to introduce automatic teller machines and cross-link with other domestic banks. The other innovation that may help to circumvent this geographic restriction is home banking, which has been introduced in Malaysia and Singapore.

The other approach of mobilizing savings which is very common among the SEACEN countries is the establishment of contractual savings schemes. Nearly all the SEACEN countries have such schemes to provide both social security to retired people as well as a cheap source of finance for the government. While provident and pension funds exist in all the SEACEN countries, only Malaysia and Singapore seem to be the most successful in mobilizing substantial savings through these funds. It is estimated that contributions to these provident and pension funds amounted to about one third of their respective national savings in Malaysia and Singapore. The success in this mobilization effort was due to several factors, including wider coverage and strict enforcement of the contractual savings schemes (at least one third of the population in Malaysia), higher income growth in these two countries for the past 15 years or so; and the relatively high contribution rates imposed on both employers and employees (20 per cent and 35 per cent of each worker's salary for Malaysia and Singapore, respectively). The experiences of Malaysia and Singapore indicate that contractual savings schemes can be an effective means of mobilizing savings for long-term investment activities.

B. Allocation of Medium- and Long-term Credit

The non-securities markets in the SEACEN countries provide the bulk of medium- and long-term credit to both public enterprises and private sector firms through a wide range of financial institutions, namely commercial banks, development finance institutions and specialized banks. In addition, the provision of medium- and long-term credit is complemented by extensive government involvement in the provision of refinancing, direct lending to priority borrowers and equity finance of certain lending institutions. The degree and emphasis of government involvement in allocation of credit varies from country to country.

Despite the dominance of commercial banks in terms of both assets and deposits, commercial banks in the SEACEN countries tend to confine their activities generally to mobilizing short-term deposits, trade financing and provision of traditional banking services. The extension of medium- to long-term lending would have been limited without government intervention and moral suasion. Government intervention include direct ownership of commercial banks, provision of refinancing, imposition of lending guidelines, selective credit controls, interest rate ceilings, provision of credit guarantee and, in some cases, encouraging them to provide equity finance in development finance institutions.

In Indonesia and Sri Lanka, the emphasis is more on central bank refinancing as the major commercial banks are government-owned. In Indonesia, Bank Indonesia provides "liquidity credit" to state banks to fund loans to development projects undertaken by government agencies and government-owned corporations. After the financial reform in June 1983, Bank Indonesia drastically reduced the volume of liquidity credit to state banks which are forced to mobilize savings on their own, leading to a rapid rise in interest rates. Liquidity credit is now restricted to investment and working capital requirements of high priority sectors only. The major issue encountered by Indonesia at the moment is the high cost of funds, following the deregulation of interest rates since June 1983.

Sri Lanka also places great emphasis on refinancing schemes to provide medium- and long-term credit to priority sectors. These sectors include agriculture, fishery, export sector, and tourism. For agriculture and fisheries, the refinancing is up to 100 per cent while for other sectors, the refinancing ranges from 60 to 70 per cent. The maturity periods range from 3 to 15 years. The interest charged ranges from 7.5 per cent to 12 per cent, depending on the category of loans. Apart from

the Central Bank of Sri Lanka, development finance institutions also provide refinancing facilities especially to the industrial sector.

The approach adopted by Malaysia is more towards moral suasion, lending guidelines and lending rate ceilings. However, over the past few years till end of 1987, lending guidelines for commercial banks and finance companies were limited to the Bumiputra community (indigenous people), farmers and enterprises engaged in agricultural food production, low-cost house buyers and small scale enterprises. The main reason for narrowing down the priority sectors was that credit was readily available following an easier liquidity condition in the banking system. Secondly, development finance institutions such as the Agricultural Bank of Malaysia, the Development Bank of Malaysia, the Malaysian Industrial Development Finance and the Industrial Bank of Malaysia are well established to provide medium- and long-term loans to the private sector. In other words, the reliance on commercial banks for medium- and long-term loans has been reduced significantly over the years.

In Nepal, commercial banks play a lesser role in providing medium- to long-term loans to the public enterprises and private sector for various reasons. Firstly, the financing of public enterprises depends very much on budgetary appropriation while the private sector is still considered small and its financing is insignificant. As a result, the debt-equity ratio for Nepal is very low (0.45 in 1986). Secondly, the two largest development finance institutions, namely, the Agricultural Development Bank of Nepal and the Nepal Industrial Development Corporation (NIDC) took a significant share of development finance in the country.

In both the Philippines and Thailand, selective credit control and interest rate ceilings were used, apart from refinancing facilities provided by the respective central banks. The two governments have attempted to ensure adequate credit supply to agriculture and rural areas partly by directives to banks, and partly by providing banks with incentives to establish new branches in rural areas. Only Singapore is free of this type of government intervention since 1970. The allocation of credit is mainly through market forces.

Development finance institutions in the SEACEN countries are one of the major sources of medium- and long-term financing for the private sector, especially the priority sector. The establishment of these development finance institutions was to provide investment finance, normally at subsidized interest rates. Their main source of funds is mainly from government budgetary allocation and hence private participation is very limited. The major problem of these institutions is that

they do not mobilize funds on their own and are over-dependent on government budgetary appropriation. Some of these institutions also encountered loan arrears problems arising from financing the risky long-term projects.

Specialized banks such as finance companies, leasing companies and merchant banks are also involved in capital market activities. The finance companies in Malaysia, Singapore, Sri Lanka and Thailand actively engage in hire-purchase business. Leasing companies are active in Malaysia, Singapore and the Philippines but they are still new in Indonesia and Thailand. Merchant banks in the SEACEN region are involved not only in the non-securities market but also in the securities market activities as well. Apart from underwriting new issues of shares, they also actively engage in consortium loans and conduct feasibility studies.

Other financial institutions such as the contractual savings institutions and savings banks are less involved in term lending activities.

C. Implications on the Development of Non-Securities Markets

The non-securities markets in the SEACEN countries are characterized by a gradual deregulation of interest rate policies, the common use of selective credit control, a distinct segmentation within the formal financial system and the prevalence of financial dualism. The implications of these structures on the development of the non-securities markets can be at times very serious and lead to financial repression.

On interest rate policies, all the SEACEN countries except Thailand have freed their interest rates to a significant degree. In Malaysia and Singapore, the fluctuation of interest rates has not been substantial. For countries such as Indonesia, the Philippines and Sri Lanka, interest rates have shot up rapidly immediately after their liberalization. The liberalization of interest rates in these SEACEN countries is only partial as interest rate ceilings are still imposed on priority sectors. This has created a chronic excess demand for funds especially in those countries where interest rates have moved up substantially.

Another consequence of liberalization of interest rates and the cut-back of refinancing facilities is that deposit-taking institutions tend to compete with each other for more deposits. The result is the sharp increase in interest rates and general liquidity in the banking systems as in Indonesia, the Philippines and Sri Lanka. At the same time, liberalization has increased competition between banks and non-banks for

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deposits through non-price competition such as the provision of ATM, longer office hours, and new savings media.

The high interest rates following the liberalization in Indonesia, Sri Lanka and the Philippines have dampened somewhat the orderly development of the securities market. This is particularly so in Indonesia where the only return from share investment is dividends and not capital gains (and also capital loss). This has discouraged investors from investing in shares as the interest rates offered in the non-securities markets are much higher than the share dividends (see Table 1.13). Bond issuers are also reluctant to issue more bonds as the bond rates have to be high enough to attract more investors. This means high cost of funds for the bond issuers.

Selective credit controls together with concessionary interest rates are pervasive among many SEACEN countries. The purpose of these credit controls is to ensure the priority sector's access to an adequate supply of finance, normally at concessionary terms. This type of credit controls have not been effective and often result in non-performing loans. Firstly, the interest cost represents only a small portion of total costs and hence is not an attractive incentive to increase priority sector activities. Secondly, selective credit controls with concessionary terms tend to have a credit rationing effect. The easy access to credit at concessionary terms will automatically increase the demand for loans. This excess demand for loans tends to induce the loan officers to approve

Table 1.13 SEACEN COUNTRIES: INTEREST RATE STRUCTURE IN 1986

	Year of Liberaliza- tion	Deposit rates (%)	Lending rate (%)	Yield on government securities (%)	Dividend Yield (%)	Inflation rate (%)
Indonesia	1983	15.4	21.2	n.a	16.10	5.9
Malaysia	1978	6.9	10.5	8.3	3.5	0.7
Nepal	1986	12.5 ^a	15.0 ^b	13.0	n.a.	19.0
Philippines	1981	9.5	13.9	n.a	16.76	0.7
Singapore	1970	2.9	6.2	5.2 ^c	6.5 ^d	-1.4
Sri Lanka	1977	11.8	9.8	12.0	n.a	8.0
Thailand	1980	9.5	15.0	8.1	4.04	1.8

^a Refers to one-year deposit.

^b Minimum lending rate.

^c Refers to 5-year yield of government securities in May 1987.

^d Refers to 1985 figure.

Sources: International Monetary Fund, *International Financial Statistics*, various issues.
Bryan de Caire. *The G.T. Guide to World Equity Markets 1987*. London: Euromoney Publications and G.T. Management, 1987.

those loans whose borrowers can furnish a reasonable amount of collateral securities. As a result, those who are in more need of funds but cannot furnish collateral securities tend to have less chance to obtain the loans. The unsuccessful applicants have no choice but to turn to the informal financial sector for credit at higher interest. This partly explains the persistence of financial dualism in many SEACEN countries.

Selective credit controls at concessionary terms also tend to attract borrowers whose projects are considered as non-viable on commercial terms. This adverse selection process has often resulted in non-performing loans. A number of the SEACEN countries have instituted credit guarantee schemes to remedy the credit rationing and adverse selection situation. But the performance so far has not been encouraging.

Segmentation within the financial system is prevalent among all the SEACEN countries except the Philippines. For instance, in a number of the SEACEN countries, their commercial banks tend to confine their activities relating to retail banking while their merchant banks are involved more in wholesale banking and fee-based activities. Finance companies on the other hand, are allowed to be involved mainly in the hire-purchase business. As a result of this clear-cut demarcation of financial activities, there is very little competition among the three types of institutions. One way to circumvent such restriction is to own subsidiaries, either partly owned or fully controlled. This has resulted in financial conglomeration within the financial sector.

As noted earlier, financial dualism still persists in the SEACEN countries. The implication arising from this kind of financial structure on the development of the non-securities market is the seriousness of financial disintermediation and the loosening of monetary control. Financial disintermediation arises when people withdraw deposits from the banking system and invest in, say, rotating savings and credit societies which are very rampant in many SEACEN countries. On the other hand, monetary control will be diffused to a significant degree if the informal financial sector is relatively large (see Chandavarkar, 1985). As a result, any credit control or interest rate ceilings will be modified or offset partly or fully by the activities in the informal financial sector.

From the discussion above, it is noted that the undesirable financial structures can be impediments to the orderly development of the non-securities market. The role of the governments, in particular the central banks, should aim towards removing the dualistic structures so that deregulation of the financial system can be accelerated. Apart from providing conducive environment of the orderly working of market forces in the financial system, the governments in the SEACEN countries

should also enhance the pace of term transformation in the non-securities market and also ensure financial stability in the system.

IV. THE DEVELOPMENT OF SECURITIES MARKETS

The securities markets in the SEACEN countries are not as well developed as their non-securities counterparts in their respective countries. The extent of the securities market development also varies from country to country. On the one hand, Malaysia, Singapore and to a significant extent, Thailand, have relatively well-developed securities markets. On the other hand, the securities markets in Indonesia, Sri Lanka and Nepal are still rudimentary. In between these two extremes is the Philippines, whose securities markets have all the comparable fundamental structures as Singapore and Malaysia but lack the same vigour and resilience of the former two markets, arising mainly from the recent political instability and economic downturn. However, the securities markets in the region are, as a whole, still far less developed than those in the developed countries.

A. The Equity Market and Corporate Financing

The existence of stock markets is not new in the SEACEN countries. As far back as 1912, Indonesia established its own stock exchange under the Dutch colonial rule. The Manila Stock Exchange which is still in existence was established in 1927. For Malaysia and Singapore, the formation of the Malayan Stock Exchange in 1960 marked a new era for the securities industry in the two countries. Thailand started its stock exchange in 1962 but it failed to achieve much progress until 1975 when the Securities Exchange of Thailand was formally established under government supervision. Sri Lanka set up its properly structured Colombo Stock Exchange only in 1984 while Nepal had its Securities Exchange Centre as late as 1983.

The stock exchanges in the SEACEN countries tend to concentrate on trading of stocks and shares, rather than bonds, be they government or corporate. The main reason is that bond markets in the SEACEN region are much less developed than the share markets. We will deal with bond markets in the next section.

The share markets or the equity markets in the SEACEN countries are not homogeneous; those in Malaysia, Singapore and Thailand are more active than those in Indonesia, Nepal, the Philippines and Sri

Lanka. The problems and constraints encountered by the two groups are therefore totally different. We will analyze them separately.

1. Equity Markets in Malaysia, Thailand and Singapore

In the case of Malaysia and Thailand, the problems and constraints on the development of the equity markets are not due so much to the scarcity of equities and deficiency in the demand for such equities. In fact, one of the major problems faced by Malaysia and Thailand is the high demand for shares especially in recent years and the dominance of massive speculation in their stock markets. The high demand for shares is partly due to the high level of income and the growing number of middle-income and professional groups as well as the increasing portfolio investment from abroad in the two countries. High demand is also due to excessive speculation by both individual investors as well as unknown syndicates in their share markets. This massive speculation had led to the collapse of the stock exchange in Thailand in 1979. Two special funds, the Krung Thai Fund and the Capital Markets Development Fund were then set up to support the share markets. The type of speculation common in Thailand and Malaysia is characterized by two phenomena. The first is the unknown syndicate which manipulates the share markets; the other is the dominance of a large number of inexperienced individual investors with inadequate access to information. Such phenomena tend to interact with each other to produce overbought or oversold markets which do not reflect the fundamentals in the markets. As the bubble finally bursts, the inexperienced investors normally get their fingers burnt.

Another salient feature of the equity markets in the two countries is the relative absence of institutional investors in the secondary market (actually most of the SEACEN countries suffer this same structural weakness). There are many potential institutional investors in these countries, but they are not active in the share markets. For instance, the Employees Provident Fund of Malaysia with its huge financial base can be an active participant in the share market. However, it has been relatively inactive due to a number of factors. One major factor is the legal restriction preventing it from investing in securities except those that are considered relatively riskless. As a result, they invest mainly in government securities and Treasury bills. Even the insurance companies in these countries are restricted in their portfolio investment and a certain percentage of their funds has to be invested in government securities. In addition, only those shares that are listed in the trustee acts

are eligible for investment. On the other hand, mutual funds and unit trusts are not popular among the individual investors as the past records of returns on these funds are not even comparable to the interest rates offered by the banking sector. Foreign institutional investors began to show their interest in the two share markets only in recent years.

Of the two markets, Malaysia has the highest level of participation by the institutional investors, accounting for 47.8 per cent of the investors. The high institutional concentration was due largely to investment by Permodalan Nasional Berhad (National Equity Corporation), the Employees Provident Fund and the various state economic development corporations. Merchant banks and insurance companies form the second most important group of institutional investors while the mutual funds and unit trusts accounted for an insignificant share of the total investment. Despite the high percentage of institutional investors, these investors tend to lock in their shares for long-term investment. In Thailand, institutional investors tend to shy away from share markets as they consider such investment risky.

Oversubscription of new issues also characterize the primary issue markets in Malaysia and Thailand. The oversubscription in the past was due to a number of factors. One major factor is the underpricing of new share issues. In the case of Malaysia, the underpricing was not opposed by the authorities mainly for equitable reasons, i.e., to encourage share ownership among the lower income group. In the case of Thailand, new issues must be issued at any price not lower than the par value. In general, the prices of new issues are normally set lower than the market prices. However, this underpricing has resulted in the oversubscription of new issues, occasionally reaching 60 to 70 times the amount of funds desired to be raised. The underpricing of new issues would not be a sufficient condition for oversubscription, had there not been good prospects for capital gains through immediate sale in the market after successful allotment. The possibility of making a quick fortune, together with the capital gains tax exemption, have encouraged even common people to invest in the new shares. The oversubscription rate also tended to be high when the prevailing interest rates were relatively lower.

On the supply side, there is no lack of companies for potential listing in the share markets in Malaysia and Thailand. However, the listing requirements and procedures are either difficult to meet or fulfil for one reason or another. For instance, there is a large number of family businesses which are eligible for listing but are reluctant to do so because of the apprehension of losing control of business, the fear of having to disclose trade and business information to rival firms or to

evade taxes, especially where tax laws are not strictly enforced. On the other hand, there are also companies which have the potential but still cannot meet the listing requirements. In this case, Thailand had set up a second board in May 1987 with the primary objective of providing young companies with good growth prospects but without an established track record, with an avenue to raise necessary capital funds for further investment. At the end of 1987, there were seven companies listed in this second board. Malaysia is now considering setting up a second board in the Kuala Lumpur Stock Exchange. (Singapore also had set up a second securities market called the Stock Exchange of Singapore Dealing and Automated Quotation System in February 1987).

The other source of supply of new shares is through the privatization of state public corporations. There has been a number of successful cases in Malaysia. Three prominent cases were the Malaysian Airline System (MAS), the Malaysian International Shipping Corporation (MISC) and the Telecommunications Department. Privatization or divestment programmes can only be successful provided that the public corporations have proven track records of profitability or at least have the potential to generate profits in the future. This kind of public corporations are hard to come by. Public corporations in many SEACEN countries tend not to perform well commercially.

As noted earlier, the stockbroking industry in Malaysia exhibited several structural weaknesses. The brokers were under-capitalized and yet overtraded in the share markets before 1985. At the same time, these brokers were on a partnership basis and highly dependent on remisiers or dealer representatives for their business contact. As a result, they failed to build up their strong research and sales teams of their own and were not able to monitor their clients properly. In most cases, the deposits placed by their remisiers with the brokers were not even enough to cover the potential risks involved in dealing with a large number of unknown clients. Malaysia had accelerated the pace of corporatization of its stockbroking industry. The three largest banks were given stockbroking licences while another four were restructured to have corporate status. At the end of February 1988, seven out of 53 firms were corporatized. The corporatization of stockbroking firms in Malaysia is in response to two developments. One is to remedy the structural weaknesses within the industry itself as noted earlier. The more important factor for the acceleration of corporatization is the globalization of securities. A strong stockbroking industry especially with increased foreign ownership will help to boost the local securities industry and attract foreign portfolio investment.

Apart from corporatization of stockbroking firms, several measures were adopted by the Malaysian authorities to develop the equity market in recent years, as follows:

- i) The introduction of the Malaysian Code on Takeovers and Mergers in 1987 to regulate the procedures on takeovers and mergers with the basic objectives of protecting the interest of shareholders, especially minority shareholders and the public at large;
- ii) The setting up of a Panel on Takeovers and Mergers in March 1986 to administer the Malaysian Code on Takeovers and Mergers;
- iii) The publication of a set of guidelines for the new issue of securities and valuation of public limited companies in April 1986 and the revision of the guidelines in May 1987;
- iv) The introduction of real time price reporting system (MASA) to provide up-to-date minute information on the movement of share prices in the Kuala Lumpur Stock Exchange (KLSE);
- v) The establishment of an Advance Warning and Surveillance (AWAS) unit in the KLSE with the aim of alerting the relevant authorities of any stock broking houses and listed companies which may be in trouble so that corrective measures can be undertaken immediately; and,
- vi) The revision of the listing manual of the KLSE to provide more stringent requirements on corporate disclosure policies.

While local investors in Singapore continue to be enthusiastic about share ownership, the Stock Exchange of Singapore has experienced a large increase in the presence of large foreign and domestic institutional investors over the last two years. The number and quality of international and local brokerage firms have increased significantly over the past two years, as has the number of international research firms. These should be viewed in the context of a couple of developments.

First, the securities industry in Singapore has benefited significantly since 1986 from global trends in securitization and international diversification. This led to increases in the number of foreign establishments involved in investment research and advisory services, brokerage, fund management and in associated services such as international legal and accounting services.

Second, the securities industry in Singapore underwent considerable restructuring after the Pan-El debacle in 1985. The Stock Exchange of Singapore experienced serious difficulties owing to the massive defaults in forward contracts of stocks brought about by the recession and the collapse of Pan-Electric Industries. As a consequence, the Securities Industry Act (1986) and other measures by the Monetary Authority of Singapore were implemented to raise the levels of prudential safeguards and professional standards of the industry.

The minimum paid-up capital of local brokerage firms was raised from S\$5 million to S\$10 million, while their total liability was limited to 12 times their net capital (which must be at least S\$0.25 million). To secure their dealer's licence, all brokerage firms must fulfil various rules and regulations to increase the safety margin of their operations and maintain the integrity of their representatives. The level of foreign ownership of local brokerage firms could be raised up to 49 per cent of their voting capital if this would result in the upgrading of their capabilities. Finally, the big four local banks were encouraged to set up local brokerage subsidiaries to provide an anchor to the industry. Such developmental and prudential measures have served the Stock Exchange of Singapore (SES) well and have enabled the securities industry in Singapore to avoid the serious problems encountered in Hong Kong during the October stock market collapse.

All the developments since 1986 point to a substantial increase in the involvement of professional institutional investors in the stock market in Singapore. While the largest pool of domestic institutional savings in the Central Provident Fund remains largely invested in government securities, there has been no lack of investment from other large domestic investors, especially the banks and insurance companies. Presently, there are four closed-end funds and eighteen unit trusts listed in the Singapore Stock Exchange. International and local brokerage firms, research houses and merchant banks in Singapore provide a widening array of services to international investors from the U.S., EEC and Japan, which have increased their stake in local securities. There has also been a steady increase in the number of offshore fund managers in Singapore. Collectively, these developments dispel any notion that the Singapore market can be manipulated by syndicates.

The floatation of shares of newly listed companies has been very enthusiastically received by the investing public in Singapore, even after October 1987. The new share issues have generally been underpriced, which has contributed much to their oversubscription and to the popularity of share ownership in Singapore among the lower income groups. The authorities in Singapore have not intervened in nor guided the pricing process of such new issues.

Family-run businesses in Singapore have become more receptive to being listed in the stock exchange, as have subsidiaries of foreign companies. This has led to more listings of smaller businesses in Singapore, especially with the establishment of the second securities market, the Stock Exchange of Singapore Dealing and Automated Quotation (SESDAQ) system in February 1987. Within a year, nine companies have been listed.

2. *Equity Markets in Indonesia, Nepal, the Philippines and Sri Lanka*

Unlike Malaysia, Singapore and Thailand, the other SEACEN countries such as Indonesia, Nepal, the Philippines and Sri Lanka encountered the fundamental problems of limited supply of and demand for equity shares. Therefore, the equity markets in these countries provided only a narrow range of stocks and shares and raised a small amount of capital funds. The secondary markets also had low turnover volumes. The capital market institutions such as stockbrokers, share dealers, underwriters and the stock exchanges also lack strength and sophistication. The supervisory and regulatory framework in these markets is still rudimentary and their enforcement need to be strengthened further.

One of the main problems that hinder the development of equity markets in the four countries is the limited number of listed companies and their shares in the stock exchange. There are several factors contributing to such scarcity of shares for securities investment. One of the main factors is the level of economic and financial development in these countries. Indonesia, Nepal, the Philippines and Sri Lanka have not achieved rapid economic growth, especially since the turn of the 1980s. The financial developments in these countries were not as rapid as those in Malaysia, Singapore and Thailand (see Table 1.14). The supply of equity shares also depends on the relative share of the private sector in economic activities. Except for the Philippines, government ownership in enterprises still dominate in Indonesia, Nepal and Sri Lanka. These public enterprises were financed through either budgetary appropriation or through refinancing facilities at concessionary terms. The question of raising capital funds for these public enterprises did not arise at all. There have been suggestions to privatize these enterprises but their business performances so far have not been encouraging.

As a result of the relatively well-developed non-securities markets as discussed earlier, the private firms in the four countries under study generally prefer to borrow from financial institutions such as commercial banks, finance companies and development finance institutions. The access to these institutional credits is therefore relatively easy and at lower cost. Secondly, most of the private firms are generally small in size and their capital fund needs are consequently modest. Hence, there is no incentive for these private firms to raise capital funds from the securities market.

The cost of raising funds from the equity market depends on the listing procedure, dividend policies and the pricing of new issues. If the listing procedures are very tedious, the time and cost involved will be

Table 1.14 SEACEN COUNTRIES: CAPITAL MARKET DEVELOPMENT (in per cent)

	<u>M1^a</u> <u>GDP</u>	<u>M2^b</u> <u>GDP</u>	<u>Comm. Bank Assets</u> <u>GDP</u>	<u>Market Capitalization</u> <u>GDP</u>
Indonesia				
1975	10.1	16.0	23.4	n.a.
1980	11.0	17.0	22.9	0.1
1986	12.1	27.4	42.9	0.1
Malaysia				
1975	19.5	44.8	48.4	52.6
1980	18.3	51.5	60.4	80.8
1986	20.3	75.7	110.5	89.9
Nepal				
1975	8.0	13.2	11.0	n.a.
1980	12.3	23.7	19.5	n.a.
1986	13.9	31.0	25.7	1.3
Philippines				
1975	9.0	16.8	46.4	9.2
1980	8.5	20.9	52.3	10.0
1986	6.8	21.9	39.9	9.0
Singapore				
1975	26.0	61.0	107.8	105.1
1980	24.5	64.0	132.8	203.7
1986	26.0	82.0	203.4	192.1 ^c
Sri Lanka				
1975	11.5	17.9	19.9	n.a.
1980	14.0	32.0	40.0	3.0 ^d
1986	11.7	29.2	36.9	5.0 ^c
Thailand				
1975	11.6	34.5	39.4	1.7
1980	10.4	36.8	44.6	3.7
1986	9.6	61.5	70.7	6.8

^a M1 comprises currency with non-bank private sector and demand deposits.

^b M2 includes M1 plus savings and time deposits.

^c Refers to 1985 figures.

^d Refers to 1981 figures.

Sources: International Monetary Fund, *International Financial Statistics*, various issues.

Bryan de Caire. *The G. T. Guide to World Equity Markets 1987*. London: Euromoney Publications and G.T. Management, 1987.

substantial. For instance, in Indonesia, the Capital Market Executive Agency (BAPEPAM) takes 90 days to issue a licence for a company to be listed in the Jakarta Stock Exchange. Prior to the submission, the company needs their assets to be evaluated by a company appraiser. The submission also requires the approval from various government offices, such as the Ministry of Justice, the Director-General of Taxes,

and the Investment Co-ordinating Board (BKPM) before BAPEPAM processes its application. The whole process will take at least five months before a company can be listed.

Dividend is another element of cost for the listed companies. Without a good dividend pay-out ratio, investors would not invest their money in the company. To make things worse, in some of the SEACEN countries, dividends are taxed but deposits with the banking sector are either taxed at a lower rate or not taxed at all. For instance, in Indonesia and Sri Lanka, dividends are taxable but time and savings deposits are tax free. This means that the listed companies have to pay dividends which must be at least comparable to tax free interest rates. The higher the dividend, the higher will be the cost of raising funds from the equity market.

Finally, the underpricing of new issues is a common practice among the SEACEN countries. The consequence is that more shares have to be issued to raise a certain target level of funds. This results in higher administrative costs serving a large number of shareholders, more dividend pay-out in future years, as well as the erosion of ownership control by the promoters.

The erosion of ownership control by the original owners can be another factor which limits the supply of shares in the equity markets in the SEACEN countries. It must be noted that most of the business firms in this region are family businesses. The retention of ownership control within the family circle may be considered as utmost important and may be defended at all cost.

Closely related to this apprehension of diluting the control of family business is the listing requirement that substantial information about financial status of the listed company be disclosed. The purpose of the disclosure requirement is to protect the investing public. In Indonesia, for instance, listed companies must submit financial statements to BAPEPAM not later than 120 days after the close of the company's financial year. In addition, the listed company must notify BAPEPAM within 30 days of any significant event which may affect the company's operations. BAPEPAM may also request any additional reports.

In the Philippines, every listed company must make a reasonable, full, fair and accurate disclosure of every material fact relating to, or affect, it which is of interest to investors. Disclosure is required to be made by publication in a national newspaper. Other SEACEN countries also require disclosure of information and the difference is a matter of degree.

The disclosure and reporting requirement for a listed company can act as a severe deterrent for private firms, especially the family type, to

be listed in the stock exchange. The disclosure requirement may result in revealing too much information not only to business rivals but also the tax authorities. As long as this apprehension exists and there is a ready alternative source of finance, the private firms will tend to avoid offering shares to the public.

Apart from factors limiting the supply of shares to the market, there are also a number of factors affecting the demand for equities in the SEACEN countries, in particular Indonesia, Nepal, the Philippines and Sri Lanka.

For individual investors, they always look for investments which earn the highest return, the lowest risk and yet easily accessible and without much effort. In general, individual investors are risk averse. The demand for financial assets will depend very much on the level of income and the availability of financial assets. In countries, like Indonesia and Nepal, the availability of financial assets is limited. In times of inflation, individual savers tend to save in the form of real assets such as real estate, bullion and jewellery. Sometimes, these real assets are more liquid than shares whose secondary market is not active. Tax free bank deposits also provide a better investment alternative than shares because bank deposits are less risky assets, easily accessible and without much effort. The investment in shares will require some level of education in order to be able to analyse financial statements. In Indonesia, capital gains (or loss) on shares are eliminated through the intervention of the state-owned national investment trust called P.T. Danareksa. In such a situation, bank deposits represent a much better alternative than share investment. This was especially so when Indonesia freed its interest rates since June 1983. Bank interest rates soared to 15 to 20 per cent, as compared to the dividend yield of around 10 per cent for share investment.

Individual investors also have a general lack of confidence in the securities markets in a number of SEACEN countries. Appropriate and up-to-date financial information about the securities markets is scanty. Even if the financial reports are readily available, they are either out-of-date or inadequate for thorough and meaningful investment analysis.

On the other hand, most of the small savers in the SEACEN countries still lack information about the operation of the stock exchange. To them, the stock exchange is too sophisticated for them to invest in. The easier way is to save their money in commercial banks in the form of savings and time deposits.

The institutional demand for equity shares differs very much from the individual investors'. The institutional investors which are normally in trust of public fund tend to be cautious and conservative in their

investment. They will look for those investment that can produce long-term rates of returns that are at least competitive to alternative investment opportunities.

In the SEACEN countries, the institutional investors mainly consist of employees provident funds, insurance companies, unit trusts, investment companies and merchant banks. For the contractual savings institutions, they are required by law to invest largely in government securities. As a result, their demand for shares investment is limited. For instance, in Malaysia, the Employees Provident Fund is required by statute, to invest 70 per cent of its funds in government securities while the insurance companies are required to invest 25 per cent of their funds in government securities. The National Savings Bank is also required to invest 65 per cent of its funds in government securities effective from 1984. Consequently, these three institutions are not active institutional investors in the shares market.

As for unit trusts, investment companies and merchant banks, they are either restricted by law to invest only in blue chips or by nature tend to be conservative in outlook, as they are in trust of their customers' funds.

B. Development of the Bond Markets

The bond markets in the SEACEN countries are well dominated by the government securities market. The private bond market is either non-existent (Nepal and to a significant degree, Sri Lanka), or relatively dormant. Even the government securities markets, especially those with longer maturities, are also relatively inactive in terms of their secondary market activity. The prospect of developing the bond markets in many SEACEN countries is not very encouraging.

First of all, most government securities markets are not well developed mainly as a result of the governments' deliberate policy to raise long-term funds from captive sources at lower rates of interest. There is less incentive for the governments to develop these markets as the opportunity cost of foregoing cheaper sources of finance is prohibitively high. Consequently, the government securities markets lack both breadth and depth in their market structure. They lack breadth because the holders of government securities are heavily concentrated in the hands of a few financial institutions such as employees provident funds, government savings banks, insurance companies, central banks and commercial banks (see Table 1.15). This represents a captive market mainly as a result of several factors. Firstly, some of these institutions,

Table 1.15 SEACEN COUNTRIES: GOVERNMENT DOMESTIC DEBT CLASSIFIED BY HOLDERS¹

	Malaysia (1986)	Nepal (1985)	Philippines (1985)	Singapore (1982)	Sri Lanka (1985)	Thailand (1985)
Provident and pension funds	59.2	...	n.a.	68.1	37.2	—
Government savings banks	2.2	—	n.a.	4.5	34.9	4.5
Insurance companies	1.8	—	n.a.	2.2	3.0	—
Central bank	4.9	6.0	12.5	1.2	0.1	37.9
Commercial banks	9.7	56.9	21.7	10.2	2.3	48.5
Others	22.2	37.1	65.8 ^a	13.8	22.5	9.1
	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>

Note: Indonesia does not have government securities.

¹ Refer to medium- and long-term government securities.

^a Include holdings by provident funds, government savings banks and insurance companies.

Source: The SEACEN Centre member banks' publications, various issues.

especially the provident funds, insurance companies and savings banks are required by law to invest a large portion of their investible funds in government securities. Secondly, government securities are considered as trustee stocks to be legally eligible to be invested by trust funds in some of the SEACEN countries. Thirdly, they are also considered as liquid assets even though their maturities may range from 10 to 20 years because the central bank are the buyer of last resort in this instance. Fourthly, in some SEACEN countries, the purchase of government securities up to a percentage is one of the condition for opening up branches. Fifthly, government securities are considered as eligible collateral for central bank advances or eligible instruments for repurchase agreements with the central banks. Lastly, in a number of the SEACEN countries, government securities represent one of the few financial assets that are available for liquidity management especially by the banking sector. As the government securities markets are captive in nature, there is no incentive for governments to offer market rates of interest. Inevitably, individual investors are not attracted to these securities as there are many alternative investments which offer better returns at reasonably low risk.

The government securities markets also lack depth because there is hardly any secondary market for these securities. Most of the secondary transactions are carried out, not in the stock exchange but in the dealing

rooms of the central banks. The institutional holders of government securities also tend to hold the securities till the maturity dates and a substantial volume of government securities is locked in the captive market. Secondary trading is therefore limited.

However, deliberate efforts have been made to liberalize and activate the government securities market in a number of the SEACEN countries. For instance, in Malaysia, two-prong strategies were adopted in recent years; one aims at removing rigidities prevailing in the money market and the other has the objective of promoting directly the secondary market. The measures to remove rigidities in the money market include unpegging of interest rates since 1 February 1987, unifying statutory reserve and liquidity requirements of banking institutions and averaging of liquidity ratios since 1 February 1987. The steps undertaken by the authorities to develop an active secondary market for government securities include regularizing and standardizing the size of government securities offering to facilitate investment planning of securities buyers, more attractive and market-related yields on new issues of government securities and increasing the availability of government securities of short-term maturities.

The prospects for the private bond markets in many SEACEN countries also appear limited for several reasons. On the supply side, firstly, there are not many big firms with reputation to issue bonds. In order to attract investors, the bond issuers must be very well established and have good track records of profit. This type of companies are hard to come by as most of the firms in the SEACEN countries are family-owned and hence small in size. Even if there are big firms which are able to issue saleable bonds, they will not issue bonds to raise long-term funds because there is always an alternative way of financing. They can approach the commercial banks for loans at reasonable rates of interest as they are the prime customers of these banks. They can also issue equity shares and offer to the public.

Secondly, the interest rate structures in the SEACEN countries are not conducive for issuing bonds to raise capital funds. For those countries with high interest rates, such as Indonesia, the issuing of bonds can be an expensive affair to private companies. For those countries with low interest rate such as Malaysia, it is better for the private firms to borrow from the banking sector rather than issue bonds to raise funds on their own. The exercise may end up with higher cost.

On the demand side, the relatively low return on bonds is a serious factor which is detrimental to stimulating demand for bonds by investors, especially the individual investors. The relatively low returns on bonds is due to two factors. Firstly, there is still no established tax treat-

ment on income earned on bonds.⁵ This uncertainty on tax treatment creates an “overhang” in the minds of investors. In most cases, income earned from bonds are fully taxed while interest from deposits are either not taxed or taxed at a lower rate. Secondly, the returns on bonds is low as compared to shares and stocks because there exists no capital gains (and also capital loss) for bond investment as the secondary market for bonds is not active.

Thirdly, liquidity aspects of securities investment is another consideration for attracting investors. As the bond market is shallow and lack secondary market activities, investors (in particular, the individual investors) will not be attracted to bond investment because of the apprehension of huge capital loss through forced selling when they are in need of liquid funds.

Fourthly, in some of the SEACEN countries, the maturity structure of bond issues cannot meet the need of investors especially when the secondary market for bonds is not well developed. Investors normally prefer bonds with shorter maturities rather than 10 to 20 years maturities.

Finally, there is generally a lack of information on the credit rating of bonds by authoritative credit rating agencies. In the developed countries, such as Standard and Poor's in the United States, credit rating of various corporate bonds were regularly provided. The availability of such information will be valuable to investors to assess credit risks and make investment decisions. The absence of such a credit rating agency in the SEACEN countries is probably another impediment toward the development of the corporate bond market.

The serious implication arising from the underdeveloped bond markets, especially the government securities market, is that the central bank would not be able to conduct open market operations. One of the basic conditions for successful open market operations is that the government securities markets must have reasonable breadth and depth in their market structure so that the central bank can buy and sell any desired quantity of government securities to influence the monetary conditions. To stimulate the government securities market will directly imply the offering of higher interest rates to the buyers. This will be in conflict with the governments' desire to tap the cheaper source of funds. The conflict has yet to be resolved somehow by the SEACEN countries. Some of the SEACEN countries have instead issued central bank bonds with relatively high interest rates for the purpose of open market operations. This dualistic structure in interest rates also would

5. In the Philippines, a final withholding of 20 per cent is levied on interest income from deposits and deposit substitutes (including debt securities).

not resolve the problem of conflict with the governments' objective of acquiring cheaper sources of funds.

V. CONCLUDING REMARKS

The development of capital markets in the SEACEN countries has been uneven among and within the SEACEN countries. While Singapore has stood out as an international financial centre catering to the financial needs of the region, many other SEACEN countries have yet to reach the stage of self-financing, especially the private sector. Except for Singapore and Malaysia, the other SEACEN countries have not achieved reasonably high savings rate for economic growth. In terms of capital market structures, the development for all the SEACEN countries is lop-sided, and biased towards the non-securities market. Singapore has made much effort to improve its securities markets in recent years, including the setting up of a second stock exchange and accelerating the process of corporatization of stockbroking firms. Malaysia and Thailand also moved along the same way, albeit at a slower pace. In response to global securitization, Malaysia, Singapore and Thailand also introduced several measures to attract foreign portfolio investment. The capital markets of these three countries seem to have much potential for further development.

The Philippines have all the necessary capital market institutional structures, but it is still lacking in vigour in terms of financial and economic activities. Once the economy recovers, the capital market activity will pick up and develop into a full-fledged one.

For the other SEACEN countries, namely Indonesia, Nepal and Sri Lanka, there is still a need for further financial liberalization. Steps have been taken by these countries towards this direction. There are signs that financial liberalization in these countries has produced encouraging results.

For the development of capital markets in the SEACEN countries, concerted effort should be directed towards accelerating economic development. The rapid economic development will help to spur rising level of income and the need for further investment. The higher level of income will encourage savings which in turn will meet the needs of investment.

The development of non-securities markets in this context should be directed at resource mobilization, facilitating term transformation and provision of medium- and long-term credit facilities. Financial liberalization and stabilization will help develop the non-securities markets by

removing restrictions towards financial development, especially financial segmentation and financial conglomeration.

On the securities market, the governments of the SEACEN countries should look at the securities market development as part and parcel of the overall capital market development. Government policies including fiscal and financial incentives should not discriminate against the development of the securities market. Those problems and constraints affecting the supply of and demand for securities should also be removed to a significant extent so that a viable and active securities market can be established.

The overall development of capital markets in the SEACEN countries will depend very much on political stability, rapid economic growth, and the larger role of the private sector. Legal and regulatory framework should also be strengthened to ensure public confidence and promote orderly development of the capital markets. More important still, the governments of the SEACEN countries will have to allow market forces to play a greater role in both pricing and allocation of resources. The role of governments should ensure that the legal framework has been properly instituted to provide a more conducive environment for market forces to operate in an efficient and orderly way. □

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PART II: COUNTRY STUDIES

CHAPTER 2

Development of the Capital Market in Indonesia*

SUSENO
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I. INTRODUCTION

The purpose of this paper is to analyze the fundamental problems and issues encountered in the process of developing the private capital market in Indonesia. It also tries to identify factors which are crucial for the development of a well-functioning capital market. In addition, it also analyzes various financial and monetary implications which may arise in the process of developing the capital market. Finally, it will provide an assessment on the capital market development in Indonesia.

It is recognized that the private capital market plays an important role in providing a major source of funds for economic development. However, at present the role of the private capital market in Indonesia as a source of finance for economic development is rather limited and has to be complemented by funds provided by the public sector. To comprehend how the private capital market has functioned and the obstacles which prevents it from playing a greater role in the economy, it is imperative to analyze the existing capital market and its structure.

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The capital market studied in this paper is defined as the long-term fund market comprising (i) long-term credit market (ii) long-term bond market, and (iii) equity market. Market (i) forms the non-securities market whereas market (ii) and (iii) together form the security-type capital market. Although the focus of the paper is on the capital market, a brief description and analysis of various components in the financial system are necessary because the capital market itself is a sub-sector of the whole financial system and its development will interact closely with each component.

This paper comprises four sections. The second section provides detailed description and analysis of the non-securities market and institutions in Indonesia which include largely Bank Indonesia, commercial banks and other non-bank financial institutions in the mobilization of funds and allocation of financial resources. Section three explores the securities market which includes stock exchange, equity and bond markets. Finally, section four will provide an overall assessment of the capital market development in Indonesia.

II. THE DEVELOPMENT OF THE NON-SECURITIES MARKET

A. Overview of the Non-Securities Market Structure

The non-securities market in Indonesia has been the major part of the capital market. This market is also more well developed than its counterpart, the securities market. For the purpose of this study, the non-securities market is confined to Bank Indonesia, commercial banks and other non-bank financial institutions.

1. *Bank Indonesia*

Bank Indonesia is the central bank of the Republic of Indonesia and is the successor to De Javasche Bank, which was established by the Dutch in 1828. Its functions and responsibilities are prescribed by the Central Bank Act of 1968. The central bank formulates and implements monetary policy through the regulation of credit in the economy but recently it has supplemented this by the use of discount facilities and open market operations. Bank Indonesia also supervises and regulates financial institutions in the country, with the exception of the investment,

insurance and development finance companies, and it acts as a lender of last resort to the banking system. Finally, Bank Indonesia acts as the government's banker, holding the official foreign reserves of the Republic as well as the government's treasury accounts, making advances available to the government as and when necessary and advising the government on economic policy.

In addition to the traditional functions of a central bank, Bank Indonesia is also involved in the development of the capital market by participating actively in various development finance institutions. These include three private development finance companies, a housing finance company, a credit insurance company for small business loans and a commercial bank in the Netherlands. To complement the private capital market, Bank Indonesia also provides "liquidity credit" to deposit money banks to fund loans for development projects undertaken by government agencies and government-owned corporations and also to refinance the general credit operations of the deposit money banks. In addition, loans are extended to Badan Urusan Logistik (BULOG) through Bank Rakyat Indonesia for the purchase of food reserves under its stockpile and price support programme. As of 31 December 1986, total credit outstanding of Bank Indonesia (excluding claims on the Central Government and certain other minor claims) amounted to Rp 9,883 billion, of which Rp 7,770 billion or 78.6 per cent represented credit to deposit money banks.

In line with the decision taken in June 1983 to initiate a process of gradual deregulation and development of the banking system, Bank Indonesia has taken a number of steps which include the sharp reduction of direct credit to industry and a cutback on the availability of liquidity credit to deposit money banks for the purpose of refinancing their general credit operations. Such credit is now restricted to the investment and working capital requirements of high priority sectors. Other measures included the launching of central bank certificates of deposit (Sertifikat Bank Indonesia or "SBI") and the introduction of two new discount facilities for deposit money banks, both in February 1984. In February 1985, Bank Indonesia introduced a new money market security known as Surat Berharga Pasar Uang or SBPU, based on bank loan assets. Such type of securities was introduced to assist further in the development of a money market by providing additional liquidity to the financial system. Special discount facilities for such instruments were also established through PT Ficorinvest (a finance company controlled by Bank Indonesia), which is for the time being the sole dealer in SBPU's. These securities have since then become attractive short-term investment instruments for financial institutions.

2. Banks and Non-Bank Financial Institutions

Commercial banking in Indonesia is dominated by five state-owned banks, each being originally established to provide banking services to a specific sector of the economy: Bank Rakyat Indonesia to smallholder agriculture and rural development; Bank Bumi Daya to estate agriculture and forestry; Bank Negara Indonesia 1946 or BNI 1946 to industry; Bank Dagang Negara to mining; and Bank Ekspor Impor Indonesia to the export sector. All of these activities are now undertaken by each of the state banks, except Bank Rakyat Indonesia which remains a specialized bank for the agricultural sector. The important sources of funds for the state banks are demand, time and savings deposits and credit from Bank Indonesia through various refinancing facilities.

There are also 65 private national commercial banks owned and operated by Indonesians. Ten of these banks are licensed to deal in foreign exchange. These private commercial banks have been expanding relatively rapidly in recent years, although in the aggregate they represent only a small proportion of commercial banking activities in Indonesia. The principal source of funds for these banks is their own equity capital and deposits. In addition, there are ten branches of foreign commercial banks and one joint-venture bank in Indonesia.

The 29 development banks include one major bank owned by the government, 27 regional banks wholly or partially-owned by the provincial governments and one privately-owned bank. The state-owned, Bank Pembangunan Indonesia (BAPINDO) is the largest development bank in Indonesia. Most of its long-term loans have final maturities of less than ten years, although the maximum maturity is 15 years. BAPINDO's largest source of funds was, and continues to be, credit provided by Bank Indonesia in the form of refinancing credit. Other sources include government pension funds and other government sources, deposits, including demand deposits, and bonds.

There is also a great number of non-deposit money banks in Indonesia. Of importance are the state-owned Bank Tabungan Negara and a private savings bank, both of which operate nationally. The others are the 5,800 rural and village banks and credit cooperatives (see Table 2.1). Since 1972, a number of development finance companies and investment finance companies were established with the purpose of promoting money and capital markets in Indonesia. Neither type of institutions is authorized to accept deposits. They are, however, permitted to issue and deal in commercial papers and long-term securities, and to provide equity investment and loans. In February 1980, the govern-

Table 2.1 INDONESIA: NUMBER OF BANKS AND THEIR OFFICES

Particulars	31 Mar. 1985	31 Mar. 1986	31 Mar. 1987
	Number of banks/ offices	Number of banks/ offices	Number of banks/ offices
<i>Commercial banks</i>			
State banks			
– Number of banks	5	5	5
– Number of offices	749	764	780
Private national commercial banks			
– Number of banks	69	68	65
– Number of offices	390	430	464
Foreign banks/joint ventures			
– Number of banks	11	11	11
– Number of offices	21	21	21
<i>Development banks</i>			
State development banks			
– Number of banks	1	1	1
– Number of offices	22	22	22
Regional development banks			
– Number of banks	27	27	27
– Number of offices	201	214	228
Private development banks			
– Number of banks	1	1	1
– Number of offices	1	3	3
<i>Savings banks</i>			
State savings banks			
– Number of banks	1	1	1
– Number of offices	12	12	15
Private savings banks			
– Number of banks	1	1	1
– Number of offices	1	1	1
<i>Number of commercial banks, development banks and savings banks</i>			
– Number of banks	116	115	112
– Number of offices	1,397	1,467	1,534
<i>Rural banks¹</i>			
– Village banks	3,581	3,565	3,550
– Paddy banks	2,078	2,078	2,063
– Petty traders banks	172	175	175
– Employees banks	1	1	1
Total number of banks	5,948	5,934	5,901
Total number of offices	7,229	7,286	7,323

¹ Number of banks/offices.

The number of offices comprising headquarters, branches and sub-branch offices.

ment approved the establishment of PT Papan Sejahtera, a housing finance institution, especially for financing house ownership. This institution is empowered to mobilize funds through issuance of medium- or long-term bonds and to extend medium- and long-term loans for house ownership.

The past few years also saw the rapid growth of leasing activities in Indonesia with no less than 83 leasing companies having been established up to March 1987. Of these, about 40 per cent represents joint-ventures with foreign entities.

The rapid growth of the banking system in recent years is evident from Table 2.2. Total deposits (including demand, time and savings deposits) grew at an average compound rate of 27 per cent per annum from 1981 to 1985, while loans increased by an annual average of 31 per cent. As of 31 December 1985, total credit outstanding amounted to Rp 22,157 billion, of which state banks including BAPINDO accounted for 69 per cent, private banks and regional development banks 22 per cent, branches of foreign banks 5 per cent and Bank Indonesia 4 per cent. Approximately 34 per cent of these credit went to the manufacturing sector, 33 per cent to the foreign and domestic trade sectors, 19 per cent to the service sector, 8 per cent to agriculture and the remainder to other sectors.

B. Fund Mobilization

This part will focus on the general issues and policies implemented in Indonesia with respect to fund mobilization in the non-securities market which is dominated by the banking system. Funds mobilized by the banking system are mainly from demand deposits, time deposits and savings deposits.

The watershed which has serious implications on fund mobilization in Indonesia was the 1 June 1983 deregulation. Before the 1 June 1983 deregulation, the source of funds in the banking system which was mostly dominated by the state banks, consisted mainly of demand deposits, time deposits, savings deposits, liquidity credit (refinancing facilities) and long-term investment fund from Bank Indonesia. The share of demand deposits to total deposits was high in the state banks, ranging from 50-70 per cent of the total deposits accepted. In addition, the state commercial banks used to depend on Bank Indonesia for refinancing facilities as their major source of funds for long-term lending. The refinancing facilities were essentially subsidized credit with low interest rates channelled through state banks in order to achieve a

Table 2.2 INDONESIA: CONSOLIDATED BALANCE SHEET OF DEPOSIT-MONEY BANKS (billions of Rupiah)

	31 December					
	1981	1982	1983	1984	1985	1986
<i>Assets</i>						
Reserve Assets	1,342	1,883	1,569	2,046	2,691	2,259
Claims on the Central Government, Official Entities and Public Enterprises	1,866	2,496	3,150	4,983	4,534	5,776
Claims on the Private Sector	5,987	8,127	10,498	14,096	17,298	21,766
Other Assets (net) ¹	2,601	1,674	2,857	3,894	4,754	5,154
Total Assets	11,796	14,180	18,074	25,019	30,277	34,955
<i>Liabilities</i>						
Demand Deposits ²	4,761	4,825	4,955	6,214	7,444	7,815
Time and Savings Deposits	3,127	3,897	6,983	9,331	12,985	15,942
Import Deposits	298	300	242	218	268	402
Credit from Bank Indonesia	2,596	3,890	4,264	7,045	7,039	7,747
Capital Account	1,014	1,268	1,630	2,211	2,541	3,049
Total Liabilities	11,796	14,180	18,074	25,019	30,277	34,955

¹ Includes the net amount of foreign assets and other assets against foreign liabilities and other liabilities.

² Includes deposits of the Government.

Source: Bank Indonesia

variety of development objectives. Moreover, these refinancing facilities were essentially derived from public sector surplus created by oil export revenue.

On the interest rate policies implemented before 1983, interest rates paid by state banks on time and savings deposits were fixed by Bank Indonesia. However, since January 1978, state banks had been allowed to set their own rates on time deposits with maturities shorter than six months. Private and foreign banks were also free to set their own interest rates but the government did not provide guarantee on deposits with non-state banks. As a result, non-state banks paid higher interest

rates on time deposits to compensate for non-interest incentives given to the state banks. However, because they were not competitive as compared with state banks on longer-term time deposits, they have been concentrating on acquiring demand and short-term time deposits. Another form of preferential treatment for the state banks is the government regulation forbidding government institutions to open accounts with private and foreign banks.

On many occasions, Bank Indonesia subsidized the interest costs of time deposits to state banks because the interest rates paid on such deposits exceeded the average rate of interest earned on the banks' loans. From October 1968 to March 1969, Bank Indonesia paid one third of all interest costs for 6- and 12-month time deposits with the state banks. Effective from March 1969, the subsidy for 12-month deposits was reduced to 1 per cent; it was finally abolished in May 1969. As of April 1974, 18- and 24-month maturities were introduced and the government paid subsidies for them at 8 per cent and 15 per cent per annum, respectively. Starting from December 1974, the subsidies were reduced to 6 per cent and 9 per cent respectively. In January 1977, the 18-month time deposit was eliminated and the subsidy for 24-month time deposits was further reduced to 6 per cent. With the general reduction of deposit rates in January 1978, the subsidies paid to the state banks on time deposits were also reduced. The subsidies are now given only on 24-month deposits, 4.5 per cent being paid on deposits up to Rp 2.5 million (bearing 15 per cent interest) and 1.5 per cent on those over Rp 2.5 million (bearing 12 per cent interest).

Fiscal incentives to promote time and savings deposits were also given in the form of tax exemptions for interest received by residents and a lack of tax inquiries into the origin of the funds invested by investors. The tax privileges also applied to the holders of certificates of deposits issued by all authorized commercial banks. Except for Tabanas (National Development Savings Scheme) and Taska (Insurance Savings Scheme), time and savings deposits with non-government banks do not carry similar tax privileges. The government efforts to mobilize funds through various incentives on interest rates, subsidies, tax treatment and other incentives mentioned above, successfully increased the amount of bank sources of funds. In view of the policies of providing refinancing facilities and setting up of credit ceilings, this situation literally discouraged the banking system to actively mobilize funds from the public on their own effort.

As oil prices weakened in 1982/1983, the government's financial position came under pressure. The provision of refinancing facilities to state banks was not possible. As a result, Bank Indonesia introduced a major

reform of the financial sector in June 1983 to stimulate private financial savings, improve resource allocations, and reduce the over-dependence of the banking system on Bank Indonesia for liquidity credit. Consequently, the state banks were free to set their deposit rates; credit ceilings were eliminated for all banks and the number of special priority programme qualifying for (and the state banks' access to) Bank Indonesia's new liquidity credit were also substantially reduced.

These reforms had a dramatic impact on the banking system. Nominal (and real) deposit rates paid by state banks increased sharply; and there had been a rapid increase in bank deposits, particularly, time deposits of state banks in the post-June 1983 period. Given these changes, the cost of funds and lending rates of state banks had also increased sharply. Nominal lending rates of state banks on non-priority (general) loans rose from a range of 13-13.5 per cent to 18 per cent for term loans and 21-24 per cent for working capital, representing real lending rates of around 9-15 per cent. Real lending rates of private banks were even higher, ranging from 15-19 per cent per annum. With the removal of credit ceilings, private banks also increased their share of bank credit from 11 per cent in June 1983 to 16 per cent in December 1984. An active inter-bank money market had also emerged. These changes have been on the whole beneficial to the long-term development of the financial system, although a number of concerns have emerged. The first and the most important is the potentially adverse impact of the sharp rise in real interest rates on investment activity. Secondly, the recent changes have an adverse impact on the cost and availability of funds to the private sector. In particular, the reduction of Bank Indonesia liquidity credits have created funding problems for the development banks. Thirdly, the rise in deposit rates and the favourable tax treatment of bank deposits have adversely affected the development of the securities market which cannot afford to offer competitive and comparable rates of returns to investors.

Prior to 1983, the gross domestic capital formation exceeded the gross national savings, and this condition led to the widening savings-investment gap. After 1983, Indonesia was successful to a certain extent in financing its domestic investment as indicated by a narrowing savings-investment gap. Indonesia's savings-investment gap as shown in Table 2.3 indicates that gross domestic capital formation exceeded the gross domestic savings for the period of 1976 to 1983, resulting in the widening savings-investment gap. The performance of gross domestic savings in the 1970s was very encouraging; its ratio to Gross Domestic Product (GDP) increased from 11.5 per cent in 1970 to 28.5 per cent in 1985, but the gross domestic capital formation as a

Table 2.3 INDONESIA: SAVINGS-INVESTMENT GAP, 1976-1985

	Gross Domestic Savings as % of GDP	Gross Domestic Capital Formation as % of GDP	Savings-Investment GAP
1976	20.00	22.50	-2.50
1977	22.03	24.00	-1.97
1978	20.27	25.80	-5.53
1979	25.45	25.60	-0.15
1980	27.76	27.80	-0.04
1981	23.58	28.30	-4.72
1982	19.70	31.20	-11.5
1983	23.77	32.70	-8.93
1984	26.33	25.40	0.93
1985	28.52	23.90	4.62

Note: GDP until 1983 was based on 1973 constant prices. Starting from 1984 onwards, 1983 constant prices were used.

Source: Central Bureau of Statistics.

percentage of GDP also increased sharply until 1982. The savings-investment gap turned from a deficit of -8.93 per cent in 1983 to a surplus of 4.62 per cent in 1985. This was due to the government policy to reschedule a large part of government projects in May 1983 and also the June 1983 Banking Deregulation which actively encouraged savings and to a certain degree, dampened private investment expenditure.

C. The Allocation of Financial Resources

The financial resources derived from the non-securities market are mainly channelled through the short-term credit market. The short-term credit market comprises commercial banks and investment finance companies whereas the medium- and long-term loans are extended mostly with the back-up of the government credit programme and are provided largely by Bank Indonesia, BAPINDO, state commercial banks and development finance companies. Private commercial banks, on the other hand, provide long-term loans through roll-over short-term credit. The trends of the outstanding credit extended by banks are shown in Table 2.4. This table clearly shows the dominance of Bank Indonesia and state banks in the loan market activities. Credit extended by non-bank financial institutions as shown in Table 2.5 is, however, relatively small compared with those of the banking system.

Table 2.4 INDONESIA: CREDIT OUTSTANDING BY GROUP OF BANKS (Year-end, Rp billion)

	1979	1980	1981	1982	1983	1984	1985	1986
Bank Indonesia	2,163	2,454	2,649	2,771	2,356	870	964	1,144
State Commercial Banks	3,270	4,301	5,881	8,031	9,787	13,345	15,374	17,782
National Priv. Banks	406	566	834	1,197	1,883	3,042	4,106	5,506
Local Dev. Banks	87	145	247	357	411	510	640	766
Foreign Banks	342	414	548	666	862	1,046	1,073	1,204
Total	6,268	7,880	10,159	13,022	15,299	18,813	22,157	26,402

Source: Bank Indonesia, Weekly Report.

Table 2.5 INDONESIA: ASSETS OF THE FINANCIAL SYSTEM (Amounts in billion Rupiahs)

Type of Institution	1980	1981	1982	1983	1984	1985	1986
<i>Financial System</i>							
1. Monetary system ¹	10,398	12,455	14,411	18,581	22,713	28,021	35,234
2. Savings banks	129	256	452	683	946	1,290	1,614
3. Rural banks	52	60	80	104	177	292	350*
4. Non-bank financial institution							
a. Insurance companies	665	723	999	1,381	1,740	2,154	2,306*
b. Leasing companies	35	60	114	368	633	845	927
c. Pawnshop	50	59	79	80	91	105	121*
d. Others ²	404	557	805	1,108	1,327	2,073	2,227
TOTAL	11,733	14,170	16,940	22,305	27,627	34,780	42,779
– Percentage growth from previous year	38.3	20.8	19.5	31.7	23.9	25.9	23.0
– Ratio of total assets of financial system to GDP	0.26	0.24	0.27	0.30	0.32	0.36	0.44

¹ Consists of central bank, commercial banks and development banks.

² Consists of non-bank financial institutions, development type, investment type and house ownership type.

* Provisional figures.

With respect to long-term investment credit, the allocation of such credit can be characterized as follows :

1. The investment credit extended by state and private national banks were partly refinanced by liquidity credit from Bank Indonesia.

2. Small scale investment credit known as Kredit Investasi Kecil or KIK which is part of the credit provided for priority sectors. Bank Indonesia refinances 80 per cent of this type of credit and charges an interest rate of 3 per cent per annum.

3. Direct credit also extended by Bank Indonesia to selected state-owned enterprises such as Pertamina and Krakatau Steel.

4. Investment credit extended by banks using their own funds was limited.

From the analysis mentioned above, Bank Indonesia plays a very dominant role in the allocation of investment credit. However, its role had diminished gradually over the years as indicated in Table 2.6.

D. Financial Implication and Regulatory Issues

Indonesia's external accounts weakened substantially in 1982, in the wake of the fall in oil export volumes and the continued weakness in the prices of non-oil export commodities. In response to the weakening resource prospects, the Indonesian authorities decided to implement adjustment policies which included, inter alia, a major financial reform as noted earlier.

The main objective of the financial reform is to reduce the over-reliance of banks, particularly the state banks, on the financial support provided by Bank Indonesia. The reform is also expected to enhance the incentives for the mobilization of financial savings and improve the allocation of such savings. In order to achieve these objectives, most deposits and lending rates of state banks were freed from regulations; the liquidity credit was cut by reducing a wide range of loan categories from access to rediscount credit; and the system of credit ceilings was terminated by switching to indirect monetary control through the management of reserve money. The changes introduced in the reform were designed to provide greater autonomy to commercial banks in credit allocation decisions, develop a sharply focused definition of priority sectors, and achieve better control over reserve money expansion.

The initial effects of deregulation of state bank interest rates were a narrowing of the interest rate differentials between these rates and the unregulated rates prevailing in the private bank sector, a substantial change in the term structure of state bank deposit rates, a sharp increase in time deposits of the banking system, and a shortening of the average

Table 2.6 INDONESIA: BANK INDONESIA CREDITS TO BANKS, OTHER FACILITIES AND DIRECT CREDITS BY ECONOMIC SECTOR¹ (In Billions of Rupiah)

	1981	1982	1983	1984	1985	1986
Credit to Banks ²	2,127.00	3,222.00	3,782.00	6,010.00	6,615.00	7,770.00
Percent to Total	20.94	24.74	24.72	31.95	29.86	29.43
Estate	29.00	89.00	206.00	302.00	461.00	742.00
Fertilizer	24.00	32.00	99.00	177.00	215.00	157.00
Bimas	137.00	109.00	137.00	155.00	34.00	24.00
Mining	0.00	0.00	0.00	109.00	104.00	93.00
Export	92.00	157.00	311.00	550.00	666.00	1,121.00
Investment Credit	668.00	960.00	1,442.00	1,590.00	1,628.00	1,692.00
Food Stock	0.00	0.00	0.00	1,642.00	1,671.00	1,587.00
Others	1,177.00	1,875.00	1,587.00	1,485.00	1,836.00	2,354.00
Direct Credits	2,649.00	2,771.00	2,356.00	870.00	964.00	1,144.00
Per cent of Total	26.08	21.28	15.40	4.62	4.35	4.33
Agriculture						
Mining ^{3,5}	1,644.00	1,402.00	720.00	169.00	0.00	0.00
Manufacturing Industry						
Trade ⁴	809.00	994.00	1,110.00	0.00	0.00	0.00
Service Rendering Industry	79.00	118.00	140.00	163.00	212.00	243.00
Others	117.00	257.00	386.00	538.00	752.00	801.00
Others	421.00	520.00	583.00	1,218.00	1,020.00	969.00
Percent of Total	4.14	3.99	3.81	6.47	4.60	3.67
Discount Window Facility	0.00	0.00	0.00	1.00	0.00	67.00
Special Credit Facility	0.00	0.00	0.00	289.00	4.00	0.00
Others						
- Construction	0.00	0.00	0.00	192.00	197.00	
- Manufacturing Industry	421.00	520.00	583.00	736.00	819.00	902.00
Sub Total	5,197.00	6,513.00	6,721.00	8,098.00	8,599.00	9,883.00
Per cent of total	51.16	50.02	43.93	43.04	38.81	37.43
Total Credit of the Banking System	10,159.00	13,022.00	15,299.00	18,813.00	22,157.00	26,402.00

Note:

¹ Excludes rediscount Money Market Paper to Bank Indonesia.

² Known as Liquidity Credits.

³ Includes credit to Pertamina for repayment of foreign borrowing.

⁴ Mainly for financing of food supply and starting from 2 April 1984, this credit is regarded as liquidity credit.

⁵ Since November 1984 a part of credit to mining sector is regarded as liquidity credit.

maturities of these deposits. The changes in the state bank deposit rates did not affect in any noticeable way, the rates charged by private banks although for some maturities the private bank rates fell slightly. This might be because private banks witnessed a substantial growth in deposits following the June 1983 reform, while the demand for their loans remained sluggish owing to the impact of adjustment measures.

The growth in time deposits accelerated after June 1983 in both private and state banks. Moreover, for the first time, the state banks witnessed a larger growth in time deposits than did the private banks. The behaviour of deposits in 1983 was sharply influenced by the outflow of capital following the March 1983 devaluation, and therefore overstated the full significance of changes in interest rates. Nevertheless, it is clear from Table 2.7 that there was a substantial acceleration of growth in time deposits after June 1983, and that this growth was mostly concentrated in short-term deposits, particularly six-month deposits with state banks. After June 1983, the deceleration in growth of time deposits with private banks and of the demand deposits with state banks suggested that there might have been some shifts of funds from these sources into the state bank time deposits. Even after allowing for possible substitution between assets, it appeared that the rapid growth in time deposits was largely on account of capital inflows induced by the increase in interest rates, and by the fall in the expected yield of offshore deposits.

While changes in the liquidity credit mechanism were substantial, their impact was gradual. A wide range of loan categories was made ineligible for liquidity credit at a gradual pace. These non-priority loans consist mostly of large investment loans (in excess of Rp 75 million), loans to PT Krakatau Steel and Perumtel (telecommunications company), and working capital loans for financing trade in agricultural commodities. However, many of the non-priority categories remained temporarily eligible for liquidity credit, thereby providing some time for the banking system to adjust. In addition, the liquidity credit for non-priority investment loans will be repaid only gradually as they mature, because the maturity structure of liquidity credit matches exactly with that of bank loans supported by them. This factor, together with the temporary eligibility of temporary loans, contributed to a gradual drawdown of liquidity credit for non-priority sectors.

The higher cost of deposit funds and the reduction in subsidies to banks through changes in the liquidity credit mechanism led to a sharp increase in the lending rates of state banks. However, the changes in the liquidity credit system had only a small impact on the cost of funds to the private banks because their use of liquidity credit was in the past limited.

Table 2.7 INDONESIA: TIME DEPOSITS IN RUPIAH AND FOREIGN CURRENCY AT ALL BANKS BY MATURITIES
(Billions of Rupiah)

End of period	1 month *			3 months			6 months			9 months			12 months		
	Rupiah	Fx	Sub-Total	Rupiah	Fx	Sub-Total	Rupiah	Fx	Sub-Total	Rupiah	Fx	Sub-Total	Rupiah	Fx	Sub-Total
1972	7.4	4.1	11.5	14.5	7.6	22.1	13.8	47.3	61.1	-	-	-	23.1	9.7	32.8
1973	9.8	7.0	16.8	19.1	13.0	32.1	18.1	70.6	88.7	-	0.1	0.1	30.3	17.3	47.6
1974	16.2	12.6	28.8	32.0	23.1	55.1	30.4	121.7	152.1	-	0.1	0.1	50.9	30.8	81.7
1975	24.4	13.2	37.6	48.0	24.0	72.0	45.6	153.4	199.0	-	0.2	0.2	76.3	30.5	106.8
1976	28.1	19.0	47.1	41.7	11.7	53.4	52.6	182.2	234.8	-	-	-	112.1	5.5	117.6
1977	63.9	17.3	81.2	49.5	9.7	59.2	91.6	172.9	264.5	-	0.1	0.1	81.8	8.9	90.7
1978	73.5	48.7	122.2	42.6	37.5	80.1	104.1	255.4	359.5	-	-	-	97.2	14.2	111.4
1979	102.9	50.0	152.9	31.9	42.4	74.3	126.3	345.6	471.9	1.1	0.6	1.7	99.1	28.3	127.4
1980	167.5	28.0	195.5	99.8	36.6	136.4	183.1	293.2	476.3	4.0	-	4.0	128.4	13.0	141.4
1981	252.2	109.4	361.6	160.5	31.3	191.8	237.3	299.7	537.0	2.4	-	2.4	231.0	13.7	244.7
1982	357.6	282.7	640.3	195.4	58.0	253.4	274.6	420.3	694.9	10.2	-	10.2	321.9	20.9	342.8
1983	934.6	444.8	1,379.4	605.5	144.5	750.0	842.6	698.2	1,540.9	4.1	-	4.2	1,264.5	51.7	1,316.2
1984	1,061.8	789.6	1,851.4	876.5	317.8	1,194.3	1,132.2	538.2	1,670.4	6.2	0.2	6.4	2,351.7	110.3	2,462.0
1985	1,328.6	1,774.5	3,103.1	1,402.9	520.8	1,923.7	1,503.9	320.4	1,824.3	32.4	0.4	32.8	3,926.9	222.6	4,149.5
1986	1,280.1	1,817.0	3,097.1	1,448.0	725.3	2,173.3	1,767.0	430.6	2,197.6	5.6	0.5	6.1	5,227.6	468.0	5,695.6

* Includes matured time deposits and deposit on call.

Fx: Foreign Currency.

Table 2.7 (Cont'd)

End of period	18 months			24 months			Others			Total		
	Rupiah	Fx	Sub-Total	Rupiah	Fx	Sub-Total	Rupiah	Fx	Sub-Total	Rupiah	Fx	Sub-Total
1972	3.3	0.1	3.4	92.7	1.4	94.1	8.3	0.1	8.4	163.1	70.3	233.4
1973	4.3	0.5	4.8	121.7	14.9	136.6	10.8	1.4	12.2	214.1	124.8	338.9
1974	7.3	1.0	8.3	204.2	30.0	234.2	18.2	2.7	20.9	359.2	222.0	581.2
1975	10.9	-	10.9	306.4	-	306.4	27.3	-	27.3	538.9	221.3	760.2
1976	4.5	-	4.5	522.8	-	522.8	0.2	-	0.2	762.0	218.4	980.4
1977	2.5	-	2.5	605.5	-	605.5	0.2	-	0.2	895.0	208.9	1,103.9
1978	1.6	-	1.6	612.1	0.1	612.2	0.4	-	0.4	931.5	355.9	1,287.4
1979	1.8	-	1.8	611.9	0.3	612.2	16.0	-	16.0	991.0	467.2	1,458.2
1980	2.3	-	2.3	679.2	0.3	679.5	14.1	1.3	15.4	1,278.4	372.4	1,650.8
1981	1.8	-	1.8	833.7	-	833.7	35.2	1.7	36.9	1,754.1	455.8	2,209.9
1982	5.9	-	5.9	966.4	0.9	967.3	65.5	1.3	66.8	2,197.5	784.1	2,981.6
1983	11.0	-	11.0	682.5	1.5	684.0	96.3	-	96.3	4,441.1	1,340.7	5,781.8
1984	3.7	0.8	4.5	395.9	-	395.9	194.0	-	194.0	6,022.0	1,756.9	7,778.9
1985	7.8	-	7.6	535.6	-	535.6	150.0	-	150.0	8,887.9	2,838.7	11,726.6
1986	5.2	-	5.2	670.6	0.8	671.4	121.1	0.1	121.2	10,525.2	3,442.3	13,967.5

Fx: Foreign Currency.

As a result of the uncertainty about the future course of interest rates, the term loans to non-priority sectors now generally carry rates that are adjustable every three to six months, usually based on the banks' cost of funds. Given the substantial differences in the cost of funds and calculated profit margins among banks and among groups of banks, the loan rate system after June 1983 was in a state of flux, causing considerable uncertainty to borrowers.

Following the June 1983 reform, there was also a further build-up of surplus funds within the banking system in excess of reserve requirements. This was because the large growth in deposits following the reform was not initially matched by a similar increase in demand for credit arising from the considerable uncertainty on the variable loan rates. In addition, the increased share of time deposits in total deposits reduced the growth in required reserves, because time deposits were subject to lower reserve requirements. Also, owing to interest rate uncertainties, the shortening of deposit maturities, and the perceived uncertainties in the future course of financial policies, the banking community remained somewhat cautious in making loans, particularly medium- and long-term loans for investment. These reasons, along with the reduction in the subsidies granted through the liquidity credit mechanism and uncertainty over the rate of devaluation of the rupiah, thwarted any downward influence on interest rates that the increase in excess bank reserves could have had otherwise.

III. THE DEVELOPMENT OF THE SECURITIES MARKETS

A. Overview of the Indonesian Securities Market

The operation of the securities market in Indonesia is not new. A stock exchange existed in Indonesia as far back as 1912. It was established in Batavia (now Jakarta) in December 1912 with the name of *Vereniging Voor de Effecten Handel*. It was followed by the opening of the stock exchange in Surabaya in January 1925 and in Semarang in August 1925. These securities markets were essentially established to meet the needs of the Dutch business community as well as individual investors.

The above stock exchange markets were closed during the Japanese occupation and the struggle for independence till 1952. The stock exchange in Jakarta was reopened in 1952 and continued to operate until 1958. The nationalization of foreign enterprises, especially the Dutch companies, followed by the exit of Dutch nationals in 1958 contributed

to the demise of this stock exchange market. The development of the stock exchange market from 1958 through 1970 was inhibited by several factors such as unstable economic condition and high rates of inflation. Nevertheless, the most important factor was that the infrastructure which could sustain a capital market had been severely damaged. The securities listed in the Jakarta stock exchange between 1952-1958 are shown in Appendix 2.1.

Economic adjustment undertaken by the government, especially in the financial sector in 1967 led to the re-opening of the stock exchange in August 1977. At present, the securities market in Indonesia is still at the early stage of development as evidenced by the low ratio of securities outstanding GDP. The ratio of value of shares and bonds to GDP in 1986 was only 0.5 per cent.

The first company going public after the re-opening of the stock market was PT Semen Cibinong, a cement producing company, in August 1977. The growth of the listed companies was very slow. Until March 1987, only 24 companies were listed in the stock exchange.

In early 1983, three listed companies issued bonds to be listed in the stock exchange, namely PT Jasa Marga, a state-owned company; BAPINDO, a state-owned development bank; and PT Papan Sejahtera, a new type of housing finance institution. As at end of March 1987, the total number of bond issues by these three companies was 12. The bond issuers listed in the stock exchange market are shown in Table 2.8

B. The Stock Exchange and Its Evolution

As noted earlier, the existence of the stock market is not new in Indonesia. However, since 1958, when the government imposed nationalization of foreign enterprises, especially Dutch companies, followed by the exit of Dutch nationals, the activities in the stock exchange decreased sharply. This depressed condition continued until 1966 during which Indonesia's economy was in crisis.

During the period 1967-1976, the government began to reactivate and promote the capital market. In July 1968, the Team on the Preparation of Money and Capital Market (Team Persiapan Pasar Uang dan Modal – PUM) was formed and responsible for collecting information and data, as well as proposing recommendations to Bank Indonesia for the purpose of promoting the money and capital markets. The Team noted that the unfavourable monetary, economic and largely political conditions were the factors contributing to the stagnation of the money and capital markets.

Some of the recommendations proposed by the Team on the steps to be taken by Bank Indonesia were as follows:

- establish primary and secondary money markets,
- promote and develop securities as an instrument of financing,
- the development of discount facilities by the central bank,
- re-evaluate the legal status of enterprises, especially in the status of voting power and the shares,
- enhance education and training in the field of money and capital markets,
- establish an institution such as a securities and exchange commission to be responsible for the supervision and regulation of securities markets,
- issue securities by the central bank, and
- review and revalue outstanding bonds and other securities, buy or convert them into new securities with more favourable terms.

In January 1972, Badan Pembina Pasar Uang dan Modal (BAPEPAM) a capital market executive agency was established under the Ministry of Finance. This agency assumed the same function as those of the Securities and Exchange Commission in the United States. This institution was authorized to promote money and capital markets, to set up money and capital market institutions and to control and coordinate the stock exchange activities. In 1976, a state-owned investment trust company, PT Danareksa was formed. In addition, some rules were instituted to ensure that the government objective of equitable ownership of private companies is met.

Finally, after almost 20 years of absence in the Indonesian economy, the stock exchange was officially re-established in August 1977. Since its opening, the number of companies listed on the exchange market increased very slowly. As of March 1987, only 24 companies were listed in the stock exchange, of which three companies were listed as bond issuers.

C. Equity Market and Corporate Financing

As noted earlier, the equity market in Indonesia was re-opened in 1977. Its development was relatively slow. This was evidenced by the fact that although there were thousands of companies existing in Indonesia, only 24 of them were actually listed in the stock exchange.

The slow development of the equity market was primarily attributable to insufficient supply of securities in this market. This in turn could

Table 2.8 INDONESIA: PLACEMENT OF SHARES AND BONDS IN THE CAPITAL MARKET*

Enterprises	Shares/bonds issued				Interest rates on bonds (% p.a.)
	Date of issuance permit (go public)	Number of issuance	Initial price per share/bond	Value (millions of rupiah)	
I. Shares		58,719,592		133,103	
PT Semen Cibinong		557,096		7,022	
- Emission I	6.8.1977	(342,116)	10,000	(3,421)	
- Emission II	10.5.1982	(214,980)	16,750	(3,601)	
PT Centex		700,000		3,558	
- Emission I	4.5.1979	(116,000)	5,500	(638)	
- Emission II	24.9.1983	(584,000)	5,000	(2,920)	
PT BAT Indonesia	19.10.1979	6,600,000	2,500	16,500	
PT Tifcorps	29.12.1979	1,000,000	7,250	7,975	
PT Richardson Vicks Ind.			420,000	1,260	
- Emission I	6.3.1980	(280,000)	3,000	(840)	
- Emission II	15.12.1982	(50,000)	3,000	(150)	
- Emission III	20.12.1983	(30,000)	3,000	(90)	
- Emission IV	3.12.1986	(60,000)	3,000	(180)	
PT Goodyear Indonesia	10.11.1980	6,150,000	1,250	7,688	
PT Merck Indonesia	23.6.1981	1,680,000	1,900	3,192	
PT Multi Bintang Indonesia	27.10.1981	3,520,012	1,570	5,526	
PT Unilever Indonesia	16.11.1981	9,200,000	3,175	29,210	
PT Sepatu Bata		1,950,000		2,486	
- Emission I	6.2.1982	(1,200,000)	1,275	(1,530)	
- Emission II	9.1.1985	(288,000)	1,275	(367)	
- Emission III	24.12.1986	(462,000)	1,275	(589)	
PT Unitex	12.5.1982	733,500	1,475	1,082	
PT Sucaco	5.6.1982	4,800,000	1,100	5,280	
PT Bayer Indonesia	16.6.1982	2,324,100	1,325	3,079	
PT Panin Bank		4,800,000		16,917	
- Emission I	28.10.1982	(1,637,500)	3,475	(5,690)	
- Emission II	18.6.1983	(3,162,500)	3,550	(11,227)	

PT Squibb Indonesia	12.2.1983	972,000	1,050	1,021
PT AJ Panin Putra	30.4.1983	1,020,000	2,950	3,009
PT Sari Husada		1,409,720		2,612
– Emission I	4.6.1983	(1,000,000)	1,850	(1,850)
– Emission II	16.7.1984	(192,000)	1,850	(355)
– Emission III	23.2.1987	(217,720)	1,870	(407)
PT Pan Union Insurance	13.8.1983	765,000	1,150	880
PT Regnis Indonesia	21.11.1983	523,500	1,540	806
PT Pfizer Indonesia	21.12.1983	600,000	1,425	855
PT Delta Djakarta		389,088		1,148
– Emission I	23.12.1983	(347,400)	2,950	(1,025)
– Emission II	8.7.1985	(41,688)	2,950	(123)
PT Hotel Prapatan	29.12.1983	1,665,976	1,050	1,749
PT Jakarta International Hotel	30.12.1983	6,618,600	1,500	9,928
PT Prodentia Indonesia	9.10.1984	221,000	1,450	320
II. Bonds				
PT Jasa Marga		285,915		404,718
– Issuance I	15.1.1983	239,750		293,718
– Issuance II	10.9.1983	(200,000)		(23,718)
– Issuance III	23.12.1983	(13,500)		(40,000)
– Issuance IV	23.12.1983	(3,600)		(20,000)
– Issuance V	23.12.1983	(3,600)		(20,000)
– Issuance VI	23.12.1983	(3,600)		(20,000)
– Issuance VII	12.12.1984	(3,600)		(40,000)
– Issuance VIII	12.12.1984	(2,900)		(30,000)
– Issuance IX	27.11.1985	(3,700)		(40,000)
– Issuance IX	23.12.1985	(5,250)		(60,000)
Bank Pembangunan Indonesia		36,395		75,000
– Issuance I	29.1.1983	(32,650)		(25,000)
– Issuance II	28.8.1986	(3,745)		(50,000)
PT Papan Sejahtera		9,770		36,000
– Issuance I	16.4.1983	(6,280)		(6,000)
– Issuance II	29.8.1985	(3,490)		(30,000)
Total I + II		59,005,507		537,821

* Up to March 1987.

be attributed to various factors which depressed the supply of and demand for funds through this market. Factors which depress the supply of equity capital may have originated partly from the lack of understanding of the nature of equity market by the general public. In addition, private individual investors normally expect equity investment to be as profitable as depositing money with banks. This expectation has made the investors demand relatively high dividend yield on stocks which must be at least comparable to deposit rates. Investors consider the prevailing 18 per cent interest paid on time deposit with tax exemption privileges to be more attractive than a 15 per cent nominal dividend paid on the nominal value of stocks. There is also a perception that stock investment is speculative and often comparable to gambling which may be prohibitive for religious reasons. The general public may have difficulty in understanding the intricacies of the stock exchange. The expected high returns through capital gain in share investment were also limited. This was because of active intervention by the government through PT Danareksa, a government investment trust company, to smoothen the price fluctuation in the stock market. All these factors had discouraged the public from actively participating in equity investment.

There are also constraints which restrain potential companies from going public. First, the prevailing dividend policy imposed on the listed companies to pay high dividends increased the cost of funds for the issuing companies. The potential companies tend to look for alternative sources of finance rather than depend on equity finance. Many of the existing companies had, in fact, paid out more dividend than what they had earned to attract investors. This kind of dividend policy has been adopted by several companies mainly to meet the stock investors' demand for high return. This practice had burdened the companies' financial positions and discouraged them from issuing more shares in the stock exchange.

The second factor is the time-consuming and tedious procedures for a company to obtain a licence for listing in the stock exchange. It takes formally 90 days from the date of submission of letter of intent to BAPEPAM, before a licence is issued. The company is also required to obtain approval from various government offices such as the Ministry of Justice, the Director General of Taxes, and the Investment Coordinating Board (BKPM) before BAPEPAM can start the review process. In addition, companies usually need to have their assets evaluated by companies appraisers, prior to their submission of the application forms to BAPEPAM. This adds an additional two months before formal submission of application to BAPEPAM.

Thirdly, many owners of private enterprises consider that going public would be diluting their control over their closely held family business operations. In addition, going public means disclosing their financial conditions to the public, which in turn would make their tax liability more open. Finally, many potential investors with surplus income, or investible funds, consider investment in equity less attractive than utilizing the funds for their own business undertakings, particularly in trade or real estate sectors.

D. The Bond Market and Its Development

The bond market which is part of the securities market in Indonesia has been inactive. The bond market was not developed until 1982. The main reason for its sluggishness is that the market is still new to both the issuers and the investors. Also the supply of this kind of securities was almost negligible in the past. The recent high interest rates prevailing in the economy and tax treatment on bonds also hampered the development of the bond market in Indonesia.

Despite the unfavourable conditions, three institutions started to offer bonds to the securities market in 1983. These institutions are PT Jasa Marga, Bank Pembangunan Indonesia (BAPINDO) and PT Papan Sejahtera. All the three institutions are government controlled institutions. BAPINDO is a state-owned development bank while PT Jasa Marga is a state-owned company which is involved in the financing of the toll roads in Indonesia. PT Papan Sejahtera is a new institution which provides housing project financing.

The first issue of the PT Jasa Marga bond was started in February 1983, consisting of 200,000 bonds, five-year maturity, 15.5 per cent interest rate, with a value of Rp 23,718 million. BAPINDO bonds, its first issue amounting to a value of Rp 25,000 million was initiated in March 1983, comprising 32,650 bonds with five-year maturity and 15.5 per cent interest rate. The first issue of PT Papan Sejahtera bond was launched in May 1983, comprising 62,180 bonds, with a value of Rp 6,000 million. The issue carried five years maturity, with 15.5 per cent interest rate. There was also a second issue of bonds by PT Papan Sejahtera and BAPINDO, and fourth issue of bonds by PT Jasa Marga. As at end March 1987, the number of institutions issuing bonds remained unchanged.

Several factors affected the orderly development of the bond market in Indonesia. One of the factors was the high interest rates prevailing in the Indonesian economy. In such a situation, many companies were

reluctant and also in a difficult position to issue long-term bonds, since only high coupon-rate bonds were marketable under such situation. This implies that cost of funds to the issuing companies will be very high. For example, the three bond issues in early 1983 with an interest rate of 15.5 per cent were not able to compete with the prevailing interest rates. By the time the companies issued the bonds, commercial banks had already increased their interest rates paid on time deposits to a much higher level. That was why PT Jasa Marga in their second issue of bonds also had to increase its coupon rate to 16.5 per cent. However, unlike PT Jasa Marga, PT Papan Sejahtera could not afford to raise the coupon rate in its second issue.

The other factor which affects the development of the bond market is the uncertainty over the tax status of each bond issue. As an example, the three bond issues in early 1983 all carried a 15.5 per cent coupon rate with 50 per cent tax exemption. However, the second PT Jasa Marga bond issue at the end of 1983 and its subsequent series which carried a 16.5 per cent coupon rate, were totally tax exempted.

Despite the difficulties faced by the bond market, in the future it can be expected that there are good prospects for a gradual development of the bond market. Bonds outstanding have grown from 259,630 with a nominal value of Rp 134,718 million at the end of March 1983 to a total of 285,915 with a nominal value of Rp 404,718 million at the end of 1986 (Table 2.8).

E. Government Policies and Strategies

The effort to reactivate the money and capital market in Indonesia had been initiated since the beginning of the new order government. It was initiated with the reform in the banking system as reflected by the enforcement of Act No. 14, 1967 on banking system and the Act No. 13, 1968 on central banking. Stabilization and rehabilitation in the financial sector were directed towards the development of the money and capital markets. To date, the government of Indonesia continues to undertake several policy measures as an effort to promote the development of the money and capital markets.

The government continuously encourages public enterprises to raise long-term funds from the capital market, especially through bond issues. Besides PT Jasa Marga, BAPINDO and PT Papan Sejahtera which had already issued bonds, public enterprises such as Perum Telkom (telecommunication public enterprise) and PLN (state electricity company) also have the potential to issue bonds. Currently, BAPEPAM

is studying various possibilities to develop the capital market, especially on revising the regulations and exploring the feasibility of setting up an over-the-counter market for stocks which are not qualified for listing in the stock exchange market.

In addition, efforts to revise the Banking Act of 1967 is underway. It is expected that the changes in the Banking Act of 1967 will have significant impact on the prospect and development of the money and capital markets, especially the role of commercial banks as underwriters or dealers of securities. These activities, which are permitted by the Ministry of Finance, are not legally incorporated in the Banking Act of 1967.

IV. CONCLUDING REMARKS

Much government effort has been directed towards the development of the non-securities market. In this regard, the June 1983 Deregulation represented the major step in reforming this sector of the capital market. The major impact of this policy is that the banking system is left to mobilize long-term funds on their own at market rates of interest. Secondly, the non-priority sector would not be subsidized through refinancing from Bank Indonesia. The implication is that any investment which earn rates of return below the market lending rates would have to be phased out, thus increasing productivity in the long run.

However, the liberalization of interest rates had an adverse impact on the securities market. The government should look into this kind of conflict in the process of developing the capital market which comprises non-securities and securities market.

As to the securities market, there are still factors which inhibit its proper development towards maturity. Firstly, viewed from the supply side of securities, there is a need for long-term capital in various public as well as private enterprises. However, this supply cannot be fulfilled because of the following:

- The strict requirements for companies going public are considered to be discouraging, particularly the required 10 per cent return on capital during the last two years prevents many medium-sized companies from tapping the capital market,

- Long and tedious procedures for companies to be listed in the stock exchange, and,

- A still depressed business climate, excess capacity, low levels of production and profitability have contributed to the reduced activities in the equity market.

CAPITAL MARKETS

Secondly, from the other perspective, the demand for securities is rather limited. Factors affecting the lack of demand of long-term funds are as follows:

- The relatively low income per capita in the country,
- Limited public comprehension about the capital markets, particularly the stock exchange and also the past unfavourable experiences such as high inflation rates during the 1960s discouraged the public from participating in the capital markets. In addition, lack of public confidence towards the degree of liquidity of securities also affect the activities of the secondary markets,
- The discriminatory tax treatment and other benefits of the securities market vis-a-vis bank deposits. This is reflected in the unfavourable tax treatment towards dividends which discourage the public from buying securities, whereas interest earned from bank deposits are exempted from taxation, and,
- Limited capital gains for securities investment arising from indirect government intervention to smoothen the securities prices.

The third factor that affects both the demand and supply is the relatively high interest rates prevailing in the economy. Many companies are reluctant to issue long-term bonds with high coupon rates. However, only high coupon rate bonds are marketable under the present high interest rate situation. This situation also causes the public to invest their surplus funds into time deposits rather than in securities.

The overall assessment as noted earlier indicates that a number of measures will be needed in the near future to revive and encourage the further development of the capital markets, as follows:

- Corrective action to put the equity and bond markets on an equal footing with banking institutions with regard to tax treatment and other benefits. The authorities should remove the fiscal hurdles impeding the growth of the securities market without adversely affecting the mobilization of long-term deposits or the implementation of the tax reform. A temporary tax exemption for bonds might be needed in order to encourage securities market development,
- Improving the regulatory framework to make the capital market attractive to potential borrowers and investors and to encourage the development of underwriting and streamlining the procedures for companies going public, and,
- Liberalization on securities market is needed, especially the movement of securities prices.

To sum up, the development of the capital market should be focused on both non-securities and securities markets so as to provide competition and promote efficiency in mobilizing surplus funds and allocating these funds to the productive sectors. □

**Appendix 2.1 INDONESIA: SECURITIES LISTED IN THE
JAKARTA STOCK EXCHANGE (1952 – 1958)**

1. A. C. F. Industry
2. American Motors
3. Anacoconda Copper
4. Atchison Topeka Sa.Fe R. Coy
5. Bethlehem Steel
6. Canadian Pacific
7. Canadian Pacific perp. bond 4%
8. Cities Service
9. Continental Oil
10. Securities Wright Corp.
11. General Electric
12. General Motors
13. International Nickel
14. Kcccocott Copper
15. New York Centre R.r.
16. North American Aviation
17. Repblic Steel
18. Shell Oil
19. South Pacific Coy
20. Standard Brands
21. Tide Water
22. United Air Craft
23. United States Steel
24. West Penn. Electric

Sources: Pasar Modal dan Pembangunan Nasional, Departemen Penerangan, R.I., 1984

CHAPTER 3

Development of the Capital Market in Malaysia

ZETI AKHTAR AZIZ

I. THE DEVELOPMENT OF THE SECURITIES MARKET

The Malaysian financial system has now reached the stage in development whereby the non-securities market is fairly well developed. In recent years, priority has been given to develop the securities market. This is not only aimed to ensure access to funds for private enterprise but also to reduce distortions in the interest rate structure, to improve the scope for monetary policy and to assist in the development process.

The securities market in Malaysia is made up of two major components, the equity market and the bond market. The bond market which mainly comprises the government securities market represents the major component in terms of primary funds raised. Total funds raised by the public sector has generally accounted for 80 – 90 per cent of the total funds raised in the securities market. However, the equity market while still relatively small, represents the more active component.

The growth of the securities market has been steady since 1960, but the pace has accelerated particularly in recent years. By the end of 1987, the Kuala Lumpur Stock Exchange had 50 member broker firms with 291 companies listed with a total paid-up capital of M\$74 billion compared to only 4 stockbrokers in 1961 with 138 companies listed with a paid-up capital of M\$708 million. A similar pattern of growth may be observed in the government securities market. During the 1960s when the need for government borrowing was not important given that the government budget was generally balanced, the size of the market was relatively small. At the end of 1960, the total amount of government securities outstanding was M\$853 million. By the end of 1987, the total amount outstanding was M\$48 billion.

In response to the changing economic and financial environment, the authorities have taken steps to review and re-examine the fundamental structures and systems in order to identify areas in which change and improvement is necessary. This section will trace the reforms and developments that have taken place over the last two decades, not only to further develop the institutional framework and mechanism, but also address the problems faced by the securities market and strengthen the regulatory system and practices of the market. This section discusses the development of the corporate and government securities market, the issues that have emerged in this process and the strategy that has been adopted by the authorities to develop this market.

A. The Stock Exchange and Its Evolution

As early as in the 1870s, there existed in Malaya a number of share broking firms. However, share exchange was not their only form of business activity. The broking firms mainly dealt in commodity broking and exchange, and share broking was only a side activity¹. The share transactions then were infrequent and the turnover small.

In the first decade of the twentieth century, a few foreign tin mining companies and plantation companies were established. These industries were the initiators of the Malaysian capital market². However, the growth of the securities industry was hindered by the advent of the First World War (1914-18). During the 1920s, there was a small but steady increase in the choice of shares available to investors. The 1929 Wall Street Crash, however, had an effect on the Malayan securities market. During this time of economic recession, malpractices and cut-throat competition were rampant: stockholders employed ruthless means to survive, applying ad hoc rules and practices.

The aftermath of the crash brought a realization of the importance and need for a standardised set of rules and regulations. There was an urgent need for an association to bring about security, discipline, as well as for the dissemination of information. Consequently, on 23 June 1930 the Singapore Stockbrokers' Association was formed. This Association was the embryo of the present Kuala Lumpur Stock Exchange. As a result, a rudimentary framework of rules, regulations and bye-laws were adopted.

The Stock Exchange business started to expand once the effect of the 1929 Wall Street Crash was over. A larger body, the Malayan Stockbrokers' Association, was formed in Kuala Lumpur on 31

1. For example, Fraser and Co. Ltd. (1903) and Anthony and Anderson (1905).

2. Some of the companies formed were Malakoff Plantation Ltd. (1897), Rahman Tin Company Ltd. (circa. 1900), Inch Kenneth Rubber Ltd. (1902) and Guthrie Company Ltd. (1905).

October 1937. With the outbreak of World War II (1939-1945), the Malayan Stockbrokers' Association ceased operations, but was reestablished on 26 August 1946. (Dealings actually resumed in 1945).

After the war, there was renewed interest in investment with domestic investors becoming active in the market. By 1953, there were 93 companies listed under Industrial, Tins, Sterlings and Dollar Rubber with 17 brokers operating under the rules and regulations as set up by the Association (nine in Singapore and eight in Kuala Lumpur, Penang and Ipoh).

It was not until 9 May 1960 that public trading of stock and shares was actually undertaken when the Malayan Stock Exchange was established, with two trading rooms operating in Singapore and Kuala Lumpur. Four stockbrokers in Kuala Lumpur gathered daily at the Central Bank's clearing house to conduct their first 'call' and price marking. In 1961, the 'Board Trading System' or the 'Trading Post System' was introduced, whereby the shares of the various companies were posted on boards in each trading room and bids and offers were entered into on a continuous auction basis. This was in keeping with trading procedures in established stock exchanges.

Dissatisfaction had, however, begun to arise over London registered companies. Malayan investors were subject to lengthy procedures to claim their dividends, often lasting nine months to a year. In addition, shareholders were often not given enough time to register for dividends. In 1960, the Central Bank initiated discussions between the Malayan Government and the British Government on the establishment of branch registers in Malaya, of companies incorporated in the United Kingdom, but whose principal businesses were located in Malaya and whose shares were actively traded in Malaya. Agreement with the British government was secured in 1962, and by 1964, 40 British companies had set up local branch registers. These registers facilitated local share transfers and registration.

By 1962, there were 20 stockbroking firms in Malaya. Ten of them were in Singapore, five in Kuala Lumpur, three in Penang and two in Ipoh. The exchange in Kuala Lumpur moved to its own trading room from 15 June 1962, and the new trading room had a public gallery. The exchange also extended its hours of operation, as the clearing house of the Central Bank had been available for only a limited number of hours each day. Direct telephone links were installed between the Singapore and Kuala Lumpur trading rooms to enable the best 'bid' and 'offered' prices in these two exchanges to be reflected almost simultaneously in their trading rooms. This allowed for the effective integration of the two trading rooms into a single market with the same stock and shares

listed at a single set of prices on both boards. Links with brokers in Penang and Ipoh were also subsequently established.

With the emergence of Malaysia as a new political entity on 31 August 1963, the name of the exchange was changed to the Stock Exchange of Malaysia in November 1964. However, in 1965 when Malaysia and Singapore became two separate political entities, the stock exchange was renamed again as the Stock Exchange of Malaysia and Singapore. The Stock Exchange operated as a united stock exchange with separate trading rooms in Singapore and Kuala Lumpur

Arising from widespread and excessive speculative activity in the Stock Exchange during the initial years, this prompted efforts to introduce stricter rules to protect the investing public and to promote the development of the market. At the same time, the rules for share trading were strictly enforced. In 1963, a board to consider applications for the listing of shares and to determine listing requirements was established. As an effort to ensure greater orderliness in the market, further measures were introduced in 1964 including new rules and bye-laws³.

A more comprehensive legal framework for supervising the operations of companies came into force in 1965 with the new Companies Act. The Act provided for more significant disclosure by the companies of their operations and capital structure. In 1968, the informal arrangements that had existed between the Central Bank and the Stock Exchange were formalised with the establishment of the Capital Issues Committee (CIC). The CIC was established to supervise the issue of shares and other securities by companies applying for listing or already listed on the Exchange as well as regulating the timing of the issue of the shares to ensure an orderly market. The CIC examines the draft prospectus or announcements of a company that intended to make a new issue or that seek to be listed on the Exchange.

Following a number of developments in the early 1970s, steps were taken to separate the joint Stock Exchange of Malaysia and Singapore. A major development was the decision to terminate the currency interchangeability arrangement between Malaysia and Singapore in May 1973 and to allow the floating of the ringgit. By this stage of the development of the Stock Exchange, the number of companies incorporated in Malaysia that were listed in the joint stock exchange had increased significantly and the volume of transactions in the stock exchange in Kuala Lumpur had become substantial. Further, the number of sharebroking firms in the major towns in Malaysia was also sufficiently large.

3. The Stock Exchange engaged an expert (A. G. Wallance) and came out with a new Listing Manual with new rules and bye-laws that were adopted on 21 June 1984.

These developments resulted in the incorporation of the Kuala Lumpur Stock Exchange (KLSE) Berhad on 2 July 1973 as a limited company. All shares that were listed in the joint stock exchange were listed in the KLSE. During the same year, the Securities Industry Act 1973 was gazetted, however, it was not enforced until December 1976. The implementation of this Act was the responsibility of the Registrar of Companies (ROC). For the purposes of the implementation of this Act, the ROC was responsible to the Minister of Finance. The Act includes provisions for the Government to ensure safeguards for the proper listing of and dealing in securities, for the licensing of share dealers and for the maintenance of proper and adequate records that may be inspected by the Registrar of Companies. The Act has provisions for the control of false trading, excessive speculation, market rigging, insider trading and market manipulation.

While the Act makes provision for the Minister of Finance to consult with the CIC on matters relating to the implementation of the Act, it did not, however, have provisions relating to the powers of the Capital Issues Committee (CIC). Finally, under the Act, the Minister could initiate an investigation on any matter on trading or dealing securities, if it was deemed in the public interest to do so.

A further development during this period was the formation of the Foreign Investment Committee (FIC) on 12 February 1974. The main function of the FIC was to provide guidelines to regulate the acquisition of assets, mergers and takeovers of companies and businesses, while ensuring that they would benefit the Malaysian public.

An important development during 1974 was the transfer by some companies of their headquarters to Malaysia. The next big event was a civil suit filed against the Exchange for alleged graft. It was thus obvious that the operations of the Stock Exchange needed to be further regulated.

The 1980s saw another stage in the development of the securities market. A number of events in the market prompted the authorities to review the fundamental structure and the supervisory framework and introduce improvements and reforms to promote the development of the securities market. It had become apparent that the 1973 Act was inadequate to deal effectively with the developments in the market. On 2 December 1983, the new Securities Industry Act 1983 replaced the 1973 legislation. As a result, a new company called the KLSE officially took over from the KLSE Berhad on the same day. While similar in its fundamental objectives, the new legislation had new provisions on enforcement and investigation, the specific role and function of the CIC, the conduct of the securities business and the trading in securities. The Act also gave powers to the Minister of Finance to initiate amend-

ments to the rules of the Stock Exchange. The Act describes in detail the means and procedures for carrying out investigations that are in the public interest. It also provides the Minister with the power to institute legal action against offenders.

A number of initiatives were taken in the years that followed to promote development of the market. To enhance efficiency, the Exchange set up a Data Processing Department in 1982 to establish a computerised clearing house for the industry. Initially, computerised clearing was limited to 20 counters but was extended to all by March 1984. The clearing house is known as Securities Clearing Automated Network Services Sdn. Bhd. or SCANS. This was complemented by the subsequent installation of a real time reporting system (MASA) in May 1987 which provides immediate information on transactions, with a similar service "Livecom" made available to non-securities markets. Further, a new market indicator, the KLSE Composite Index was introduced on 4 April 1986 to replace the KLSE Industrial as the major indicator, as the former's composition is more reflective of the diversified nature of present listings in the market.

In line with developments in securities markets around the world, the stockbroking industry was allowed to be corporatized with effect from March 1986. The objective was to improve the financial strength, as well as to upgrade the level of technical expertise and professionalism of the industry. Malaysian corporate ownership was initially limited to 60 per cent but was increased to 100 per cent, when the pace of corporatization was deemed to be too slow. Similarly, foreign corporate ownership was increased from 30 per cent to 40 per cent in July 1988. Currently, Malaysian participation is restricted to commercial banks and merchant banks while foreign participation is restricted to reputable broking houses. Broking licences have been granted to the three largest domestic banks - Malayan Banking Berhad, Bank Bumiputra Malaysia Berhad and United Malayan Banking Corporation. To date, there are a total of seven corporate ownership of stockbroking companies. In line with upgrading the skills in the industry, formal training was made available to investors, remisiers and brokers with the setting up of the Research Institute of Investment Analysis Malaysia (RIIAM) in 1986.

Apart from efforts to make the market more efficient and competitive, changes were also on the regulatory front. A Panel on Takeovers and Mergers was set up in March 1986 to administer the Malaysian Code on Takeovers and Mergers as provided under the Companies Act (Amendment) 1985.

Since March 1986, the Panel of Takeovers and Mergers (PTM) was established to assume the functions of FIC to administer the Malaysian Code on Takeovers and Mergers. The purpose of the Code is to estab-

lish the principles and procedures for takeovers and mergers and to lay down the code of conduct to be observed by parties involved in takeover and merger transactions. It is aimed at protecting the investing public from possible abuses arising from corporate activities. In addition, an Advance Warning and Surveillance (AWAS) unit in the KLSE was introduced in July 1987 to help alert the regulatory authorities of any stockbroking houses and listed companies which may be in trouble so that pre-emptive corrective measures can be taken. This was particularly in response to both the Pan-Electric crisis of December 1985 which had significant adverse rippling effects across the Exchange, and the rising incidents of bankruptcies and insolvencies of companies caught unawares by the sudden downturn in the economy during the period 1985-86. A revised set of guidelines for the new issue of securities and valuation of public limited companies was issued by the CIC. (The latest was issued in August 1988). These reforms contributed to strengthen the Exchange to withstand pressures as experienced during the 1987 Crash that occurred in the securities market on a global scale. The Kuala Lumpur stock market, while adversely affected survived. There was no systemic failure. Since then, the stock market had recovered in response to good "fundamentals" namely the improved economic conditions. To date, there is a total of 53 broking firms dealing on the Exchange with a total of 292 companies listed at end June 1988.

B. The Equity Market and Corporate Financing

1. *The New Issues Market*

The growth of the new issues market for corporate securities began in earnest in the early 1960s. The instrument issued to tap this market had predominantly been in the form of ordinary shares during 1961-87. Debentures/loan stocks were occasionally issued, but the amount constituted an insignificant proportion of the total new issues. Preference shares and bond issues were even more insignificant.

In the earlier part of the review period 1961-87, public issues of ordinary shares constituted the major means for raising funds in the equity market. Thereafter, other means have become more important, such as rights issues, special issues to the Bumiputra community (to conform to the requirements of the New Economic Policy) and private placement. Public issues accounted for 40 – 100 per cent of the total issue of ordinary shares during the 1960s. In the 1970s and 1980s, with the exception

of the years 1976 and 1978, public issues accounted for less than 40 per cent of the total issue each year.

During the period 1961-87, the amount of funds raised by new issues of ordinary shares was on the uptrend, with amounts raised each year less than M\$50 million. During 1968-76, the amount raised increased to the range of M\$45 – 86 million a year. The increase continued over the years 1977-80. During 1981-84, however, funds raised by new issues expanded spectacularly. The amount for 1981 was M\$902 million. While it fell in 1982 to M\$629 million, it still remained substantially above the amount raised prior to 1980. In 1983, the amount reached M\$1,262 million, doubling that of the previous year. In 1984, the amount was M\$2,034 million, about one and a half times the amount of the previous year. Funds raised through new issues, however, declined significantly during 1985 and 1986, but increased substantially again to M\$1,385 million in 1987. The new issues market for equities had thus become a significant source of corporate finance during the 1980s. By 1987, new issues in the Malaysian corporate securities market averaged 2.5 per cent of GNP compared with 4 per cent in Singapore, 6 per cent in Japan and 8 per cent in the United Kingdom.

a) Factors Affecting the Development of the New Issues Market

Factors affecting the development of the new issues market could be broadly classified as follows:

- i) Economic and political environment including Government policies;
- ii) Prevailing share market conditions;
- iii) Relative cost and availability of raising finance in the equity market vis-a-vis other means.

The stock market experienced a substantial boom in new share issues between September 1961 and June 1964.⁴ A total of 24 companies sought an amount of M\$128 million and many of the issues were vastly over-subscribed. The reasons given for issuing shares were mixed. Some companies had sought investment projects requiring new capital; some foreign companies sought localization, either for political reason or for repatriation of foreign capital; and some were attracted by the ease of acquiring funds in a rising market.

4. P.J. Drake, "The New-Issue Boom in Malaya and Singapore 1961-64", Reprinted in D. Lim (ed), *Readings on Malaysian Economic Development*, Oxford University Press, Kuala Lumpur, 1975.

In 1965, there was only one public issue and the amount raised fell drastically to only M\$4 million, reflecting mainly unfavourable market conditions at the time, although economic conditions in 1965 were relatively buoyant. Between 1965 and 1967, the appearance of fraud shares was a major problem that plagued the Stock Exchange. From 1968 onwards, there was a marked recovery in the market for new issues, reflecting the better economic climate, implementation of the requirement by the government that companies granted tax relief through pioneer status should become public companies, and the more orderly market conditions for share issues under the supervision of the CIC.

During the early 1980s, the marked increase in the total amount of funds raised through corporate share issues again reflected the tendency for companies to take advantage of the buoyant demand for equity to substitute equity capital for bank borrowing which had become more costly with rising interest rates and to comply with the requirements of the New Economic Policy (NEP). On the other hand, the lesser amount in 1985 and 1986 reflected the freeze on new share issues and listings in 1985, and the decline in corporate activity and private sector investment. In line with the recovery in the economy and the more buoyant stock market, the new issues market was more active in 1987. The publicly listed companies also took advantage of the easy liquidity in the economy to improve their debt-equity ratio by substituting equity capital for bank borrowing.

However, one of the major drawbacks of equity financing is that dividend payouts are not tax-deductible. Secondly, there is the absence of flexibility of common stocks in meeting financial requirements, as in the case of debt securities where they can be 'retired', rolled over or converted. Apart from these drawbacks, there are costs to be incurred in equity financing. One such expense that a firm is likely to incur when it decides to raise capital via the sale of stocks is the floatation costs, unless of course it is able to arrange for the sale without the assistance of professional under-writers. The floatation costs to be incurred in the new issues of common stocks depend on the size of the issue, the stability of the firm, and the potential market for the stock of the firm. Another cost the firm will have to bear in an effort to raise capital via the issuance of new common stock is the transaction costs, or what is often referred to as the brokerage fee. The extent to which the firm will incur brokerage fee will depend on the method used by the firm to raise equity capital and the firm's plans in disposing its income from common stock. (For details see Appendix 3.1).

It is obvious from the *Guidelines for the New Issue of Securities and the Valuation of Public Limited Companies* that there are limitations to

a firm wanting to raise additional equity capital. For example, a firm intending to sell new stocks should have a good track record of three to five years as well as good prospects for future profits. Such considerations governing the new issues are necessary in order to safeguard and promote a strong and healthy share market in line with the provisions contained in the Securities Industry Act. However, in the new Guidelines issued in August 1988, the CIC has relaxed some rulings on new issues, namely that a wider range of prospective price earnings multiples was permitted for the determination of prices of new issues with additional criteria for rights issues, namely the reduction of the appropriate debt-equity ratio from not less than 1 to not less than 0.5 on industrial, property and tourism, and plantation companies. Therefore, highly-leveraged companies are encouraged to seek funds through the equity market. The minimum paid-up capital of companies seeking listing was raised from M\$5 million to M\$20 million to concur with the permission given to the KLSE to set up a second board comprising smaller companies with paid-up capital of less than M\$5 million. Further, the recent 1989 Budget reduced corporate tax from 40 per cent to 35 per cent which will enhance investment in equities.

2. Secondary Market

During the 1966-1973 period the annual turnover on the Stock Exchange of Malaysia and Singapore rose from 169 million units in 1966 to 938 million units in 1972. In terms of value, the amount rose from M\$226 million to M\$2,156 million for the corresponding period. The average annual turnover during the 1966-1973 period was 548 million units valued at M\$1,226 million. In 1973, the Stock Exchange of Malaysia and Singapore was reorganized into two separate institutions, namely the Kuala Lumpur Stock Exchange (KLSE) and the Singapore Stock Exchange (SSE).

While banks and finance companies represent a source of raising funds, businessmen and entrepreneurs have been increasingly turning towards equity as another means of financing their expanding operations. Consequently, more and more local companies chose to be listed on the KLSE. Trading of issued shares also increased rapidly. The growing size of the secondary market is reflected in the higher turnovers. Between 1974 and 1987, total turnover on the KLSE rose from 391 million units, with a total value of M\$722 million in 1974 to a peak of 5,286 million units, with a total value of M\$10,078 million in 1987. The average turnover for the 1974-79 period was about 631 million units per year, with an average annual value of about M\$1,378 million.

Trading activity at the KLSE was also affected by developments in the Malaysian economy and to a certain extent by external factors. In 1979, total turnover on the KLSE fell to 638 million units which was more than half of the 1978 level. The volume of transactions was affected by the increase in oil prices, the worsening political situation at the border of Thailand and Kampuchea, the U.S.-Iran crisis and the political unrest in Afghanistan. However, trading activity turned around and improved in 1980 as a result of sustained economic growth, reported inflows of foreign funds, expectations of mergers and takeovers, scrip issues and improved corporate results. The average turnover on the KLSE amounted to 1,940 million units for the period 1981-1985, compared with 852 million units traded in 1976-80. The value traded increased even more, rising from M\$2,368 million to M\$6,228 million. During this period, the lowest recorded was in 1982 with an annual turnover of 1,066 million valued at M\$3,253 million reflecting the uncertainty in the international economic and political situation, depressed commodity prices and exports, the lack of confidence in major overseas stock markets, especially Hongkong, and lower corporate profits.

For the greater part of 1984-1986 market sentiment was generally weak. The impact of the collapse of Pan-Electric Industries and the 3 days closure of the market at the end of 1985 continued to be felt in 1986. Trading activity remained sluggish for the greater part of the year as investors' confidence was low, undermined by unfavourable economic and political developments, including pervasive public uncertainty over the duration and depth of the recession, the sharp decline in commodity prices, financial problems which surfaced in the corporate and financial sectors coupled with unfavourable political developments. Investors were also generally cautious following the Central Bank's investigation into the activities of the deposit-taking cooperatives and the subsequent freeze on their assets. The KLSE generally turned buoyant in 1987 attributable to the continued uptrend in commodity prices and the improvement in overall economic conditions during the year. The decline in interest rates and easy liquidity also led to more funds being invested in the stock market than in bank deposits. A strong inflow of foreign funds aided by the establishment of the Malaysia Fund Inc. in New York and improved corporate results also contributed to the higher turnover.

Investors, however, turned cautious from mid-August 1987, with sentiment becoming more depressed following the global stock market crash in October 1987. Since then, the market has recovered significantly, influenced largely by firm commodity prices and improved corporate earnings reflecting the upturn in economic conditions. The

improvement in KLSE's trading environment and systems is expected to increase trading at the exchange. The growth in the number of companies listed on the KLSE, the globalization of stock trading, the greater participation of foreign institutional investors, the advancement and use of electronically aided equipment as well as maturity of Malaysian investors are factors which can help generate growth for the secondary market. The internationalization of Malaysian equities is likely to continue for the corporations, especially with the exemption from stamp duty on all contract notes made in connection between a local broker and foreign broker from May 1988. Meanwhile, reductions in corporate tax (which has begun as part of the government strategy to initiate growth), will improve dividend yields which are taxed at source.

Turnover on the KLSE continued to be dominated by trading in industrial shares which accounted for 67 per cent of the total volume of transactions in 1987. Meanwhile, finance shares remained the second most actively traded group of stocks, accounting for 14 per cent of the total volume of turnover, followed by commodity shares which accounted for 8 per cent. Trading of property and hotel shares accounted for the balance.

3. Insider Trading

Although insider trading is a continuing challenge to securities exchange regulators, the laws against insider trading are relatively new. In the U.K. for example, the offence was defined only as recently as 1980. However, law against insider trading which started in 1934 in the U.S., is strictly enforced. The suspects, if convicted, face not only heavy fines and possible imprisonment, but third-party liability and a lifetime ban from the U.S. securities business as well. In Malaysia, while there are laws against insider trading, to date there have been few investigations or prosecutions of investors suspected of trading in securities based on inside information.

C. The Bond Market and Its Development

The bond market in Malaysia consists mainly of primary issue market of government securities. Raising finance on a long-term basis via corporate bonds has not gained significance in Malaysia. The demand for bonds by the public has in general been limited given the relatively lower return from capital gains compared to shares. The investment in bonds has mainly been concentrated among institutional investors. In

particular, the holding of government bonds reflect existing regulatory portfolio requirements on financial institutions such as the provident fund, national savings bank, commercial banks, finance companies and insurance companies. While the coupon rate paid on corporate bonds has generally been higher than the rates for government bonds, unlike the latter, corporate bonds are subject to stamp duties and income tax. In recent years, initiatives have been intensified to develop the secondary market for government bonds. These developments represent part of a broader programme to develop the overall capital market.

1. The Government Securities Market

The government securities market is the largest component of the Malaysian capital market in terms of funds raised. In the last few years, steps have been taken to liberalise this market. In the early years, this market was highly regulated and almost entirely dependent on captive demand. The yield on government securities for the most part has been relatively lower than comparable papers in view of the need to contain government interest burdens and to enable the government to provide loans at preferential rates.

The rigid nature of the government securities market has had a number of undesirable effects on the development of the market. Arising from constraints that exist in the market, the interest rate structure in the overall financial sector has for the main part remained distorted. The captive nature of the market has also prevented the development of an active secondary market in government securities. This has in turn inhibited the growth of the rest of the capital market. Under these circumstances, the scope for open market operations as an instrument of monetary management has also been constrained. Finally, in keeping the rate on government papers low to contain the government debt interest burden, it has only served to delay the fiscal adjustment that was necessary when the debt had reached unsustainable levels in the early 1980s.

Growth in the government securities market increased at an accelerated pace in the late 1970s. The government securities market while growing at a steady rate during the 1960s was still relatively small. Government borrowing was not important given that the government budget was generally balanced. At the end of 1960, the total government securities outstanding was M\$853 million. By the end of 1970 the total amount outstanding had increased to M\$3.5 billion. The net issue of government securities, however, increased sharply during the late

1970s and early 1980s. By the end of 1987, total government securities outstanding had reached M\$49.3 billion.

A number of factors have contributed to the accelerated increase in the net issue of government securities. The size of the government debt reflects the borrowing needs of the government. The size of the government debt, however, is subject to a statutory ceiling which has been periodically adjusted upwards to accommodate the borrowing requirements of the government. The statutory ceiling on the permitted amount of government securities outstanding is specified by the Loan (Local) Ordinance, 1959, (Sec. 3 (3)). Parliamentary approval is required for amendments to the ceiling. In 1965, the ceiling was M\$1.2 billion. This ceiling was raised to M\$3.7 billion in 1969, M\$7.2 billion in 1972, M\$15.0 billion in 1976, M\$40.0 billion in 1980 and M\$60.0 billion in 1986.

As has been noted earlier, growth of the government securities market during the 1960s while steady, had remained low, given that the government budget during this period remained balanced. However, the size of the government deficit increased sharply towards the end of the 1970s and in the early 1980s. By 1982, the size of the deficit had peaked to 17.5 per cent of GNP. During this period there was a corresponding increase in the domestic debt. The net issue of government papers peaked at M\$5.6 billion during this year.

By mid 1982, it was recognized that such high government deficits could not be sustained. In the years that followed, the government undertook a fiscal adjustment exercise. Thereafter, there was a deceleration in the net issues of government securities. However, during the years 1987-88, the government again turned to the domestic capital market in the face of an unfavourable international environment, in terms of high international interest rates and sharp movements in exchange rates. During this period, the government was more active in the management of its external debt. In addition, given the higher level of the Central Bank's holdings of international reserves and with excess liquidity in the domestic financial system in 1987 and 1988, the government has prepaid some of the nation's more expensive external borrowings and turned to the domestic market to finance its deficit. In so doing, excess liquidity in the financial system was also absorbed.

Government securities have generally been issued in the primary market about three times a year, during January-April, May-August and September-December. The issues have generally been fully subscribed. Over the years, a number of initiatives have been taken to make the securities more attractive instruments. In 1960, advanced subscriptions towards future issues of the securities was allowed. An

increasing amount of shorter term maturities were also issued. In 1960, 96 per cent of the government securities outstanding had maturities of 15 years and above. By 1980, the proportion declined to 52 per cent. In 1987, the availability of securities with shorter maturities was increased significantly. This was part of the programme to promote an active secondary market for government papers. Of the total net issue in government securities in 1987, only 20 per cent was of securities with maturities of 12 years and above.

Other measures that were introduced as early as 1960 included the following. Transaction in government securities were exempted from stamp duty and government securities were tenderable as payment for estate duty at par value. To encourage a secondary market, higher rates of commission were made payable to brokers. The growth of the market, however, has depended to a large extent on the captive demand for the securities arising from the legal provisions that require certain financial institutions to invest a minimum proportion of their funds in government securities. The Employees Provident Fund represents the largest single holder of government securities. Under the Employees Provident Fund Ordinance 1951, the Fund is required to invest at least 70 per cent of its investible funds in government securities. Its actual holdings, however, has ranged from 80 to 90 per cent. At the end of 1987, holdings of government securities by the Provident Fund accounted for 57 per cent of the total securities outstanding. In recent years, however, the Provident Fund has moved to diversify its portfolio and reduce the proportion of government papers to higher yielding instruments.

The commercial banks, finance companies and merchant banks are also required to hold a certain proportion of their eligible liabilities in the form of specified secondary liquid assets, the major component of which is in government securities. The National Savings Bank is required to hold 65 per cent of its assets in government securities. Under the Insurance Act 1963, government securities are made eligible as authorised assets to meet their minimum Malaysian assets requirements. The discount houses in turn are required to invest at least 85 per cent of the call deposits in government securities with maturities of up to three years.

As noted earlier, the rate of return on government securities is regulated by the government and have, in general, been relatively lower than other comparable instruments. The rates while infrequently adjusted have, over the years, shown a slowly increasing trend. The rates have only been reduced twice over the 30-year period. Once, at the beginning of 1977, when the rates on all securities issued, with the

exception of maturity of 15 years were reduced by one-third to one half percentage point and in early 1987 when the rates were progressively reduced reflecting the general decline of interest rates in the financial system. During the period 1980-82, the coupon rates on government securities continued to increase again in line with the general increase in interest in the country. Thereafter, the rates remained unchanged until early 1987 when the rates were progressively reduced reflecting the general decline of interest rates in the financial system.

2. The Private Corporate Bond Market

Although a market for corporate bonds exists in Malaysia, the market besides being rather small and inactive, is dominated by a primary issue market with little or no secondary trading activity. Most original subscribers of the bonds hold the bonds until maturity. Despite inactive trading of bonds, the coupon rates payable is generally higher than the rates for government securities. The first corporate bond issued was the Arab Malaysian Finance (AMF) bond in 1980. Since then, there has been greater interest in bonds issue. The issue of Cagamas (the national mortgage corporation) bonds in 1987 marks a significant development and augurs well for the secondary bond market. By mid-1988, Cagamas had made three bond issues for a total of M\$900 million worth of unsecured bearer Cagamas bonds. Their bonds are traded through a principal dealer network. In addition, MIDF made its first bond issue of M\$50 million in September 1988. The lifting of all stamp duties on corporate bonds in the 1989 Budget seeks to activate the secondary market.

A number of factors have contributed to the slow development of the corporate bond market. On the supply side, the number of large, well established firms with a track record that are in a position to issue saleable bonds remains small. Further, such firms generally have access to alternative means of financing. More specifically, such firms are generally the prime customers of commercial banks and therefore have access to borrowing at reasonable rates. In particular, during periods of relatively low interest rates, borrowing from the banking sector represents a relatively more attractive alternative. Such large firms are also in a position to issue equity shares. The slow development of the corporate bond market is largely because of the high transaction cost of issuing and trading in corporate bonds. Until the 1989 Budget, a high stamp duty and brokerage fee was imposed on corporate bonds:

- i) 0.5 per cent of stamp duty on nominal value of the bond for the primary issue;

- ii) 0.3 per cent of stamp duty payable on its sale price in secondary trading;
- iii) 1 per cent of brokerage fee payable by both buyer and seller on the transacted price of the bond.

Meanwhile, the only transaction cost involved in trading of government securities is a brokerage fee of 0.015 per cent. Hence, the high cost of trading in corporate bonds affects its liquidity and marketability. The lack of a secondary market for corporate bonds and its effect on the liquidity of the instrument has had a dampening effect on its demand. Investors, in particular, individual investors are not attracted to such an investment in view of the prospect of substantial capital loss in the event of forced selling when the need for liquidity arose.

The limited demand for corporate bonds has also been a factor contributing to the slow development of the private corporate bond market. A number of factors have inhibited the demand for corporate bonds. The relatively low return on corporate bonds has been a factor that is detrimental to stimulating demand. Unlike shares, there is no opportunity for capital gains given the lack of a secondary market for such bonds. In addition, the existing tax structure requires holders of corporate bonds to pay income tax on the interest income earned in accordance to the normal income tax rate. On the other hand, the holders of government bonds are exempted from payment of income tax on the interest income earned. Moreover, interest income which are derived from deposits of 12-month maturity and above with commercial banks, such as fixed deposits and negotiable certificate of deposits, have so far been exempted from payment of income tax, although the recent Budget (October 1988) tax reforms gave way to a uniform 5 per cent withholding tax on all deposits. However, the overall tax rate can be said to be fairly low. Therefore, the normal tax rate imposed on interest income derived from corporate bonds has had an unfavourable impact on the development of the corporate bond market.

Another factor which has accounted for the slow development in the corporate bond market is institutional arrangements. Certain large institutional investors are required by law or guidelines to invest a substantial proportion of their funds in government bonds. As noted earlier, these include the Employees Provident Fund, the National Savings Bank, the banking institutions and insurance companies. As a result, a substantial proportion of their portfolios are already in the form of bonds, for the most part in long-term bonds. Investment in private corporate bonds would thus have to be made over and above these legal requirements. The scope for such investment remains limited. Further, the maturity profile of the bonds have not been conducive to stimulat-

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ing demand. Investors generally have a preference for maturities at the shorter end, that is, five to ten years as opposed to ten to twenty years. This is especially the case when the secondary market for such bonds is not developed.

Finally, the lack of expertise such as trained dealers capable of trading in bonds, and the lack of technical knowledge on bonds and foreign exchange transactions are also some of the factors which dampened the development of the bond market.

In view of the above factors, the private sector has tended to meet their long-term requirements through financial institutions or by issuing equity. Unlike in Malaysia, bond issues have been a primary source of long-term finance for major established corporations in the U.S., Japanese, West German and British capital markets. However, in Malaysia, corporate bonds can also be viewed as an avenue for investment if the transaction costs for dealing in such bonds are made competitive with that of government and mortgage bonds. There is also a need for investors as well as fund managers to be more professional in their investment decisions, and the need to develop trained manpower in dealing with bonds. □

Table 3.1 MALAYSIA: NEW ISSUES OF CORPORATE SECURITIES¹

	Total Issue	Ordinary Shares						Preference Shares	Debentures/ Loan Stocks	Bond Issue
		Total	Public Issue	Private Placement	Rights Issue	Special Issue ²				
1961	5.6	15.6	15.6	-	-	-	-	-	-	-
1962	34.4	26.9	26.9	-	-	-	-	-	7.5	-
1963	44.3	37.3	25.9	3.0	8.4	-	-	-	7.0	-
1964	41.1	41.4	35.1	2.4	3.6	-	-	-	-	-
1965	4.0	4.0	4.0	-	-	-	-	-	-	-
1966	49.0	36.0	19.6	-	16.4	-	4.0	9.0	-	-
1967	22.6	22.6	22.2	0.4	-	-	-	-	-	-
1968	67.0	67.0	28.4	0.1	38.5	-	-	-	-	-
1969	75.8	75.8	30.6	4.0	41.2	-	-	-	-	-
1970	76.3	74.8	14.5	17.7	42.6	-	1.5	-	-	-
1971	45.0	45.0	6.5	8.5	30.0	-	-	-	-	-
1972	64.9	55.9	21.0	6.7	28.2	-	-	9.0	-	-
1973	77.7	77.7	23.4	8.3	46.0	-	-	-	-	-
1974	85.6	85.6	32.0	4.1	49.5	-	-	-	-	-
1975	76.0	27.7	18.2	-	9.5	-	-	48.3	-	-
1976	51.5	51.5	-	18.8	22.0	10.7	-	-	-	-
1977	119.8	119.8	21.8	-	94.2	3.8	-	-	-	-
1978	99.2	99.2	51.8	2.4	24.5	20.5	-	-	-	-
1979	210.9	210.9	1.7	-	143.4	65.8	-	-	-	-
1980	157.1	137.1	2.1	-	103.2	31.8	-	-	-	20.0
1981	900.4	900.4	103.7	-	599.3	197.4	-	-	-	-
1982	652.7	602.7	196.1	-	286.8	119.8	-	-	50.0	-
1983	1,399.3	1,262.4	182.6	-	644.2	435.6	-	-	136.9	-
1984	2,382.5	1,990.4	174.4	-	1,377.2	438.8	-	-	392.1	-
1985	631.9	631.9	237.2	-	357.4	37.3	-	-	-	-
1986	188.6	188.6	26.0	-	69.6	93.0	-	-	-	-
1987	1,454.8	1,384.8	311.1	76.6	867.6	129.5	-	-	70.0	100.0

¹ Refer to corporate securities issued by Malaysian incorporated companies listed on the Stock Exchange.

² Special issues to Bumiputra investors nominated or approved by the Ministry of Trade and Industry.

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Table 3.2 MALAYSIA: TURNOVER OF SHARES

Year	Turnover	
	Volume (million units)	Value (M\$ million)
1966	169	226
1967	260	420
1968	472	859
1969	587	1,139
1970	455	747
1971	579	934
1972	938	2,156
1973	921	3,329
1974	391	722
1975	617	1,306
1976	432	1,011
1977	598	1,047
1978	1,107	2,539
1979	638	1,641
1980	1,482	5,600
1981	1,636	8,059
1982	1,066	3,253
1983	2,276	7,934
1984	1,852	5,714
1985	2,870	6,181
1986	2,289	3,369
1987	5,286	10,078

Source: Bank Negara Malaysia, *Annual Report*, various issues.

APPENDIX 3.1: MALAYSIA: THE KLSE

A) Objective and Functions¹

1. To provide, regulate and maintain facilities for conducting the stockbroking business in Malaysia.
2. To promote and protect the interests and welfare of the Members of the Exchange.
3. To provide investors service and to promote interests in securities market, and to furnish quotations of share prices transacted on the Exchange.
4. To acquire, publish, circulate and preserve reports, records and useful information.
5. To provide and enact listing requirements and undertakings relating to listed companies, and to enunciate and enforce a code for mergers, takeovers and acquisitions.
6. To communicate and cooperate with chambers of commerce and other mercantile and public bodies throughout the world.
7. To appoint representatives both in Malaysia and overseas, and to retain their services for such duration as may be considered necessary for the purposes of the Exchange.
8. To invest the monies of the Exchange not immediately required for its purposes in/upon such investments, securities or property in Malaysia.
9. To establish a fidelity fund to be kept separate from all other property belonging to the Exchange.
10. The income and property of the Exchange is to be applied solely towards the promotion of the objects of the Exchange.

B) Regulations Governing Member Companies²

1. It must be incorporated in Malaysia under the Companies Act, 1965.

1. Source: Kuala Lumpur Stock Exchange, *KLSE: Rules Relating to Member Firms and Member Companies*.

2. Source: Kuala Lumpur Stock Exchange, *KLSE Listing Requirements*.

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2. Its sole business must be that of a stock broker or dealer in securities. The Memorandum and Articles of Association, and any changes in the contents must be approved by the Committee.
3. It must not go into voluntary liquidation without giving the Committee not less than 30 days advance written notice.
4. Member company with limited liability must have paid-up capital of not less than M\$2 million if it has no Corporate Member as one of its shareholders or a paid-up capital of M\$5 million if it has.
5. Member firms and Member companies must at all times maintain a certain liquid fund for the business:
 - a) not less than M\$100,000 for each partner of a Member firm, or
 - b) an amount that is equivalent to four times the monthly net brokerage earned
6. Every Member company must maintain a trust account and invest its stockbrokers' Trust Funds in accordance with the Act.

C) Listing Requirements³

- I) Companies applying for quotation or ordinary shares are, as a general note, expected to meet the following criteria:
 1. It has a paid-up capital of at least M\$5,000,000.
 2. At least M\$1,250,000 or 25 per cent of the issued and paid-up capital is in the hands of the public and a minimum percentage of the issued and paid-up capital is in the hands of 500 shareholders holding not more than 10,000 shares each and not less than 500 shares each.
 3. Prospectus and other documents can only be issued to the public after it has been approved by the Committee.
 4. Approval must first be obtained from the CIC before listing and quotation of any shares will be considered.
- II) A limited liability company seeking official quotation of loan securities is expected to meet the following requirements:
 1. Has at least M\$750,000 of issued loan securities of the class to be quoted.

3. Source: Kuala Lumpur Stock Exchange, *KLSE Listing Requirements*.

2. There are at least 100 holders of such securities.
3. The securities that are created and issued must comply with the trust deed requirements of the Exchange.

III) As for the foreign companies, the requirements are:

1. Meets the Official List requirements applicable to Malaysian registered companies, approval from CIC, compliance with the Companies Act, 1965, wherever applicable to foreign companies.
2. Maintains a share register in Malaysia or a register of depository receipts or appropriate facilities for transfer registration.
3. Forwards prompt cabled advice to the Exchange of all material announcements by the company (e.g., dividends, new issues and profit figures).

D) Other Information⁴

I) Corporate Disclosure Policy

Guidelines on corporate disclosure include those on:

1. Immediate public disclosure of material information.
2. Thorough public dissemination.
3. Clarification or confirmation of rumours and reports.
4. Response to unusual market action.
5. Unwarranted promotional disclosure.
6. Insider trading.

II) Penalty

The following penalties may be imposed on listed companies for the breach of any provision of the Listing Requirements:

1. Public reprimand.
2. Suspension in the trading of the company's securities.
3. Restrict all dealing in the company's securities to immediate or prompt bargains.
4. Delist the company from Official List.

4. Source: Kuala Lumpur Stock Exchange, *KLSE Listing Requirements*.

E) Cost of Raising Finance via New Issues⁵

1. Pricing

- The pricing of a floatation is normally pitched according to the ratings of the most comparable companies, which are influenced by certain fundamental factors. For a company to be floated or to go public, it has to qualify the price-earnings multiple (P/E) set by Capital Issues Committee (CIC):

- 3.5 – 4.0 – trading/services companies
- 3.5 – 5.0 – property companies
- 4.0 – 5.5 – manufacturing/construction companies
- 6.0 – 8.0 – finance companies
- 8.0 – 12.0 – commercial banks/merchant banks
- 4.0 – 6.0 – transportation companies
- 4.5 – 6.0 – tourism (including hotels)
- 5.0 – 6.0 – plantation companies
- 5.0 – 7.0 – insurance companies

2. Underwriting

- 1 per cent of the amount underwritten (excluding the amount allocated for directors and staff of the company).

3. Sharebroking

- 1 per cent of the amount underwritten.

4. Other fees

- a) Initial listing fee (imposed by KLSE)
 - M\$500 per million ringgit or part thereof of the issued capital of a company, with a minimum fee of M\$2,000 and a maximum of M\$20,000.
- b) Merchant bank fees
 - in excess of M\$100,000 in respect of floatation of a company.
- c) Accountant fee
 - varies depending on the complexity of work and from one auditing company to another.
- d) Issuing house fee (imposed by MIDF)
 - 1 per cent of the public issue amount.
- e) Issuing expenses (imposed by MIDF)
 - 1 per cent of the public issue amount.

5. Source: Corporate Finance, AIM Bankers.

F) Application

1. Applications by individuals must be accompanied by a photocopy of their identity cards and change of address cards (if any);
2. Corporate applicants will have to provide their company registration numbers;
3. The purchaser of the bankers' draft, money order, cashier's order or postal order, unless under exceptional circumstances and at the sole discretion of the board, shall be deemed to be the applicant;
4. The current practice where the board of directors reserves the right to ask the successful applicant to collect the shares certificate by hand at MIDFCCS is also to be changed. The new form states that the board reserves the right to serve the successful applicant with a notice to appear in person at MIDFCCS. The board will not be responsible for any loss or non-receipt of the notice, nor will it be accountable for any expenses incurred by the successful applicant in complying with this clause; and,
5. Applicants must also declare that they are not acquiring the shares as a nominee of another person. The changes in the share application form will deter syndicates and unscrupulous investors from making use of other people's names, without consent, to apply for the shares.

CHAPTER 4

Development of the Capital Market in Nepal

YUBA RAJ KHATIWADA

I. OVERVIEW OF THE EXISTING CAPITAL MARKET STRUCTURE

The history of the capital market in Nepal is a recent one as compared to those of other countries in the SEACEN region. As such, the capital market in Nepal is still at a primitive stage with a few financial institutions and little stock exchange activities. The non-securities market of the country is fragmented into the organized and unorganized parts, with the latter sharing a much larger part of the market. The organized market itself is characterized by fewer institutions and a small portfolio of financial instruments. The securities market is confined mainly to the government securities market and a small underdeveloped stock exchange market.

A. Evolution of the Capital Market

The legal and regulatory framework of the financial institutions emerged with the introduction of the Nepal Rastra Bank Act, 1955 under which Nepal Rastra Bank (NRB), the central bank, was established. Prior to this, only one financial institution, namely, Nepal Bank Ltd. (NBL), was in operation under the NBL Act, 1937. With the establishment of another commercial bank under the Rastriya Banijya Bank Act, 1966 it was felt that two different acts on commercial banking would create regulatory complications. So a single commercial bank act was enacted in 1974. The Finance Company Act, 1985 also came into effect in 1986 although no companies have so far, been registered under this Act.

With the implementation of its first five-year plan in 1956, the NRB was established to achieve the goals as aspired by the plan. But the establishment of the central bank alone was not sufficient to promote trade and industry in a fully agrarian economy, thus the Nepal Industrial Development Corporation (NIDC) was established with a view to promoting private industries in the country whereas the Agricultural Development Bank of Nepal (ADB/N) was entrusted with the responsibility of bringing about dynamism in agricultural development with the provision of capital and credit to this sector. In view of the narrow coverage of the two commercial banks established so far, ADB/N was also authorized to conduct commercial banking activities in the areas not covered by the commercial banking network. Commercial banks were also encouraged to expand their branches in the country to provide, on average, a commercial bank branch to each 30 thousand population by 1985. Accordingly, the financial system witnessed a great ramification of the commercial bank as well as ADB/N branches during the 1970s and early 1980s. To ensure that credit is readily available to priority sectors, Priority Sector Credit Programme was introduced by the Nepal Rastra Bank. To provide modern banking facilities, and create competitiveness among the commercial banking sector, a liberal policy was adopted for the entry of foreign banks in joint collaboration with domestic banks.

With the entry of joint venture banks, the NRB has adopted some deregulatory measures since mid-1980s. Accordingly, some autonomy is granted to the financial institutions in terms of deposit and lending rates; and the liquidity requirement for commercial banks which was to be maintained at 25 per cent of the total deposit liabilities, is also withdrawn.

The evolution for the primary stock market dates back to the enactment of the first Company Act in 1936. However, it was only in 1964 that a new Company Act was enacted with a view to providing a more sound legal base for the promotion of public companies in Nepal. The Securities Marketing Centre was established in 1977 under the Company Act 1964 to promote the securities exchange and this was later replaced by the establishment of the Securities Exchange Centre (SEC) under a new Securities Exchange Act, 1983. The SEC was the single institution established so far under this Act and after the commencement of this Act, no person or body except the SEC is allowed to be involved in exchange of securities.

The legal framework for government securities market was set up with the enactment of the Public Debt Act in 1961. The Act allowed the government to issue stocks, promissory notes, Treasury bills, Bearer

Bonds, Prize Bonds and other securities as prescribed by the Act. The Nepal Rastra Bank was legally authorized for public debt management including the issue, sales and purchases of government securities. The Nepal Rastra Bank Act, 1955 itself also allowed the Bank to issue savings certificates, savings stamps and other securities on the sanction of the government.

The government, since the early 1960s, took the initiative to develop the government securities market. But the secondary market for such securities emerged only with the establishment of the Securities Marketing Centre (SMC) in 1977. Besides creating a secondary market, the provision of lucrative interest rates was also essential for the development of such securities market. So the interest rates on Development Bonds and National Savings Certificates (NSCs) were made more attractive. However, sale of the latter was restricted to the banking system.

B. Structure of the Non-Securities Market

The non-securities market structure in Nepal is characterized by the existence of a few financial institutions, small portfolio of financial instruments, and limited financial intermediation or financial activities. The financial system comprises a central bank, five commercial banks, two development banks, two contractual savings type institutions and a securities exchange centre. Besides, there are some institutions of a financial nature, namely the postal savings scheme, the cooperatives, and the agricultural and industrial service centres.

1. Capital Market Institutions

(a) *Nepal Rastra Bank (NRB)*: The establishment of NRB, the central bank of the country, in 1956 can be regarded as a watershed in the growth of the organized financial system in Nepal. The functions of the NRB as stated in the preamble of the Nepal Rastra Bank Act, 1955 were “to ensure facilities and maintain economic interest of the general public, to regulate the issue of paper money with a view to secure countrywide circulation of the Nepalese currency, and achieving stability in its exchange rate, to mobilize capital for economic development and for the stimulation of trade and industries, and to develop the banking system in the country”¹. Thus the NRB was entrusted with the responsibilities of developing the money and capital markets in the country.

1. Nepal Rastra Bank Act, 1955, unofficial translation, Research Department, NRB.

Moreover, the responsibilities of public debt management and savings mobilization extended to the NRB also helped in the development of these markets in Nepal.

Since the development of an organized financial system was essential for the effective use of monetary policy, the NRB left no stone unturned in the development of the financial infrastructure. Financial assistance to the establishment of the Cooperative Bank, share participation in the capital of the Agricultural Development Bank, the Nepal Industrial Development Corporation, the National Insurance Corporation, the Credit Guarantee Corporation and the Securities Exchange Centre, financial assistance to the commercial banks for the ramification of their branch network and the provision of the Banking Development Board were all geared towards creating a sound financial infrastructure in the country.

(b) *Commercial Banks*: Nepal Bank Ltd. (NBL) is the oldest bank operating before the establishment of the NRB. Another commercial bank namely, Rastriya Banijya Bank (RBB) was established in 1966 under full government capital subscription. These two commercial banks dominated the banking activities for nearly two decades. It was only in 1984 that Nepal Arab Bank Ltd. (NABIL), the first joint-venture bank was established. This paved the way for another two commercial banks to enter the financial system, i.e., Nepal Indosuez Bank Ltd. (NIB) in 1986 and Nepal Grindlays Bank Ltd. (NGB) in 1987. Though the NRB had initiated commercial bank branch expansion programme to provide one commercial bank branch among each 30 thousand population by 1985, rapid population growth followed by a relatively slow expansion of bank branches resulted in 43.9 thousand population per bank in 1985. In July 1986, total commercial bank branches stood at 424 including 32 branches of ADB/N and covered 40.4 thousand population by each bank branch.

(c) *Development Banks*: The Nepal Industrial Development Corporation (NIDC) and the Agricultural Development Bank (ADB/N) are the two most important development banks in the country apart from two rural development banks which have not commenced their operations.

The NIDC was established to promote private sector industrial activities by making available financial and technical assistance to the industrial sector. The NIDC has remained the only institution serving as an industrial development bank in the country. Its equity shares are held by the government and the NRB. Before the establishment of the Industrial Service Centre (ISC) in 1971, the NIDC used to extend technical assistance in the form of preparation and dissemination of industrial feasibility reports, providing consultancy services to potential

investors, and development and management of industrial districts. These activities are, henceforth handed over to the ISC, and the NIDC has now mainly concentrated in extending medium- and long-term loans to industries, equity participation, guarantee of loans provided by the commercial banks to its clientele industries and underwriting equity shares of public limited companies. After the dissolution of the Small Industries Development Corporation in 1972, the NIDC was also involved in the promotion of cottage industries till 1976 when commercial banks took over the business.

ADB/N was established in 1968 incorporating the assets and liabilities of the Cooperative Bank set up in 1963. Its paid-up capital was owned by the government, the NRB, the cooperatives and individuals. ADB/N has been engaged mainly in providing short-, medium- and long-term loans to individuals, the cooperatives and corporate bodies for agricultural development. But the resource problem that ADB/N faced from time to time (mostly solved by borrowing from the NRB) led the NRB to empower it in 1984 to collect deposits through its branches in any area irrespective of whether a commercial bank exists there or not. As at end of July 1980, there were 32 such branches of ADB/N, collecting deposits in the urban areas and providing funds for investment in the rural areas. The role of ADB/N to meet agricultural credit needs expanded further with the establishment of the Agricultural Projects Services Centre (APROSC) in 1971 and the introduction of the Small Farmers Development Project (SFDP) in 1975. These unique innovations ensured therefore a flow of agricultural credit to small and marginal farmers who normally could not pledge collateral to have access to the ADB/N credit.

(d) *Contractual Savings Organizations*: The Employee's Provident Fund (EPF) was established in 1962 under the Employee's Provident Fund Act, 1962 incorporating the provident fund formerly run by the government for its employees. The sources of the EPF comprise of (i) a ten per cent deduction from the monthly salary of the government and corporate employees, (ii) an equivalent amount deposited by each employing agency, and (iii) the interest earned on loans and investments. On the uses side, a large part of the EPF fund comprises time deposits with commercial banks followed by direct loans to individuals and industries and investment in government securities. After the amendment of the EPF Act in 1985, the corporation is diversifying its assets structure towards investment in industrial and services sectors. Notably, the EPF is contemplating investment diversification through promoting housing schemes along with participating in the shares of real estate development projects.

The National Insurance Corporation (NIC) was set up in 1967 as a private limited company under the Company Act 1964 and was later reestablished under the NIC Act in 1968. The major shareholders of the NIC are the government, the NRB and the NBL. Though indigenous insurance activity started in 1946 with the establishment of the Nepal Insurance and Transport Company Ltd., the insurance business was concentrated in the hands of a few Indian insurance companies until the establishment of the NIC. The NIC is involved mainly in non-life insurance business, and life insurance activities were conducted through the Life Insurance Corporation (LIC) of India. Effective from mid-July 1977, the NIC took over the charge of life insurance policies of Nepali citizens from the LIC. Insurance premium has remained the major source of NIC funds and investment in government securities the major use of funds.

(e) *Other Financial Institutions:* The Credit Guarantee Corporation (CGC) was established in 1974 as an organization guaranteeing (for repayment) the loan extended by commercial banks in the priority sectors, with the joint investment of the NRB, NBL and RBB. In 1974, a priority sector lending programme was launched and the commercial banks were urged to advance loans at lower interest rates to small scale agricultural, industrial and service sectors. The CGC was established to provide guarantee against such risk associated with small and rural area lendings and in the event of default, it compensates up to 80 per cent of the loan.

Postal Savings Scheme: Opening of savings accounts in post office was introduced in 1976. Though such a scheme is highly useful in mobilizing the savings scattered in small amounts in rural areas, it has yet to gain momentum in our financial system. Up to the end of 1984/85, there were 75 postal offices operating the saving deposit accounts but the amount collected by them was insignificant.

2. Share Distribution of Total Financial Assets

In view of the premature stage of financial development, the share of the central bank in total financial assets remains a dominant one. In Nepal, the share of NRB assets to total financial assets (FAs) stood at 61.9 per cent in 1970. With the gradual development of other financial institutions, such a share declined to 39.5 per cent in 1980. Since then, the share of NRB assets to total financial assets continued to decline. With the gradual development of the financial structure, the shares of financial institutions other than the central bank have grown faster. This

has been especially evident in the case of commercial banks. The share of commercial banks' assets to total financial assets which stood at 28.2 per cent in 1970 increased to 43.1 per cent in 1980. With the entry of additional commercial banks into the financial system during the 1980s and the increasing scale of intermediation, such a share increased further to 43.9 per cent in 1985.

The share of development banks in total financial assets increased from 6 per cent in 1970 to 10 per cent in 1980. But it could not improve thereafter as the share in 1986 stood at the same level as in 1980.

A major upswing is observed in the assets share of contractual savings organizations. From 3.9 per cent in 1970, their share to total financial assets increased to 7.4 per cent in 1980 and to 9.3 per cent in 1986. The rapid growth of assets of both the EPF and the NIC resulted in such an upsurge in their share to total financial assets. The share of other institutions in total financial assets has been less than one per cent (Table 4.1).

3. Share Composition of Total Deposit

The commercial banks are the major holders of financial deposits in the Nepalese financial system. The other institutions authorized to collect deposits are ADB/N and the postal savings banks. The deposits collected by these institutions, however, constitute a small fraction of the total deposits mobilized. With the permission granted to conduct commercial banking activities to some branches of ADB/N in the urban areas, the share of ADB/N to total deposit collection has somehow improved. From less than one per cent in 1980, its share has increased to 1.8 per cent in 1986.

4. Share Composition of Loans and Investment

The share composition of financial institutions in total loans and investment shows commercial banks always at the fore. Though the share of commercial banks shows a declining trend, from 50 per cent in 1970 to 43 per cent in 1986, the share of the NRB in total loans and investment shows an increasing trend from 28 per cent in 1970 to 35 per cent in 1986. This is mostly on account of the growing amount of overdraft to the government since the early 1980s. The share of development banks in total loans and investments stood at 10 per cent in 1986 (Table 4.2). The share of EPF loans also remained at more than 10 per cent of the total loans and investment throughout the review period.

Table 4.1 NEPAL: TOTAL ASSETS OF FINANCIAL INSTITUTIONS (COMBINED)
(As at Mid-July) In Millions of NRs

Name	Existing Number	1970	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
1) Nepal Rastra Bank	1	1,131	2,232	2,353	2,651	3,124	3,822	4,152	4,607	5,426	6,218	6,934	8,800	11,379
2) Commercial Banks ¹	5	515	1,824	1,998	2,661	3,194	3,907	4,526	5,973	6,229	7,713	8,541	10,583	12,694
3) Development Banks ²	2	110	491	558	710	829	953	1,042	1,109	1,334	1,573	1,890	2,333	2,905
4) Contractual Savings Institutions ³	2	72	244	305	406	508	617	777	965	1,216	1,506	1,862	2,345	2,770
5) Others ⁴	2	-	3	4	5	5	6	6	8	13	15	17	24	28
Total		1,828	4,794	5,218	6,433	7,660	9,305	10,503	12,662	14,218	17,025	19,244	24,085	29,776

SHARE OF VARIOUS FI's IN TOTAL FINANCIAL ASSETS

Name	1970	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
1) Nepal Rastra Bank	61.9	46.6	45.1	41.2	40.8	41.1	39.5	36.4	38.2	36.5	36.0	36.5	38.2
2) Commercial Banks ¹	28.2	38.0	38.3	41.4	41.7	42.0	43.1	47.2	43.8	45.3	44.4	43.9	42.6
3) Development Banks ²	6.0	10.2	10.7	11.0	10.8	10.2	9.9	8.7	9.4	9.2	9.7	9.7	9.8
4) Contractual Savings Institutions ³	3.9	5.1	5.8	6.3	6.6	6.6	7.4	7.6	8.5	8.8	9.8	9.8	9.3
5) Others ⁴	-	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

¹ Excludes Interbank Deposits.

² Agricultural Development Bank and Nepal Industrial Development Corporation.

³ Employee's Provident Fund Corporation and National Insurance Corporation.

⁴ Securities Exchange Centre and Credit Guarantee Corporation.

Table 4.2 NEPAL: SHARE COMPOSITION OF TOTAL LOANS AND ADVANCES¹
(As of Mid-July) Rs in Million

Fls	1970	1975	1980	1981	1982	1983	1984	1985	1986 ^e
NRB	176.3	992.9	1,790.0	2,016.9	2,154.1	3,644.1	4,463.0	5,832.6	7,271.4
CBs	315.4	1,322.0	3,169.2	3,928.0	4,223.3	5,152.4	5,770.5	7,503.8	8,978.3
ADB/N	20.2	247.2	476.4	493.0	585.2	721.5	944.6	1,191.5	1,505.0
NIDC ²	56.0	160.1	299.5	330.2	352.0	367.7	438.9	482.5	549.2
PFC	63.2	215.3	662.9	829.1	1,046.1	1,294.1	1,575.8	1,960.8	2,365.8
NIC	2.6	13.2	62.3	77.2	93.0	118.6	188.1	237.8	259.4
CGC	-	3.0	5.8	6.3	11.4	12.8	11.7	18.1	22.9
Total	633.7	2,953.7	6,466.1	7,680.7	8,465.1	11,311.2	13,392.6	17,227.1	20,952.0

PERCENTAGE SHARE

Fls	1970	1975	1980	1981	1982	1983	1984	1985	1986 ^e
NRB	27.8	33.6	27.7	26.3	25.4	32.2	33.3	33.9	34.7
CBs	49.8	44.8	49.0	51.1	49.9	45.6	43.0	43.6	42.9
ADB/N	3.2	8.4	7.4	6.4	6.9	6.4	7.1	6.9	7.2
NIDC	8.8	6.4	4.6	4.3	4.2	3.3	3.3	2.8	2.6
PFC	10.0	7.3	10.2	10.8	12.4	11.4	11.8	11.4	11.3
NIC	0.4	0.4	1.0	1.0	1.1	1.0	1.4	1.4	1.2
CGC	-	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

¹ Includes investments and inter-financial institutional claims.

² Excludes guarantee for loans.

e = Estimated.

C. Structure of the Securities Market

The securities market in Nepal is still in its infancy stage. The SEC has been engaged mostly in transacting government securities and very little private securities. Although the legislation of the Securities Exchange Act empowered the SEC to resume stock exchange activities, so far, only 22 companies have listed their shares in the SEC, and the transaction of these shares in the secondary market is negligible. Bonds other than those issued by the government are almost non-existent. The undeveloped capital structure of companies in Nepal is such that it is inhibiting the growth of the capital market. Since most of the companies are either fully government owned or private limited in legal status, development of the primary issue market has been thwarted by the limited number of public listed companies.

1. *The Bond Market*

The history of government securities market started with the issuance of Treasury bills in 1962. It was followed by the issuance of the bonds such as Land Compensation Bonds, Forest Compensation Bonds and Development Bonds in 1964, Prize Bonds in 1967, Special Bonds in 1971 and National Savings Certificates in 1984. The SEC from the very beginning of its inception started transacting government securities. Development Bonds and National Savings Certificates (NSCs) are transacted in the secondary market.

The state of the corporate bond market is more discouraging. ADB/N issued debentures for the first time in 1979 and this was followed by the NIDC in 1981. However, these debentures fared low in the secondary market. Till now, the debentures issued by the NIDC and ADB/N are least traded in the secondary market. The NRB has become the ultimate purchaser of these debentures. Recently, Bottlers Nepal had issued debentures at a high (18 per cent) interest rate and these were oversubscribed. Other than these, no corporate bonds have emerged in the capital market.

2. *The Stock Market*

Prior to the enactment of the Securities Exchange Act, 1983, the SEC was mainly engaged in dealing with government securities. With the commencement of this Act, it is mandatory for all the corporate bodies

to list the securities issued and allotted by them. Even the securities issued and allotted before the commencement of this Act will have to be listed within six months after the commencement of this Act. As the definition of securities was widened to include shares, stocks, bonds, debentures, and stocks and loans issued by His Majesty's Government, the SEC, henceforth, got a proper mandate to conduct secondary market for shares. To date, the SEC has remained the sole stock exchange centre in the country.

The government policies in recent years have been geared towards the development of the stock exchange. In 1985, the budget announced an incentive of 5 per cent tax exemption to those companies which were listed in the SEC. In 1986, the tax rate for companies listed in the SEC was revised so that such companies could pay tax at a flat rate of 40 per cent of their net income. Formerly, the corporate tax rate structure was progressive, ranging between 5 – 55 per cent and some high profit making institutions had to pay corporate tax up to 55 per cent of the income.

The Securities Exchange Act, 1983 was the first to make provisions for the legal status of the brokers. However, no brokers are registered in the SEC so far and hence there is an absence of brokerage activities.

II. THE DEVELOPMENT OF THE NON-SECURITIES MARKET

The non-securities market is the dominant part of the capital market in Nepal. The non-securities market has manifested some improvement during the 1970s and more significantly during the first half of the 1980s. Nepal is in the process of revamping the financial system to promote financial development.

A. Mobilization of Domestic Savings

The level of domestic savings in Nepal has remained low. Domestic savings comprised less than 13 per cent of GDP compared with investment of up to 21 per cent during 1975-86 (see Table 4.3). The gap is met by foreign savings. So mobilization of domestic savings has been essential in promoting investment activities, taking into consideration the vulnerability of foreign savings.

In Nepal there is a severe need of capital to enhance investment activities to promote economic development. The investment need is

Table 4.3 NEPAL: GROSS DOMESTIC PRODUCT AND SAVINGS (In Millions of NRs)

	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
Consumption	14,909	15,354	14,948	17,192	19,630	20,760	24,333	28,126	30,703	34,247	37,047	45,135
Public	1,257	1,294	1,260	1,471	1,889	1,565	1,922	2,638	3,416	3,644	4,113	4,760
Private	13,652	14,060	13,688	15,721	17,741	19,195	22,411	25,488	27,287	30,603	32,934	40,375
Investment	2,402	2,632	2,769	3,507	3,514	4,270	4,808	5,098	6,799	7,402	8,636	9,722
Public	505	632	689	1,113	1,138	1,466	1,823	2,487	2,941	3,139	3,543	4,267
Private	1,718	1,811	1,892	2,181	2,125	2,215	2,476	2,762	3,806	3,819	4,605	5,455
Change in Stock	179	189	188	313	251	589	509	-151	52	444	488	-
Net Export of Goods and Non-Factor Services	-740	-592	-437	-967	-929	-1,679	-1,834	-2,236	-3,741	-3,465	-3,945	-4,733
Exports ¹	1,475	1,874	2,037	2,086	2,618	2,695	3,523	3,592	3,455	4,196	5,372	6,488
Imports ²	2,215	2,466	2,474	3,053	3,547	4,374	5,357	5,828	7,196	7,661	9,317	11,221
GDP at Market Price	16,571	17,394	17,280	19,732	22,215	23,351	27,307	30,988	33,761	38,184	41,739	50,124
Net Factor Income from Abroad	267	277	319	291	370	494	587	615	697	625	651	650
GNP	16,838	17,671	17,599	20,023	22,605	23,845	27,894	31,603	34,458	38,809	42,384	50,774
Gross Domestic Savings	1,662	2,040	2,332	2,540	2,585	2,591	2,974	2,862	3,058	3,937	4,691	4,989
Private Savings	2,077	2,423	2,492	2,767	2,997	2,627	2,860	3,289	4,053	4,844	5,653	6,090
Govt. Savings	-415	-383	-160	-227	-412	-36	114	-427	-995	-907	-962	-1,101
Foreign Savings	652	200	-4	444	471	1,102	1,157	1,555	2,991	2,724	3,186	3,732
Gross National Savings	2,283	2,692	3,023	3,216	3,554	3,929	4,512	4,705	5,128	6,265	6,854	7,157
Memorandum Items:												
(As per cent of GDP)												
Gross Domestic Savings	10.0	11.7	13.5	12.9	11.6	11.1	10.9	9.2	9.1	10.3	11.2	10.0
Gross Investment	14.5	15.1	16.0	17.8	15.8	18.3	17.6	16.4	20.1	19.4	20.7	20.7
Gross National Savings	13.8	15.5	17.5	16.3	16.0	16.8	16.5	15.2	15.2	16.4	16.4	14.3

¹ Sum of exports and receipts from services other than investment income.² Sum of imports and payments for services other than investment income.

felt by both the public and the private sectors. Growing public sector expenditure over the years had resulted in the budget deficits of the government. Budget deficit as a percentage of GDP has soared from 1.3 per cent in 1975 to 8.0 per cent in 1986. As a result, the government has to resort mostly to foreign loans to finance its budget deficit. But with the shortage of domestic counterpart fund needed to utilize the foreign loans (generally required to be more than 20 per cent of the project cost), Nepal's utilization of sanctioned foreign aid stood, on average, at less than 60 per cent during the last five years. In this respect, the mobilization of domestic resources has been crucial not only for attaining self-reliance in development activities but also for improving aid utilization capacity.

1. Recent Trends and Structure of Domestic Savings

The sluggish growth of GDP and the relatively higher income elasticity of consumption (1.02 for 1975-86) led to the slow growth (10.5 per cent per annum) in domestic savings in nominal terms. From 10 per cent in 1975, domestic savings as a percentage of GDP rose to 11.1 per cent in 1980 and further to 11.2 per cent in 1985. In 1986, it stood at 10 per cent, at the same level of 1975. Of this, private savings increased from 12.5 per cent in 1975 to 13.5 per cent in 1985 and government dissaving decreased from 2.5 per cent in 1975 to 2.3 per cent in 1985.

From the breakdown of gross domestic savings, it is observed that private domestic savings is growing steadily whereas government domestic savings has remained negative throughout the last decade. The development of the financial infrastructure and the ramification of banking network in particular has helped to mobilize a higher level of private savings. However, in real terms the growth of domestic savings has been minimal. The gradual shifting of economic activities from agricultural to non-agricultural ones (industry, service and trading) has also promoted non-agricultural savings. For the government sector, the level of consumption which could not be offset by the growth in tax revenue resulted in dissavings during the period 1975-86. While the average growth of government revenue during the period was at 13.7 per cent per annum, expenditure also recorded an average growth of 13.3 per cent per annum. Therefore, the government remained in a position of dissaving throughout the review period.

As noted earlier, financial savings have been emerging as the most important part of gross domestic savings. As the degree of monetization is low in Nepal, currency, savings and time deposits serve as major

forms of savings. Financial savings comprise more than 50 per cent of domestic savings if insurance and provident funds are included. In the total financial savings, the share of commercial banks is the largest. But the growth of insurance and provident funds is surpassing the growth of commercial banks deposits. Of the financial savings, deposits with the banking system increased at a compound rate of 19.1 per cent between 1970-1986 whereas provident fund increased at a rate of 40.6 per cent during the same time.

The emergence of new financial instruments, *inter alia* has stimulated financial savings during the review period. The initiation of life insurance activities by the NIC and wider coverage of EPF activities have also contributed to the rapid rise in savings.

A major breakthrough in financial savings mobilization was observed in 1975 when interest rate was substantially revised. Henceforth, the deposit rates on savings deposits and one-year fixed deposits were raised from the level of 5 per cent and 7.5 per cent to 8 per cent and 15 per cent, respectively. As a response to such a financial liberalization, time deposits with the commercial banks increased remarkably. In 1985, some liberal steps regarding deposit rates were adopted. Accordingly, commercial banks were empowered to offer higher interest rates on savings and fixed deposits by up to 1.5 percentage points and one percentage point respectively above the minimum rate prescribed by the NRB. The policy was liberalized further in May 1986 when the maximum limit of the deposit rates were lifted. With this, the financial institutions needing more resources have become free to offer higher interest rates to depositors to capture a larger share of the savings.

The drive towards financial deregulation, the establishment of commercial banks with foreign collaborations, and the gradual inception of modern banking technology has promoted competition in the financial system. As a result, the financial institutions offer higher deposit rates on time deposits with easy terms and conditions of withdrawal. Besides, the role of non-bank financial institutions in mobilizing financial savings is gradually emerging. ADB/N enhanced its deposit collection by opening commercial banking branches in some of the advanced urban areas and by initiating mobile banking services in rural areas. Similarly, the handling of life insurance activities by the NIC along with the expansion of business activities in the country has generated higher savings in the form of insurance premium. More encouraging has been the growth of provident funds. The other financial institutions which have a role in savings mobilization are the Post Office Savings Bank (POSB) and the SEC. However, the deposit collected by the

POSB is negligible and the role of the SEC in this regard is yet to be strengthened.

2. Role of the Unorganized Sector in Savings Mobilization

The unorganized sector also plays a great role in savings mobilization in Nepal. Despite the efforts to expand commercial banking network throughout the entire country, there were only 392 commercial bank branches in July 1986 providing on average one bank service to around 44 thousand population. In the wake of uneven distribution of bank branches in the rural and urban areas, the unorganized money market which bears an exorbitantly high interest rate on credit has been equally active in mobilizing rural savings to fulfil agricultural credit need in the rural areas of the country.

3. Government Policies and Strategies in Mobilization of Domestic Savings

From the very beginning of the planned development period, the government has realised the role of internal resources for financing development activities. The government in this regard has been making efforts to mobilize domestic savings. In general, the national policies and programmes such as expansion of financial institutions, introduction of contractual savings schemes, interest rate policies, tax and other incentives, introduction of new schemes for deposits and campaigning, and other informal arrangements for savings mobilization have been somewhat helpful for the mobilization of domestic resources. The following are the measures undertaken by the government to mobilize domestic savings.

(a) *Institution Building and Branch Expansion Policy*: National policies to encourage savings mobilization were initiated with the establishment of the NRB in 1956. At first, the NRB indulged in widening the circulation of domestic currency (and removing Indian Rupee from circulation) and in maintaining the stability of the exchange-rate between NRs and the Indian Rupee. Since the late 1960s, the emphasis had shifted towards the expansion of banking services, promotion of an organized financial system, and the use of monetary and credit instruments to promote resource mobilization in the country. In spite of the fact that the NBL, the oldest commercial bank in the country, had been operating prior to the establishment of the NRB, its coverage in terms of both

area and activities was very limited. So, another commercial bank, the RBB, was established in 1966 fully under government subscription. Thereafter, these two commercial banks dominated the commercial banking industry in the country for nearly two decades. With the entry of the Nepal Arab Bank Ltd. (NABIL), the first commercial bank with foreign collaboration in 1984 and subsequent establishment of two other such commercial banks, namely the Nepal Indosuez Bank (NIB) and the Nepal Grindlays Bank (NGB) in 1986 and 1987 respectively, the number of commercial banks has reached five, with 406 branches as at end of April 1987.

(i) **Branch Expansion Policy:** With the establishment of the RBB in 1966, ramification of the banking network was activated to bring more economic activities into the sphere of monetization, and to channel small and scattered savings towards the banking system. A Banking Promotion Board was set up in 1970 with the objective of providing at least one commercial bank branch in each of the 75 districts in the country. The NRB came forward to compensate any loss incurred by the banks on account of opening new branches in the areas recommended by the Board. A certain amount of operating capital was also provided for those banks operating under this scheme. By 1976/77, the service of at least one commercial bank branch was made available in each district of the country. After a gap of three years, the policy of providing one commercial bank branch to every 30 thousand people by 1984/85 was promulgated with the inception of the Sixth Plan in 1980. However, as the goal was too ambitious, the number of population per bank branch stood at 44 thousand in 1984/85. The same target has been set for the Seventh Plan (1985-90).

(ii) **Establishment of Term Financing Institutions:** The establishment of the NIDC in 1959 was a watershed in the field of term financing. Although it did not collect deposits, it helped to mobilize private sector idle savings in industrial ventures. The establishment of the Cooperatives Bank in 1963 and the provision of compulsory savings with the enactment of the Land Reform Programme became helpful in mobilizing rural savings until the establishment of ADB/N in 1968. ADB/N was responsible for supplying long- and medium-term credit to agriculture along with accepting deposits in those areas not covered by the commercial banks.

(b) **Contractual Savings Scheme:** The EPF, established on government initiative was the first financial institution to mobilize contractual savings. Its activities expanded gradually to cover the provident funds of organized corporate and private sector employees along with the civil servants. The NIC, the other institution of this nature, was established

with the major share coming from the government. After it resumed life insurance activities in 1977, insurance premiums have been growing steeply.

(c) *Interest Rate Policy*: Interest rates in the Nepalese financial system are administered by the NRB, although some autonomy has been granted to the financial institutions themselves in the recent years. But revisions on interest rates are generally in line with government policies and programmes. To support the view that positive real interest rate is essential for savings mobilization, the NRB adopted a high interest rate policy since the early 1970s. However, the landmark step was taken in 1975 when interest rate on savings deposit was raised by 3 percentage points and one-year and two-year fixed deposits by 7.5 and 8.5 percentage points respectively. In this way savings deposits, one-year and two-year fixed deposits fetched interest rates of 8 per cent, 15 per cent and 16 per cent, respectively. One-year and two-year fixed deposit rates were, however, lowered to 12 per cent and 13 per cent respectively in 1977. The structure of deposit rates did not change until June 1982 when the rates on savings, one-year and two-year deposits were raised by half of a percentage point. Effective from 29 May 1986, the NRB adopted a more liberal interest rate policy by allowing the financial institutions to determine the interest rate structure on their discretion which should be, however, not less than the minimum rates prescribed by the former. Thus, the financial institutions have gained more freedom to mobilize savings and allocate these savings.

(d) *Tax and Other Incentives*: Tax on interest income on bank deposits was introduced in 1977/78. Previously, interest income used to be included in other incomes to assess net taxable income. This arrangement not only tapped at sources but also created progressive rate structure of the tax on interest income. The rates ranged from 5 per cent for income up to Rs 3,250 above the exemption limit (Rs 1,000) to 20 per cent on the amount above Rs 6,500. In 1980/81, the slab system of taxing interest income as well as the exemption limit were withdrawn and a flat tax rate of 5 per cent on all slabs of interest income was introduced. But for persons having interest earning as the only source of income, exemption was allowed as per the provision on personal income tax law.² In 1986/87, a progressive rate structure was introduced for taxing interest income on fixed deposits. After a year's experience, the previous flat rate system has been reintroduced. There are no taxes on insurance premium and provident funds. The exemp-

2. Krishna B. Hamal and Mukti P. Upadhyaya, "Rural Savings Mobilization in Nepal" *The Economic Journal of Nepal*, Vol. 9, No. 3, p. 62

tion on insurance premium was finally withdrawn in July 1986. However, as the tax rates on property are also low, people have a greater tendency to hold savings in the form of real estates rather than financial assets.

(e) *Policies and Programmes in the Informal Sector:* A compulsory deposit scheme was launched in 1965 along with the implementation of a land reform programme. It required compulsory deposits by farm households in the form of a certain portion of their farm income in cash or kind. Although the scheme mobilized a sizeable amount of deposits, mismanagement, improper book-keeping and insecurity of the deposits resulted in the failure of this scheme after a few years of its implementation.

Another form of savings mobilization in the non-financial sector is through group-savings scheme under the Small Farmers Development Project (SFDP). The SFDP initiated in 1975 has spread, with 250 offices in 60 districts of the country. The savings collected under the group-savings scheme is also encouraging. The savings collected both in cash and kind can be regarded as contingency funds to meet the urgent credit needs as well as the production cost of the contributing members.

In summary, the supply of financial savings has been responsive to the incentive offered to the savers. Moreover, with the consolidation of fragmented financial markets and ramification of the financial network, the savings scattered in small amounts have been accumulated in the financial system. The growth of financial resources has, in turn, helped in the development of the financial intermediaries, as the expanded resource base has induced them to intensify the process of financial intermediation along with the innovations of new financial instruments.

The source of savings came mainly from the private sector. Of the total deposits collected by the banking system, about 70 per cent goes to the individual savers. Such deposits, particularly the fixed deposits, are highly affected by the interest rate offered on such deposits. Empirical studies reveal that fixed deposits are highly responsive to the expected rate of return on them.³ Higher savings generated in the non-bank financial institutions are, however, the result of expanding private as well as public sector activities. Growth of insurance and provident funds is mainly the outcome of wide coverage of their activities as well as expanding business activities. Accumulation of large savings has forced the financial institutions to engage in capital market activities.

3. *The Demand for Money in Nepal*, Research Department, Draft Report, 1987.

B. Allocation of Financial Resources

Apart from mobilizing funds, the role of the capital market is to channel these funds for productive uses. In the case of the non-securities market, financial intermediaries perform the financial intermediation through which various financial instruments are used to allocate funds. In Nepal, the commercial banks, the NIDC, the ADB/N and contractual provident and insurance funds play an important role in allocating funds. This section will discuss the ways the government, the corporate sector and the priority sector are financed.

1. Financing the Government Sector

The conventional methods of financing public expenditure are revenue and foreign grants. But, as mentioned earlier, the growth of these resources has been lagging behind the growth of expenditure, thus resulting in a widening budget deficit. The methods practised for financing the deficit are external loans, internal loans and drawdown of reserves. Of the internal sources, the issue of Treasury bills and Development Bonds, and overdraft from the NRB have been used to raise loans. Most of such securities were held by financial institutions, particularly the banking system. In 1984, National Savings Certificates were also issued to raise funds from the non-banking system. However, most of these certificates were again held by financial institutions, namely, the EPF and the NIC. The share of financial institutions in holding total government securities outstanding has been substantial, ranging between 90 per cent to 95 per cent during 1975-86 (Table 4.4). In addition to the issuance of securities, the government also increasingly relies on the NRB overdraft facility to meet the resources gap since 1982. As the returns on Treasury bills and Development Bonds are less attractive to private sector investors, most of these tend to be held by the financial system. Therefore, financing of the budget deficit from internal loans automatically implies borrowing from the financial system.

The alternative source of financing the deficit by drawing down the internal reserves can no longer be used as government reserves has been depleting after 1984. Sometimes, the financing of government deficit has been at the cost of allocating resources to the needy financial institutions, particularly the term-lending ones. The issuance of National Savings Certificates by the government has diverted the investment portfolio of the EPF and NIC towards these certificates from time deposits at the banks whereas some private savers also preferred these

Table 4.4 NEPAL: PATTERN OF HOLDINGS OF GOVERNMENT SECURITIES
(Outstanding As of Mid-July) In Millions of NRs

	1970	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
Treasury Bills	-	50	150	350	490	590	670	420	620	1,000	1,830	2,830	3,080
Held by Fls	-	50	150	340	490	590	664	413	614	987	1,775	2,806	3,073
Of which: NRB	(-)	(50)	(150)	(139)	(490)	(565)	(646)	(413)	(405)	(839)	(1,775)	(2,607)	(3,004)
Held by Non-Fls	-	-	-	1	-	-	6	7	6	13	55	24	7
Development Bonds	57	327	370	450	530	600	650	850	1,100	1,670	1,810	2,010	2,290
Held by Fls	33	265	298	362	438	503	558	758	994	1,552	1,728	1,948	2,185
Of which: CBs	(17)	(100)	(121)	(270)	(351)	(347)	(354)	(325)	(432)	(1,013)	(1,483)	(1,819)	(1,771)
Held by Non-Fls	24	62	72	88	92	97	92	92	106	118	82	62	105
National Savings Cert.	-	-	-	-	-	-	-	-	-	-	500	1,000	1,500
Held by Fls	-	-	-	-	-	-	-	-	-	-	377	779	1,186
Of which: EPF	-	-	-	-	-	-	-	-	-	-	(185)	(356)	(447)
Held by Non-Fls	-	-	-	-	-	-	-	-	-	-	123	221	314
Special Bonds	-	-	-	-	-	-	-	-	-	-	-	-	-
Held by NRB	60	222	217	208	199	200	177	168	174	203	197	192	320
Forest Compensation Bonds	-	-	-	-	-	-	-	-	-	-	-	-	-
Of which: EPF	6	6	6	6	6	6	6	6	6	6	-	-	-
Individuals	4	4	4	4	4	4	4	4	4	4	-	-	-
Total Securities	125*	605	743	1,014	1,225	1,396	1,503	1,444	1,900	2,878	4,337	6,032	7,190
Held by Fls	98	541	669	923	1,131	1,297	1,403	1,343	1,786	2,746	4,077	5,725	6,764
Held by Non-Fls	27	64	74	91	94	99	100	101	114	132	260	307	426

* Includes Land Compensation Bonds.

securities instead of bank deposits. However, the holding of government securities by the non-financial sector has been negligible.

2. Financing the Corporate Sector

The demand for loanable funds from the corporate sector is high on account of various reasons. Firstly, most of the corporations are running at a loss requiring capital to compensate for the loss. Secondly, most of the corporations are operating in a situation of under-capacity utilization and their sales have been insufficient to meet the overhead cost. Thirdly, some of the public enterprises are marketing their goods and services at government-administered prices which are insufficient to meet their operational costs. And lastly, new enterprises are entering into the economy with some existing ones expanding their plant capacities. These enterprises require both fixed as well as working capital.

The sources of capital of the corporate sector are equity, long-term loans including foreign loans on government guarantee, subsidies or grants from the government or donor agencies via the government, reserves, and depreciation funds. Of the total financial resources, equity capital has constituted the major share followed by long-term loans. The long-term loans are mostly obtained from the government, ADB/N and the NIDC whereas short-term loans are obtained from the banking system. However, the loans of the banking system are not completely short-term, they are often of the medium- and even of the long-term nature. The credit extended by the banking system to the public enterprises increased with an annual growth of 15 per cent during 1975-86.

From 1971 through 1979, the equity/debt ratio measured by the ratio of equity to long-term loans ranged between 1.7: 1 to 3.6:1. It shows that equity capital has remained the major source of financing corporate activities. The ratio which stood at 1.9:1 in 1971 increased to 2.2:1 in 1986 with large oscillations during the mid-1970s (Table 4.5).

3. Financing of Priority Sectors

The priority sectors in Nepal comprise agriculture, industry and specified services. To promote the priority sector, commercial banks were directed to invest at least 5 per cent of their deposit liabilities in "small sectors" in 1974. Small sectors included agricultural, cottage and

Table 4.5 NEPAL: COMPOSITION OF FINANCIAL RESOURCES OF THE PEs (In Millions of NRs)

	1971	1972	1973	1974	1975	1976	1977	1978	1979
1) Equity Capital	341	462	536	612	1,004	1,353	1,645	1,857	2,083
HMG	322	430	502	568	939	-	-	-	-
Private Parties ¹	19	32	34	44	65	-	-	-	-
2) Long Term Loans	187	199	308	359	288	529	634	881	1,019
3) Subsidy and Grants	7	8	15	16	24	17	18	21	157
4) Reserve Fund & Depreciation	50	68	93	118	146	-	-	-	-
5) Undistributed Profit/Loss	-18	-29	-36	-42	-54	-	-	-	-
Gross Financial Investment	567	708	916	1,063	1,408	2,400	3,936	3,482	4,110
Total Net Financial Investment	543	674	872	997	1,332	-	-	-	-
HMG's Financial Assistance	536	664	860	977	1,302	-	-	-	-
Value Added	110	108	138	164	282	312	395	420	501
Capital Employed	637	774	987	1,192	1,495	1,814	2,204	2,569	2,864
Net profit after tax	13	13	19	26	11	-27	22	14	-15
Return on Capital Employed (%)	5.9	4.5	4.2	3.5	3.7	2.0	3.5	3.0	2.6
Equity/Loan Ratio ²	1.9:1	2.4:1	1.8:1	1.7:1	3.6:1	2.6:1	2.6:1	2.1:1	2.1:1

¹ Includes public enterprises² Equity includes subsidy and grants also.

Source: C.C.C., Ministry of Finance, HMG/N

small scale industrial and service businesses. Such a provision was raised to 7 per cent in 1977. However, the commercial banks failed to comply with this provision. The establishment of the CGC to guarantee bank credit invested in such areas was also of little help in stimulating resources towards such sectors. So the priority sector programme was revitalised in 1981 with the introduction of the Intensive Banking Programme. As per this programme, effective from October 1982, commercial banks were directed to invest at least 10 per cent of their deposit liabilities in these sectors. However, due to the lack of experience in non-traditional investment activities, commercial banks could not comply with this provision. To streamline the programme with more realistic provisions for bank lending in priority sectors, commercial banks in 1984 were directed to invest at least 25 per cent of their total credit in productive sectors including 8 per cent in the priority sectors. The definition of productive sector credit included credit extended to all activities specified under priority sector programme, credit extended to small, medium and large industries, export bills and pre-export credit and investment in shares and debentures of government, semi-government or private sector agro-business, insurance, godown, banking business and other industrial concerns. Table 4.6 shows commercial bank credit to the priority sectors.

The rationale behind the implementation of the priority sector credit programme were enhancement of production and productive employment, transformation of collateral backed lending practices of commercial banks towards project based lending, provision of adequate bank credit to small farmers and entrepreneurs, and ultimately, relief to these people from the exploitation of local moneylenders.

C. Issues and Problems

The lending activities of the commercial banks are still of short-term nature. The permission for the commercial banks to invest up to a period of 12 years and rapid growth of time deposits with banks have created a sound base for long-term investment and lending. But, most of the capital market activities of the commercial banks are concentrated in investing on government securities and in equity participation of a few companies. Their contribution to the long-term capital needs of the private sector has been minimal. Despite the longer term nature of their deposit liabilities, commercial banks are confined to short-term lendings. Therefore, the term transformation process is yet to gain momentum. Even then, the commercial banks in Nepal have been

Table 4.6 NEPAL: COMMERCIAL BANK CREDIT EXTENDED TO PRIORITY SECTORS (In Millions of N. Rupees)

Mid-July	Total Deposits*	Credit Extended to							
		Total Credit	Agriculture	Industry	Services	Total	Required Disbursement¹	Percentage of 7 to 2	Percentage of 7 to 3
1	2	3	4	5	6	7	8	9	10
1977	1530.5	1,153	18.8	19.9	31.7	70.4	107.1	4.6	6.1
1978	2055.1	1,722	60.5	31.9	35.5	127.9	143.9	6.2	7.4
1979	2405.8	2,186	55.6	44.9	35.3	135.8	168.4	5.6	6.2
1980	2902.2	2,673	61.4	53.1	47.5	162.0	203.2	5.6	6.1
1981	3329.7	3,579	67.3	60.4	38.4	166.1	233.1	5.0	4.6
1982	4143.2	3,140	57.1	57.2	41.7	156.0	290.0	3.8	5.0
1983	4907.0	3,384	74.0	81.0	19.4	174.4	490.7	3.6	5.1
1984	6286.5	3,526	119.5	138.6	31.0	289.1	628.7	4.6	8.2
1985	8536.1	4,532	129.8	262.8	37.5	430.1	362.6	5.0	9.5
1986	10275.7	5,974	162.3	347.0	48.7	558.0	477.9	5.4	9.3

* Total deposits exclude inter-bank deposits and margin deposits up to 1979, and exclude only inter-bank deposits thereafter. The deposit which serve as the base for required minimum credit to priority sectors are (as shown here) deposits at the preceding year's mid-July.

¹ 7 per cent of total deposits up to 1982, 10 per cent of total deposits up to 1984, and 8 per cent of total credit thereafter.

competitive in some lending areas such as agriculture and industry with term lending institutions like ADB/N and the NIDC. The scope for private investment created by the SEC by providing secondary market for securities has diverted some private sector resources towards these ventures which could otherwise go to the banking system in the form of time deposits. This has compelled commercial banks to be more conscious in mobilizing additional savings. Along with this, the entry of new commercial banks with foreign collaborations has enhanced competitiveness within the commercial banking system itself.

The Employee's Provident Fund which can play an important role in capital market activities has been legally restricted to invest mainly in government securities and shares of industries and the housing sector. If the EPF is allowed to establish industries on its own initiative subject to gradual hand-over of their shares to the public, it would stimulate capital market activities. Similarly, up to now, commercial banks are allowed to invest up to only 15 per cent of their total deposits as long-term credit; such a limit has hampered the growth of domestic capital market.

Though demand for loanable funds has remained high in Nepal, most of such demand stems from consumption needs rather than investment. Of the total credit extended by the financial institutions, more than two-thirds is estimated to have gone for consumption purposes.⁴ Such a trend is generally detrimental to growth of the capital market. The excess credit demand for imports and other consumption purposes and subsequently the need for credit control measures to be opted for by the NRB in the wake of resource scarcity in other sectors has sometimes adversely affected the smooth functioning of the financial institutions. The major problem is rooted on the dualistic nature of economic development. The domestic sector, particularly the real sector of the economy, is not growing satisfactorily as compared to the growth in the external sector. External trade as a per cent of GDP increased from 16.3 per cent in 1975 to 25 per cent in 1986. The growth of GDP stood at 10.6 per cent in nominal terms and 3.2 per cent in real terms during 1975-86 whereas the nominal growth of the external sector stood at 14 per cent during the period. Of this, the growth of imports (14.7 per cent) was higher than the growth of exports (12 per cent). The unbalanced expansion of the internal and external sectors has lured financial resources towards the external sector and control of such trade financing credit has sometimes been necessary to prevent the foreign exchange reserves from going out of the country.

4. The SEACEN Centre, *The Financial Structure and Its Implications for Monetary Policy in the SEACEN Countries*, 1986, p. 237.

The unbalanced growth of the internal and external sectors has adversely affected the allocative efficiency of bank credit. The rates of return on all forms of domestic investment are apparently unattractive compared to the return on trading business (on sophisticated luxury and consumption goods) although the contribution of the latter on economic growth is insignificant. Low demand for financial resources from the productive sector as well as apathy of the institutions towards risk-prone rural financing has led the authorities to innovate ways to overcome these constraints. Along this line, the Intensive Banking Programme was initiated to assess credit requirements for all genuine activities in a specified area, provide project loans and supervise the credit to prevent the misuse of credit. But the response of the commercial banks to this programme remained rather unsatisfactory, and the apathy of the banks towards such financing could not be corrected by the establishment of the CGC also.

Even though the interest rate policy during the last decade was successful in mobilizing resources at a higher rate, it was not true in the case of credit allocation. Banks were often found reluctant to extend credit to the non-trading sector and they had to divert their resources towards purchasing government securities. Although this enlarged the market for relatively low-yielding government securities such as Treasury bills and Development Bonds, the allocative efficiency of the bank was distorted.

The political and bureaucratic influence is equally important in the development of the financial system. But, this has not always been congenial to the smooth functioning of the financial institutions. Besides, most of the financial institutions are enjoying monopoly in the credit market and poor service of the institutions can be taken as the outcome of monopoly power enjoyed by them.⁵

III. THE DEVELOPMENT OF THE SECURITIES MARKET

A. The Stock Exchange and Its Legal Framework

Stock exchange activities in Nepal has a most recent history among the countries in the SEACEN region. It was only with the enactment of the Securities Exchange Act, 1983 that the Securities Exchange Centre

5. Ibid, p. 229.

resumed stock exchange activities. Although the SEC was formerly working under the name of Securities Marketing Centre (SMC), the functions of the SMC were concentrated on bond market activities (mostly transacting government securities). In the absence of a proper mandate, the centre had not been able to conduct stock exchange activities. The Securities Exchange Act, 1983 therefore empowered the SEC to function as the only stock exchange centre in the country.

The initial capital of the SEC comprised the shares of the NIDC and the NRB. In 1982, the government also participated in its share capital. The board of directors of the SEC consists of representatives from the shareholders, two each from the NIDC and the NRB and one from the Ministry of Industry on behalf of the government. The management and regular activities of the SEC are conducted through the board of directors and the general manager.

1. Legal and Regulatory Framework

After the commencement of the Securities Exchange Act, no person or body except the SEC or broker through the SEC, is allowed to be involved in exchange of securities. Notwithstanding these provisions, no corporate bodies will be allowed to function as the Securities Exchange Centre if the establishment of the centre is not felt necessary on account of the existing state of industrial enterprises and the volume of exchange. Besides, any person or body, wishing to be involved in securities activities as a broker, has to submit an application for a licence to the SEC. It is only after the issue of the licence by the SEC that any person or body can perform brokerage activities.

Any securities issued and allotted by the corporate body requires compulsory listing in the SEC and thus exchange of securities not listed in the SEC is illegal.

The Administrative Ministry supervising the SEC (presently Ministry of Industry) may appoint up to two directors in the Board of Directors of the SEC, issue necessary orders or directives to the centre in the light of the monetary and financial situation of the country and inspect the activities of the centre directly or authorize the NRB or any other authority for inspection. It is obligatory for the SEC to submit to the concerned office quarterly and annual reports relating to its activities. Similarly, the brokers have to submit to the SEC the annual reports of their activities. Besides, the corporate bodies whose securities are listed in the centre have to submit data, information or statements which are related to securities and demanded by the centre. If it is deemed neces-

sary for the welfare and the interest of investors, the centre may suspend the exchange of any securities upon giving notice to the concerned office.⁶

2. Operations and Trading Practices

The financial instruments transacted in the securities market are shares of public companies, National Savings Certificates, National Development bonds, and Treasury bills issued by the government and the debentures of the public companies. Prior to the commencement of the Securities Exchange Act in 1983, the SEC (then SMC) was entrusted with the task of developing the secondary market for government securities only. So the centre was directly involved in transacting such securities, not only mediating between the seller and the purchaser but also itself selling and purchasing these securities. Presently, the SEC is involved in transacting companies' shares, providing financial consultancy services, and promoting new issue market.

Any public company desiring to raise capital by public issue and allotment of its shares through the SEC has to float at least 15 per cent of the required capital in the market. Any company desiring to float shares through the SEC should have already built up basic infrastructures of the company's establishment. The centre charges service fee ranging between 1.25 per cent to 2 per cent of the total issued capital depending upon its volume. The company can allot the shares only after consulting with the SEC in case the amount issued in public is over-subscribed. The companies willing to issue shares at prices more or less than the face value of the shares should consult the SEC prior to the issue of such shares. The face value of the shares floated through the SEC should not be more than Rs 100 per share. The sales period of such securities should be for a minimum of one month. However, if the floated shares are over-subscribed, the collection of applications can be closed after a minimum period of seven days. Generally, two weeks prior to the date of accepting applications for the shares, the companies willing to sell their shares should publish the summary of their prospectus in wide circulating newspapers so that all the potential investors could get the opportunity to invest. The companies seeking underwriting service from the centre have to submit related documents to the SEC and it is under the discretion of the latter whether to provide underwriting services to such companies or not.

6. SEC, Securities Exchange Act, 1983.

Any investor willing to purchase the shares of a particular listed company has to apply to the SEC mentioning the maximum price offered for the shares. Along with this, money equivalent to 10 per cent of the total amount offered for the shares should be deposited in the account of the SEC. This offer remains effective for three days. In case the shares do not become available, the investor can renew the offer or withdraw the deposit. If the deposited amount remains overdue, the SEC provides interest at the rate equivalent to Treasury bill rate (5 per cent at present). Similarly, shareholders willing to sell their shares have to submit their certificates of the shares mentioning the minimum price sought for the shares and the duration of the sales offer. The SEC tries to ensure the real price of the shares complying within the limit offered by the seller and the purchaser. After consent is given on the price, the whole amount needed to purchase the shares should be deposited with the account of the centre. The latter, in turn, pays the amount to the seller of the shares after the hand-over of ownership. For this intermediation, the centre charges 1 per cent commission from both the seller and the purchaser.

If a public company has to float its shares or if the old shareholders have to sell their shares in the market for the first time, the SEC often analyzes the financial performance, and the future prospect of the company on request of the concerned parties and suggests what the market price of the shares could be. The SEC, in its notice board, puts down the maximum price offered for the shares, minimum sales price sought by the shareholder and the price settled for the shares.

B. The Equity Market and Corporate Financing

1. *New Issue Market*

Generally, the methods of floating new issues are invitation to the public to subscribe by issuing prospectus, offer for sale by the existing shareholders who have taken up the whole or a large part of the company, public placing by listing the securities in the Securities Exchange Centre and offer to existing shareholders by a circular (applicable only to the established companies) wishing to issue additional capital. Any public company willing to raise capital via the SEC has to submit documents such as project report, memorandum, rules, long-term loan agreement and others as sought by the SEC. The latter can provide primary issue and sales services, and underwriting facilities

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on request by the company if it views the company viable and the issue of capital favourable to the investors. The fees charged for the new issue and sales services are 2 per cent for capital amounting up to Rs 2.5 million, 1.75 per cent for capital amounting within Rs 2.5 million and Rs 5 million, 1.5 per cent for capital amounting within Rs 5 million and Rs 10 million and 1.25 per cent for capital amounting to more than Rs 10 million. The charge for underwriting services rendered is 3 per cent of the underwritten capital. However, the SEC has been able to provide new issue and underwriting services to only a few companies (Table 4.7). The commission charged by the centre for the settlement of share exchange is one per cent of the share capital.

Regarding the disclosure of information, the companies intending to list their securities in the SEC have to enclose with the application, the Memorandum and Articles of Association or other prescribed documents, a list of security holders, balance sheet as well as profit and loss account and other related documents. Companies not listed in the SEC

**Table 4.7 NEPAL: NEW ISSUES AND SECONDARY MARKET
ACTIVITIES OF SEC
In Millions of NRs (Other than those specified)**

	1983/84	1984/85	1985/86	1986/87*
New Issues Market				
Consultancy services provided to companies (In number)	2	4	3	1
Shares issued	2.8	34.1	32.0	7.5
Shares transacted	1.4	14.9	17.2	7.5
Shares underwriting (No. of companies)	4	2	4	4
Secondary Market				
Listed companies (In number)		11	16	22
Book value of listed shares		270	340	590
Market value of listed shares		360	490	640
Shares transacted		2.2	10.1	5.9
Transaction of Government Securities		270	370	520

* First nine months (July - April)

Source: Gorkha Patra, 7 July 1987.

but wishing to raise capital through public floatation of shares, have to publish their prospectus. The prospectus should include the objectives of the company and other important particulars, financial position of the company, auditor's report, balance sheet of the company, profit and loss account, the terms and conditions relating to the directors and managing agents, and others.

A very important indicator of the growth of equity market is the growth of corporate enterprises, i.e., public companies, their paid-up capital and the structure of shareholdings. During the period 1975-86, 7,877 new industries were registered in the Department of Industry in which public companies numbered only 60. Even large scale industries (fixed capital exceeding Rs 10 million) were established as private limited companies. Of the total private limited industries (1,662) registered during 1975-86, 372 were large and medium scale industries (fixed capital of the medium scale industries ranging from Rs 5 million to Rs 10 million). This shows that Nepal is still in the rudimentary stage of modern industrial development and whatever industries are established, most of them are not organized as public limited companies. The desire to limit ownership of companies within a close circle of the proprietors has stood in the way of smooth development of the public companies and subsequently the equity market. Lack of impetus from the government side for the companies to go public is also responsible for such a sluggish growth of the public companies. As the development of the stock market is closely associated with the growth of public limited companies, the sluggish growth of the latter has adversely affected the new issue market of equities.

Even though the demand for capital comes from various sources, only public limited companies are allowed to raise capital through the public issuance of their equities. As stated in the Company Act, 1964, public companies in Nepal can raise capital in various ways, namely (i) issue of shares—ordinary or preference, (ii) sale of debentures, and (iii) borrowings, whereas private limited companies are not allowed to publicly float their shares and debentures. Notwithstanding the allowance for public issue of equity capital, public companies in Nepal are either solely government-owned or owned by a narrow circle of proprietors. There are very few companies which have issued equity capital for public participation. As paid-up capital comprises the major portion of the public sector companies' sources of funds and as the public issue of such capital in the market is insignificant, it can be said that most of the public companies are self-financed. Although self-financing has been considered necessary to finance the expansion and modernization of public companies, it is not an unmixed blessing. It is

often stated that higher reliance on self-finance rather than the capital market undermines the relative profitability of the investment and it results in deficiency in the structure of the capital market. Though such a tendency is detrimental to the development of the equity market, it is believed that this would enable the companies to grow to an economic size with the capacity to operate efficiently and to raise capital through new issues in the long run.⁷

The possibility of raising capital in the form of shares and debentures depends upon a number of factors, such as the size of the capital issue, whether the issue is by a new company or an old company and if by the old one, its profits and dividend records, the management of the company, the underwriting facilities, the terms and conditions of issue, and ultimately the state of the secondary market. However, most of the public companies, particularly the government corporations, have not fared well so far in terms of their financial performance and management of the public companies. Most of the public companies, therefore, have to resort to self-financing and financing through intermediaries rather than issuing of shares.

2. Secondary Market

The secondary market activities on the equities are limited because of several factors, viz, very short history of the evolution of the stock exchanges, tendency towards self-financing and financing through financial intermediaries, limited number of listed companies, small size of the listed shares, poor financial performance of the listed companies and inclination of the public to hold their assets in the form of real estate, bullions and bank deposits. Of the 22 companies listed so far, the shares of only a few companies are transacted daily. Among the companies' shares transacted in the secondary market, market values of only a few are greater than the face values. Since the market has a small volume of transaction and is lacking in speculation, the chances of market manipulation and insider trading are also rare.

Generally, the SEC publishes information regarding the activities of the listed companies such as information likely to affect the market price of securities. Market activities on the securities are often published in newspapers. SEC itself is often involved in the dealing of shares to support the market.

7. Ram Saran Mahat, *Capital Market, Financial Flows and Industrial Finance in Nepal* (Kathmandu, Sajha Prakashan, 1981) p. 51.

3. Factors Affecting the Development of the Equity Market

As mentioned earlier, the supply side of the equity market is weak because of the existence of a few public companies. Most of the companies in Nepal are either privately-owned or fully government-owned. Although the government has been trying to hand over the shares of government enterprises to the public, it has not been successful. Nor are there any initiatives taken and incentives given to transform the private companies into public. Also, the performances of most of the existing public companies are less than satisfactory. The establishment of large and medium scale industries in the private sector has led to the establishment of private companies, whose transactions are large enough to justify for listing in the SEC. But, there is a lack of incentives for them to go public.

The demand side is equally responsible for the sluggish development of the equity market. One can question whether there would have been enough demand for equities from the public had the companies gone public and issued their capital. Historical, social and economic reasons reveal that demand would not have been encouraging. For instance, people have less confidence in the performance of companies because they are worried of becoming the victims of mismanagement and ultimate failure of these companies. At the same time, companies running persistent losses, especially some government enterprises, have deteriorated their credibility and hence led to public reluctance to subscribe for their capital issues. That is why the government offer for the public to participate in the shares of public corporations has achieved little success.

On the other hand, some public companies which have enlisted themselves in the SEC are quite small and cannot attract the attention of potential investors. Similarly, the risk-averting nature of the investors and their lack of experience in modern business activities have made the public hesitant to invest in companies' shares. The investors usually prefer riskless ventures such as real estate, bullions and trading activities rather than being involved in industrial concerns. At the same time, the investors are also discouraged by the very primitive state of the secondary market. Holding of assets in the form of equities is often more illiquid than the holding of real estates. Even though liquidity could be traded off with the high return from the equities, it is not likely that the investors would be psychologically ready for such a trade-off.

The most important variable that affects the demand for financial assets is the level of income. In Nepal, where every two out of five

households subsist below poverty-line, where the growth of gross national product has barely exceeded the growth of population and where marginal propensity to consume as well as income elasticity of consumption are high, sufficient savings cannot be expected to come forth for investment in equities. Even though income distribution is highly skewed in Nepal and savings are generated in some section of the society, there are other riskless ventures in the financial sector such as investment in government securities and time deposits with commercial banks, leave alone non-financial ventures. Unless the risk-loving and entrepreneurial habit develops among the potential investors, it is not likely that savings would go to equity participation.

Notwithstanding all these, there are some brighter aspects of the equity market. The development of the financial system and the growing inclination of the financial institutions towards equity participation of the public companies, resumption of secondary market activities by the SEC, growing number of listed companies, the government's policy to hand over gradually the shares of public enterprises to the private sector, the emergence of public companies with collaboration of reputed foreign companies and the floatation of their shares in the market are all pointers towards developing a sound base for the development of the equity market. The EPF and the NIC which have been able to mobilize huge amounts of financial savings have been diversifying their investment portfolio to equity participation of public companies. The government policies are also geared towards revamping public sector activities by providing tax exemptions on dividends, income tax deduction for the income ploughed-back by the enterprises and by creating the legal framework for stock exchange activities.

C. The Bond Market and its Development

1. Primary Issue Market

The bond market in Nepal is solely the government securities market. The enactment of the Public Debt Act, 1961 allowed the government to raise internal loans through the issuance of securities. As per the provision in the Act, the government could raise internal loans by the issue of (i) stocks, (ii) promissory notes and Treasury bills, (iii) Bearer Bonds, (iv) Prize Bonds, and (v) other securities issued in the patterns and ways prescribed by this Act. The NRB was authorized to conduct public debt management activities and entrusted to forward advices to

the government on public debt matters. As the legal framework for government securities had been already built up, the government issued Treasury bills for the first time in 1962. This was followed by the issuance of Forest/Land Compensation Bonds and Development Bonds in 1964, Prize Bonds in 1967, Special Bonds in 1971 and National Savings Certificates (NSC) in 1964. Up to 1975, Treasury bills stood at Rs 50 million. But after that, and particularly from the early 1980s, growing resource need in the public sector forced the government to issue a higher volume of such securities. At the end of 1985, total amount of outstanding bills soared up to Rs 2,830 million.

The first series of Development Bonds issued in 1964 carried an interest rate of 6 per cent and a maturity period of five years. However, the maturity period of the bonds issued later on ranged between six to ten years and the interest rate between 7 – 10.5 per cent. Till 1980, the outstanding amount of the bonds stood at Rs 650 million. But during the first half of the 1980s, the issuance of such bonds went far ahead of the amortization and thus the outstanding amount of the bonds issued so far stood at Rs 2,010 million in 1985. Though the rate of return on these securities is higher than that on Treasury bills and savings deposits with banks, it is still lower than the fixed deposit rates and rate of return on the NSCs. Therefore, participation of the private sector, particularly the individuals in such securities is low. A major portion of the bonds is held by the financial institutions, in general, and the commercial banks, in particular. The share of the commercial banks in total bonds outstanding ranged between 31 per cent and 92 per cent during 1975 – 86. It is customary for the NRB to take up the portion of the new loan not purchased by other investors at the time of floatation with a view to sell them during the rest of the year. That is why the holding of Development Bonds by the NRB fluctuates markedly.

The commercial banks are inclined to purchase these securities to earn interest and to meet liquidity requirement. As commercial banks were, till May 1986, required to maintain liquidity at 25 per cent of their total deposit liabilities and as the government securities were accepted as liquid assets, the banks invested a sizeable amount of their resources on such bonds. In the case of credit demand, they pledge the bonds with the NRB and get resources for investment. That is why most of such bonds are concentrated with the commercial banks.

The Land/Forest Compensation Bonds were issued in 1964 for specific purposes, and with the complete amortization of the bonds, they no longer exist in the market. Prize Bonds are also already amortized and no new issues have appeared in the market. Special Bonds which include IMF promissory notes, 13-year bonds, and 25-

year bonds are issued from time to time and all are held by the NRB. Promissory notes are issued by the government as payments to the NRB on account of the former's financial liability to the IMF which is settled by the NRB. It is the usual practice that when the government has to pay or deposit some amount for the quota increase in the IMF, for the depreciation of Nepalese Rupee held by the IMF or for the use of Fund credit, the NRB as the banker of the government makes the payment and the government refunds the amount to the NRB in the form of promissory notes. The amount of Special Bonds outstanding thus fluctuates widely.

A new securities instrument that has been emerging as the most popular one among the gilt-edged securities is the National Savings Certificates issued first in 1984. They are designed to be floated to the non-banking system. However, the sale of this security has not been successful. As a result, the NRB has to hold a portion of such securities. Of the outstanding amount of the NSCs, the NRB's holding of these securities ranged between 27 per cent to 33 per cent. A sizeable portion of such securities is held by the EPF and the NIC. The interest rate on such securities is competitive (13 per cent) as compared with 12.5 per cent and 13.5 per cent respectively for one-year and two-year time deposits. Individual investors have also shown interest in purchasing these securities.

Some of the financial institutions also issue debentures and the total amount of corporate debentures stood at Rs 290 million in 1986. Interestingly, most of the debentures are held by other financial institutions, notably the NRB. The holding of such debentures by the NRB stood at Rs 140 million in 1985 and Rs 200 million in 1986.

We have already observed that for the corporate bonds, the financial system is the sole buyer. Although the demand for securities issued by the government comes from the commercial banks, provident and insurance fund corporations, government-owned profit seeking enterprises, profit seeking private sector enterprises as well as charitable organizations, only the NRB and commercial banks are the major holders of securities. Practically, all of the above organizations buy gilt-edged securities to meet certain statutory requirements. The gap between demand and supply is filled by the NRB which buys these securities on its own account and uses them to meet the investment need of the financial institutions later on. However, sale of the securities in the market when the NRB opts for tight-money policy is quite ineffective as the market for such securities is limited. As the rate of return on these securities is low compared with alternative prospects of investment, private sector demand on such securities is low. The NRB has to

purchase securities issued by the government but cannot sell them as desired. It is only when the financial institutions demand some of the securities, NRB can then unshoulder a part of the burden. That is why the share ownership of the NRB in total government securities outstanding has ranged between 38 per cent and 65 per cent during 1975-86. It is evident that the holding of securities by the non-bank sector is insignificant. Whatever amount is held by the non-banking system, most of it is under the ownership of the EPF and the NIC. The share of government business enterprises, private business enterprises, non-profit organizations and the individuals in total securities is less than 16 per cent. Even some of the NSCs whose holding is reserved for the non-banking sector only, are to be held by the NRB for quite a long period before the demand for these securities finally arises in the non-banking sector.

2. Secondary Market

The heavy concentration of securities in the financial system had resulted in a small volume of transactions through the SEC. It is observed that the NRB holds a large portfolio of government securities of different maturities. The portfolio is replenished through subscriptions at the time of new issue and offer to sell at other times. Beside transaction of government securities through the NRB, the SEC is involved in exchange of these securities. The NSCs are the major securities transacted through the SEC. However, the volume of securities transacted through the SEC is quite low, Rs 270 million in 1985 and Rs 370 million in 1986. The discount charged by the SEC for purchasing the NSCs from the sellers ranges between 0.05 per cent to 0.2 per cent depending upon the volume of transaction.

3. Factors Affecting the Development of the Bond Market

The fiscal policy of the government which has been expansionary over the years has led to a widening budget deficit, particularly during the 1980s. This has enlarged the volume of securities issued by the government. However, most of the securities issued by the government have not been competitive in the market. Except the NSCs, which fetch a rate of return similar to time deposit rates and enjoy tax exemptions, other securities have low yields. Though Development Bonds also fetch an interest rate of 10.5 per cent and enjoy tax exemptions, a high rate of inflation has often turned the real rate to negative. As all the

securities are issued at face value, as discount rates (commissions) to be charged by the SEC for conducting the transaction of the securities are fixed, and as there are no other brokerage activities, there is very little market speculation. As high rate of inflation often thwarts the return on these securities, the investors have to face depreciation on the real worth of their investment. A review of the real rate of return on Development Bonds and the NSCs during 1975-86 reveals that real rates on Development Bonds were negative in some years. Real rates of return on these bonds ranged between a positive level of 10.6 per cent to a negative level of 5.7 per cent during the period. Similarly, the real rates of interest on the NSCs stood positive until 1986 when it also turned negative owing to a high rate of inflation arising from the consequence of the devaluation of Nepalese Rupee vis-a-vis all currencies by 14.7 per cent in late 1985 (see Table 4.8) Although real rates of interest on bank deposits were also negative in some years during 1975-86, the case with fixed deposit rates was not so acute as in the case of government securities. Such a negative rate of return itself explains why most of the securities are concentrated in the banking system and in the case of short-term securities with the NRB.

The maturity structure of the securities has also been a detrimental factor to the development of the securities market. Since the maturity mix of the existing securities cannot serve the interest of medium term investors, they prefer bank deposits instead of such securities. For example, for those investors willing to invest for one to ten years, there are hardly any securities. One has either to invest in very short term securities (maturing in 90 days) or very long-term securities (maturing in 10 and 15 years). Although the interest rate on long-term securities is quite lucrative, the long maturity period and the underdeveloped state of the secondary market of these securities have discouraged the potential investors.

The other important factor which is detrimental to the development of the bond market is the tendency of the public to hold their assets in the form of real estate, bullion and bank deposits. Since the rates of return on these forms of investment, particularly the former two, are relatively high, investors prefer to hold these assets rather than government or corporate bonds. Some forms of such assets are apparently more liquid than the securities, considering the underdeveloped state of their secondary markets. The deep-rooted culture of the people to keep their savings "under the mattress" also stands in the way of higher demand for securities.

Corporate bodies are also reluctant to float bonds or debentures to raise capital and they prefer direct borrowing from the financial institu-

Table 4.8 NEPAL: NOMINAL AND REAL RATES ON INTEREST ON GOVERNMENT SECURITIES (In Per cent)

Mid-July	Nominal Rates			Real Rates (R) ¹		
	Treasury Bills	Development Bonds	National Savings Certificate	Treasury Bills	Development Bonds	National Savings Certificate
1975	4	10	-	-10.9	-5.7	-
1976	4	10	-	4.7	10.6	-
1977	4	10	-	1.6	7.4	-
1978	5	10	-	-5.6	-1.1	-
1979	5	10	-	1.4	6.3	-
1980	5	10	-	-4.4	0.2	-
1981	5	10	-	-7.4	-3.0	-
1982	5	10.5	-	-4.9	0.1	-
1983	5	10.5	-	-8.1	-3.2	-
1984	5	10.5	13	-1.1	4.0	6.4
1985	5	10.5	13	0.9	6.1	8.5
1986	5	10.5	13	-9.3	-4.6	-2.4

¹ The following formula was used to compute the real rates:

$$R = \left[r - \frac{\Delta P}{P} \right] + \left[1 + \frac{\Delta P}{P} \right] - 100$$

tions or issue additional share capital to the existing shareholders. This has hindered the prospect of issuing new corporate bonds. Provided that interest rates are high enough, there would be no shortage of investors on such securities. But most of the corporate bodies are reluctant to offer such a high rate of interest and subsequently fail to attract potential investors.

As most of the corporate bodies are directly under government ownership and responsibility, the government makes provision to finance them through various budgetary provisions (such as subsidy, loan and share participation). Had the corporate bodies been more autonomous and less reliant on government budgetary provisions for financing their resource needs, they would have been compelled to float securities in the market.

Thus it seems that the liberal policy of the government in financing the corporate sector has hindered the development of the securities market. The unnecessary provision of soft financial credit and foreign loans to public corporations has adversely affected the rapid expansion of the security market – both equity and bonds.

IV. MAJOR FINDINGS AND CONCLUDING REMARKS

A cursory review on the capital market activities reveals that both the securities and non-securities markets are in a rudimentary stage in Nepal. Even though the latter has a relatively long history of evolution, the former is still in its infancy. The existence of limited types of financial institutions, small array of financial instruments, low degree of financial intermediation, concentration of a large part of the financial assets within the financial system itself, recent evolution of the stock exchange, a small number of listed companies, and near non-existence of the secondary market and brokerage activities manifest that the capital market in Nepal has yet to grow perfectly. Financial institutions, which are an integral part of the capital market in terms of transforming funds from surplus spending units to deficit spending units through the process of intermediation, can influence the capital stock for growth purposes in various ways. However, these institutions in Nepal have not fully emerged to pursue these responsibilities. The size of the financial sector in relation to physical infrastructure as measured by various indicators reflects their extremely limited role in the economy. Nevertheless, the financial interrelation ratio or the marginal rate of financialization reveals that the financial sector is growing faster than

the real sector activities. Similarly, although the degree of financial deepening has been low, it is also giving signals of development. The financial layering ratio which ranged between 1.102 and 1.221 during 1975-86 reveals that either there is lack of viable investment opportunities for the financial institutions funds or they prefer relatively safe channels of investment. This also shows higher dependency of most of the financial institutions on the NRB for their financial resources.

One important characteristic of the evolution of financial institutions in Nepal is that most of them are the off-spring of government initiation and are entirely owned by the public sector. Therefore, the financial institutions have to perform twin functions: pursuing their traditional/institutional activities and meeting social goals as well. But these functions have often been in conflict.

The changing structure of deposits (increasing share of fixed deposits in total deposits) has created scope for the commercial banks' indulgence in long-term lending without endangering liquidity. But the banks have not been able to extend long-term loans. Though they have invested a substantial part of their funds in government securities, they have not provided adequate long-term loans and investment in corporate securities. In this respect, the Commercial Bank Act which allows the banks to extend only 15 per cent of their resources as long-term credit needs a revision so as to empower the banks to extend more long-term credit. It is obvious that commercial banks have a greater role to play in the development of both the non-securities and securities market. They can do so by underwriting the securities jointly with other financial institutions, purchasing securities floated in the market, granting loans against shares, undertaking brokerage business, and opting differential treatment policy for private and public companies. Furthermore, commercial banks can promote the securities market by floating their own stock in the market. At this juncture, enlistment of some of the commercial banks in the SEC and transaction of their stocks at high premium should be regarded as a good indication towards this direction. But the active role of the commercial banks in the promotion of capital market is yet to emerge.

The contribution of the development banks to the development of the capital market has not been substantial so far. They can do so in a variety of ways through the floatation of their equity portfolio, providing preferential treatment to the public companies in terms of lending and participating in equities, conducting underwriting operations more widely, and issuing securities to raise resources for investment. But these banks have mostly easy access to the government, the NRB, and foreign countries/institutions in meeting their resource need and have

taken little trouble to issue securities. The NIDC which is entrusted with financing the industrial sector should give special emphasis to public companies while providing financial assistance and participating in equity capital. It has been found that those companies whose shares are mostly held by the NIDC are organized as private companies with no chance of floating their shares. Such companies should have been set up as public companies so that the share capital could be floated in the market. Other financial institutions such as the EPF and the NIC can assist capital market development through greater participation in the securities market. Their participation in government securities has been negligible. So is their participation in the equity of public industries. They should go ahead to establish industries and gradually float their shares to the public.

A brief review of the securities market in Nepal reveals that it is in a rudimentary stage. With few companies listed in the SEC, little transaction of the shares in the secondary market, a small array of government securities, and a near absence of corporate bonds, it can be inferred that securities activities have yet to gain momentum. Both constraints on the demand and supply sides have been detrimental to the growth of the securities market. The drawbacks in the supply side are associated with a small number of public companies, government ownership of most of the companies, concentration of the companies in a few urban areas, and more interestingly, the tendency of such companies to resort to self-financing and financing through the financial institutions. Most of the public companies are reluctant to float their share capital and bonds to the public to raise financial resources. Although some of the public enterprises are making fair profit and increasing their net worth, the shares could be disposed off at a price higher than the net worth. But the government as the owner of these enterprises is not ready, at least at present, to offer shares to the public. This is due to social-political reasons. Even though the government has recently taken initiatives to float the shares of some government enterprises to the public, the number of such enterprises is small and some of them have already lost credibility.

The bulk of the increase in equity capital of the public companies was the result of government subscription to expand the capital base of the enterprises owned by it. But the bias of the companies towards equity financing rather than debt financing has mostly been obvious in the case of government-owned companies. In the case of private sector companies, the bias is towards debt financing. This is because of the easy access to long-term as well as short-term borrowing through the financial institutions.

The demand side of the securities market reveals that the market for such securities cannot be ensured in the wake of investors' indulgence in relatively safe areas of investment such as real estate, bullion and bank deposits. The former two are apparently more lucrative, taking into consideration the growing level of prices. In such a situation, bank deposits and investment in gilt-edged securities remain as better investment alternatives than the shares in view of their safety and marketability of the securities. But the market for government securities has not been broad on account of several factors. Firstly, the rates of interest on most of the securities (especially short-term ones) are so low that the investors prefer keeping their money "under the mattress" rather than investing in such securities. Secondly, the maturity mix of the securities has not been able to satisfy the preference schedule of all savers. Thirdly, the state of the secondary market on these securities is such that other forms of asset holding are more liquid than the holding of these securities. Lastly, the market for such securities is not widespread, for the transaction of these securities is held by the SEC with the sole office in the capital and the NRB with its few offices in major urban areas in the kingdom. It is, therefore, pertinent that the SEC open its branches in other parts of the country and widen the market for securities transaction. At the same time, the promotion of brokerage activities is highly vital to the orderly development of the securities market.

The widening savings-investment gap which stemmed mainly from the resource gap in the government sector calls for larger efforts at domestic resource mobilization. It is likely that the gap will become more severe if private sector investment activities also expand rapidly. In such a situation, the issue of securities by the government to meet its resource need will be of little help, for either the demand for such securities will be low or the purchase of such securities by the private sector will have crowding-out implications if the level of income does not grow as desired. Nevertheless, the government can raise resources by floating the shares of its enterprises to the public and allocating them in more productive channels. At the same time, mobilization of more financial savings is possible with the growing degree of monetization in the economy and the ramification of financial institutions. Provided with proper mandate, financial institutions can contribute to a larger extent in the development of the capital market. The introduction of a variety of other financial institutions such as finance companies, investment banks, private pension and trust funds and other development banks is also highly necessary for the development of the capital market. In conclusion, Nepal has a long way to develop its capital market into an efficient one to promote economic development. □

CHAPTER 5

Development of the Capital Market in the Philippines

CATALINA T. ROBLEDO

I. OVERVIEW OF THE EXISTING CAPITAL MARKET STRUCTURE

A. Non-securities Market

1. *Historical Development*

The evolution of the financial system in the Philippines covered five epochal periods: the Spanish period (1594-1900), the American period (1900-1941), the Japanese period (1942-1945), the Postwar period (1945-1948) and the Central Bank era (1949-present). The banking industry started during the Spanish regime but banks established during the period operated only in accordance with their respective charters and the Spanish Code of Commerce. Bank supervision started in 1900 with the passage of Act No. 52 by the Philippine Commission, placing all banks under the Bureau of Treasury. In 1929, the Bureau of Banking which was headed by the Bank Commissioner took over the supervision of banks and was placed under the Department of Finance.

The American regime was characterized not only by the onset of bank supervision but also by the establishment of more banks. Of significance was the founding of the Philippine National Bank (PNB) in 1916 under Act No. 2612. The PNB was made the sole depository of government funds and had the authority to issue currency notes.

The growing financial requirements of the country's business sector after World War I encouraged several foreign banks to establish branches in the Philippines. In 1927, the country also witnessed the

establishment of its first stock exchange, the Manila Stock Exchange. However, it was only nine years later, in 1936, that the Securities Act was promulgated.

To make the financial system responsive to the rehabilitation and development of the economy following World War II, the government in 1948 promulgated the Central Bank Act (RA No. 265) and the General Banking Act (RA No. 337). Thus, on 3 January 1949, the Central Bank of the Philippines was established.

There was rapid expansion in the number of banks established particularly in the 1960s. Banking services also increased in variety and type to meet the special requirements of various clients. The early 1970s saw the emergence of non-bank financial institutions, notably investment houses and finance companies, and the development of the money market. It was also during this time that Euro-currency banking started in the Philippines with the establishment of special foreign currency deposit units (FCDUs) of local commercial banks. The FCDUs became the forerunners of offshore banking units (OBUs) which started operations in mid-1977 primarily to service the growing requirements for foreign exchange of the country's development programme.

With these developments, the Central Bank was made to perform the function of a monetary authority as provided in Article XV, Section 14 of the New Constitution promulgated on 19 January 1973. Following the recommendations by a study conducted by a joint IMF-World Bank Mission in 1979, significant financial reforms were instituted in 1980, the major aspects of which were: a) the introduction of expanded commercial banks which, in addition to commercial banking functions, were vested with the powers of an investment house (underwriting, securities dealership and equity investment); b) a reduction in differentiation among categories of banks and non-bank financial intermediaries authorized to perform quasi-banking; c) the deletion of all functional distinctions among thrift banks; and d) an increase in the powers and functions of non-bank financial intermediaries authorized to perform quasi-banking functions. These reforms were complemented by the deregulation in interest rates and the increase in the required minimum capitalization of banks to enhance competition among them for greater efficiency and for increasing the availability of longer-term funds.

2. Structure of the Philippine Financial System

The existing Philippine financial system is composed of the Central Bank (the central monetary authority), commercial banks, thrift banks, specialized government banks, rural banks, and non-bank financial

institutions. As of end-December 1986, the institutions comprising the Philippine financial system numbered 6,110 with aggregate resources amounting to P731 billion (see Table 5.1).

(a) The Central Bank of the Philippines

The Central Bank of the Philippines was established on 3 January 1949 pursuant to Republic Act (RA) No. 265 primarily to make the mon-

Table 5.1 PHILIPPINES: THE FINANCIAL SYSTEM (As at end of 1986)

	Number	Total Resources	
		(P Million)	(Per cent)
Financial System	6,110	730,974	100.0
A. Banking Institutions	3,616	617,976	84.5
1. Central Bank	1	313,892	42.9
2. Commercial Banks	1,765	248,526	34.0
3. Thrift Banks	665	17,652	2.4
a) Savings Banks	231	8,124	1.1
b) Private Development Banks	213	5,625	0.8
c) Stock Savings and Loan Associations	221	3,903	0.5
4. Specialized Government Banks	100	28,556	3.9
5. Rural Banks	1,085	9,350	1.3
B. Non-Banking Institutions	2,494	112,998	15.5
1. Investment Houses	40	7,519	1.0
2. Finance Companies	334	5,627	0.8
3. Investment Companies	82	10,154	1.4
4. Securities Dealers/Brokers	124	946	0.1
5. Pawnshops	1,367	1,011	0.1
6. Fund Managers	11	1,288	0.2
7. Lending Investors	300	237	#
8. Non-Stock Savings and Loan Associations	75	1,187	0.2
9. Mutual Building and Loan Associations	7	16	#
10. Private Insurance Companies	127	20,284	2.8
11. Government Non-Banks	5	64,603	8.8
12. Venture Capital Corporations	17	126	#
13. Money Brokers	5	n.a.	-

n.a. - not available

- less than 0.1 per cent.

tary and banking system responsive to the rehabilitation and development of the Philippine economy which had been devastated by World War II.

The Central Bank administers the monetary, banking and credit system of the Philippines to achieve the following objectives: (a) to maintain internal and external monetary stability, and to preserve the international value of the peso and the convertibility of the peso into other fully convertible currencies; and (b) to foster monetary, credit and exchange conditions conducive to a balanced and sustainable growth of the economy. In line with these objectives, the Central Bank manages the country's currency system, controls the economy's supply of money and credit, manages the country's international reserves, acts as the country's sole bank of issue, and as the depository and fiscal agent of the Philippine government and its instrumentalities. As the central monetary authority, the Central Bank provides policy direction in the areas of money, banking and credit and has supervisory and regulatory authority over the operations of banks and exercises such regulatory authority as may be provided by law over the operations of non-bank financial intermediaries.

Of the non-bank financial institutions, only building and loan associations, non-stock savings and loan associations and pawnshops are directly supervised and regulated by the Central Bank. The Central Bank exercises only regulatory authority over the operations and activities of other non-bank financial intermediaries, which may include, but not limited to, the imposition of constraints covering minimum size of funds received; methods of marketing and distribution; term and maturities of funds received; uses of funds; and, for non-banks with quasi-banking functions the imposition of net worth to risk-asset ratios; reserve requirements and methods of computing thereof; prescribing maximum charges which may be collected; minimum capitalization; and the submission of statistical reports.

(b) Commercial Banks

As of end-1986, commercial banking units (including branches) numbered 1,765 and accounted for about 34 per cent and 40 per cent of the total resources of the financial system and the banking system, respectively. Of the 30 head offices of commercial banks, 25 were domestic private banks, four were foreign bank branches and one was a government-controlled bank. There were nine expanded commercial banks or unibanks which perform the functions of commercial banks and investment houses and 30 Foreign Currency Deposit Units.

Total loans outstanding of commercial banks at end-1986 amounted to P83.1 billion or 51 per cent of total loans outstanding of the financial system. Classified by industry, outstanding loans to the manufacturing sector comprised 26 per cent of commercial bank loans. Loans outstanding to financing, insurance and business services, shared 15.6 per cent, an improvement over its 6.4 per cent share in 1977, while the share of loans outstanding to wholesale and retail trade declined to 16.5 per cent from 29 per cent in 1977. The share of agriculture, fishery and forestry to total loans outstanding rose slightly to 16 per cent from its 1977 level of 13.6 per cent. Almost 70 per cent of the loans outstanding of commercial banks were short-term and demand loans although the proportionate share of medium- and long-term loans to total loans outstanding rose from 14.7 per cent at end-1977 to 30.9 per cent at end-1986.

Deposits made up 55.5 per cent of total commercial bank funds (total liabilities plus capital accounts) in 1986. Commercial bank deposit liabilities accounted for 48 per cent of the total deposit liabilities of the financial system, a decline from its 76 per cent share in 1970.

(c) Thrift Banks

Thrift banks – savings banks, private development banks and stock savings and loan associations – numbered 665 at end-1986 with total resources of P17.6 billion or 2.4 per cent of the total resources of the financial system. Total deposit liabilities of thrift banks in 1986 amounted to P13 billion or 4.5 per cent of total deposit liabilities of the financial system, a decline from its relative share of 6.6 per cent at end-1970.

Savings banks collect savings from the community, particularly the small savers. These funds are primarily loaned to business and individuals and invested in government securities. There were 231 savings banks in 1986 with total assets of P8.1 billion.

Savings deposits made up more than half of the total funds of savings banks while loans to the private sector made up the bulk of fund use.

Loans outstanding of savings banks in 1986 totalled P3.6 billion, or 2.2 per cent of total loans of the financial system, the bulk of which was lent to the combined financing, insurance, business services and real estate sectors. In 1986, almost 50 per cent of the outstanding loans were of short-term maturities which marked an increase of share of total outstanding loans from 26 per cent in 1977. Accordingly, the shares of medium- and long-term loans declined from 38 per cent and 34 per cent, respectively, in 1977 to 13 per cent and 33 per cent, respectively, in 1986.

Stock savings and loan associations (SSLAs) accumulate savings of their stockholders to be lent to households for personal finance and long-term financing for house-building and development, and/or for investment in the securities of productive enterprises and the government. Stock savings and loan associations numbered 221 as of end-1986, with total assets of P3.9 billion.

Total deposit liabilities of SSLAs at end-1986 amounted to P2.6 billion, which comprised less than 1 per cent of the total deposit liabilities of the financial system. Their total loans outstanding as of end-1986 amounted to P2.0 billion, the bulk of which went to services, commerce and agriculture. More than 50 per cent of loans outstanding were short-term, an improvement compared with the 70 per cent share of short-term loans in 1979.

Private development banks (PDBs), which numbered 213 at end-1986 and with total assets of P5.6 billion, provide medium- and long-term credit mostly to the small- and medium-scale industrial/agricultural sectors. They are extended financial assistance by the Development Bank of the Philippines (DBP). Total deposit liabilities of PDBs at end-1986 amounted to P3.3 billion, or 1.1 per cent of the system's total deposit liabilities, while total loans outstanding amounted to P2.9 billion, or 1.8 per cent of the system's total loans outstanding. Loans to the manufacturing industry comprised 26 per cent of loans outstanding of PDBs, while loans to agriculture took up 24 per cent. The share of short-term loans to total loans outstanding of PDBs rose from 36 per cent in 1979 to 54 per cent in 1986 while the share of medium- and long-term loans declined from 44 per cent to 30 per cent and from 20 per cent to 16 per cent, respectively, during the same period.

(d) Specialized Government Banks (SGBs)

The three specialized government banks (SGBs), the Development Bank of the Philippines (DBP), the Land Bank of the Philippines (LBP), and the Philippine Amanah Bank (PAB) were established for specific purposes. The DBP provides medium- and long-term funds for industrial, agricultural and community development; and assists private development banks and rural banks through equity investment, rediscounting facilities, technical assistance and training programmes. The Land Bank of the Philippines, on the other hand, was established mainly to finance the acquisition of landed estates by the government as part of its land reform programme, while the Philippine Amanah Bank was set up to accept deposits and to provide credit to the Muslim communities in Mindanao.

As of end-1986, the three SGBs had combined assets of P28.6 billion, comprising 4 per cent of the total resources of the financial system. Total deposit liabilities amounted to P11.5 billion, which comprised 4 per cent of the system's total, while total loans outstanding amounted to P11.9 billion or 7.3 per cent of the system's total. Loans outstanding of SGBs have been declining for the past two years. In 1986, the decline was partly due to the transfer of selected non-performing assets of one bank to the National Government.

(e) Rural Banks

The Rural Banks Act (Republic Art No. 720) dated 6 June 1952, provided for the establishment of rural banks to mobilize funds for rural investment and development. Rural banks numbered 1,085 at end-1986. Their total assets, amounting to P9.4 billion, comprised only a little over 1 per cent of the total resources of the financial system.

Total deposit liabilities of rural banks amounted to P3.8 billion at end-1986 or 1.3 per cent of the system's total while total loans outstanding amounted to P6.8 billion or 4.2 per cent of the system's total.

(f) Non-Bank Financial Institutions

(i) *Contractual Savings Institutions.* The most significant non-bank financial institutions are the insurance companies whose combined assets totalled P84.9 billion at end-1986. These institutions are the government-owned Government Service Insurance System and Social Security System and the private insurance companies.

The *Government Service Insurance System (GSIS)* has for its primary objective the provision of insurance protection (retirement, pension and life) to government employees. The premiums paid by the employers and employees are fixed by law and the contributions of employees represent compulsory savings. The sources of funds of the GSIS are premiums received from life insurance, retirement insurance, mortgage redemption insurance and salary loan insurance; income from investments, service income, commissions and reinsurance, miscellaneous income and borrowings. The bulk of GSIS liabilities comes from notes payable and claims payable. Loans and investments are not limited to servicing the needs of its members whose loans are presently in the policy and salary loan categories. The larger part of these assets is in the form of industrial and real estate loans, stocks and bonds and other investments.

Membership in the *Social Security System (SSS)* is compulsory as provided for by law for all privately-owned firms and their employees. Its operations are similar to the GSIS. The major portion of its funds are used for lending (salary loans, housing loans and viable business projects) and investments in government and other securities, while the bulk of its liabilities are in accounts payable, reserves for insurance premiums, losses, claims and other liabilities.

Private insurance companies numbered 127 at end-1986 with total assets of P20.3 billion or 2.8 per cent of the system's total. Loans and investments totalled P13.8 billion and gross premiums amounted to P6.8 billion as of the same date.

(ii) *Investment-type Institutions*. These are investment houses, investment companies, fund managers, lending investors, venture capital corporations and cooperatives/credit unions.

Investment houses are enterprises engaged in guaranteed underwriting of securities of another person or enterprise, including securities of government and its instrumentalities. As of end-1986, there were 40 investment houses with total assets of P7.5 billion. Of this number, eight are engaged in quasi-banking activities, that is, borrowing funds for the borrower's own account (obtaining or raising funds with the assumption of liability in one's own capacity and not in representation, or as an agent or trustee of another). Borrowing is done through the issuance of deposit substitutes (promissory notes, repurchase agreements, certificates of participation/assignment with recourse) to twenty or more lenders at a time. Investment houses also perform a wide variety of financial services ranging from portfolio management to issuing and investing in bonds and securities and advancing loans receivable, underwriting of new issues of capital, term loans to industries and loan syndications.

Investment companies are primarily engaged in investing, reinvesting or trading in securities. There are two types: open-ended and close-ended. Open-ended companies have no fixed amount of paid-in capital and sell their shares on a day-to-day basis with the shares redeemable on demand. Close-ended companies cannot redeem shares on a day-to-day basis and have a relatively fixed amount of capital outstanding. Total resources of investment companies which numbered 82 in 1986 amounted to P10.2 billion.

Venture capital corporations are entities organized jointly by private banks, the National Development Corporation and Technology Resource Centre and/or such other government agency as may be authorized by the appropriate authority, the primary purpose of which is to develop, promote and assist, through debt or equity financing or

any other means, any small- and medium-scale enterprise in the country. At end-1986, there were 17 venture capital corporations, with total resources of P126 million.

Fund managers are institutional and personal administrators of funds created or constituted for the benefit of others. The funds consist mostly of pension or trust funds and employees' welfare funds. At end-1986, there were 11 fund managers, a significant decline from their number in the early 1970s. Total resources of fund managers at end-1986 amounted to P1.3 billion.

Other financial institutions include finance companies, lending investors, pawnshops, non-stock savings and loans associations and mutual building and loan associations.

B. Securities Market

1. *The Equity Market*

Data from the Securities and Exchange Commission (SEC) showed that of the P9.0 billion worth of stocks registered and traded in 1986, P5.8 billion or 64 per cent were primary issues, i.e., direct sales by issuer corporations to investors, or sales of company issues sold for the first time, either directly to investors or intermediated by brokers and dealers. The rest were sold in the secondary market, i.e., on the stock exchanges or in the over-the-counter market. Sales in the over-the-counter market are insignificant compared to trading in the exchanges. In 1986, over-the-counter sales comprised less than 0.05 per cent of volume traded and less than 2 per cent of value traded in the exchanges.

2. *The Stock Market*

The Philippines has two operating stock exchanges: the Manila Stock Exchange (MSE), founded in 1927 and the Makati Stock Exchange (MkSE), which started operations in 1965. A third exchange, the Metropolitan Stock Exchange (Metrex), established in 1974, is now defunct.

(a) *Membership and Organisation:* The MSE has at present 65 members, of which 44 are active, while the MkSE has 64 members, of which 43 are active. The exchanges are self-regulating bodies which operate under the close supervision of the Securities and Exchange Commission (SEC). Each exchange governs itself through a policy-making body

known as the Board of Governors, whose members are elected by its entire membership. Each exchange's Board of Governors has nine members. The day-to-day administration of the MkSE is vested in the Executive Secretary. He has direct responsibility over employees and personnel of the exchange, implements the Board resolutions and performs such other duties as the Board of Governors may prescribe. His counterpart in the MSE is the General Manager.

(b) *Listing*: To be listed on the exchanges, securities must first be registered with the SEC. Once registered, they have to be approved for listing by the Joint Listing Committee, which has members from the two exchanges. The Joint Listing Committee undertakes a thorough examination of an applicant-company to determine if it complies with all listing requirements and to ensure that listing will not be prejudicial to public interest. All securities approved for listing and trading are automatically listed in the two exchanges by virtue of the Uniform Listing Law (Presidential Decree No. 167). Securities registered with and licensed for sale by the SEC but not listed on the exchanges may be traded in the over-the-counter market (OTC), i.e., among brokers outside the trading hours of the exchanges.

As of end-December 1986, there were 207 stocks of 130 companies listed on the exchanges, broken down as follows: Commercial and Industrial (C-I), 114; Mining, 60; and Oil, 33. Of the total, 33 were listed on the Big Board ("blue chips") and 60 on the Small Board ("speculatives"). There are three stocks listed on the New York Stock Exchange and the American Stock Exchange: Atlas Consolidated, Benguet Corporation and Philippine Long Distance Telephone Company.

(c) *Trading Mechanics*: Trading on the exchange is done from 9.30 a.m. to 12.10 p.m. on weekdays, except during legal and special holidays. Trading is done by board lots or units of trading. Depending on the price range of the particular stock, the unit of trading ranges from 5 to 200,000 shares per board lot. Trading on odd lots (i.e., for shares less than the normal unit of trading for that stock) is allowed among brokers. While the prices at which the stocks are traded are determined by the forces of supply and demand, there are rules established by the exchanges to govern stock price fluctuations. Transactions beyond the minimum fluctuation of the last sales price are not allowed, except in the case of cross sales, where transactions may be made through two minimum fluctuations.

A stock transaction tax of 1/4 of 1 per cent of the value of stocks sold is imposed on listed stocks in lieu of the capital gains tax.

3. *The Bond Market*

The bond market in the Philippines is dominated by government securities. Since 1970, when one corporation issued its convertible debenture bonds, there have been no private corporate bond issues.

4. *The Government Securities Market*

To date, the government securities market offers an array of outstanding debt instruments consisting of bonds, notes, bills and certificates of indebtedness with a variety of purposes, terms, conditions, utilities and other pertinent features all designed to enhance their competitiveness as alternative investment outlets.

II. THE DEVELOPMENT OF THE NON-SECURITIES MARKET

A. Mobilization of Domestic Savings

1. *Need for Domestic Resource Mobilization*

Except for the year 1973, the period 1970-1983 was generally marked by an increasing trend in the savings-investment gap as domestic savings failed to match the rise in investments. Beginning from 1984, the savings-investment gap narrowed, and for the next two years was positive as investments dropped sharply with the general slowdown in business activity (see Table 5.2)

Gross domestic savings averaged 22.5 per cent of Gross Domestic Product (GDP) during the 1970s. After peaking at 25.6 per cent in 1979, gross domestic savings as a proportion of GDP gradually declined to 16.9 per cent in 1984 as a rising inflation rate and a domestic recession caused an overall deterioration in real incomes. In 1986, savings improved to 19.1 per cent of GDP, only slightly lower than the level in 1983, following the slight improvement in real income during the year. Investments, on the other hand, averaged 25.4 per cent of GDP during the decade of the 1970s and 26.7 per cent for the first half of the 1980s. Construction accounted for a substantial portion of the increase in investment in 1976-1982. Government construction, which averaged 2.1 per cent of GDP in 1970-1975, averaged 6.3 per cent of GDP in 1976-1982 as the government stepped up its infrastructure programme. Likewise, private sector construction grew in importance, averaging 7.6

Table 5.2 PHILIPPINES: THE SAVINGS-INVESTMENT GAP, 1970-1986 (In Million Pesos)

Period	Gross Domestic Savings (GDS)	Gross Domestic Capital Formation (GDCF)	Savings - Investment Gap (GDS-GDCF)
1970	8,163	8,303	-140
1971	9,536	9,919	-383
1972	10,433	10,890	-457
1973	17,174	14,634	2,540
1974	21,919	25,053	-3,134
1975	26,055	33,840	-7,785
1976	33,400	41,993	-8,593
1977	38,540	44,369	-5,829
1978	42,447	51,348	-8,901
1979	55,589	67,687	-12,098
1980	66,039	81,153	-15,114
1981	76,708	93,261	-16,553
1982	73,350	96,521	-23,171
1983	76,655	102,526	-25,871
1984	100,139	100,820	-681
1985	114,744	96,679	18,065
1986	132,400	84,591	47,809

per cent of GDP during 1976-1982, from 5.0 per cent in 1970-1975. In 1983-1986, the share of construction to GDP dropped to an average of 10.6 per cent (see Table 5.3)

Low interest rates in foreign financial markets encouraged increasing reliance on foreign borrowings as a source of financing the resource gap during the second half of the 1970s, so that by 1979, Philippine foreign exchange liabilities had risen to a level of \$13.4 billion, more than five times its size at the beginning of the decade. The deterioration in the country's net terms of trade following the subsequent rise in oil prices after the second oil shock and the stiffer terms on foreign loans in 1980 led to further increases in foreign liabilities in the 1980s. As of end-1986, the country's foreign borrowings totalled \$28.2 billion. The high cost of debt service and the tremendous pressure this exerts on the country's international reserves as well as the constraint this places on the country's growth efforts underscore the need to mobilize domestic savings for productive use.

2. Recent Trends and Structure of Domestic Savings

Personal (household) savings accounted for the bulk of net domestic savings in 1970-1978, averaging 55.7 per cent during the period. Its

Appendix 5.1 PHILIPPINES: NUMBER OF FINANCIAL INSTITUTIONS

	1970	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
I. Total Financial Institutions	1542	3549	3943	4068	4322	4741	5057	5421	5569	5810	5993	5780	6109
II. Banking Institutions	1316	2129	2461	2669	2873	3169	3364	3652	3749	3861	3829	3630	3615
1. Commercial Banks	643	996	1109	1208	1287	1405	1503	1732	1842	1905	1922	1752	1765
2. Thrift Banks	138	246	392	447	509	589	673	637	676	708	650	661	665
a. Savings Banks	56	91	162	184	207	236	268	187	193	209	211	226	231
b. Private Development Banks	54	86	98	109	117	130	154	182	203	218	209	215	213
c. Stock Savings & Loan Assoc.	28	69	132	154	185	223	251	268	280	281	230	220	221
3. Specialized Govt. Banks	28	67	73	81	83	89	92	116	119	97	100	100	100
4. Rural Banks	507	820	887	933	994	1086	1096	1167	1112	1151	1157	1117	1085
III. Non-Banking Institutions	226	1420	1482	1399	1449	1572	1693	1769	1820	1949	2164	2150	2494
1. Investment houses	n.a.	40	43	56	56	57	62	49	52	51	49	47	40
2. Finance companies	n.a.	319	348	388	419	478	531	559	537	532	545	353	334
3. Investment companies	n.a.	23	59	59	58	63	62	63	66	65	68	80	82
4. Securities dealers/brokers	n.a.	117	126	128	130	137	141	141	123	124	127	125	124
5. Pawnshops	n.a.	462	472	492	508	546	598	634	693	797	970	1097	1367
6. Fund managers	n.a.	194	178	9	9	9	12	9	10	12	12	12	11
7. Lending investors	n.a.	38	31	34	40	53	61	78	96	124	152	200	300
8. Non-Stock Savings & Loan Assoc.	65	67	68	74	71	71	71	74	74	74	75	75	75
9. Mutual Bldg. & Loan Assoc.	7	7	7	7	7	7	7	7	7	7	7	7	7
10. Private insurance companies	150	149	146	145	143	141	137	136	136	136	131	127	127
11. Government non-banks	4	4	4	4	4	5	6	6	5	6	6	5	5
12. Venture capital corp.	-	-	-	-	-	-	-	8	15	6	17	17	17
13. Money brokers	-	-	-	3	4	5	5	5	6	15	5	5	5

n.a. - not available

- - nil

Source of Basic Data: Supervisory Reports Office - Central Bank of the Philippines.

share declined to less than 50 per cent beginning 1979, reached a low of -6.4 per cent in 1983 and rose to 60.2 per cent in 1986 (see Table 5.4). The decline in the share of personal savings coincided with increases in consumer prices and the slowdown and eventual fall in real income. The inflation rate rose from 7.3 per cent in 1978 to 18.2 per cent in 1980, slowed down to 10.0 per cent in 1983 and accelerated to 50.3 per cent in 1984, while the growth in real income decelerated from 6.9 per cent in 1979 to 1.1 per cent in 1983. The slowdown in real income was due largely to the recession in international markets and the uncertainties that prevailed in the economy after the Aquino assassination in August 1983. The widespread panic-buying towards the end of 1983 resulted in the dissaving of households during the year.

Corporate savings averaged 19.5 per cent of net domestic savings during the period 1970-1978. Its share rose to 33.9 per cent in 1979 and to 50.5 per cent in 1983 but subsequently dropped to negative levels in 1984-1986, as a number of corporations suffered severe distress due to the fall in aggregate demand. Meanwhile, the share of general government savings to net domestic savings fluctuated from a low of 12.6 per cent in 1976 to a high of 106.8 per cent in 1985, before declining to 45.4 per cent in 1986. The increase in the share of government savings in 1983 was primarily the result of the deceleration in disbursements consistent with the policy of fiscal restraint. The share of government savings to total net domestic savings rose even higher to 98.9 per cent in 1984 as the increase in expenditure on debt service caused current disbursements to rise by more than 24 per cent, offsetting the considerable improvement in current receipts arising from the implementation of new tax measures and the overall improvement in tax administration. In 1985, government savings in absolute terms declined, as government pursued a reflation programme during the second half of the year to

Table 5.4 PHILIPPINES: STRUCTURE OF NET DOMESTIC SAVINGS, 1970-1986 (In Per cent)

	1970	1975	1980	1981	1982	1983	1984	1985	1986
Net Domestic Savings	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Households	46.1	54.4	31.0	36.5	21.1	-6.4	8.0	10.7	43.8
Corporate	30.4	22.3	35.1	36.0	44.4	50.5	-6.9	-14.9	-5.6
Government	23.4	23.3	33.9	27.5	34.5	55.9	98.9	104.2	61.8

Source: NEDA - National Accounts Office.

stimulate production and demand in some sectors of the economy. The decline in government savings continued in 1986.

3. Government Policies and Strategies in the Mobilization of Domestic Savings

The period 1956-1973 was characterized by low and rigid interest rates. During this period, the Central Bank had no power to set lending rates, which were governed by the Anti-Usury Act of 1916. Lending rates were limited to 12 per cent on secured loans and 14 per cent on unsecured loans. The ceilings on lending rates indirectly set the limits on interest rates on deposits which were prescribed by the Central Bank at rates lower than the interest rate ceilings on loans. Meanwhile, credits from the Central Bank and other government banks were extended to priority activities at differential but concessional rates. Thus, financial policy was geared towards encouraging investment in certain sectors by artificially keeping the cost of capital low. The low interest rate policy, however, served as a disincentive to savers and encouraged banks to depend on the Central Bank as a cheap source of funds.

To improve deposit mobilization, significant measures were undertaken during the 1970s and the first half of the 1980s as follows:

(a) *Interest Rate Policy.* In 1973, the Monetary Board was authorized to prescribe and to charge maximum rates of interest on loans as warranted by the prevailing socio-economic conditions and in 1975, the Monetary Board was given the authority to eliminate, exempt from, or suspend the effectivity of interest rate ceilings on certain types of loans. During the period 1974-1980, five revisions in interest rate ceilings were made, and interest rate policy began to be used as an instrument to improve the mobilization of domestic savings. Interest rate ceilings on savings and time deposits were adjusted upward, and ceilings on over two-year time deposits were removed to promote longer-term savings; loans were categorized into short-term and long-term, with a higher ceiling imposed on long-term loans; interest rate ceilings were imposed on deposit substitutes to stem the unrestrained flow of funds away from regular deposits; and in 1980 the Monetary Board allowed the floating of interest rates on loans with maturities of over four years.

In 1981, a floating interest rate policy was formally instituted. Ceilings on all deposit and loan rates were lifted except those for short-term loans. The decision to float interest rates on deposits and loans was intended to effect a more efficient allocation of resources; induce fund flows to give financial institutions greater flexibility in their fund intermediation, especially long-term funds, and to allow the system to

respond more promptly to domestic and external developments. Ceilings on short-term loans were retained to serve as an interim measure to effect a smooth transition to the new policy and also to serve as benchmark for other interest rates.¹ In 1983, the remaining ceilings on interest rates of short-term loans were lifted.

(b) *Institution Building*. To increase the flow of financial savings and to make an increasing proportion of such flows available to borrowers on medium- and longer-terms, the modified universal banking concept was adopted in 1980. Under the modified concept of universal banking, the following changes in the financial structure were made:

- (i) the introduction of expanded commercial banks;
- (ii) the elimination of all functional distinctions among thrift banks;
- (iii) a reduction in differentiation among categories of banks and non-bank financial intermediaries authorized to perform quasi-banking functions; and,
- (iv) an increase in the powers and functions of non-bank financial intermediaries authorized to perform quasi-banking functions.

Expanded commercial banking, defined as the combination of commercial banking (full domestic and international banking) with the powers of an investment house (underwriting, securities dealership, and equity investment), was made available to banks authorized to perform commercial banking functions and banks authorized to do full domestic banking, either by conversion, merger or consolidation, or sheer expansion of the capital base to at least P500 million, and in the case of investment houses, either by conversion, merger or consolidation, with any of the foregoing entities.

Distinctions among the three types of thrift banks (private development banks, savings and mortgage banks and stock savings and loan associations) in so far as inherent powers and functions are concerned, were removed. Moreover, upon meeting the uniform minimum capital requirement for all thrift banks, any of the banks in this category could qualify for the full range of "full domestic banking" powers, defined as commercial banking without international banking operations. These powers include the operation of demand deposit accounts and NOW accounts. There is thus now very little distinction between the powers of thrift banks and those of commercial banks.²

Rural banks were given broader domestic banking powers but without activities (such as domestic letters of credit and trust services) not considered essential to their countryside operations.

1. Jaime C. Laya, *A Crisis of Confidence and Other Papers*, 1982, p. 107.

2. *Ibid*, p. 167.

Non-bank financial institutions authorized to perform quasi-banking functions (NBQBs) were given access to Central Bank credit facilities in order to enhance their ability to generate longer-term funds and make them more competitive. To enable investment houses to provide more effective longer-term financing and packaging, they have been allowed to undertake two additional functions, namely, trust functions and foreign exchange operations.

(c) *Protection of Depositors.* To provide deposit insurance protection to bank depositors, the Philippine Deposit Insurance Corporation (PDIC) was created. A special law was created to set aside a P15 million fund for the payment of depositors of closed banks in amounts not more than P10,000 each. This insurance protection was increased to a maximum of P15,000 in June 1978. To provide greater protection to bank depositors, the PDIC's maximum coverage was further raised to P40,000 effective 11 January 1984.

(d) *Financial Instruments to Promote Savings.* The following financial instruments were introduced during the 1970s and the first half of the 1980s to promote savings:

Premyo Savings Bonds (PSBs) were introduced in 1974 in line with the Savings for Progress Campaign intended to instill discipline in savings at the grassroot level. The initial issue of these bonds amounted to P500 million, of which P401 million were sold. These bonds have been phased out beginning 31 August 1987.

Deposit Substitutes. Towards the end of 1974, the Central Bank authorized certain institutions to engage in quasi-banking, defined as borrowing from 20 or more lenders, by issuing or accepting deposit substitutes (i.e., promissory notes, certificates of assignment or participation with recourse and repurchase agreements), for the purpose of relending or purchasing receivables and other obligations.

Biglang Bahay Bonds were introduced in 1978 as a mass savings instrument in support of the housing programme of the government. Total authorized issuance of these securities amounted to P1.0 billion. These bonds were also phased out beginning 31 August 1987.

The Automatic Transfer of Funds from a customer's savings account to his current account was introduced by some commercial banks during the early 1970s. To allow the customer to earn interest on his savings, the same was required only to maintain a minimum balance in his checking account. When his balance goes below the minimum, the bank automatically transfers funds from the savings account to the checking account in an amount exactly equal to what is required to maintain the minimum balance. With bank computerization in the late 1970s and early 1980s, this practice became widespread among com-

mercial banks, with different banks requiring different minimum balances.

NOW Accounts (Negotiable Orders of Withdrawal) are a special form of account from which funds may be withdrawn by means of negotiable orders of withdrawal. The Central Bank granted banks the authority to accept NOW accounts starting 1979.

CB (Central Bank) bills were introduced in March 1984 to support monetary policy objectives of moderating liquidity expansion and reducing inflationary pressures. Starting October 1986, CB Bill issuances were phased out on maturity dates to give way to auctioned Treasury bills as the primary instrument for open market operations.

Automatic Teller Machines (ATMs) were introduced in 1986. Commercial banks installed these machines in highly accessible and prime locations to allow depositors/cardholders to deposit/withdraw their funds anytime, even beyond regular banking hours. An earlier form of this card-type financial instrument was the bank customer service card which had the combined features of a credit, cash, deferred payment and instalment card.

4. Problems, Issues and Prospects

a) One of the objectives of the 1980 financial reforms was to encourage term-transformation among financial institutions, i.e., the rechanneling of short-term liabilities to long-term assets. The trend in the composition of assets and liabilities of commercial banks, however, would show that little term-transformation has occurred. While there has been an increase in the proportion of total commercial bank liabilities in the form of medium-term resources, i.e., savings and time deposits and capital and reserves to an average of 51.0 per cent in 1980-1986 from 43.0 per cent in 1975-1979 (see Table 5.5), short-term loans continued to account for more than half of loans outstanding of commercial banks, averaging 58.7 per cent in 1980-1986, from 62.3 per cent in 1977-1979. Commercial banks have shown preference for extending short-term loans to clients, rolling them over when due because this allows them to earn more from fees and other charges while minimizing liquidity and interest rate risks;

b) Domestic savings mobilization through deposits in banks has not grown fast enough to augment the financial requirements for economic recovery and thereby lessen the demand for external funds/debt;

c) Data for the first six months of 1987 showed a noticeable shift in the structure of deposits compared to December of 1986, from time deposits to savings and demand deposits, hence, the volatility of the

**Table 5.5 PHILIPPINES: STRUCTURE OF ASSETS AND LIABILITIES OF COMMERCIAL BANKS,
1975-1986 (In Per cent of Total)**

	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
Assets												
Cash and Other Cash Items	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Due from CB & Other Banks	3.8	3.7	3.1	2.6	2.8	2.4	1.9	1.6	1.6	1.4	1.5	2.4
Loans and Discounts	13.6	10.5	9.0	9.5	12.1	13.3	12.9	13.1	11.2	17.7	20.0	22.8
Investments in Bonds/ Securities & Customer's Liability Acceptance	49.0	53.5	53.8	54.4	55.2	55.9	55.0	54.7	56.2	46.4	43.9	37.7
Other Assets ¹	23.9	23.0	24.4	23.0	21.1	17.8	17.4	16.9	14.9	15.0	13.3	15.7
	9.6	9.2	9.6	10.4	8.8	10.6	12.7	13.8	16.1	19.5	21.3	21.4
Liabilities												
Demand Deposits	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Savings Deposits	12.5	12.7	13.2	10.7	10.0	9.2	8.7	6.2	7.7	5.3	5.2	7.9
Time Deposits	16.8	18.8	19.3	19.3	18.3	16.6	16.4	17.5	16.5	16.3	19.9	28.5
Bills Payable ²	9.6	12.9	16.7	18.6	20.8	26.6	23.0	25.0	22.6	24.9	25.4	19.1
Other Liabilities ³	34.2	30.4	23.8	24.2	24.6	23.7	27.2	24.9	26.7	22.5	24.2	11.8
Capital & Reserves	17.0	15.4	16.8	18.2	18.2	16.1	16.1	17.6	18.4	22.4	17.7	21.3
	9.7	9.8	10.2	8.9	8.0	7.7	8.5	8.8	8.1	8.5	7.6	11.4

¹ Includes bank premises, furniture and other real property.

² Includes deposit substitutes.

³ Includes dues to banks and treasurers'/managers' checks.

Source of basic data: Consolidated statement of condition of commercial banks.

existing fund base for long-term investment, notwithstanding the improvement in the investment climate for long-term projects.

B. Allocation of Financial Resources

1. *Financing the Government Sector*³

Government expenditure rose steadily from P26.2 billion in 1975 to P178.2 billion in 1984, an increase of almost 600 per cent. The increase was accounted for primarily by government corporations whose expenditures climbed from P8.0 billion in 1970 to P122.0 billion in 1984, an increase of over 1,400 per cent. Expressed in terms of their proportion to GNP, National Government (NG) expenditures showed a declining trend during the period, local government expenditures remained fairly constant and government corporations showed an increasing trend. The decline in the share of NG expenditure and the corresponding growth in the relative magnitudes of government corporate expenditure particularly evident since 1981, may be explained by the large-scale projects undertaken by government corporations in the areas of energy development, transportation, water supply and irrigation, as well as regular government functions undertaken by government corporations such as road building, port construction and subsidy programmes.

Taxes financed an average of 38.7 per cent of public sector expenditures over the period (Table 5.6). Non-tax receipts including government corporation operating receipts financed an average of 42.9 per cent of total public sector expenditures. In general, internal cash generation of government corporations was not sufficient to cover government corporate investments, so that government corporations had to rely on NG assistance (subsidy, equity and net lending) and on borrowings, particularly from foreign sources, to finance their savings-investment gap. Financing the corporate investment programme through borrowing or financial assistance from the NG exerts pressure on the budget, the balance of payments and money supply, and will eventually have to be financed from taxes, thus effectively shifting the burden of support to the government corporate sector from those who benefited from their services to the general taxpaying public. Net borrowing (loan availments less repayments or increase in deposits with the banking sys-

3. Source: Juanita D. Amatong, "Financing Government, 1975-1984", *CB Review*, November 1986, pp.24-31. Government is defined to include the National Government, local governments and 60 government corporations and is used synonymously with public sector.

Table 5.6 PHILIPPINES: FINANCING OF PUBLIC SECTOR EXPENDITURES, 1975-1984 (In Billion Pesos)

	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984
TOTAL	26.2	45.1	51.5	48.7	60.1	71.1	100.6	110.4	136.3	178.2
Taxes	14.5	16.1	18.0	21.7	27.5	32.1	33.3	35.8	41.8	53.1
Non-Tax Receipts, including Government Corporations	8.0	13.6	19.1	29.6	25.2	40.2	37.9	47.6	66.9	74.8
Net Borrowing	3.7	15.4	14.4	-2.6	7.4	-1.2	29.4	27.0	27.6	50.3
Foreign	1.2	1.8	6.7	7.1	7.8	6.3	9.4	16.9	32.6	42.9
Domestic ¹	2.5	13.6	7.7	-9.7	-0.4	-7.5	20.0	10.1	-5.0	7.4

¹ Computed as a residual. Positive sign means availment of domestic credit; negative sign represents an increase in cash balances and/or deposits.

Source: J. D. Amatong, "Financing Government, 1975-1984", *CB Review*, November 1986, p. 25.

tem plus NG equity contributions and net lending to government corporations) financed an average of 18.4 per cent of total public expenditure from 1975-1984. Net borrowing was a major source of financing for the years 1976-1977 and 1981-1984. Net foreign borrowing comprised the bulk of net borrowings of the public sector, with government corporations more heavily dependent on foreign borrowing than the National Government. Net domestic borrowing of the public sector consists of bank and non-bank borrowing (mainly borrowing from the public through issuance of government securities). Net bank borrowing was a more stable source of financing than non-bank financing, and the NG has relied more heavily on bank credit, especially from the Central Bank. In subsequent years, the trend has been reversed as non-bank borrowing became a major source of NG financing.

2. Financing the Corporate Sector

The private corporate sector, as represented by the top 1,000 corporations, relied heavily on creditors' funds to finance their assets. During the period 1970-1984, the debt-equity ratio, i.e., total liabilities over total stockholders' equity of the corporate sector averaged 2.9. This implied a highly leveraged financial structure as liabilities were more than twice the funds supplied by the owners themselves and the trend showed that this ratio was even increasing. In 1984, the debt-equity ratio increased to 5.38 (see Table 5.7).

Table 5.7 PHILIPPINES: DEBT - EQUITY RATIOS OF TOP 1,000 CORPORATIONS

Earlier Industrial Classification	1970	1975	Present Industrial Classification	1980	1981	1982	1983	1984
Agriculture	1.91	1.61	Agriculture, fishing	2.07	2.40	2.15	4.18	3.73
Utilities	2.54	2.09	Construction	2.98	3.49	4.15	2.40	22.76
Manufacturing	1.56	1.77	Electricity, gas & water	0.97	1.32	1.42	1.97	2.47
Mining	0.59	1.02	Manufacturing	2.51	2.17	2.13	2.43	2.81
Services	1.20	1.94	Mining & quarrying	1.14	2.09	3.47	4.26	4.53
Commercial	1.96	2.50	Services	1.56	1.67	1.78	1.12	1.61
Unclassified	1.90		Transportation, communication	2.75	3.16	3.69	6.50	3.38
			Wholesale & retail trade	3.50	3.92	3.97	3.79	3.73
			Financing, real estate	6.32	5.75	9.86	10.36	10.28
Total	1.56	1.77	Total	3.96	4.64	4.66	5.03	5.38

Source: Business Day, Top 1,000 Corporations in the Philippines.

By industry classification, the financing and real estate sector was the most leveraged sector with an average debt-equity ratio of 8.51 during the five-year period 1980-1984. The least leveraged sector, on the other hand, was the electricity, gas and water group with a debt-equity ratio average of 1.63.

While ideal financing would require that current assets be financed by current liabilities and fixed assets by long-term liabilities, such greater use of debt financing by the corporate sector implied that the sector faced greater risk of incurring greater losses during periods of adversity and vice-versa. Minimum reliance on equity by the corporate sector implied likewise the less profitable use of equity over debt partly owing to the deficiencies in the equities market, resulting in a higher cost of equity capital.

3. Financing the Agriculture Sector

The Philippines being a predominantly agricultural country, the government has, over the years, formulated policies designed to increase agricultural productivity. Among these were measures intended to increase the flow of credit to the sector.

(a) *Development of the Rural Banking System.* With the passage of the Rural Banks Act, the government made it a policy to promote and expand the rural economy in an orderly and effective manner by providing rural communities with the means of facilitating and improving their productive activities and encouraging cooperatives. Towards this end, the government helped establish rural banks whose function was to meet the credit needs of small borrowers who, because of the lack of bankable properties, are considered poor risks by commercial banks and other credit institutions. Basically, rural banks granted short-term loans although, with prior approval of the Director of the then Central Bank Department of Savings Banks and Savings and Loans Associations, they could also grant medium- and long-term loans. The types of loans rural banks were allowed to grant were: i) agricultural loans to small farmers exclusively for actual and incidental farm expenses; ii) commercial loans to small merchants for the purpose of purchasing merchandise for resale; iii) industrial loans to operators of rural industries exclusively for expenses for the manufacture and processing of essential or semi-essential goods which are readily saleable; and iv) loans to cooperatives either agricultural, commercial or industrial in nature for the purpose of assisting their members in the production, processing, storage and marketing of their crops, goods or merchandise.

Rural banks were allowed to grant medium- and long-term loans for such purposes as the purchase of farm land; improvement of agricultural, commercial and industrial real estate; acquisition of agricultural or industrial machinery, tools and other equipment needed in operations; and production and harvesting needs of crops which have a production cycle of more than one year.

With the financial reforms of 1981, rural banks were empowered to grant loans and make investment, accept savings and time deposits, sell domestic drafts, act as correspondent for other financial institutions and serve as financial collection agent for their customers. More than these, rural banks may also service current or NOW accounts, act as trustees of estates of farmers and merchants, and invest in financial and non-financial allied undertakings.

In terms of number and resources, rural banks grew substantially, from 507 in 1970 with total resources of P660 million to 1,085 at end-1986 with total resources of P9.4 billion.

(b) *Agricultural Credit Quota Policy.* To encourage urban-oriented institutions to undertake rural lending and to mobilize the resources of urban-based institutions for agricultural development, all banking institutions, whether government or private, were required since 1975, to set aside at least 25 per cent of their net loanable funds for agricultural credit in general. Of this quota, a minimum of 40 per cent (10 per cent of total loanable funds) was required to be made available for agrarian reform credit. Banking institutions were allowed to invest in eligible government securities any portion of the amount set aside for agrarian reform credit not actually loaned out. Presidential Decree (P.D.) No. 2032 dated February 1986, however, disallowed the use of alternative means of compliance with the agrarian quota requirement (i.e., eligible government securities).

Banks have consistently exceeded the minimum agricultural credit requirement (15 per cent) and agrarian reform credit subquota (10 per cent) by an average of 111 per cent and 34 per cent, respectively, during the period 1975-1986. Banks' compliance with the agrarian reform subquota was, however, largely in the form of eligible government securities.

It has also been observed that the requirement did not substantially increase the share of agricultural credit. At end-1979, the share of agricultural loans to total loans outstanding of banks averaged 17.1 per cent; at end-1986 this had only slightly risen to an average of 20.8 per cent.

(c) *Subsidized Credit.* Credit subsidy to agriculture came in the form of preferred interest rates on loans obtained from the Central Bank and

other government financial institutions. The different schemes for availment of agricultural credit subsidy were the following: (i) special time deposit availed of through the Special Financing Programme administered by the Central Bank; (ii) the regular rediscounting window of the Central Bank; and (iii) other special credit programmes of other government agencies.⁴

The provision of relatively cheap loanable funds to agriculture through the various Central Bank and National Government-managed credit programmes resulted in several negative, unintended effects on savings mobilization and the development of rural financial markets. There was very little attempt on the part of rural banks to build up internal resources and mobilize rural savings because subsidized loanable funds were available. The rural banks in effect became mere channels of government credit, sourcing almost half of their loanable funds from special time deposits and rediscounts with the Central Bank of the Philippines.⁵ Because rural banks were heavily dependent on government for their supply of loanable funds and for management assistance, they could not diversify their portfolios and spread their risks. Thus, many rural banks found themselves saddled with high arrearages. Past due loans rose from 19 per cent of the rural banking system loan portfolio in 1970 to 37 per cent at end-1985. Meanwhile, rural banks' arrearages to the CB increased to 80 per cent of outstanding regular rediscounts in 1985 from 6 per cent in 1970.⁶ On the part of farmer-borrowers, subsidized credit resulted in an excess demand for cheap institutional credit, prompting banks to resort to credit rationing. Thus, only the bigger farmers who had assets eligible for collateral had access to cheap institutional credit, driving small farmers to the informal credit markets, their only other alternative source of credit.⁷

To remedy the deteriorating condition of the financial system, a package of financial reforms was introduced recently. As part of the deregulation of the financial system, a uniform and market-oriented rediscount rate was adopted in 1986, in place of the selective and subsidized credit policy. In early 1987, a circular was passed providing for a rehabilitation package for rural banks. A Comprehensive Agricultural Loan Fund (CALF) was also created which consolidates the different special credit programmes of the Department of Agriculture into a single fund, which was converted into a guarantee fund. Under the guarantee scheme, the CALF assumes a maximum of 85 per cent of the

4. P. F. Neri, G.M. Llanto, *Agricultural Credit Subsidy*, CB Review, October 1985.

5. Ibid.

6. CB, Ad Hoc Study Group Report on *Rediscount Policy and the Arrearages Problem*, 1986.

7. G. M. Llanto, *Rural Credit Policy: Do We Need to Target?*, 1987, p.8

default risks of banks lending to agricultural projects. This risk-sharing strategy is expected to attract private banks to lend to agricultural projects.⁸

The Agricultural Loan Fund (ALF) was also established in 1985 to increase loanable funds to agriculture at market interest rates. Funding from the ALF came mainly from a loan from the World Bank.

C. Regulatory Issues

1. In 1981 a crisis of confidence in the financial system ensued when a banker, Dewey Dee, fled the country leaving behind hundreds of million pesos in debt. To prevent a recurrence of the crisis, the Central Bank, in coordination with the Securities and Exchange Commission, drew up new rules and regulations so that only prime borrowers could avail themselves of funds and suppliers of funds could be provided protection in the money market. Among others, a limit was set on the total outstanding liabilities or borrowings of a commercial paper issuer to not more than 300 per cent of its net worth. Any proposed issue was also required to be supported by a committed credit line agreement with a qualified bank. In 1981 also, a credit information system and a credit rating bureau were set up in order to provide lending institutions with more information on the total borrowings and credit standing of their borrowers.

2. To determine the true financial condition of banks and quasi-banks, the Supervision and Examination Sector (SES) of the Central Bank conducts periodic examinations of these institutions. There are, however, factors which serve as deterrents to a thorough examination of banks. For instance, the Secrecy of Deposits Act (Republic Act No. 1405) hampers the ability of Central Bank examiners to check the disposition of proceeds of loans lodged in deposit accounts.

Thus, a review of the legal constraints and other related factors may be undertaken to further improve the examination of financial institutions.

3. In order for bank management to establish sound banking policies and maintain confidence of its clients, limits are imposed on loans that may be availed of by directors, officers, stockholders and related interests (DOSRI). In the wake of recent bank failures which had been caused mainly by the non-collection of loans, especially those made to linked borrowers, it has been recommended that the definition of

8. Ibid, p. 12.

DOSRI be expanded to include borrowers with special linkages to DOSRI which do not fall under the coverage of the present DOSRI definition or to adopt separate regulations to limit loans to said borrowers with special linkages to DOSRI.

4. It has also been recognized that the early warning system of SES has to be continuously improved to come up with indicators to detect early signs of a failing bank.

D. Factors Affecting the Development of the Non-Securities Market

The development of the financial system as measured by the ratio M2/GNP may be related to movements in real interest rates and real incomes. During the early 1970s (1970-1974) when interest rates were administratively set at very low levels, there was an observed decline in financial intermediation. M2/GNP dropped from 0.23 in 1970 to 0.17 in 1974. The gap between deposit and loan rates was aggravated by the inflation rate (which hit double-digit levels due to the first oil shock and the floating of the peso), resulting in negative real deposit rates, which served to discourage savings. In 1974-1977, interest rate ceilings on savings and time deposits were adjusted upward, the ceiling on time deposits of over two years maturity was lifted and interest rate ceilings were imposed on deposit substitutes. In 1975-1978 when inflation rates narrowed down to single-digit levels, real interest rates turned positive (except on savings deposits) and led to an increase in financial intermediation, as indicated by the steady rise in M2/GNP from 0.17 in 1975 to 0.23 in 1978. The second oil shock in 1979 reverted inflation to double-digit rates. As real interest rates turned negative, disintermediation again occurred – M2/GNP declined to 0.21 and M3/GNP from 0.29 in 1977-1978 to 0.26. Financial savings initially responded positively to the lifting of interest rate ceilings beginning in 1981 and M2/GNP rose from 0.21 in 1979, to 0.22 in 1981 to 0.25 in 1983. However, the positive impact of interest rate deregulation on financial intermediation was short-lived. The deterioration in real income in 1984 and 1985 led to a drop in demand for financial assets. The overall reduction in aggregate demand resulted in financial difficulty for many firms and a weaker demand for loans. Thus, there was a drop in M2/GNP from 0.25 in 1983 to 0.21 in 1984-1985.

Aside from the developments in real income and the shift from a deregulated system of interest rates to floating interest rates, the non-securities market was also affected by the economic crisis in 1984 and 1985 when the country faced severe balance of payments problems.

External adjustments and tight monetary measures were called for to stabilize the exchange rate and the inflation rate. The demand for loans, however, dropped with the depreciation of the peso and the rise in domestic interest rates. As the economic recession persisted with the uncertainties in the political environment, the private credit market virtually became inactive. Banks became highly selective with their lending activities and engaged in the purchase of relatively high-yielding Central Bank bills, the primary monetary instrument used to mop up excess liquidity during the crisis years.

III. THE DEVELOPMENT OF THE SECURITIES MARKET

A. The Equity Market and Corporate Financing

Although the Manila Stock Exchange was established in 1927 and the Makati Stock Exchange in 1965, the Philippine stock market remained underdeveloped. In 1984, only 6.7 per cent of shares available in the market was traded on the exchanges. In 1986, considered a boom year for the Stock Market, the ratio rose to only 18.2 per cent. Of the total 207 stocks listed in both exchanges, as of end-1986, only a few were actively traded. In 1986, the 20 most heavily traded stocks in the Manila Stock Exchange accounted for almost 50 per cent of the total value of transactions, while in the Makati Stock Exchange, the 20 most heavily traded stocks accounted for 90 per cent of the total value of transactions. These figures suggest that from 50-90 per cent of trading activity in the exchanges is limited to only about 15 per cent of the total shares listed.

Moreover, while market capitalization has risen from P26 billion in 1985 to P40 billion in 1986, its proportion to GNP at 6.6 per cent in 1986 was still lower than the 12 per cent and 9 per cent ratios registered in 1980 and 1976, respectively. Table 5.8 shows the stock exchange transactions between 1972 to 1987.

The Philippine equity market is characterized by a low supply of, and a low demand for, securities. A study conducted by the Asian Development Bank⁹ attributed the low supply of securities in the market to several factors, one of which was the reluctance of corporations to go public. Of the top 1,000 corporations in the Philippines, less than 60 are listed in the exchanges. Many top-ranking corporations are

9. Asian Development Bank, *A Capital Market Study of the Philippines*, 1984.

Table 5.8 PHILIPPINES: STOCK MARKET TRANSACTIONS, 1972-1987
(Volume in Million Shares/Value in Million Pesos)

Item	1972		1973		1974		1975		1976		1977		1978		1979	
	Volume	Value	Volume	Value	Volume	Value	Volume	Value	Volume	Value	Volume	Value	Volume	Value	Volume	Value
Total	23,588	608	136,365	5,927	148,212	6,702	115,095	3,138	248,581	6,791	129,406	2,505	153,030	5,371	130,040	4,973
Commercial & Industrial	11	34	46	315	199	317	33	207	1,768	363	3,414	232	3,466	1,123	3,709	775
Mining	10,299	414	70,541	4,530	97,245	5,394	86,737	2,488	91,721	2,558	40,213	881	57,621	1,872	43,450	1,926
Oil	13,278	160	65,778	1,082	50,768	991	28,325	443	155,092	3,870	85,779	1,392	91,943	2,376	82,881	2,272
Item	1980		1981		1982		1983		1984		1985		1986		1987 ^a	
	Volume	Value	Volume	Value	Volume	Value	Volume	Value	Volume	Value	Volume	Value	Volume	Value	Volume	Value
Total	102,203	4,660	51,774	1,291	41,349	1,218	37,114	5,364	23,625	2,083	11,694	2,059	58,601	11,470	118,642	11,325
Commercial & Industrial	3,236	949	762	302	72	377	265	3,984	86	1,402	74	1,719	379	7,901	338	4,498
Mining	44,066	2,485	18,094	623	12,262	450	23,152	1,234	15,063	639	4,284	294	24,394	3,211	48,655	5,101
Oil	54,901	1,226	32,918	366	29,015	391	13,697	146	8,476	42	7,336	46	33,828	358	69,649	1,726

^a Half of the year

Source: Department of Economic Research - Domestic, Central Bank of the Philippines.

closely-held, whose owners maintain control over income and voting rights by raising their capital requirements through debt rather than issuing shares to the public.

The above accounts for the high debt-to-equity ratios of Philippine corporations (discussed in the section on Financing the Corporate Sector). This dependence on debt financing was encouraged partly by the government's low interest rate policy in the past, and its policy of providing cheap credit to certain preferred areas of economic activity.

The equity market is also characterized by a low demand for securities. The ordinary saver may not be knowledgeable about securities as an alternative to other forms of savings, such as traditional deposits which are considered "safer" and more liquid. The stock market is generally considered speculative and investment in stocks almost akin to gambling. Until the recent boom, moreover, money market instruments and later, government securities, particularly in 1984-1985, were the more financially-rewarding investments.

Another factor which is considered detrimental to the development of the equity market is the absence of clear and well-defined policies to develop the market. There is no single agency assigned the task of developing and promoting the stock market. It should be noted that the SEC's role is purely regulatory.

Realizing the need for a comprehensive policy to develop the Philippine capital market, the government and the private sector jointly sponsored a capital markets development workshop in May 1988. The objectives of the workshop were: (a) to assess the current state and condition of the Philippine capital markets; and (b) to identify a set of policy proposals directed towards the development of the Philippine capital markets.

The workshop passed the following major recommendations: (a) Declare capital markets development a priority policy of the government; and (b) Create the Capital Markets Development Commission to formulate, integrate and rationalize policies.

The proposed Capital Markets Development Commission will monitor and assess the changing conditions in the capital markets and recommend to both the executive and legislative branches the necessary measures which will accelerate domestic capital formation and economic recovery through the capital markets. As an interim measure, the workshop proposed the creation of a Study Group on Capital Markets Development to conduct a comprehensive review of pertinent laws and regulations, liaise with the private sector, and prepare an agenda for the Commission.

B. The Government Securities Market

In 1949, the Central Bank acting as fiscal agent of the National Government, introduced government securities in the financial market. Until 1965, however, the market for government securities was very limited. Securities issued within this period, which had maturities ranging from one year to 30 years and carried interest rates of 1 1/2 per cent to 5 per cent, were absorbed mostly by banks, particularly the Central Bank and a few institutional investors.

In 1966, the government securities market saw the launching of the Treasury Bills Programme. The programme aimed to provide the Central Bank with an additional monetary instrument for open market operations and to give the government a new, flexible and non-inflationary source of funds. The introduction of the Treasury bills in the market provided the staple for short-term funds, developing eventually to some extent secondary bills trading. A dealer network composed of five commercial banks and two investment houses which were accredited by the Central Bank comprised the nucleus of the bills market.

Another major development in the government securities market occurred in 1970 when the Central Bank Certificates of Indebtedness (CBCIs) Floatation Programme was launched. The prevailing monetary situation at that time reflected excess liquidity in urban centres and there was the need to rechannel these excess funds to the rural areas. Hand in hand with the liquidity dispersal objective, the CBCIs were likewise designed to provide effective means for open market operations and spark activity in the long-term markets.

In 1978, the Overall Programme for the Rationalization of Yields and Terms of Government Securities was instituted with a view to aligning yields of government securities with market rates and eventually establishing an active securities market in which debt management and open market operations may be effectively conducted in accordance with policy objectives. Initial implementation of the Programme came in the form of issuance of the redesigned CBCIs with a term of four years and a coupon rate of 9 per cent and which were sold at a discount through the auction method. With the introduction of these auctioned CBCI series, yields which used to be fixed, were made to follow market rates.

The following years saw a number of developments in the government securities market. New issues as well as refinancing issues of government securities were to be distributed as marketable or non-marketable instruments (see Table 5.9) Debt instruments to be publicly offered incorporate uniform marketability features, while those

Table 5.9 PHILIPPINES: SECURITIES ISSUED BY THE GOVERNMENT*

A. Direct Obligations of the National Government

1. Marketable Securities
 - a. Treasury Bills
 - b. Treasury Notes (Auction Series)
 - c. Treasury Notes (Regular Series)
 - d. Treasury Bonds
2. Non-Marketable Securities
 - a. Treasury Notes
 - b. Treasury Bonds
 - c. Public Works and Educational Development (PWED) Bonds
 - d. National Power Corporation (NPC) Capital Bonds
 - e. Metropolitan Waterworks and Sewerage System (MWSS) Capital Bonds
 - f. Land Bank Capital Bonds
 - g. Premyo Savings Bonds
 - h. Biglang Bahay Bonds
 - i. Capital Treasury Bonds
 - j. Capital Treasury Notes
 - k. Capital Bonds
 - l. Treasury Promissory Notes
 - m. National Irrigation Administration (NIA) Bonds
 - n. Treasury Capital Bonds
 - o. National Power Corporation Bonds
 - p. Special Series Treasury Bills A
 - q. Special Series Treasury Bills B

B. Guaranteed Obligations of the National Government

1. Marketable
 - a. National Development Corporation (NDC) Bonds
 - b. National Food Authority (NFA) Bonds
 - c. Bahayan Certificates
 - d. Philippine National Bank (PNB) Bonds
 - e. Land Bank of the Philippines (LBP) Investors' Series Bonds
 - f. National Housing Authority (NHA) Bonds
 - g. Light Rail Transit (LRT) Notes
 - h. National Power Corporation (NPC) Bonds
 - i. Export Processing Zone Authority (EPZA) Bonds
 - j. Public Estates Authority (PEA) Bonds
2. Non-Marketable Securities
 - a. National Waterworks and Sewerage Administration (NAWASA) Bonds
 - b. MWSS Bonds
 - c. Cultural Centre of the Philippines (CCP) Bonds
 - d. Philippine Charity Sweepstakes Office (PCSO) Bonds

C. Issues of the Central Bank of the Philippines

1. Central Bank Certificates of Indebtedness (CBCIs) (Direct Sale)
2. CBCIs (Auctioned)
3. Special Series CBCIs
4. Central Bank Bills

* Exclude foreign-denominated securities

intended for legal reserves or other statutory purposes carried non-competitive interest yields, rates and features.

1. *Primary Issues Market*

Under the Central Bank Charter (Republic Act No. 265, as amended), the actual issue, placement, marketing, servicing, and redemption of bonds and securities representing obligations of the National Government, its political subdivisions or instrumentalities is undertaken principally by the Central Bank. Although the respective charters of public corporations authorize them to undertake direct sales of their securities for purposes of control, uniformity, efficiency, and economy of operations and a more coordinated fiscal and monetary policy of the government, the actual issue and marketing of these securities have been lodged in one centralized directing authority.¹⁰

Primary distribution of government securities is made through subscription, negotiated sales or underwriting, or auction methods. These securities normally carry low rates. However, present policy directions reveal a move towards the issuance of more market-oriented government securities. With the complete deregulation of interest rates, government securities have slowly but surely gained marketability. The revival of the auction system in October 1986 in the determination of yields on government securities from the previously negotiated basis is one big step in boosting the marketability of government securities. When rates were negotiated, the absence of a "market" rate tended to create an artificial demand for securities which led to distortions in market conditions and imbalance in the flow of funds between the public and private sectors.

2. *The Secondary Market*

The secondary market for government securities developed alongside the development of a dealer network.¹¹ Soon after Treasury bills were floated in 1966, a dealer network composed of five commercial banks and two investment houses was formed under the organization of the National Association of Government Securities Dealers (NAGSD). NAGSD was accredited by the Central Bank and formed the nucleus of the Treasury bills market. However, its activities, which initially grew, slowed down and eventually stopped in the wake of the government

10. L. N. Salazar, "Understanding Government Securities", *Bondline*, First Quarter, 1974.

11. ADB, *A Capital Market Study of the Philippines*, 1984.

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policy to allow government institutions to participate in the auction of T-bills at lower discounts and higher volume. In 1974, the CB Securities Marketing Department was created primarily to market CBCIs, Premyo Savings Bonds and Treasury bills. Despite efforts to promote the sale of government securities, however, trading in the secondary market remained low. In 1981, the government renewed its efforts to promote the sale of government securities and in 1982, a network of Central Bank-accredited government securities dealers (AGSD) was formed, consisting of 12 banks and investment houses. The number of accredited dealers has increased since then to 15 by 1983 and 18 by 1986.

It is hoped that with the renewed efforts of the government in the promotion of secondary trading and the present policy of market-orientation as evidence by the revival of the auction system, a more active secondary trading may evolve which would provide a liquidity mechanism for investors/savers.

Table 5.10 and Table 5.11 show outstanding government securities by maturities and by holders.

C. Factors Affecting the Development of the Bond Market

The development of the bond market in the Philippines, particularly the government securities market, has largely been dependent on government policy objectives. The market has been utilized as a source of flexible and non-inflationary funds and issues were likewise used as instruments in the Central Bank open market operations. A vivid example was the floatation of CBCIs which provided the means to reduce excess liquidity in urban areas with funds rechannelled to the rural sector.

The market has also been influenced by the basic investor's consideration of liquidity and yield of the instruments purchased in financial markets. Developments in the early 1960s revealed the non-competitiveness of government securities in terms of yield rates vis-a-vis issues by some private firms. However, in the 1970s, following the gradual deregulation of interest rates and the adoption of the auction system in determining the rates on government securities, these instruments substantially gained marketability.

D. Prospects of the Government Securities Market

1. A new method for the computation of withholding tax on discounts which would result in lower tax to the investors may boost the marketability of government securities.

Table 5.10 PHILIPPINES: OUTSTANDING GOVERNMENT SECURITIES CLASSIFIED AS TO MATURITY
As of end-December 1985-1986 (In Million Pesos)

	1985				1986			
	Total	Short-Term	Medium-Term	Long-Term	Total	Short-Term	Medium-Term	Long-Term
National Government	59,399.2	32,548.8	8,880.9	17,969.5	88,878.3	60,201.2	9,361.2	19,315.9
Government Corporations	10,137.2	183.6	7,250.1	2,703.5	11,170.6	1,894.5	6,266.8	3,009.3
Monetary Institutions	25,353.4	25,015.4	338.0	—	23,662.0	23,324.0	313.0	25.0
Total	94,889.8	57,747.8	16,469.0	20,673.0	123,710.9	85,419.7	15,941.0	22,350.2

Source: Government Securities Department - Central Bank of the Philippines.

Table 5.11 PHILIPPINES: OUTSTANDING GOVERNMENT SECURITIES CLASSIFIED BY HOLDERS
As of end-December 1985-1986 (In Million Pesos)

Holders	1985			1986		
	Total ¹	National Government Corporations	Monetary Institutions	Total ¹	National Government Corporations	Monetary Institutions
Total	97,001.7	61,519.6	25,353.4	125,475.6	90,726.4	23,662.0
Central Bank	12,182.0	11,249.2	—	11,070.1	10,106.5	—
Commercial Banks	19,886.6	9,856.1	6,718.0	25,988.5	16,650.8	5,830.2
Land Bank of the Philippines	2,740.8	2,047.0	658.7	3,812.5	3,258.1	442.0
Others	62,192.8	38,367.8	17,976.7	84,604.5	60,711.0	17,389.8

¹ Includes foreign currency-denominated bonds.

Source of Basic Data: Government Securities Department - Central Bank of the Philippines CBP Form 5-17-05.

2. Despite the insurgency problem, the political and business climate has definitely improved with the stabilization of inflation rates, exchange rate movements and interest rates. This development should contribute to the marketability of government securities and lead to the normalization of the yield curve on government securities which showed abnormally high rates during the crisis years in the early 1980s.
3. To widen the market for government securities, the issuance of five-year savings bonds with a rate of 15 per cent (to be compounded annually) has been programmed in the future. The predetermination and eventual phase-out of Premyo Savings Bonds has been started. Likewise, low-yielding, reserve-eligible government securities have been gradually phased-out since 1986.

IV. CONCLUSION

“The future development of the capital market in the Philippines depends on a host of factors. One is the adoption and implementation by the government of a set of comprehensive policy measures to promote and develop the market. The workshop on the Development of the Capital Market held in May identified areas of concern for the priority attention of government policymakers. However, given that the Philippine government adopts a set of comprehensive policy measures geared towards the development of the capital market, the success of these measures in mobilizing domestic savings will, in turn, depend largely on the public’s perception of political stability and the peace and order situation.” □

Table 5.3 PHILIPPINES: CAPITAL ACCOUNTS BY SECTOR, 1970-1986 (As Per cent of GDP)

	1970	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Gross Domestic Savings												
1. Net Domestic Savings	9.0	12.6	14.4	14.9	14.1	16.3	15.6	14.6	9.8	8.4	4.6	3.5
a) Households	4.2	6.9	9.5	9.4	7.2	5.4	4.8	5.3	2.1	-0.5	0.4	0.4
b) Corporations	2.8	2.8	3.1	2.4	2.9	5.5	5.5	5.2	4.4	4.2	-0.3	-0.5
c) Government	2.1	2.9	1.8	3.1	4.0	5.4	5.3	4.0	3.4	4.7	4.5	3.6
2. Capital Consumption Allowance	8.9	9.9	9.5	9.5	9.4	9.4	9.3	10.0	10.2	10.2	9.9	11.0
3. Net Factor Income from Abroad	-1.7	-0.2	-0.8	-0.6	-0.4	0.2	0.0	-0.5	-1.5	-1.4	-2.4	-2.4
Total (S) ... (1+2+3)	19.7	22.7	24.7	25.0	23.9	25.6	24.9	25.1	21.5	20.0	16.9	16.9
Gross Domestic Investment												
1. Fixed Capital Formation	16.9	23.7	24.9	23.6	23.8	25.8	25.7	26.0	25.3	24.8	18.5	14.8
a) Construction	6.3	10.2	13.2	13.2	12.8	14.0	14.1	15.1	15.1	14.2	11.8	9.2
i) Government	1.0	3.8	6.1	6.2	6.0	6.7	6.2	6.6	6.5	5.1	3.7	3.1
ii) Private	5.3	6.4	7.0	7.1	6.8	7.4	7.9	8.5	8.6	9.0	8.1	6.2
b) Durable Equipment	10.6	13.4	11.7	10.4	11.0	11.8	11.6	10.9	10.2	10.6	6.7	5.5
i) Government	0.2	0.5	0.4	0.7	1.2	0.7	0.8	1.4	0.6	0.8	0.5	0.3
ii) Private	10.4	12.9	11.3	9.7	9.8	11.1	10.8	9.5	9.6	9.8	6.2	5.2
2. Increase in Stocks	3.1	5.8	6.1	5.1	5.1	5.2	5.0	4.6	3.1	1.9	-1.5	-0.8
Total (I) ... (1+2)	20.0	29.5	31.0	28.7	28.9	31.1	30.7	30.6	28.4	26.7	17.0	14.0
Investment-Savings Gap (S)-(I)	-0.3	-6.8	-6.3	-3.7	-5.0	-5.5	-5.8	-5.5	-6.9	-6.7	-0.1	2.9

Sources: CB Balance Sheet

Consolidated Statement of Condition of Commercial Banks, Thrift Banks, Specialized Government Banks and Rural Banks.

Appendix 5.2 PHILIPPINES: ASSETS OF THE FINANCIAL SYSTEM (In Million Pesos)

	1970	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
Financial System	30,833	122,648	142,936	159,257	200,920	254,583	313,217	360,930	430,862	561,306	693,264	754,010	730,974
A. Banks	24,784	95,838	108,997	124,189	159,597	204,995	254,271	297,628	356,707	469,273	597,783	646,751	617,976
1. Central Banks	6,003	25,974	28,972	28,983	38,358	50,970	65,447	71,571	91,697	130,372	206,026	251,612	313,892
2. Commercial Banks	14,066	53,173	58,731	68,676	89,798	113,953	138,417	164,615	190,972	247,928	289,151	283,347	248,526
3. Thrift Banks	944	2,126	3,024	4,080	5,603	7,675	10,558	11,631	12,586	16,149	14,968	15,081	17,652
a. Savings Banks	724	1,422	2,043	2,810	3,897	5,390	7,352	6,931	5,873	7,400	7,614	6,847	8,124
b. Pte. Development Banks	161	382	482	596	760	1,023	1,621	2,631	3,703	4,613	4,525	5,084	5,625
c. Stock Savings & Loan Assoc.	59	322	499	674	946	1,262	1,585	2,069	3,010	4,136	2,829	3,150	3,903
4. Specialized Govt. Banks	3,107	11,792	15,217	19,067	21,726	27,379	34,207	43,180	53,316	65,324	78,615	87,889	28,556
5. Rural Banks	664	2,773	3,053	3,383	4,112	5,018	5,642	6,631	8,136	9,500	9,023	8,822	9,350
B. Non-banks	6,049	26,810	33,939	35,068	41,323	49,588	58,946	63,302	74,155	92,033	95,481	107,259	112,998
1. Investment Houses	n.a.	4,774	4,825	4,747	4,763	6,553	8,607	5,865	6,764	7,210	7,506	6,600	7,519
2. Finance Companies	n.a.	3,467	4,644	5,852	7,366	9,743	11,902	12,123	12,919	11,811	9,588	6,164	5,627
3. Investment Companies	n.a.	1,092	2,829	2,950	3,613	4,088	4,980	5,513	5,916	6,160	2,603	11,855	10,154
4. Securities Dealers/Brokers	n.a.	1,067	1,092	978	1,120	1,035	1,036	997	642	683	548	463	946
5. Pawnshops	n.a.	90	149	179	192	229	291	336	382	438	624	808	1,011
6. Fund Managers	n.a.	2,610	3,307	552	834	1,158	1,658	749	1,114	1,530	943	1,649	1,288
7. Lending Investors	n.a.	61	17	16	19	23	50	35	40	49	68	93	237
8. Non-Stock Savings & Loan Assoc.	46	86	112	144	193	253	302	394	523	648	679	854	1,187
9. Mutual Bldg. & Loan Assoc.	25	26	23	23	21	21	19	18	20	19	17	16	16
10. Pte. Insurance Companies	1,669	4,225	5,230	6,168	7,803	8,955	9,997	11,334	13,716	13,716	14,139	18,065	20,284
11. Government Non-Banks	4,309	9,312	11,711	13,459	15,399	17,530	20,104	25,910	32,022	49,658	58,651	60,567	64,603
12. Venture Capital Corps.	-	-	-	-	-	-	-	48	97	111	115	125	126
13. Money Brokers	-	-	-	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

n.a. - not available

- - nil

Sources: CBP Forms 7-16-05, 7-16-05B & 7-16-04B

Appendix 5.3 PHILIPPINES: TOTAL DEPOSIT LIABILITIES OF THE FINANCIAL SYSTEM
(In Million Pesos)

	1970	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
Financial System	10,104.4	34,687.6	42,285.5	51,441.3	66,058.0	93,182.2	119,072.7	128,478.9	152,492.8	182,713.9	213,918.8	274,393.3	286,434.8
1. Central Bank	1,235.5	7,107.2	8,188.8	8,587.6	11,099.1	22,969.5	28,668.1	28,299.9	35,759.9	42,572.1	61,582.6	106,752.0	119,963.6
2. Commercial Banks	7,685.7	20,746.7	26,243.1	33,777.0	43,652.5	55,997.2	72,630.2	79,261.7	93,230.4	116,227.0	134,547.3	143,017.7	138,026.2
3. Thrift Banks	662.8	1,593.0	2,376.1	3,274.0	4,580.7	6,281.2	7,862.3	7,223.0	9,313.7	11,183.2	7,059.1	10,478.7	12,964.7
a. Savings Banks	557.8	1,183.9	1,760.6	2,458.1	3,479.0	4,830.6	5,985.5	4,565.2	5,101.0	5,957.8	3,138.9	5,734.8	7,021.9
b. Ptc. Development Banks	70.8	196.1	258.4	332.9	424.1	576.5	779.4	1,191.5	2,025.5	2,464.7	2,185.3	2,765.4	3,315.5
c. Stock Savings & Loan Assoc.	34.2	213.0	357.1	483.0	677.6	874.1	1,097.4	1,466.3	2,187.2	2,760.7	1,734.9	1,978.5	2,627.3
4. Specialized Govt. Banks	253.8	4,146.0	4,305.1	4,476.2	5,121.1	5,990.9	7,821.4	11,219.7	11,121.6	9,047.2	7,316.5	10,838.3	11,519.7
5. Rural Banks	260.3	1,085.3	1,157.3	1,306.8	1,579.2	1,911.1	2,050.5	2,427.3	2,995.8	3,591.4	3,316.2	3,127.0	3,767.1
6. Non-Stock Savings and Loan Assoc.	6.3	9.4	15.1	19.7	25.4	32.3	40.2	47.3	71.4	93.0	97.1	179.6	193.5

Sources of Basic Data: CB Balance Sheet, Consolidated Statements of Condition of Commercial banks, Thrift Banks, Specialized Government Banks, Rural Banks and Non-Stock Savings and Loan Associations.

**Appendix 5.4 PHILIPPINES: TOTAL LOANS OUTSTANDING OF THE FINANCIAL SYSTEM,
1981-1986 (In Million Pesos)**

	1981	1982	1983	1984	1985	1986
Total	158,060.9	178,742.2	208,123.8	216,633.0	183,349.3	162,453.6
1. Banks	125,588.6	143,901.9	169,903.6	175,241.0	133,191.7	110,278.2
A. Commercial Banks	86,505.2	98,239.6	111,387.7	116,382.2	87,573.3	83,087.4
B. Thrift Banks	5,923.2	7,339.4	10,354.3	8,628.6	6,105.2	8,472.0
a. Savings banks	2,908.4	3,488.5	4,426.6	4,338.7	2,086.3	3,550.0
b. Stock Savings & Loan Assoc.	1,330.6	1,859.1	2,950.8	1,782.0	1,661.5	1,970.0
c. Pte. Development Banks	1,684.2	1,991.8	2,976.9	2,507.9	2,357.4	2,952.0
C. Specialized Govt. Banks	27,672.1	31,653.9	40,513.6	43,207.7	32,876.9	11,928.2
D. Rural Banks	5,488.1	6,669.0	7,648.0	7,022.5	6,636.3	6,790.5
2. Non-Banks	32,472.3	34,840.3	38,220.2	41,392.0	50,157.6	52,175.4

Sources of Basic Data: CBP Forms 5-17-01, 5-17-02, 5-17-09 and 5-17-05.
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CHAPTER 6

Development of the Capital Market in Singapore

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I. AN OVERVIEW OF THE EXISTING CAPITAL MARKET STRUCTURE

A. Introduction

This paper traces the development of the capital market in Singapore during the post-1970 period and discusses the factors responsible for this development. The discussion is conducted under two broad categories, namely, the non-securities market and the securities market. In this Section, an overview of the capital market and the financial institutions involved in it is provided. In Section II, the non-securities side of the market is discussed. Section III looks into the development of the securities market. Finally, Section IV concludes the paper.

B. Developments in the Financial Sector during the Post – 1965 Period

Traditionally, Singapore has been a domestic and regional banking and financial centre which in part reflects its geographic location and its role as an entrepot. Until the late-1960s, the structure of the financial system adequately served the economy.

However, with the advent of industrialization and inherent structural changes that occurred, as a result, the demands on the financial sector increased considerably. Though the essential role of the financial sector remained one of servicing trade and industry, and of financial intermediation, the potential for developing the financial sector beyond its principally domestic focus was recognized and actively pursued. Thus, rather than just fulfilling a subsidiary role to meet the needs of other sectors of the economy, it was decided to develop it as a major growth industry in its own right. The development of the capital market is part of this policy.

One of the first steps taken toward the development of the capital market was the authorization for banks to establish a separate department to handle certain international assets and liabilities in 1968. After a bank had established an "Asian Currency Unit" (ACU), it could carry out international transactions under favourable regulatory and tax conditions. This marked the commencement of internationalism in the financial industry in Singapore.

Another measure, taken in 1970, was a reversal of the then-prevailing policy of not permitting entry of new foreign banks and financial institutions. In 1971, the Monetary Authority of Singapore (MAS) was formed and took over the supervision, control and licensing of all financial institutions in Singapore. The MAS, which also took on all the other functions of a central bank except the issuing of currency, was to play a major role in the financial development in Singapore.

Numerous other developmental measures were subsequently adopted in the 1970s. These included:

- a) the progressive relaxation of exchange control culminating in complete liberalization in 1978;
- b) the provision of a variety of fiscal incentives to promote the growth of financial activities and the development of new financial instruments;
- c) the relaxation or removal of restrictive practices to encourage healthy competition and growth in the financial industry; and,
- d) the expansion of the pool of expertise in the financial industry through developing training facilities and adopting liberal entry requirements for skilled personnel.

Since the late 1960s, the financial structure of Singapore became progressively differentiated and began to experience very rapid growth. The participation of new entrants into the industry brought on new types of financial activities. New markets were developed and existing ones improved in size and structure.

C. The Non-Securities Market

At the apex of the financial system is the MAS which acts as the central bank, supervising and regulating the financial institutions. The older participants in the capital market are the commercial banks, the Development Bank of Singapore, finance and insurance companies. Newer entrants are the merchant banks. Two governmental institutions that also participate in the capital market are the Post Office Savings Bank (POSB) and the Central Provident Fund (CPF).

The most important institutions in the financial system in Singapore are the *commercial banks*. As a group, they dominate the financial institutions in terms of domestic money supply, their role in financial intermediation, employment and GDP contribution.

Commercial banks are licensed under the Banking Act and come under three categories based on the type of licence they possess. "Full licence" banks are those permitted to carry out the full range of banking activities, both personal and corporate. All locally incorporated banks and foreign banks established before 1971 have such licences. "Restricted licence" banks may also engage in all types of banking transactions but are restricted in the size of deposits they may accept. They are not allowed to accept time deposits less than \$250,000; they may not operate savings accounts and they are restricted to doing business at one location. In all other respects, they can carry on business as the full licence banks.

"Offshore licence" banks concentrate on the business outside Singapore for the benefit of the region. They have existed since 1973 and are permitted to provide wholesale banking services to non-residents. They may also engage in some domestic banking business as provided for in the guidelines governing their operations.

As at the end of 1986, there were 134 commercial banks in Singapore out of which 121 were foreign. These foreign banks are all branches and subsidiaries of large and reputable banks from U.S., U.K., Japan and elsewhere. Singapore has a branch banking system. There are at present 395 banking offices out of which 206 belong to locally incorporated banks.

The Development Bank of Singapore (DBS) was established in 1968 by the Singapore Government to provide development finance in the form of medium- and long-term loans, equity participation and guarantees to manufacturing, processing, service and other industries. It was one of the vehicles through which the government implemented its economic development and industrialization policies in the past. In the 1970s, the DBS responded to changes brought about by the government's policy to develop Singapore as a financial centre. Since then, it has been active

in projecting itself as a commercial bank as well, and has diversified into commercial, international and merchant banking, real estate and property development, and related non-banking financial activities through its subsidiaries and affiliates. The government remains the largest shareholder of the bank, owning about half of its total paid-up capital of S\$293 million (as of 31 December 1986).

Merchant banks are incorporated under the Companies Act and must be approved by the MAS before commencing operations. They are less homogeneous than commercial banks and have been part of the financial structure since 1970. As of 1986, there were 58 merchant banks, 31 of which are subsidiaries of other banks and six of which are joint ventures between local and offshore banks. Merchant banks were established to encourage foreign banks to enter into joint ventures with local banks. Local participation was initially a necessary condition for obtaining MAS approval. This requirement was later abandoned.

Some merchant banks concentrate almost wholly on offshore transactions, while others concentrate on more traditional merchant banking activities, such as floatation and underwriting of stocks and shares, loan syndication and the provision of consultancy and management services. Some undertake a mixture of both offshore as well as general merchant banking. A few also participate in the gold market. On the whole, the offshore transactions of these banks dominate their assets/liabilities.

Finance companies operate along the same lines as commercial banks. They collect deposits and lend money to the public. Unlike banks, however, they cannot operate current accounts, deal in gold and foreign exchange or grant unsecured loans in excess of S\$5,000. Their operations are basically domestic and they engage largely in hire-purchase financing and the provision of mortgage loans. Some also carry out lease financing, accounts receivable financing, trade and inventory financing and factoring.

Finance companies operate under the Finance Companies Act. As of 1986, there were 34 finance companies with 134 offices in Singapore. All finance companies are locally incorporated. Of the 34 companies, half are affiliated with commercial banks. These bank-affiliated companies operate 64 offices and account for half of the total assets/liabilities of all finance companies. Licences of finance companies are renewed annually.

Presently, there are 90 *insurance companies* in Singapore, of which six are engaged in life insurance, 77 in general insurance and seven in both. In addition, there are 15 re-insurance companies. Besides these, Lloyd's is also an approved association of underwriters authorized to do general insurance business. These were first licensed in 1967 when the Insurance

Act came into effect to provide for better control and supervision of the insurance business. In terms of size of insurance funds, composite insurers dominate the market. Insurance plays the important role of averaging the risk for the public and acting as financial intermediary between savings and investment and thus helps finance economic development.

The Central Provident Fund (CPF) is a social insurance scheme, whereby compulsory contributions are made by all employees and their employers to a compulsory savings scheme for the benefit of the employees' retirement support. With the comparatively high rate of contribution and the increase in the number of contributors since it was established in 1955, the CPF has grown into a major financial institution, with balances due to members reaching S\$29.3 billion at the end of 1986. Contributions exceed withdrawals since the CPF has not reached maturity, with the bulk of its members being well below the age of 55, the normal retirement age when contributions may be withdrawn. Withdrawals may also be made under stipulated conditions for the purchase of housing and selected securities and assets. The funds absorbed by the CPF are invested mainly in long-term government securities and thus provide another major source of funds for the public sector. Recently, measures have been adopted to release more of these funds back to the private sector for investment in approved assets, thus allowing CPF members more flexibility in handling their CPF funds.

The Post Office Savings Bank (POSB) was set up in 1972 as a national savings institution for individuals in an effort to mobilize domestic savings for public sector development. Prior to this, it had been part of the Postal Services Department. The deposits with the POSB are invested mainly in government securities, lent to other statutory authorities and extended as housing loans to the public.

The POSB presently operates 137 outlets all over the island. Prior to 1973, more than 70 per cent of its funds were invested in long-term government securities, reflecting the statutory stipulation that at least half of its assets should be in the form of government securities. It has since been allowed to include loans to statutory boards and government-owned enterprises and other approved assets in the 50 per cent stipulation. More funds are now channelled towards fixed deposits with banks and term loans, including housing loans.

D. The Securities Market

The securities market in Singapore comprises the market for corporate securities and the market for government securities. Each of these can further be divided into primary and secondary markets.

The corporate securities market is characterized by a large equities market and a relatively small bond market. In the primary market, new issues are made through public subscriptions by companies listed on the Stock Exchange of Singapore (SES) or by private placements by some companies. Rights and bonus issues of existing companies constitute other forms of capital raised in the market. There are no issuing houses in Singapore of the type found in the U.K. but commercial banks, merchant banks and stockbroking firms undertake the floatation and underwriting of corporate securities. Private placements are usually done through stockbrokers. Offers of shares by the tender system have so far not been made in the corporate securities market.

Trading in the secondary market is centred around the SES. At the end of 1986, there were 317 companies listed on the SES. Of these 122 and 183 were incorporated in Singapore and Malaysia respectively, while 12 were incorporated elsewhere. In terms of trading volume, the SES is the third largest stock exchange in Asia (after Tokyo and Hong Kong). Daily turnover averaged 15,618,000 units. Paid-up capital and market capitalization of listed companies amounted to S\$27 billion and S\$85 billion respectively. Two new types of securities were introduced in the corporate securities market in 1976, namely a Singapore dollar bearer bond issue and Singapore depositary shares. Singapore dollar bearer bonds are designated as depositable securities, that is, they must be deposited with authorized depositaries. The Singapore depositary share represents ownership of an ordinary share, denominated in a foreign currency, of a company outside Singapore. In 1986, a bond that may be converted into shares of another company owned by the issuer was floated in the Singapore market for the first time.

The government securities market is characterized by a large primary market with a smaller but expanding secondary market. In the primary market, government securities are issued periodically mainly to absorb the surpluses of the CPF. It also enables banks and financial institutions to purchase government securities to meet their statutory requirements. The MAS, as financial agent to the government, manages the issue and redemption of government securities.

The longer-term registered stocks are absorbed largely by the CPF, which is required to invest its surpluses in government securities. Shorter-term bonds are purchased by banks to make up their liquid assets. At the end of 1986, government securities held by the various institutions and individuals totalled S\$17.8 billion. The CPF held about 75 per cent of the total bearer bonds as of 1986. Government securities held by private institutions form only a small portion of the government stocks outstanding. The MAS participates in the secondary

market and quotes prices both ways to facilitate and encourage a more active secondary market.

The Asian Bond Market (ABM) is the offshore component of the securities market and it caters to an international clientele. Borrowers in the Asian Dollar Market can raise medium- and long-term capital by tapping the ABM.¹ This market was launched by the government in 1971 and has since become active in consonance with Euro-Bond Market (EBM) and the world capital market. Most of the bond issues are denominated in U.S. dollars while other currencies include the Australian dollar, Deutschemark and Special Drawing Rights (SDRs). Up to 1986, a total of 151 issues have been floated, the total amount raised being U.S.\$8.5 billion. Besides straight bond issues, floating rate notes, convertible bonds and warrant bonds have also been used. All Asian bonds are listed on the SES and most of the trading is done over the counter.

A second securities market known as the Stock Exchange of Singapore Dealing and Automated Quotation (SESDAQ) system, was opened to enable younger companies to tap long-term funds to finance their business expansion. SESDAQ is a separate, distinct market within the Exchange. There are no minimum capital requirements, but at least 500,000 shares or 15 per cent of a company's paid-up capital must normally be in public hands when dealing commences. Instead of a five-year track record required for a full listing on the main board of the SES, companies seeking listing on SESDAQ need have only a three-year record. The first company to be listed on SESDAQ was the Singapore National Printers, in February 1987. There are currently seven companies listed on the SESDAQ.

The major institutions in the securities market are dealers and investment advisers licensed under the Securities Industry Act. Dealers that are not members of the SES may only deal in securities listed on the SES through an SES member. However, all licensed dealers may deal in any securities not listed on the SES. Investment advisers are individuals or institutions licensed to give advice concerning investment in

1. The Asian Dollar Market is essentially an international money and capital market where funds, largely foreign are pooled for on-lending, mainly to countries in Asia. This market is predominantly an interbank market which benefits, in particular, from being located in a time zone with business hours overlapping with Europe on the one hand, and Japan and Australasia on the other. The operators in the market are banks and other financial institutions which have been given approval by the MAS to undertake such activities. The operators have to set up separate book-keeping units known as Asian Currency Units (ACUs) for such transactions. The bulk of the business is with non-residents.

securities, to promulgate analysis and reports on securities and to engage in fund management. All licensed banks are exempted from the requirement of holding dealers' or investment advisers' licenses.

II. DEVELOPMENT OF THE NON-SECURITIES MARKET

Capital accumulation is necessary for economic growth. *Ceteris paribus*, the higher the rate of productive capital accumulation, the faster a country's economy can grow. The means to finance capital formation comes from savings, domestic and foreign. Under normal conditions, domestic savings provides the main source of financing capital formation. This is true even for a small open economy like Singapore where foreign savings in the form of foreign direct investment plays an active part in economic development.

A. Mobilization of Domestic Savings

Among ASEAN and the NICs, Singapore has high per capita income, savings, investment and average growth rates. Indeed, Singapore's savings rate is the highest in the world. It is evident that high income levels and growth rates are interrelated with high savings and investment rates. Furthermore, savings, capital formation and capital inflows are interrelated within the system of national income and balance of payments accounts.

Table 6.1 shows the gross domestic product (GDP), the gross national savings (GNS), the gross domestic capital formation (GDCF) and the net capital inflow (NFI) for the 1970-86 period. Their growth paths are charted in Figure 6.1²

Over the last two decades, a rising trend can be observed in Singapore savings ratio (defined as GNS/GDP). It rose from 20 per cent in 1970 to 43 per cent in 1986. Singapore's gross savings has been financing an increasing percentage of GDCF. In recent years, this percentage has exceeded 90 per cent of the GDCF.

National savings originates from three sources: corporate, household and public sectors. Table 6.2 shows the breakdown between the private (corporate and household) and public sectors. While the breakdown for the private sector savings is unavailable, data for a major form of household saving, the compulsory CPF savings is.

2. From the national income accounts, we have $GDCF = GNS + NFI$.

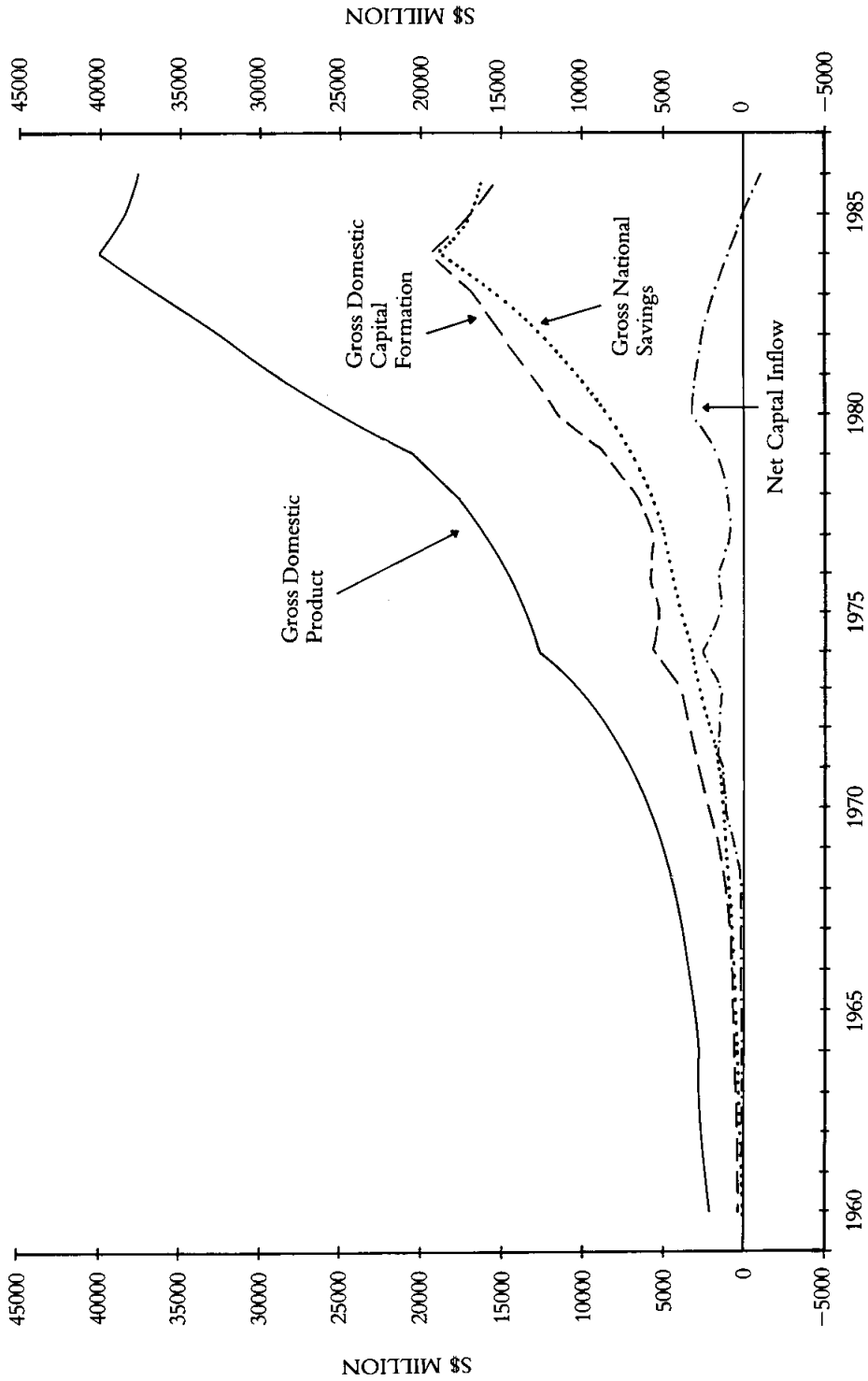
Table 6.1 SINGAPORE: CAPITAL FORMATION, SAVINGS AND CAPITAL INFLOW
(Current Market Prices, S\$m)

End of Period	Gross Domestic Product	Gross Domestic Capital Formation (GDCF)	Investment Ratio (GDCF/GDP) %	Gross National Savings (GNS)	Savings Ratio (GNS/GDP) %	Net Capital Inflows (NFI)	NFI/GDCF %	GNS/GDCF %
1960	2,149.6	244.5	11.4	-52.3	-2.4	296.8	121.4	-21.4
1965	2,956.2	647.7	21.9	341.0	11.5	306.7	47.4	52.6
1970	5,804.0	2,244.5	38.7	1,129.7	19.5	1,114.8	49.7	50.3
1971	6,823.3	2,744.1	40.2	1,252.7	18.4	1,491.4	54.3	45.7
1972	8,155.8	3,354.4	41.1	1,962.0	24.1	1,392.4	41.5	58.5
1973	10,205.1	4,000.0	39.2	2,725.0	26.7	1,275.0	31.9	68.1
1974	12,543.2	5,592.0	44.6	3,102.4	24.7	2,489.6	44.5	55.5
1975	13,373.0	5,236.1	39.2	3,850.9	28.8	1,385.2	26.5	73.5
1976	14,575.2	5,843.0	40.1	4,441.2	30.5	1,401.8	24.0	76.0
1977	15,968.9	5,624.2	35.2	4,904.4	30.7	719.8	12.8	87.2
1978	17,750.6	6,678.0	37.6	5,649.0	31.8	1,029.0	15.4	84.6
1979	20,452.3	8,546.7	41.8	6,946.6	34.0	1,600.1	18.7	81.3
1980	25,090.7	11,627.6	46.3	8,400.3	33.5	3,227.3	27.8	72.2
1981	29,299.0	13,209.8	45.1	10,298.1	35.1	2,911.7	22.0	78.0
1982	32,614.3	15,190.6	46.6	12,610.7	38.7	2,579.9	17.0	83.0
1983	36,479.7	16,946.1	46.5	15,214.9	41.7	1,731.2	10.2	89.8
1984	40,047.9	19,607.0	49.0	18,826.4	47.0	780.6	4.0	96.0
1985	38,521.1	16,826.2	43.7	16,793.8	43.6	32.4	0.2	99.8
1986P	37,773.6	15,091.5	40.0	16,134.4	42.7	-1,042.9	-6.9	106.9

Source: Department of Statistics

P: Preliminary

Figure 6.1 SINGAPORE: SAVINGS, CAPITAL FORMATION & FOREIGN INFLOW
(At Current Market Price)



Source: Department of Statistics

Table 6.2 SINGAPORE: SAVINGS BY PUBLIC AND PRIVATE SECTORS

End of Period	Gross National Savings (GNS)	Public Sector Savings \$m		Private Sector Savings (\$m)					Residents' Deposits with ACU (\$m)
		Total	% of GNS	Total	% of GNS	CPF	% of Total	% of GNS	
1974	3,102	736	23.7	2,366	76.3	643	27.2	20.7	397
1975	3,851	1,362	35.4	2,489	64.6	821	33.0	21.3	324
1976	4,441	1,470	33.1	2,971	66.9	831	28.0	18.7	- 558
1977	4,904	2,021	41.2	2,883	58.8	888	30.8	18.1	-115
1978	5,649	2,230	39.5	3,419	60.5	1,027	30.0	18.2	902
1979	6,947	2,801	40.3	4,146	59.7	1,534	37.0	22.1	627
1980	8,400	3,407	40.6	4,993	59.4	2,036	40.8	24.2	989
1981	10,298	4,261	41.4	6,037	58.6	2,599	43.1	25.2	1,808
1982	12,611	5,936	47.1	6,675	52.9	3,506	52.5	27.8	36
1983	15,215	8,649	56.8	6,566	43.2	3,849	58.6	25.3	1,048
1984	18,826	11,291	60.0	7,535	40.0	3,166	42.0	16.8	774
1985	16,794	11,052	65.8	5,742	34.2	4,159	72.4	24.8	1,226

Sources: Economic Survey of Singapore, Ministry of Trade & Industry.

Yearbook of Statistics, Department of Statistics

Note: Public sector savings refer to current surplus in consolidated accounts of the public sector.

Figures for CPF and residents' deposits with ACU are changes in year-end data.

Two features are discernible from Table 6.2. First, the share of public sector savings displays an upward trend rising from 24 per cent in 1974 to 66 per cent in 1985, while the converse is true for private savings. Second, CPF savings has taken up an increasing share of the private-sector savings rising from 27 per cent in 1974 to 72 per cent in 1985.

1. CPF and Private Savings

The CPF is a compulsory savings scheme established to provide retirement benefits for employees. The scheme is funded by contributions from both employers and employees. The combined contribution rate increased from 10 per cent at its inception in 1955 to 50 per cent in 1984. However, this rate was reduced to 35 per cent in response to the recession in 1985-86. While CPF savings constituted 21 per cent of GNS in 1974, its share in GNS in 1985 stood at 25 per cent. The CPF is therefore a significant tool for mobilizing domestic savings despite the fact that since 1968 the use of CPF funds has been liberalized.

Under the liberalization policy, CPF members may use their accumulated balances to purchase public sector flats and, lately, also private residential property. CPF members may use their balances to purchase mortgage-reducing insurance and life insurance policies (both of which are being provided by the CPF). Finally, members may also use their funds to invest in a selected range of assets approved by the CPF Board. In sum, the CPF scheme has undergone many changes to become a source of finance for the purchase of a designated list of merit goods. Despite this, annual withdrawals from CPF constitute only one third of the gross contribution to CPF. The remaining two thirds stay with the CPF.

2. Financial Intermediaries and Savings

While the growth of CPF savings is due to the force of law, the mobilization of private-sector non-CPF savings depends on the opportunities and incentives to save. With the well developed financial sector in Singapore, many avenues for financial savings exist.

Table 6.3 provides the details of financial savings in Singapore for the 1975-86 period. During this period, GDP at current market prices increased three fold but financial savings increased by four times.

Table 6.3 SINGAPORE: FINANCIAL SAVINGS (\$million)

End of Period	Currency in Active Circulation	Bank Deposits	Finance Companies Deposits	POSB Deposits	Life Insurance Savings	Total	Residents Deposits with ACUs
1974	1,306.4	6,052.1	681.4	147.6	32.6	8,220.1	1,129.9
1975	1,637.7	7,044.9	717.7	304.6	43.7	9,748.6	1,453.5
1976	1,946.8	7,838.3	846.0	788.8	53.6	11,473.5	895.7
1977	2,242.6	8,162.8	973.0	1,251.2	64.7	12,694.3	781.2
1978	2,582.8	9,027.1	1,189.7	1,778.2	77.0	14,654.8	1,682.8
1979	2,941.2	10,818.9	1,501.1	2,245.6	99.0	17,605.8	2,309.3
1980	3,137.0	14,122.3	1,788.7	2,677.7	114.8	21,840.5	3,298.6
1981	3,381.8	17,688.2	2,395.3	2,925.1	128.9	26,519.3	5,106.6
1982	3,996.0	20,411.1	3,224.8	3,647.3	167.8	31,447.0	5,142.6
1983	4,335.3	23,043.1	4,188.8	4,028.4	200.6	35,796.2	6,190.9
1984	4,619.2	24,518.6	4,813.6	4,118.6	203.5	38,273.5	6,964.8
1985	4,739.0	25,509.5	4,359.3	4,521.5	214.5	39,343.8	8,190.9
1986	5,033.4	27,966.0	4,060.4	5,169.5	244.5	42,473.8	10,746.0

Sources: Monthly Statistical Bulletin, Monetary Authority of Singapore.

Yearbook of Statistics, Department of Statistics.

Notes: 1) All figures are stock data, except for Life Insurance Savings which is an annual flow by definition.

2) Bank Deposits are demand deposits plus savings and fixed period savings.

3) Life Insurance Savings is defined as premiums less claims less surrenders less cash bonuses and annuities.

Since 1975, individual banks have freely quoted their own lending and deposit rates in accordance with market conditions.³ Being the most dominant and established of the financial institutions, commercial banks hold the largest share of the financial savings (demand deposits and quasi money). This share has, however, been declining (see Table 6.3).

The POSB has registered much growth during the last two decades. Its success was especially phenomenal since 1972 when it was separated from the Department of Postal Services. The tax-exempt status of the interest earnings from POSB deposits may be one cause. However, the re-constituted POSB also competed for deposits with other private-financial institutions by offering a higher interest rate than banks from 1974 onwards, computerizing its accounting system, installing on-line banking terminals at its branches and introducing many innovative services.⁴

Finance companies compete for deposits through offering higher rates than the banks and the POSB. They grew rapidly in the 1960s and early 1970s and thus collected a substantial share of financial savings. In the face of increasing competition from other financial institutions, they have succeeded in maintaining their share of the financial savings.

Finally, the Asian Currency Unit (ACU) is a relatively new and increasingly important institution through which financial savings may be channelled.⁵ Table 6.2 shows the growing resident deposits in the ACUs. However, we should note that these deposits are not necessarily utilized in Singapore and are, therefore, treated as an outflow of funds abroad.

Among the various capital flows, three items are best captured by the balance of payments statistics: official capital movement, movement of funds through the monetary sector (banks) and long-term direct investment. Official capital flow consists of drawing of international loans by the Singapore government (credit) and investment in foreign assets by the statutory boards (debit). In most years, official capital flow was a net inflow, but over the last few years, net redemption of loans has brought about a net outflow.

3. Prior to 1975, commercial banks' interest rates had been under a fixed cartel system. In 1975, the MAS introduced a policy to promote free and open competition, thus freeing the interest rates.

4. For further details, see Tan (1981), chapter 16.

5. ACUs are book-keeping units of those financial institutions which have approval to operate in the Asian Dollar Market which is the offshore component of the financial business in Singapore. There were 182 ACU licences among the financial institutions in Singapore as at 31 December 1986. ACUs may freely accept deposits and lend to all interested parties in all currencies except Singapore dollars.

The movement of funds through the monetary sector is essentially short-term. A large amount of funds was brought in by banks partly to finance credit expansion.

The establishment of the Asian Dollar Market (ADM) has also facilitated the flow of funds in and out of Singapore. A significant proportion of the capital that passed through the monetary sector has been channelled through the ACUs.

Long-term direct investment covers foreign physical investment in Singapore, re-investment of profits by resident branches of foreign enterprises, changes in inter-company debt, and loans and credits received by government-linked companies and statutory boards. Political stability and strategic location, coupled with a favourable investment climate have attracted a continuous inflow of private capital into manufacturing and other sectors.

The balancing item is the catch-all category for other forms of capital flows. For our present purpose, we note that total capital inflow has invariably exceeded the current account deficit in magnitude, and this surplus has gone into building Singapore's foreign reserves.

3. Singapore as a Focal Point for International Transfer of Savings from Abroad to the Region

South East Asia, Australia, and the rest of the Southern Pacific constitute a natural lending area for Singapore-based financial institutions. The Asia-Pacific region is a net recipient of savings transfer through the ACUs from the rest of the world. Europe has consistently been the largest net supplier of funds to the ACUs, though the Middle East and Western Hemisphere countries were also significant net suppliers of ACU funds.

Singapore itself has been a modest net supplier of funds to the ACUs. While the Singapore economy as a whole is a net user of savings from the rest of the world, this is largely due to net capital inflows in the form of direct investments.

B. Allocation of Funds

Gross domestic capital formation has increased almost without interruption during the last two decades (Table 6.1). It rose from 11 per cent of GDP in the initial years to 40 per cent in 1986. The only interruption to this trend occurred during the 1975-77 and 1985-86 periods when the recessions shook business confidence in Singapore.

Rapid capital accumulation and economic growth are interdependent. In the early years when industrialization was the focus of economic policy, establishment of industrial estates, construction of factories and shipyards, and installation of machinery and equipment constituted the main forms of capital accumulation. The social goal of providing public housing also constituted a major form of capital formation.

In recent years, the diversification of the economy called for the purchase of aircraft and ships for the national airline and shipping line, and the construction of hotels for the tourist industry and of new-fashioned banking offices to meet the needs of a financial centre. Modernization and urban renewal brought into being skyscrapers, shopping complexes, container ports and related facilities. Lately, technological upgrading has set the trend towards the acquisition of computers, automated machinery and equipment, modern telecommunications facilities and apparatus and so on. Significant investment projects undertaken in recent years include Changi Airport, expressways, Marina Square, Raffles City and the Mass Rapid Transit (MRT) subway system. All these processes of capital formation have been intermeshed, serving as a demand stimulus.

Table 6.4 shows that the private sector accounts for 70-80 per cent of the GDCF while the public sector takes up the remaining 20-30 per cent.

The public sector is defined to exclude commercial enterprises like the Singapore Airlines (SIA), the Neptune Orient Lines (NOL) and Keppel Shipyard which are wholly or partly owned by the government. As such, the public sector is primarily responsible for the provision of socio-economic infrastructure. Hence, construction and works form the bulk of capital formation within the public sector (see Table 6.5).

However, what stands out most in Singapore is the massive construction of Housing and Development Board (HDB) flats, which now house about 77 per cent of the population. Expenditure on hardware is mainly incurred by statutory bodies like the Public Utilities Board (PUB) on power plants, and Telecommunication Authority of Singapore (TAS) on telecommunications equipment.

In the private sector, construction and works constitute less than half of the total capital formation. The construction of residential and non-residential buildings has had its boom and bust along an uptrend. The momentum of the 1979-81 upswing carried forward into 1982 in spite of the recessionary conditions. However, the pace of construction activity began to slow down in 1983.

Table 6.4 SINGAPORE: GROSS DOMESTIC CAPITAL FORMATION BY PRIVATE AND PUBLIC SECTORS AT 1968 MARKET PRICES, 1960-1986

Year	Gross Domestic Fixed Capital Formation (S\$ mil)	Percentage Shares of	
		Public Sector	Private Sector
1960	219.9	29.8	70.2
1965	639.5	31.0	69.0
1970	1,712.0	19.2	80.8
1973	2,703.6	16.8	79.9
1974	3,024.9	17.9	77.4
1975	2,934.8	23.3	71.0
1976	2,976.7	28.6	69.1
1977	2,986.2	30.8	68.0
1978	3,171.0	30.1	75.0
1979	3,912.9	20.2	75.4
1980	4,624.7	20.8	76.3
1981	5,724.3	19.1	72.6
1982	6,797.6	23.1	71.5
1983	7,167.8	27.0	70.8
1984	7,518.6	27.8	72.9
1985	6,608.4	30.8	69.2
1986P	5,824.2	35.2	64.8
Average 1973-86		25.1	72.4

P: Preliminary data.

Source: Department of Statistics.

Private sector expenditure on machinery and equipment is well spread across industries and across various categories of hardware. The acceleration of this category of expenditure over the last decade or so reflects the increased capital intensity of production processes, particularly in the manufacturing sector. Expansion and upgrading of the services of SIA and NOL and the rationalization of the domestic transportation system have led to heavy investment in aircraft, ships, buses and taxis.

Table 6.5 SINGAPORE: STRUCTURE OF CAPITAL FORMATION
At 1968 Market Price (Per Cent)

End of Period	Gross Domestic Fixed Capital Formation (\$8m)	Public Sector					Private Sector						
		Non Residential Building		Other Construction & Works	Transport Equipment	Machinery & Equipment	Non Residential Building		Other Construction & Works	Transport Equipment	Machinery & Equipment		
		Total	Residential Building	Total	Residential Building	Transport Equipment	Total	Residential Building	Total	Residential Building	Transport Equipment		
1973	2,703.6	16.8	6.4	2.1	3.9	0.4	4.0	79.9	11.2	7.7	0.6	21.5	38.8
1974	3,024.9	17.9	6.1	2.8	4.0	0.3	4.7	77.4	9.4	6.2	0.6	21.9	39.3
1975	2,934.9	23.3	7.6	4.3	5.6	0.4	5.4	71.0	9.3	6.1	1.2	17.2	37.2
1976	2,976.7	28.6	9.1	5.5	7.2	0.5	6.4	69.1	9.3	5.1	0.9	23.2	30.6
1977	2,986.2	30.8	10.9	4.9	7.1	0.4	7.5	68.0	8.7	5.3	0.3	27.5	26.3
1978	3,171.0	30.1	9.0	4.7	6.4	0.2	9.8	75.0	6.2	9.0	0.1	30.2	29.5
1979	3,912.9	20.2	6.7	4.2	5.3	0.2	3.8	75.4	4.8	10.9	0.1	29.1	30.4
1980	4,624.7	20.8	6.2	4.3	5.9	0.3	4.1	76.3	4.7	11.5	0.2	27.6	32.3
1981	5,724.3	19.1	5.8	4.5	4.8	0.6	3.5	72.6	5.6	13.0	0.2	20.7	33.0
1982	6,797.6	23.1	8.4	4.5	4.3	0.2	5.7	71.5	8.2	14.2	0.2	20.9	28.0
1983	7,167.8	27.0	13.0	5.0	4.5	0.2	4.4	70.8	12.9	15.0	0.1	17.0	25.8
1984	7,518.6	27.8	13.1	5.1	5.0	0.3	4.3	72.9	16.5	13.7	0.1	14.7	27.9
1985	6,608.4	30.8	11.5	5.1	6.9	0.2	7.1	69.2	14.3	11.3	0.1	13.7	29.7
1986P	5,824.2	35.2	10.4	5.5	11.9	0.3	7.1	64.8	8.8	6.8	0.1	13.5	35.7

P: Preliminary data

Source: Department of Statistics

Note: All items are expressed as percentage shares of Gross Domestic Fixed Capital Formation.

1. *The Government's Role in the Utilization of Funds*

The current surplus of the government budgetary operations has been utilized to finance development expenditure. For most years, the public sector incurred a relatively small deficit after defraying current and development expenditures. This deficit ranged from S\$46 million (1978) to S\$694 million (1976). The government proper has been in overall surplus throughout. All statutory boards except the HDB have been in surplus most of the time. Only the HDB, which incurs heavy capital expenditures each year in the construction of public housing and selling or renting the flats to the public below cost, operates with a consistent deficit.

The small overall deficit of the public sector is invariably more than covered by domestic borrowing in various forms of government securities – registered stocks, bearer bonds, treasury bills, etc. The major lender to the government is the CPF, which invests more than 90 per cent of its funds in government securities, mainly registered stocks and advanced deposits, and takes up an average of 90 per cent of the total annual net government domestic debt issue. CPF savings is thus placed at the disposal of the public sector via the government debt policy.

In terms of financial needs, it is obvious that the Singapore government does not have to borrow from abroad. Hence, external borrowings have been relatively small in magnitude. Indeed, since 1979 there has been a net redemption of external debt (see Table 6.6). Nevertheless, the public sector has borrowed abroad and will presumably continue to do so.

C. Factors Contributing to the Development of the Non-Securities Market

1. *Non-Policy Factors*

An explanation of the development of the non-securities market must include both “non-policy” and “policy” factors which played significant and interacting roles.

The process of rapid economic growth in Singapore has been closely associated with the extension and increasing diversification of financial intermediation. The causation between economic growth and financial development is complex, and almost certainly not uni-directional. Growth in the production of goods and services and the accumulation

Table 6.6 SINGAPORE: PUBLIC SECTOR ACCOUNTS

	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Revenue	4,607	5,465	6,140	7,151	8,111	10,592	13,140	16,111	18,260	21,727	22,655
Tax Revenue	2,165	2,317	2,598	2,795	3,161	4,064	5,184	6,148	6,841	7,345	6,569
Expenditure	4,934	6,159	6,565	7,197	7,732	10,556	13,614	16,664	16,819	17,954	20,231
Current	3,245	3,995	4,119	4,921	5,310	7,185	8,879	10,175	9,611	10,436	11,603
Development	1,689	2,164	2,446	2,276	2,422	3,371	4,735	6,489	7,208	7,518	8,628
Current Surplus/ Deficit (-)	1,362	1,470	2,021	2,230	2,801	3,407	4,261	5,936	8,649	11,291	11,052
Overall Surplus/ Deficit (-)	-327	-694	-425	-46	379	36	-474	-553	1,441	3,773	2,424
Government Debt (net)	1,176	1,617	1,815	1,562	1,703	2,273	2,468	3,592	4,301	3,046	4,087
Domestic (net)	1,127	1,501	1,486	1,531	1,745	2,313	2,509	3,614	4,504	3,076	4,132
External (net)	49	116	329	31	-42	-40	-4	-22	-203	-30	-45
Use/Accumulation of Cash (-)	-849	-923	-1,390	-1,516	-2,082	-2,309	-1,994	-3,039	-5,742	-6,819	-6,511

Sources: Economic Survey of Singapore, Ministry of Trade and Industry.

Yearbook of Statistics, Department of Statistics.

Note: The statutory boards are HDB (Housing and Development Board), JTC (Jurong Town Corporation), PUB (Public Utilities Board), PSA (Port of Singapore Authority), TAS (Telecommunication Authority of Singapore), URA (Urban Redevelopment Authority) and SDC (Sentosa Development Corporation).

of physical and asset capital have stimulated expansion and adaptation of the activities of financial intermediaries. Innovations in financial intermediation have also catalyzed the process of real growth. There is a general tendency for financial interrelations in an economy to expand more rapidly than the real sector of the economy in the early and intermediate stages of economic development.

Most dimensions of economic activity in Singapore have grown rapidly over the last two decades or so. The most comprehensive measure of real economic activity, the GDP in constant prices has grown at a compound annual rate of 8 per cent over the 1970-86 period. To some extent, therefore, capital market growth in Singapore can be attributed to the vigorous real economic growth.

However, financial activity is too large to be entirely attributable to the growth in the domestic economy in Singapore. In particular, the growth of the banking industry cannot be attributed solely to real economic trends within Singapore itself. To appraise the basic non-policy factors encouraging financial development in Singapore, we should also include the economic and financial activity within the larger regional area in which Singapore is located.

Many parts of Asia and the Pacific, like Singapore, experienced rates of growth during the last two decades that were well above the world average. Indonesia, Malaysia, Thailand, HongKong, Korea and Taiwan all experienced annual real GDP growth rates of 7 per cent or more during the last two decades. Japan's growth rate was only slightly less than 7 per cent.

This rapid output growth in the Asia-Pacific leads naturally to the presumption that financial intermediation in Singapore has been stimulated by regional economic sector activity. The growth in the region would have required and attracted financing support of some sort. Hence, even if financial intermediation in Asia had merely passively followed output growth, banking and other finance in the region would have expanded at a vigorous rate.⁶

A third factor is that the world economy has, in recent decades, experienced marked increases in cross-border and cross-currency financial intermediation. An important explanation for this trend is the decline in effective economic distances between nations as a result of

6 For example, the mere financing of cross-border trade within the Asia-Pacific region and between that region and the rest of the world would have generated high growth in bank loans and acceptances. And, as their non-financial customers increasingly set up production and sales facilities in Asia, the larger banks in the industrial countries would have had increasing incentives to set up their presence somewhere in Asia to support these customers' activities with a range of financial services.

new communication and transportation technology which have lowered the costs of international relative to domestic financial transactions.

2. Policy Factors

Regulatory, tax, and supervisory policies in Singapore contributed to the growth of the financial sector. Beginning in the mid-1960s, the government took numerous actions to stimulate domestic savings and investment. These included major tax incentives (among others, a favouring of savings placed with the POSB) and very large mandatory contributions by both employees and employers to the CPF. In 1963-65, private consumption represented more than 80 per cent and GNS less than 7 per cent of GDP. By the mid-1980s, private consumption had fallen to less than 50 per cent of GDP, while the ratios for GNS and GDCF have risen dramatically to more than 40 per cent. This has contributed to the rapid financial growth in Singapore.

The favourable tax and regulatory environment in Singapore for offshore financial activities relative to most other Asian countries created inducements for international financial institutions to establish or expand their operations in Singapore. This is especially true for transactions with non-residents or those denominated in foreign currencies which were highly inhibited in many Asian countries.

Another factor was the "home policy" environment. Banks with head offices in countries with stringent policy environments were induced to locate elsewhere in order to conduct intermediation activities they could not otherwise carry out, or carry out in as unrestricted and profitable a way. The constraints in the home environments interacted with the attractiveness of the policy environment in Singapore to induce the establishing and expansion of Asian operations in Singapore.

3. Additional Factors

Some additional factors, which can conveniently be grouped under the heading of "locational competitiveness", should also be mentioned. These include the relative availability of communications technology, transportation facilities, support services, skilled labour, and attractive living conditions. Singapore ranks favourably in these areas relative to other prospective sites for the location of financial operations in Asia. The stability of the political and social climate in Singapore and the

time-zone considerations are additional dimensions of locational competitiveness.

While these factors are not negligible, they are less important than conventionally asserted. No doubt, some dimensions of locational competitiveness were significant factors in addition to the regulatory and tax aspects when banks were choosing a particular location in Asia to establish a new office or to expand operations, but on a more fundamental basis, these additional considerations cannot be regarded as decisive. Once a sufficient momentum of financial activity has been built up in a given geographical location, economies of scale and scope and various positive externalities tend to reinforce this momentum. As the 1970s progressed, Singapore seems to have benefited from such virtuous-circle forces that favour the concentration of financial services in a "financial centre". Arguably, these forces eventually became a major factor in catalyzing the financial development of Singapore.

III. DEVELOPMENT OF THE SECURITIES MARKET

The securities market in Singapore is made up of two major segments: the equity market and the bond market.

The equity market in Singapore consists mainly of corporate equities. Corporate bond issues are negligible compared to equity issues. The bond market in Singapore comprises a domestic and an offshore component. The domestic bond market is dominated by government bonds while the offshore market called the Asian Bond Market (ABM), caters mostly to offshore clients from the Asia-Pacific region.

A. The Equity Markets

Companies can raise equity capital through the floatation of shares in the primary market. These shares are then quoted and traded in the secondary market. (Companies may also float bonds in the primary market).

1. *Methods of New Issue*⁷

The various methods by which a company can raise equity capital in the domestic market in Singapore are through: (a) a public issue; (b) a private placement; (c) a bonus issue; and (d) a rights issue.

7. This part applies mainly to companies listed on the main board of the SES.

(a) A company may make a direct offer to the general public by issuing a prospectus with an application form inviting subscription for its securities at a stated price. This may apply to a share (or bond) issue. In most cases, the issuing company will pass the risk of an unsuccessful issue to an underwriter (usually a merchant bank, commercial bank, or a broking firm) which will guarantee full subscription in return for an underwriting commission.⁸

(b) In a private placement, the issue is offered to a limited number of buyers. The company may arrange for a bank, merchant bank or a stockbroking firm to purchase the issue and place the securities with their clients.

(c) In a bonus issue, the company offers to existing shareholders additional shares in proportion to their holding as of a book-closing date. No additional cash is paid by the shareholders. The company simply transfers its reserves to the capital account and issues additional share certificates to its existing shareholders.

(d) In a rights issue, existing shareholders are offered the right to subscribe to new shares in proportion to their existing holding as of a book-closing date. The price offered is normally lower than the market price. The shareholder can exercise his right to accept fully or partially or to reject the right. The rights may also be sold to the public through the stock exchange.

In Singapore, most of the public share issues have been over-subscribed by the public, often many times over (see Table 6.7). This shows that there is no lack of investible funds in Singapore.

2. Stock Exchange of Singapore (SES)

The SES, Singapore's sole stock exchange, was established in June 1973, following the termination of the currency interchangeability arrangement with Malaysia and the splitting of the joint stock exchange of Malaysia-Singapore. It is a non-profit public company which enables companies to seek capital funds from the public, and enables investors to trade shares of quoted companies. At the end of 1986, 317 companies were listed on the SES, of which 122 were locally incorporated.

8. By paying the commission, the issuing company is assured of the success of the issue, whether or not the entire issue is subscribed by the public. If the total amount is not subscribed by the end of the offering period, the underwriter will pay the difference between the amount sold and the total amount which should have been received. In most cases, the underwriter also advises the issuing company on the pricing of the share or bond issue, preparation of the prospectus, legal requirements, and the timing of the issue.

Table 6.7 SINGAPORE: POTENTIAL INVESTMENT DEMAND (\$'000)

Year	No.	New Issues		Rights Issues		Total Amount Collected	Percentage of Oversubscription Added Back to Total Amount Collected	
		Application Money	Amount Collected	Oversubscription	No. Collected		F = (% x C) + E	
		A	B	C = A - B	D	E = B + D	5%	10%
1976	1	6,516	4,000	2,516	4	156,000	160,126	160,252
1977	2	178,000	10,821	167,179	3	27,500	46,680	55,039
1978	10	1,720,850	129,200	1,591,650	4	56,000	264,783	344,365
1979	3	103,894	14,363	89,531	6	252,900	271,740	276,216
1980	3	1,092,070	143,125	948,945	11	521,100	711,672	759,120
1981	8	4,567,372	365,688	4,201,684	20	728,800	1,304,572	1,514,656
1982	8	2,641,963	155,201	2,486,762	9	365,000	644,539	768,877
1983	7	8,436,727	155,813	8,280,914	11	609,000	1,178,859	1,592,904
1984	4	3,072,319	106,189	2,966,130	6	571,100	825,596	973,902
1985	1	831,600	250,000	581,600	5	233,600	512,680	541,760
Total	47	22,651,311	1,334,400	21,316,911	79	3,521,000		
Average	-	2,265,131	133,440	2,131,691	-	352,100		
TOTAL ESTIMATED DEMAND OVER 10 YEARS (1976 - 1985)								
AVERAGE PER YEAR						4,855,400	5,921,247	6,987,091
						485,540	592,125	698,709

Sources: Monetary Authority of Singapore
Stock Exchange of Singapore Ltd.

The primary responsibility for management and regulation of the SES is entrusted to a nine-member committee with the MAS acting in oversight. Of the nine members, four are elected from among the directors of member companies; the other five are appointed from outside the stockbroking industry to represent the listed companies and investors. The committee meets regularly to deliberate and decide issues tabled before it.

Several sub-committees assist the main committee in designated areas, namely:

- (a) Development Sub-Committee;
- (b) Disciplinary Sub-Committee;
- (c) Listing Sub-Committee; and,
- (d) Stock Exchange of Singapore Dealing and Automated Quotation System (SESDAQ) Sub-Committee⁹

The day-to-day operations of the SES are delegated to a full-time management headed by the Executive Chairman, who is a member of the main committee. This new organisation is the result of reforms undertaken in the stock market in 1986. Further information on the SES is provided in Appendix 6.1.

There were 24 member companies in the SES in 1986, four of which were fully owned subsidiaries of local banks. The listing of companies on the SES is subject to the conditions laid down by both the SES and the Securities Industry Council. Trading and other activities in the corporate securities market are governed by the Securities Industry Act, the Companies Act, the Singapore Code on Takeovers and Mergers and the Exchange's Corporate Disclosure Policy.

For the purposes of trading, listed shares are assigned to two sections, namely, First Trading and Second Trading. Shares assigned to the First Trading section may be traded either on a ready basis or on a settlement basis. Those classified under the Second Trading section may be traded on a ready basis only. Shares transacted on a ready basis have to be delivered by Tuesday of the following week. Trades done on a settlement basis are due for delivery on the last Thursday of the month or any other day which the Stock Exchange Committee may specify. Trading on a settlement basis has been suspended since December 1985. The delivery and settlement system was revised in late 1987. Under the new system, trades will be due for settlement on the fifth business day following the date of the transactions. To be assigned to the First Trading section, companies have to fulfil certain requirements, including a minimum paid-up capital of S\$5 million, total annual turnover of

9. This sub-committee oversees the new unlisted securities market.

their shares being at least 5 per cent of their paid-up capital or 250,000 shares, and payment of an annual dividend of not less than 5 per cent.

(a) *Legal and Regulatory Framework.* The Stock Exchange, stockbroking companies and their representatives are regulated by the Securities Industry Act and Regulations which are administered by the MAS. The scope of the regulation covers licensing, conduct of business including giving priority to clients' orders and having a reasonable basis for making recommendations to clients concerning securities, maintenance of proper books and records, annual audit requirements, financial requirements, establishment and management of fidelity funds, and the prohibition of market rigging, insider trading and market manipulation.

The Rules and Bye-Laws of the Exchange supplement the statutory regulation of stockbroking companies. They cover financial requirements for member companies, standards governing their conduct of business, and rules on commission, trading and settlement. Details of the regulations governing member companies are provided in Appendix 6.2.

Many new regulations were introduced in late 1985. These reforms included the corporatization of stockbroking firms and the passing of the Securities Industry Act 1986. The new Act introduced prudential requirements which broking firms must comply with. It also required the Governing Committee of the SES to include representatives from non-stockbrokers such as investors and listed companies. The sub-committees were formed to ensure the observance of the rules and ethical behaviour of the members. Collective liability and responsibility through a common bond system are also contemplated.

In February 1987, the SES announced new guidelines for foreign ownership of local stockbroking firms. Previously, a limit of 49 per cent on foreign shareholdings in member companies was imposed. Now, foreign shareholders will be allowed to raise their shareholdings in member companies to 70 per cent after three years from their initial date of participation if they comply with certain conditions. Those foreign shareholders of exceptional merit may be permitted to increase their shareholdings to 70 per cent within three years. A quota on the number of member firms with foreign shareholdings has been set between six and eight. To-date, seven such joint ventures have been announced.

Foreign shareholders will be allowed to raise their shareholdings beyond 49 per cent if they demonstrate that:

(a) they have upgraded the research, dealing and marketing capabilities of the joint-venture firms;

- (b) they have brought in additional foreign business;
- (c) they have given active support to the various market development efforts of the SES.

In May 1987, the SES announced the following new guidelines for new share issues:

- (a) new issuers will now have to return the application money of those who are unsuccessful within 24 hours of balloting;
 - (b) partially successful applications, i.e., those whose applications have been scaled down, must be refunded as soon as possible;
 - (c) the issuing companies or its advisors must submit a full report to the SES within three days of the completion of the issue, including details such as the dates and time taken for each stage of the issue, and explaining any deviation from the guidelines;
 - (d) an SES representative be present at the balloting;
 - (e) balloting procedures be clearly spelt out and strictly adhered to;
 - (f) reasons be given for balloted applications which are later rejected;
- and
- (g) only a small number of applications be held back as reserve.

The SES liaises closely with the Securities Industry Council (SIC) and consults the SIC on any matter concerning securities. (See Appendix 6.3)

3. SESDAQ: The Second Securities Market

In February 1987, a second securities market known as the Stock Exchange of Singapore Dealing and Automated Quotation (SESDAQ) system was established with the primary objective of providing young Singapore companies with good growth prospects but without an established track record with an avenue to raise capital. This market is modelled after the U.S. National Association of Securities Dealers Automated Quotation (NASDAQ) system. Prior to this, infant companies were unable to tap the securities market for capital to fund their growth. In addition, companies which qualify for listing on the main board but do not yet wish to seek a listing on the SES may seek admission to SESDAQ. As SESDAQ is designed to cater to the financing needs of domestic industry, SESDAQ members must be locally incorporated public companies. Companies with operations in Singapore but which are majority controlled by non-residents are not, however, precluded from being listed on SESDAQ.

Companies wishing to be admitted should normally have been operating for at least three years. However, they are not required to be

profitable before they gain admission. This is in recognition of the fact that young companies need time to establish themselves. Exceptionally, venture companies and companies with trading records less than three years may be admitted if it can be shown that the amount of funds required to finance the project or product has been fully researched and costed, and the expected time scale before income is generated is not unduly protracted. Such companies may be required to submit an independent professional report to support their application.

To ensure that there will be a sufficient float of shares to facilitate secondary market trading, at least 15 per cent of SESDAQ companies' issued share capital (subject to a minimum of 500,000 shares) must be held by the public. However, to ensure that promoters maintain a vested interest in the performance of the company, not more than 50 per cent of the share capital is allowed to be offered to the public at the time of floatation. There is no specific requirement for a minimum number of shareholders. This number is determined on a case-by-case basis. Since the emphasis is on the growth potential of the company and not its size, there is no minimum requirement on the size of the share capital of SESDAQ applicants. Finally, a moratorium on the disposal of shareholdings by major shareholders and promoters may be imposed on a case-by-case basis, during the first year of admission to SESDAQ.

Continuity in the management of the company is important. In particular, where there have been recent changes in the management of the company, the SESDAQ Committee would have to be satisfied that the management as a whole has the requisite expertise. Furthermore, it would be desirable but not mandatory for SESDAQ companies to have persons of good standing as independent directors (i.e., those not connected with major shareholders or promoters) to represent the interests of minority shareholders.

Companies applying to be listed must give a written undertaking to comply with the listing rules of SESDAQ. These include periodic financial reporting and disclosure of significant events after admission to SESDAQ.

The lead manager of an issue must make a market in that stock for a minimum period of one year. Alternatively, the lead manager may assign another market participant as the market-maker. This requirement ensures that SESDAQ stocks enjoy a certain level of liquidity.

Depending on its financial needs, a company may be admitted by: (i) an introduction, (ii) a placing, or (iii) an offer for sale.

(i) An introduction is used by a company which already has an adequate spread of shareholders and does not need to offer its shares to the public. Since there is no public offer, no prospectus is required.

Only an introductory document giving essentially the same information as that required in a prospectus has to be issued;

(ii) A placing involves small companies (with market value not exceeding \$40 million) placing their shares with a small group of investors rather than offer them to the general public. A prospectus is required in a placing;

(iii) A public offer for sale has to be made when the amount of funds to be raised exceeds \$10 million. To minimise cost, prospectus would not be required to be advertised in full and a box advertisement stating where the prospectuses can be obtained would suffice.

Applications for admission into SESDAQ follow the same procedure as those in the main board. However, unlike companies listed on the SES, no public disclosure of applications for admission of additional securities are required until approval has been given. Applications are processed by a confidential secretariat which preserves confidentiality. Unlike in the SES, where pricing of shares must be finalized before the application is made, the confidential secretariat makes it unnecessary to finalize the pricing until approval has been obtained. This shortens the underwriters' exposure period which should lead to more favourable pricing for the companies. Unsuccessful applicants would also avoid embarrassment and adverse publicity.

In general, disclosure standards are equivalent to those on the SES. Also, SESDAQ companies which can satisfy the requirements for listing on the SES can do so if they so wish. Finally, small and medium-sized SESDAQ companies which need to undergo corporate restructuring or improve their accounting and management information systems may apply to the Small Enterprise Bureau of the Economic Development Board for consultancy grants. Details of companies currently listed on SESDAQ are shown in Table 6.8.

(a) *SESDAQ Trading System*. As SESDAQ is likely to have companies which have relatively small capital and are tightly controlled by existing shareholders, the auction system of matching buying and selling interests is deemed unsuitable because buyers and sellers may have to wait for relatively long periods of time before compatible interests come into the market.

Instead, a competing market-maker system similar to that used in the U.S. over-the-counter (OTC) market is used. Market-makers deal on their own account and are committed to making two-way price quotes in their registered stocks. They will adjust their price quotes according to market conditions but will always stand ready to deal on their quotes with investors. This system ensures that there will always be a price for investors to get in or out of a particular stock.

**Table 6.8 SINGAPORE: COMPANIES LISTED ON SESDAQ
As At 30 September 1987**

Date Listed	Company	Particulars	
18.2.87	Singapore National Printers	Market Capitalization	: S\$46,170,000
		No. of Shares	: 19,000,000
		P. E. Ratio	: 27.0
24.4.87	Trans-Island Bus Services Ltd.	Market Capitalization	: S\$45,900,675
		No. of Shares	: 34,000,500
		P. E. Ratio	: 10.3
06.7.87	Wah-Chang Electro Plating Ltd.	Market Capitalization	: S\$23,550,000
		No. of Shares	: 15,000,000
		P. E. Ratio	: 13.3
12.8.87	Amtek Engineering Ltd.	Market Capitalization	: S\$90,525,000
		No. of Shares	: 12,500,000
		P. E. Ratio	: 37.3
07.9.87	GB Holdings Ltd.	Market Capitalization	: S\$50,468,000
		No. of Shares	: 34,100,000
		P. E. Ratio	: 11.3
30.9.87	Tonhow Industries Ltd.	Market Capitalization	: S\$12,144,000
		No. of Shares	: 8,800,000
		P. E. Ratio	: 12.0

Source: The Singapore Stock Exchange Journal.

Central to the system is the establishment of an automated quotation system to disseminate bid and offer quotations and last done information on a real time basis. A network of computer terminals links brokers and market-makers and no trading floor is required as trading will be conducted with market-makers over the telephone. This system was developed using the U.S. NASDAQ system as a model.

Transactions in SESDAQ stocks are based on a fixed date delivery system similar to those used by the New York and Tokyo Stock Exchanges. Such transactions are settled on the fifth business day following the date of the contract. No contra deals are allowed other than those undertaken within the same business day.

Settlement and clearing in SESDAQ are done on a scripless basis. There is no physical delivery of share certificates and all SESDAQ

stocks are effected by way of book entries on scrip accounts. The Central Depository Pte Ltd (CDP), a wholly-owned subsidiary of the SES, provides depository and clearing services for transactions in SESDAQ. It acts as a nominee for participants and maintains a computer record of their shareholdings under different scrip accounts. Settlements are effected by book transfers of scrips among these accounts.

Securities deposited with the CDP are held by a custodian bank. Periodic physical audits of scrips are conducted and rectifications are made to reconcile the amount of scrips with that registered in the CDP's records.

(b) *Participation in SESDAQ.* SES members and other financial institutions are allowed to participate in SESDAQ either as clearing or non-clearing members upon application. Clearing members can trade both as a principal (in a market-making capacity or otherwise) and as a broker. Non-clearing members are not allowed to be market-makers in any SESDAQ stock without prior approval. The SES also confers associate status on institutions which are not SES members to enable them to deal in SESDAQ stocks. The following categories of institutions are eligible to apply to be associates:

- (i) approved overseas representative offices;
- (ii) full licensed banks;
- (iii) merchant banks; and,
- (iv) foreign stockbrokers with permanent establishment in Singapore.

Associates may deal directly with any member of the public in SESDAQ stocks but not in SES stocks.

SES members or associates may apply to SESDAQ to be registered market-makers. Before making a market in any particular stock, a registered market-maker must notify SESDAQ. Following notification, the market-maker may commence making a market in that stock. A registered market-maker is required to put up buy or sell prices on behalf of its clients or other member participants when so requested if those prices are better than its own bid or offer quotations. There is no limit on the number of market-makers in any one stock, but registered market-makers which are related companies cannot make a market in the same stock.

A market-maker that sponsored a company to SESDAQ must seek approval from the SESDAQ if it wants to cease making a market in that stock during the first year of floatation of the company. After the first year, market-makers can cease making a market after notifying the SESDAQ.

A market-maker must be committed to making two-way price quotations subject to a limit on the maximum spread between the bid and offer quotes, and be prepared to deal at those prices for a minimum quantity of 2,000 shares. A market-maker must also indicate to its clients the prevailing best quotations, even if they are from a competitor. All transactions must be reported within two minutes.

Registered market-makers are entitled to a brokerage commission of 1 per cent in addition to their quoted prices for dealings with the investing public. No brokerage is payable for dealing between member participants, although where a registered market-maker is requested to put up a better price quotation by another member participant, the market-maker may negotiate with the member for a brokerage commission of not more than half a per cent. Short-selling in any stock is restricted to registered market-makers.

Customers suffering losses arising from defalcation of member participants are entitled to compensation from the SESDAQ Compensation Fund or the SES Fidelity Fund.¹⁰

At the end of September 1987, there were six companies listed on SESDAQ (See Table 6.8).

(c) *The Government's Divestment Programme.* In January 1986, a Public Sector Divestment Committee was established with the task of formulating a programme for the divestment of government-linked companies (GLCs) and statutory boards and to make recommendations on the implementation of the programme. The Committee was also asked to identify opportunities for broadening and deepening the stock market in Singapore.

The results of the study were released in February 1987 and were accepted in principle by the government. The Committee recommended that a total of 23 GLCs be privatized either partially or wholly with the objective of reducing the government's interest to a 30 per cent level for most companies. In addition, four statutory boards were also recommended to be privatized.

Under the proposed divestment programme, an estimated S\$590 million worth of the GLCs' and statutory boards' shares will be released each year over the next decade.¹¹ In their report, the committee con-

10. Clearing member participants each have to lodge a bank guarantee of \$50,000 with the SES for a SESDAQ Compensation Fund. The guarantee will be called upon if the clearing member participant fails to honour his SESDAQ obligations to customers. Non-clearing member participants are not required to put up a bank guarantee for the SESDAQ Compensation Fund but customers of non-clearing member participants which are SES member firms will be able to seek compensation from the SES Fidelity Fund.

11. Of the total potential offerings, S\$2.9 billion will be divested by 23 GLCs and S\$3 billion will be divested by four statutory boards.

cluded that, based on past statistics, the Singapore stock market would be able to absorb between S\$590 million to S\$700 million new shares a year (see Table 6.7).

As can be noted, from 1976-1985, an average of S\$485 million was collected each year in new and rights issues. On average, the oversubscription each year was S\$2.13 billion or 4.4 times the money actually collected. The unsatisfied demand which was assumed to be between 5 - 10 per cent of the oversubscription thus gives an estimate of the absorptive capacity of the stock market.

Two other benefits for the financial sector are expected from the divestment programme. First, whatever the pace of divestment which might be adopted by the government or the choice of company or industry, the first-line beneficiaries will be the financial sector - in the form of fees for advice, underwriting, financing and other related services.

Second, the stock market will benefit with these new and additional issues, thereby improving the depth and breadth of the market. The addition of more and varied scrips will also broaden the scope for investors in terms of choice and quality.

4. The Bond Markets

(a) *Domestic Bond Market.* There have been relatively few bond issues in the domestic market. Between 1985-86, there were only 30 issues amounting to S\$1.6 billion (see Table 6.9). The majority of these were either convertible or warrant bonds. The warrants which were usually detachable from the bonds are listed and traded on the SES like other securities.

The relative lack of activity in the domestic bond market can be attributed to the availability of other means of raising funds in Singapore. However, with the recent government efforts to develop the local securities market, the level of activity in the domestic bond market is likely to be stimulated. These measures will be discussed below.

(b) *Asian Dollar Bond Market (ADM).* Borrowers in the Asian Dollar Market can also raise medium- and long-term capital by tapping the ABM. Asian dollar bonds are bonds managed by an Asian financial institution and listed on the SES. The first of such bonds was issued in December 1971 by the Development Bank of Singapore. Up to the end of 1986, a total of 151 issues had been floated with the total amount raised being U.S.\$8.5 billion (see Table 6.10).

Most issues are denominated in U.S. dollars while other currencies include Australian dollar, Deutschmark and Special Drawing Rights

Table 6.9 SINGAPORE: DOMESTIC BOND ISSUES (1975-1986)

Year	No. of Domestic Bond Issues	Amount raised (S\$ mil)
1975	3	48
1976	1	10
1977	1	35
1978	1	39
1979	1	20
1980	5	146
1981	2	303
1982	7	358
1983	5	446
1984	0	0
1985	1	20
1986	3	175
Total	30	1,600

★ Of the 30 issues, 12 are convertible and 8 are with warrants.

(SDRs). Straight bonds, FRNs, convertible and warrant bonds are currently being used in the ABM.

Borrowers are mainly from the Asia-Pacific region and comprise banks, multinational companies, governments and development banks. These institutions accounted for 90 of the 151 issues. Japanese financial institutions have been particularly active as issuers and managers in the ABM.

The growth of the ABM is tied with the conditions in the international markets, interest and currency movements, and the demand and supply of capital.

(c) *The Government Securities Market.* In the government securities market, the Government of Singapore issues various types of securities periodically to absorb the surpluses of the CPF. It also enables banks and finance companies to meet their statutory requirements.

There are two major types of government securities: registered stocks and bearer bonds. For registered stocks, the purchaser is registered as the owner of the securities and ownership cannot be transferred by mere delivery. Transfer can only be effected by means of a transfer form duly signed by both parties to the deal. The signed transfer form together with the original stock certificate must be delivered to the MAS which will register the change of ownership and issue a new cer-

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Table 6.10 SINGAPORE: BONDS AND FRNs FLOATED IN THE ABM, (1971 – 1986)

Year of Issue	No. of Issues			Total Amount Raised (US\$m)
	Asia-Pacific	Others	Total	
1971	1	0	1	10
1972	2	0	2	336
1973	2	1	3	70
1974	0	0	0	0
1975	2	1	3	47
1976	8	1	9	266
1977	10	4	14	369
1978	7	5	12	1,112
1979	6	2	8	358
1980	7	11	18	659
1981	13	9	22	1,238
1982	8	8	16	1,017
1983	6	10	16	1,145
1984	0	8	8	864
1985	4	0	4	235
1986	14	1	15	785
Total	90	61	151	8,511

tificate in favour of the transferee. Bearer bonds are freely negotiable. The term “stock” and “bond” are sometimes used interchangeably.

Classified by maturities, there are three types of government stocks: (a) those maturing within one year, (b) those maturing between one and three years, and (c) those with more than three years maturity. Those maturing within one year and those of two-year and three-year maturities are very actively traded by discount houses. Medium-term stocks are of five-year, six-year, seven-year, and ten-year maturities. Long-term stocks of 15-year, 17-year and 20-year maturities are mostly tax-free stocks.

The MAS is authorized by the Development Loans Act to issue securities on behalf of the government. An announcement is usually made in the press through an advertisement of the prospectus outlining the terms and conditions of such issues. Institutions intending to buy the stocks may then apply to the MAS using the official application forms available from the MAS, banks or stockbrokers. New stocks are usually issued at par and the full amount has to be paid on application. Since 1977, there has been a shift towards stocks with longer maturities.

The government securities has been characterized by a large primary market but a small secondary market.

Dealing in government stocks were continued on an "over-the-counter" basis until the SES revised its brokerage charges in November 1975. The revision made it less prohibitive to deal through the SES.

The outcome has been an increase in transactions and two-way quotes are now made daily at the SES, particularly for those with unexpired maturities of three years or less.

In the trading of government stocks, prices may be quoted above or below par. If it is above par, then the yield to maturity to a buyer will be less than the coupon rate, and vice versa.¹²

Most of the longer-term securities are taken up by the CPF and other public authorities. The CPF alone holds more than 70 per cent of the total registered stocks. Shorter-term bonds are bought by banks and finance companies to meet the statutory liquid asset requirements laid down by the MAS.

The MAS has been quite active in stimulating a secondary market for government bonds and a wider range of maturities has been offered. Recent efforts have been directed at revamping the government bond market. The restructured government bond market will help establish a yield curve essential for the development of an active fixed income secondary market. Statutory boards are also encouraged to issue bonds rather than to source funds directly from the government treasury.

The restructured market was launched in May 1987. The essence of the scheme is that the government will issue bonds, roughly estimated at S\$38 billion worth, over five years starting from 1987 with maturities ranging up to ten years. The bonds are auctioned through primary dealers, and carry an interest rate determined by the market. Previously, government bond issues had an interest rate set by the government, and certain institutions had been obliged to hold these bonds. As the

12. Once the dealing price is agreed upon, the total amount to be paid by the buyer will be computed as follows:

$$\frac{\text{Nominal Amount of Stock} \times \text{Dealing Price}}{100} + \text{Accrued Interest from Last Dividend Date to the Date of Sale.}$$

The yield to maturity, produced by a particular stock at a given dealing price may be computed by the following formula:

$$\frac{\text{Annual Coupon Rate} + \left[\frac{\text{Par Value} - \text{Market Price}}{\text{Years of Maturity}} \right]}{1/2 (\text{Par Value} + \text{Market Price})} \times 100$$

minimum denomination of government notes and bonds is S\$1,000, the ordinary man-in-the-street has an alternative means of savings which carries no risk of default.

A well developed market for government bonds would open up new investment opportunities for local and foreign investors. To local investors, government bonds would be an attractive alternative to bank deposits.

Furthermore, an active market for government bonds would speed up the development of the market for corporate bonds and banks' certificate of deposit. Active trading in government bonds is essential to the development of the domestic securities market because government bonds provide a guide for the pricing of other securities.

The new government bond market is fashioned according to those in the U.S. The bonds are auctioned but only designated financial institutions can tender. The government has for the time being limited the number of these primary dealers to five.¹³

The dealers, acting as wholesalers of government bonds, are responsible for making a market by quoting prices at which they will buy and sell government bonds. The primary dealers work only with banks that serve as retailers, buying the government bonds for resale to corporate and personal investors. These retailers are also approved by and registered with the MAS.

An electronic trading system eliminates the need to transfer actual certificates and details of transactions are recorded in computers, which reduces the paperwork for dealers and saves investors the trouble and expense of storing their bond holdings.

C. Fund Management

In the development of Singapore as a financial centre, fund management has been identified as having good growth potential. While still in its infancy, Singapore's fund management industry has experienced steady growth in the past couple of years. For resident funds alone, there are currently 21 unit trusts and four investment funds in Singapore, with a total market capitalization of S\$578 million.

To encourage offshore funds to be managed in Singapore, the Tax Exemption Scheme for Fund Management was implemented recently. Under this scheme, investment income, trading and capital gains of

13. The five primary dealers are the Oversea-Chinese Banking Corporation, the Overseas Union Bank, the United Overseas Bank, the Commercial Discount Company and the National Discount Company Merchant Bank.

offshore funds for non-residents, which are managed by approved fund managers, are exempted from taxation. The management income earned by the funds is taxed at a concessionary rate of 10 per cent, as opposed to the normal 33 per cent corporate tax rate. This scheme has attracted much interest from international fund managers since its implementation.

IV. MAJOR DEVELOPMENTS IN THE CAPITAL MARKET

In the development of the capital market in Singapore, the authorities have taken a pragmatic approach. Singapore's domestic economy is small so there has not been a large local financial market to build upon. Although financial business with locals exists, opportunities for expansion are limited. Instead, Singapore has had to turn towards the development of the offshore markets.

Singapore's capital markets are in general well developed, particularly in the more traditional financial services such as conventional banking, deposit-taking and lending, and foreign exchange transactions. Various indicators which reflect the state of capital market development over the past decade are shown in Tables 6.11 and 6.12.

In the decade to come, growth of profitable financial business is likely to be in the area of international capital market activities. Singapore's role as a capital market centre will depend on its ability to master the necessary skills and provide the necessary environment for these newer activities which are usually fee-based. These include bonds, equities, money market trading, forwards, futures and options, "securitized" private and public debt, investment advisory services and corporate mergers, acquisitions and divestitures.

Recent policy measures to develop the capital market have shown that the government has recognized the need to respond to the changes in the international capital markets. The efforts to promote the capital market come from the recent government divestment efforts and the revamping of the government securities market. In addition, numerous tax incentives and regulatory concessions were given to encourage new financial activities and practices.¹⁴ The underlying philosophy behind

14. In particular, an incentive scheme was introduced to encourage the syndication of international loans in Singapore. This was extended in 1984 to include syndication of other credit facilities such as guarantees, performance bonds and certain underwriting facilities. In 1987, tax incentives were granted to promote the trading of non-Singapore dollar securities in Singapore. Commissions, fee income and profits derived from transactions with non-residents in non-Singapore dollar securities by ACUs and approved securities companies will be taxed at a concessionary rate of 10 per cent.

Table 6.11 SINGAPORE: FINANCIAL AND ECONOMIC STATISTICS

End of Period	GNP (\$m)	GDP (\$m)	M1 (\$m)	M2 (\$m)	Prime Lending Rate (%)	POSB Savings Rate (%)	Inflation Rate (%)	Market* Cptl'tn (\$m)	No. of* Shares (in mill.)	Turnover* Value (\$m)	Turnover* Volume (in mill.)
1975	13,566.5	13,443.0	3,472.2	8,164.2	7.08	5.50	2.60	13,668	5,820	1,830	800
1976	14,569.6	14,650.9	4,000.0	9,202.5	6.78	5.50	-1.90	15,130	6,306	1,928	708
1977	15,851.7	16,039.0	4,412.1	9,806.3	7.02	5.00	3.20	18,218	6,656	1,158	640
1978	17,787.4	17,830.4	4,925.9	10,862.3	7.65	5.25	4.80	22,696	7,855	3,383	1,489
1979	20,444.1	20,523.0	5,706.1	12,899.5	9.48	6.00	4.00	29,371	8,501	2,309	963
1980	24,188.5	25,090.7	6,134.6	16,065.0	13.60	8.50	8.50	51,106	10,303	7,806	2,184
1981	28,191.2	29,339.4	7,242.1	19,671.1	11.83	9.50	8.20	71,279	15,429	13,419	2,734
1982	31,775.7	32,669.9	8,156.8	22,804.0	9.33	7.00	3.90	65,859	19,233	5,105	1,550
1983	36,561.1	36,732.8	8,607.7	25,525.7	8.98	6.50	1.20	91,446	23,630	11,620	3,359
1984	40,815.1	40,047.9	8,866.3	27,120.8	9.40	6.75	2.60	79,332	29,889	8,108	2,890
1985	39,921.0	38,521.1	8,785.0	28,147.7	7.20	5.25	0.50	70,619	33,167	6,274	2,937
1986	39,185.2	37,773.6	9,821.3	30,954.9	6.10	3.25	-1.40	85,289	33,914	7,906	3,764

* Ordinary shares only (excluding preferred shares, debentures, bonds and loan stocks).

Source: M1, M2, GNP and GDP - Department of Statistics.

Market Capitalization

No. of Shares

Turnover Volume

Turnover Value

Fact Book, Stock Exchange of Singapore

Prime Lending Rate, POSB Savings Rate and Inflation Rate - Monetary Authority of Singapore.

Table 6.12 SINGAPORE: FINANCIAL MARKET INDICATORS

	M1/GDP	M2/GDP	Mkt. Cptl'tn/ GDP	Turnover Value/ Mkt. Cptl'tn	Turnover Volume/ No. of Shares	Price/ Earning
1975	0.26	0.61	1.02	0.13	0.14	11.3
1976	0.27	0.63	1.03	0.13	0.11	12.4
1977	0.28	0.61	1.14	0.06	0.10	10.9
1978	0.28	0.61	1.27	0.15	0.19	12.7
1979	0.28	0.63	1.43	0.08	0.11	15.6
1980	0.24	0.64	2.04	0.15	0.21	24.0
1981	0.25	0.67	2.43	0.19	0.18	25.5
1982	0.25	0.70	2.02	0.08	0.08	20.7
1983	0.23	0.69	2.49	0.13	0.14	35.4
1984	0.22	0.68	1.98	0.10	0.10	54.5
1985	0.23	0.73	1.83	0.09	0.09	36.8
1986	0.26	0.82	2.26	0.09	0.11	25.7

the new initiatives is to ensure that there is continuity and certainty in the government's commitment to provide an efficient and conducive environment for financial services in Singapore.

Finally, we should note that financial sector development in Singapore differs from those of other SEACEN countries in that the focus continues to be on both the domestic markets and the offshore markets. Developmental measures in the post-1970 period in Singapore have mainly been directed to these ends. Today, Singapore stands as one of the three major financial centres in the Asia-Pacific region, competing with and complementing the other centres. Its offshore markets are much larger than its domestic markets, and both are still growing in importance.

A. Securitization

The buzzword in financial circles today is "securitization". This word merely describes the trend of major borrowers resorting increasingly to raising funds directly from the securities market rather than through traditional bank loans. It is a process of disintermediation. Good-name borrowers are now able to raise funds more cheaply through the floatation of bonds rather than through loans from banks. In 1986, accord-

ing to OECD statistics, borrowing on external bond markets rose by 35 per cent to a record high of over U.S.\$226 billion, while syndicated loans stood at U.S.\$48 billion.

This trend is marked by the creation and rapid growth of new financial instruments, most of which take the form of off-balance-sheet activities. Examples of such instruments are swaps, NIFs, RUFs and FRAs. In many respects, innovation has improved the efficiency of international financial markets by providing a broader and more flexible range of instruments both for borrowing as well as for hedging interest and exchange rate exposures. This has helped banks and their customers cope with the greater volatility of interest and exchange rates in recent years.

Securitization has been fostered by a series of disparate trends during the last two decades. One was the higher rate of inflation and the increased volatility of interest and exchange rates. This generated an increase in the risk exposure of those financial institutions that failed to maintain a strict match in the term structure of their assets and liabilities. This encouraged the development of new financial instruments which could transform and shift the burden of risk.

Another is the shift in the geographic pattern of net flows of international savings and investment. The switch in role of the U.S. from net provider to net taker of funds combined with the growth of current account surpluses in Europe and Japan increased the use of marketable debt instruments in international financial markets.

The growing world-wide tendency to deregulate has also fostered innovation by reducing structural rigidities and barriers to competition. At the same time, the increased attention which supervisory authorities have begun to pay to capital adequacy has created an incentive for banks to increase activity in business subject to less stringent capital requirements.

Another trend which has spurred innovation is the lowering of transaction costs due to widespread application of new communications and computer technology. This encompasses the expansion of world-wide information, improvements in accounting and information-processing systems and the computerization of payment systems and transactions processing.

Finally, growing competition in international financial markets has put pressure on financial institutions to expand into new areas of business.

As securitization gains momentum, Singapore's capital markets also have to adjust to this change. It is therefore not surprising that most of the recent major policies affecting the financial sector in Singapore are

directed at the capital market, or more specifically, the securities market. These include: (a) the restructuring of the SES, the establishment of a second securities market and the introduction of tax incentives for securities houses and banks which trade in international securities, (b) the privatization of government-linked companies and statutory boards through the floatation of their shares in the stock market, and (c) the revamping of the government securities market.

B. The Stock Exchange

A number of changes have been made to the organizational structure of the SES to enable it to operate more soundly, more competitively and with greater sensitivity to the needs of the economy. To add greater depth, sophistication, and financial strength to the SES, the SES has diversified its membership by admitting subsidiaries of the "Big Four" local banks and also allowing foreign institutions to acquire substantial equity stakes in existing member firms.¹⁵

Corporatization in the local stockbroking industry has opened up the industry to well-known foreign brokers and investment houses which will promote the development of stock market expertise through technology transfer and raise the standards of research, marketing and client servicing.

A natural follow-through of the corporatization trend is the issue of negotiated commissions as they are part and parcel of a modern trading system. In the past, broking firms charged a fixed rate of 1 per cent of the value of transactions. Under the new commission structure implemented in January 1988, which applies to shares priced at S\$1 or more, brokers would charge the old commission rate of 1 per cent for deals up to S\$250,000. The rate, however, would be reduced to 0.9 per cent for the next S\$250,000, 0.8 per cent for the following S\$250,000 and 0.7 per cent for the fourth S\$250,000. Commissions on trades of more than S\$1 million are negotiable to a minimum of 0.5 per cent.

Recently, a second securities market, the SESDAQ system, was launched. This aims to bring the capital-raising and other facilities of the stock exchange within the reach of small and medium sized local companies and high-risk ventures with good potential. In contrast to the main board which trades under a scrip delivery auction system, SESDAQ uses a video screen-based market-maker system of trading, similar to that in the U.S. National Association of Securities Dealers Auto-

15. The "Big Four" are the Development Bank of Singapore, Oversea-Chinese Banking Corporation, United Overseas bank, and Overseas Union Bank.

mated Quotation (NASDAQ) market. A further novel aspect of this new market is that transactions are settled on a scripless basis. There is no physical delivery of scrips and change of ownership shares is done through book entries in scrip accounts. It is envisaged that in due course, the main board will also be converted to a screen-based system.

In 1987, tax incentives for securities houses and banks trading in international securities were announced. The income derived from such activity will be taxed at a concessionary tax rate of 10 per cent. This measure will provide an inducement for international securities firms to play a bigger role in Singapore. The aim is to attract these international securities firms to conduct their activities in Singapore which will raise the overall level of sophistication in the local market, enhance Singapore's role as a financial centre and facilitate the transfer of expertise to locals.

Lastly, another significant development is the SES's recent announcement that it has concluded a linkage agreement with NASDAQ to facilitate trading in international securities. The link will establish Singapore as a trading centre for international securities.

C. The Government's Divestment Programme

One of the chief objectives of the government's privatization effort is to add breadth and depth to the local stock market. The range of corporate stocks made available by the programme will stimulate investor interests, both individual and institutional. To encourage private individuals to invest in these companies and to avoid the potential crowding-out of private sector investment opportunities, part of the CPF funds will be released for such investments.

Privatization will also generate more business for the financial sector and stimulate foreign participation in the stock market. In addition, more private corporations may also be encouraged to increase their participation in the stock market.

D. Revamped Government Securities Market

A new government securities market modelled after the U.S. government securities market was recently launched by the MAS. Under the new system, about S\$7 billion worth of government securities will be issued each year on a regular basis for the next five years. About S\$38

billion of government bonds and stocks will be issued altogether. These securities will have a range of maturities, from short-term three-month Treasury bills to longer-term five-year bonds. As the government does not need to raise additional funds from the public, the objective in issuing these securities is to promote the development of an active government securities market and to establish a yield curve and interest rate yardstick essential for establishing an active fixed income securities market through which statutory boards, GLCs and private sector companies can raise long-term funds. It will also help develop securities trading skills.

E. Singapore's Financial Role in the Asia-Pacific Region

One frequently hears speculative discussions about the relative competitiveness of Singapore, Hong Kong and Tokyo as alternative capital market centres. Policy changes in Japan in 1984-85 to implement further liberalizations of restrictions on Japanese financial transactions have caused much speculation about the future of Singapore's financial and thus capital market expansion. Such speculations imply that Singapore, Hong Kong and Tokyo should be seen as engaging in a race for pre-eminence. In fact, complementary financial relationships among Singapore, Hong Kong and Tokyo are at least as important if not more so than the respects in which these centres compete with each other. Geography tends to accord each centre comparative advantages within its regional location. For example, geographical propinquity tends to be correlated with the availability of reliable information about credit-worthiness. Thus, financial intermediaries based in Singapore can (other things being equal) better assess the risks of investing or lending to South East Asian countries than intermediaries based in Hong Kong or Tokyo.

From these natural comparative advantages, each sub-regional capital market plays a complementary role with centres in other sub-regions whenever the individual sub-regions have net excess demands or supplies of funds in the aggregate. Thus, financial intermediation in each of these centres is likely to increase substantially with the financial growth in the Asia-Pacific region, with all three locations serving as complementary foci in Asia for cross-border and cross-currency transfers of savings. □

Appendix 6.1 STOCK EXCHANGE OF SINGAPORE

Prior to the establishment of the SES in 1973, Singapore shared a common stock exchange with Malaysia. Although the joint exchange was dissolved after the termination of the currency interchangeability arrangement between the two countries, part of the historical link survives in the dual listing of some companies on the two exchanges.

The objectives and functions of the SES are:

- (1) to regulate and control the stockbroking business in Singapore;
- (2) to protect the interests of members of the Exchange;
- (3) to record transactions between member firms;
- (4) to furnish quotations of share prices transacted on the Exchange;
- (5) to provide investor services and promote interest in the securities market as a whole;
- (6) to work in close cooperation with the Securities Industry Council (SIC) and the Monetary Authority of Singapore (MAS);
- (7) to interpret and enforce the Rules and Bye-Laws of the Exchange and arbitrate between members;
- (8) to prepare, publish and circulate reports and records;
- (9) to provide and enact listing requirements and to enunciate and enforce a code for mergers, takeovers and acquisitions;
- (10) to institute a policy of market surveillance and corporate disclosure.

Shares traded on the SES are classified into six groups: industrial and commercial, finance, properties, hotels, plantations and mining. Debenture bonds and loan stocks are also traded. Trading is conducted from 10.00 am to 12.30 pm and from 2.30 pm to 4.00 pm from Monday to Friday.

In January 1978, the Securities Clearing and Computer Services (Pte) Ltd was incorporated to provide clearing and computer services to member companies. The trading system was computerised in July 1982 with the introduction of electronic trading boards. In November 1982, the Stock Exchange Communications System (SECOMS) started operations with 700 terminals at the then 25 member companies. This system transmits useful information such as price quotations, trading statistics and important announcements from the trading room to the broking firms.

The All-Share Price Indices were introduced in 1984, replacing the previous indices based on selected companies. With the relatively small number of SES listed companies and the availability of computerised data, it was considered feasible to include all companies in computing the All-Share Price Indices. The advantage of the All-Share Price Indices over those based on selected companies is that they do not require regular revision to reflect changes in the composition of listed companies.

The SES operates a number of informational services which provide investors with up-to-date information on listed companies. In November 1974, a weekly Statex service was introduced to supplement the annually published Companies Handbook. Each Statex Report includes five-year financial figures of the company and a chart illustrating price and turnover movements of the company's shares. On average, reports of five companies are published each week.

The SES also provides a Charting Service which offers price and turnover bar charts plotted on a weekly and, since June 1975, daily basis.

The SES produces the Fact Book annually containing updated information about the SES. The Financial News also provides up-to-date corporate information. The Stock Exchange Journal is published monthly containing articles contributed by business consultants, brokers, analysts and academics. The SES also supplies stock market information to the Singapore Broadcasting Corporation for its news broadcasts and SBC Text Service.

In January 1975, an in-house computer service was introduced to provide daily and weekly trading statistics, compile financial statistics of listed companies and market surveillance reports for management. Historical data is kept to facilitate ad hoc enquiries and for research work.

The Singapore Securities Research Institute (SSRI) was established in 1974 to undertake investment and economic research work on the securities industry. The SSRI is wholly owned by the SES.

Appendix 6.2 SINGAPORE: REGULATIONS GOVERNING MEMBER COMPANIES

Member companies are required to have:

- (a) a minimum paid-up capital of \$10 million;
- (b) at least \$0.5 million in adjusted net capital;
- (c) aggregate indebtedness not exceeding eight times adjusted net capital;
- (d) limits on exposure to a single security and a single client;
- (e) limits on a member company's own investment in securities; and
- (f) initial and maintenance margin requirements for margin accounts.

Other regulations governing the conduct of business include the opening the clients' accounts, operation of clients' margin and discretionary accounts, maintenance of records and financial audit. SES member companies are required to submit monthly returns. In addition, the SES Inspectorate Department may conduct inspections of member companies.

Appendix 6.3 SINGAPORE: SECURITIES INDUSTRY COUNCIL

The SIC was established pursuant to the Securities Industry Act and comprises representatives from both public and private sectors. It is a consultative body that advises the Minister of Finance on matters concerning securities. The SIC also administers the Singapore Code on Takeovers and Mergers which governs the conduct and procedure to be observed in the takeovers and mergers of public companies. This non-statutory code is modelled on the U.K. City Code on Takeovers and Mergers and supplements the statutory provisions of the Companies Act.

Appendix 6.4 SINGAPORE: LISTING REQUIREMENTS

Locally-incorporated companies seeking admission to the Official List must have:

- (a) a minimum paid-up capital of S\$4m, of which S\$1.25m or 25 per cent (whichever is greater) should be owned by at least 500 shareholders;
- (b) a five-year track record;
- (c) adequate working capital; and
- (d) continuity in management.

Companies seeking quotation of debt securities must have a minimum of S\$750,000 of issued debt securities of the class to be quoted owned by at least 100 holders, and the securities must be created and issued pursuant to a Trust Deed.

Foreign companies applying for listing must:

- (a) be quoted on their home exchange;
- (b) have net tangible assets of at least S\$50m
- (c) have accumulative pre-tax income of at least S\$50m for the last three years; and
- (d) have at least 2,000 shareholders.

Appendix 6.5 SINGAPORE: CORPORATE DISCLOSURE POLICY

Specific guidelines on corporate disclosure include those on:

- (a) immediate public disclosure of material information;
- (b) thorough public dissemination;
- (c) clarification or confirmation of rumours and reports;
- (d) response to unusual market action;
- (e) unwarranted promotional disclosure; and,
- (f) insider trading.

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CHAPTER 7

Development of the Capital Market in Sri Lanka*

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I. INTRODUCTION

Though Sri Lanka has a long history of private and corporate investment running back to almost a century, its capital market, by any comparison, is still in a state of rudiments. A bulk of the private sector's demand for medium- and long-term capital is met by long-term financial institutions which are heavily dependent on the monetary authorities for the initiative, guidance and at times, even the needed resources; financial institutions have not yet been able to liberate themselves from the subsidy/concession syndrome. Almost all of the long-term capital requirements of the government is supplied by a few captive sources which in turn depend on governmental concessions or force of law for their resource base. A secondary market for medium- and long-term government paper is virtually absent. The share market, both primary and secondary, is yet to develop and expand in order to meet the equity capital requirements of a growing private sector. There again, the task of creating a conducive atmosphere for the development of a securities market in the country has primarily devolved on the government. It is unfortunate that the capital market has continued to remain in a rudimentary state despite many measures taken by the authorities from time to time to remedy the situation.

This paper will analyze the historical trend and the present state of the development of the capital market in Sri Lanka. For the convenience of

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presentation and analysis, the capital market is defined to include all debt instruments with a maturity of more than one year. The market is broadly classified into two segments: the non-securities market comprising all financial intermediaries and the securities market consisting of the primary and secondary markets for shares, debentures, securities, bonds, etc. The paper will dig out the interrelationships between these two markets and the factors affecting their development.

II. OVERVIEW OF THE EXISTING CAPITAL MARKET STRUCTURE

A. Historical Background

The origin of the institutional set-up in Sri Lanka's capital market dates back to mid-nineteenth century, when a growing need for investment funds began to arise from the newly emerging plantations sector. A part of the capital requirements of the plantations was raised by forming limited liability companies both in the United Kingdom and in Sri Lanka around this time, but the entirety of the working capital and a negligible proportion of medium- and long-term capital was supplied by branches of foreign commercial banks set up in the country. For more than a century following this period, the country's economic activities were mainly concentrated on import and export trade and this factor contributed significantly to the faster growth recorded by commercial banks vis-a-vis the other institutions supplying investment capital.

Early history of commercial banking in Sri Lanka records a mixed performance of successes and failures. Many banks that were established in the nineteenth century ended up with failure partly due to their inability to survive hostile economic misfortunes that were experienced, such as the coffee crisis and partly due to inexperience and lack of competent managerial skills to run these banks prudently. A salient feature of the lending behaviour of commercial banks during this period was their overwhelming preference to cater to the financing needs of foreign planters. Consequently, the local entrepreneurs were financed mainly by a group of money lenders known as Nattu Kottai Chettiars who specialized in bill financing especially in relation to the trade with India.

The growing dissatisfaction with the available banking and credit arrangements in the country led to the appointment of a Banking Com-

1. For details, see Karunathilaka (1986).

mission (known as the Pochkanawala Commission) in 1934 to inquire into and report upon the existing conditions of banking and credit and propose remedial measures. Following the recommendation by the Commission, the Bank of Ceylon (BOC) was established in 1939 with both the public and private sectors participating in its share capital.

By 1960, there was a very strong need for further restructuring of the country's banking system to shift the emphasis of lending from well-developed plantation and urban sectors to the relatively unbanked rural and other sectors in the economy. To achieve this, measures were taken in 1961. First, the Bank of Ceylon was nationalized enabling the government to exercise a greater control over its activities. Second, a new bank called the People's Bank was created by replacing the existing Co-operative Federal Bank which was found to be outmoded in providing finance to a fast changing co-operative system in particular, and the needy sectors of the economy, in general. The People's Bank was jointly owned by the government and the co-operative sector. These two banks grew very rapidly in a market well protected by the imposition of restrictions on the operations of the existing foreign banks. Consequently, by 1970, these two banks accounted for slightly less than a three fourth of the total banking business of the country.

The policy stance of the authorities with regard to commercial banking in the early 1970s seems to have been directed at formation and expansion of indigenous banks vis-a-vis foreign banks. Accordingly, two locally incorporated banks were set up in 1969 and 1970, absorbing some of the branches hitherto owned by foreign banks. With this, the domestic banks, especially the two state banks, witnessed a rapid expansion of their branch network all throughout the 1970s. Though competition prevailed among these indigenous banks, they were still well protected from competition from the foreign banks, since the latter were not allowed to open branches outside Colombo.

Though the promotion of a domestically owned banking sector had its own justifications, it also carried certain hidden disadvantages with it which needed to be corrected for the successful implementation of the liberalized economic policies adopted since 1977. Thus, outside competition was needed to force these banks to improve customer services. In view of this, the government decided to allow foreign banks of good repute to open up branches in Sri Lanka to promote a greater degree of competition among banking firms. Accordingly, 14 new foreign banks commenced business in Sri Lanka between 1979 and 1985, thereby bringing the total number of banks operating in the country to 25.

Historically, commercial banks in Sri Lanka have been averse to go for long-term lending on a significant scale. As a result, specialized

agencies had to be created to take care of the long-term investment needs of the economy. The first institution so created was the Ceylon State Mortgage Bank (CSMB) which came into existence in 1931 for the purpose of providing long-term loans to agriculturists against the mortgage of agricultural property. Since the main source of funds of the CSMB was the issue of debentures guaranteed by the government, its limited resource base created a constraint to engage in long-term lending on a significant scale. The same fate of low performance was recorded in the case of the Agricultural and Industrial Credit Corporation (AICC) which was set up in 1943 for the purpose of providing long-term loans to both agricultural and industrial ventures against the primary mortgage of movable and immovable property or the mortgage of crops or farming stock of any agricultural land in Sri Lanka. Therefore, by 1975, it was felt necessary that the two institutions should merge and pool their resources together in order to continue an effective long-term lending programme. Accordingly, these two institutions were merged in 1979 to form the State Mortgage and Investment Bank (SMIB) with powers to issue a wide range of instruments for raising funds for its lending operations. The SMIB is wholly owned by the government.

At a time when the conventional lending institutions were paying little attention to investment financing, the Development Finance Corporation of Ceylon (DFCC) was set up in 1955 as a joint stock limited company to assist in the establishment, expansion and modernization of private industrial, agricultural and commercial enterprises in the country. To achieve these objectives, the DFCC can raise funds from both domestic and external sources and is empowered to offer financial assistance in the form of equity participation, loans, convertible debentures and guarantees. The most recent addition to the institutional set-up in investment financing was the establishment of the National Development Bank (NDB) in 1979. The purpose of the NDB is to promote the industrial, agricultural, commercial and other enterprises in the economy having regard, inter alia, to the development of the rural sector. As in the case of the DFCC, the NDB too can mobilize both internal and external capital to achieve these objectives. However, in keeping up with the changing business atmosphere, the NDB has been empowered to offer a wider range of services, including technical and consultancy services for prospective projects.

A noteworthy feature of the long-term lending institutions of the country was the key role played by the Central Bank in bringing them into existence and measures taken for subsequent promotion. With this objective in mind, the Central Bank commenced the operation of its

Medium- and Long-Term Credit Fund (MLCF) in 1964 for the purpose of refinancing medium- and long-term loans granted by approved credit institutions. These refinanced loans are intended to achieve the twin objectives of an uninterrupted supply of investment capital to needy sectors at a relatively lower cost.

Even though the non-securities market in Sri Lanka recorded an appreciable growth especially in the last two decades, the same cannot be said about the securities market. A share market was first set up in Sri Lanka through a Share Brokers' Association (SBA) formed in 1894. The limited liability companies formed around this time were governed by the U. K. Company legislation and the Joint Stock Company Ordinance enacted locally in 1861. Since the new tea and rubber plantations needed additional investment capital for modernization and expansion purposes, several successful new issues of shares were made in the market. In 1904, the Colombo Share Market was brought under the control of the Colombo Brokers' Association (CBA) which in 1910 enacted a set of rules to facilitate the transactions of shares in the market. However, there were still no rules governing the requirements for quotations and dealings in shares of rupee companies. Participation in the market up to the early 1950s was largely by foreign nationals and a handful of middle class local businessmen.

By the late 1950s, the CBA attempted to regularize the share market, but its activities were dwindling on account of wide-spread speculations about a possible nationalization of plantation companies and the exchange control restrictions on outward remittance imposed as from 1958. These factors contributed to discourage inflow of new foreign capital to the country which in turn reduced the activities in the share market. By the nationalization of plantation companies by the government in the early 1970s, a bulk of the quoted companies were removed from the actively traded share list, restricting the operations in the market only to newly formed rupee companies outside the plantation sector.

A renewed interest in the revival of the share market was taken after 1977 with the change in the hitherto pursued economic policies to the new policies which assigned an equal significance to the private sector in the country's economic life. Therefore, a well-developed capital market, especially a share market, was considered a *sine qua non* for the development of the private sector economy on a corporate basis. Measures taken by the government in this regard included the enactment of a new Companies Law; various tax incentives and concessions; creation of new institutions, etc.

1. *Non-Securities Market*

The non-securities market in Sri Lanka is represented by a wide array of financial institutions brought into existence from time to time largely at the initiative of the authorities. At the apex of the financial system of the country stands the Central Bank of Sri Lanka (CBSL) established in 1950 by the Monetary Law Act (MLA) No. 58 of 1949. The other institutions in the financial system as at the end of 1986 are as follows:

- i) 24 commercial banks comprising five indigenous and 19 foreign banks;
- ii) Three long-term lending institutions, viz., the Development Finance Corporation of Ceylon (DFCC) (established in 1955), the State Mortgage and Investment Bank (SMIB), and the National Development Bank (NDB) (both established in 1979);
- iii) The National Savings Bank (NSB) (established in 1972);
- iv) 54 finance companies registered with the CBSL;
- v) Two merchant banks, viz., the Merchant Bank of Sri Lanka (MBSL) (established in 1982) and the People's Merchant Bank (PMB) (established in 1983);
- vi) Employees' Provident Fund (EPF) (established in 1958);
- vii) Employees Trust Fund (ETF) (established in 1981);
- viii) 24 Foreign Currency Banking Units (FCBUs) to offer offshore banking services.

Of these institutions, the NSB and the EPF primarily cater to the investment capital needs of the government, while the others provide such facilities to the private sector in varying degrees. Almost all of the lending of the long-term lending institutions take the form of investment capital, while slightly less than a third of the credit portfolio of commercial banks and FCBUs has a maturity of more than one year. Since the loans and advances of the long-term lending institutions account for less than 3 per cent of the total loans and advances of the financial system, the share of the investment capital in the overall lending is in the region of 15 to 20 per cent which by any standard, testifies to the woefully insignificant role played by the non-securities market in providing investment capital to the economy.

(a) *Central Bank of Sri Lanka (CBSL)*. Since the CBSL has no direct dealings with the private sector, its participation in the capital market has been through approved credit institutions, viz., commercial banks and long-term lending institutions. In order to induce the latter institutions to engage in project financing and ensure an uninterrupted supply of such financing to priority sectors at a reasonably lower cost, the CBSL has inaugurated a medium- and long-term refinancing scheme as

part of its development banking strategy. Though this scheme played only an insignificant role in the initial years of its operations, the utilization of funds has been progressively increasing since 1980 partly due to the expansion of institutions eligible under the scheme, and partly due to the linking of the scheme to other development projects being implemented in various parts of the country. Accordingly, the outstanding refinance under this scheme which stood at Rs. 55 million as at the end of 1977 rose sharply to Rs. 692 million by the end of 1985. The significance of this scheme in the overall refinancing schemes of the CBSL can be gauged from its ever increasing share in total refinancing credit from about 6 per cent in 1977 to slightly less than 33 per cent in 1985.

Of the total credit portfolio of the CBSL, about 90 per cent represents credit granted to the government mainly in the form of provisional advances and investment in Treasury bills. Though both these forms, in principle, are short-term borrowings, in practice, they have become a form of rolling credit exhibiting a long-term element thus fulfilling a part of the investment financing requirements of the government. Overall limits of the provisional advances have progressively increased over time; the retiring Treasury bills have been re-issued to the CBSL except during a brief period in 1984, carrying the government's liability to an indefinite future. Therefore, in practice, almost all of the credit portfolio of the CBSL has become a form of investment financing in both private and government sectors.

(b) *Commercial Banks*. Commercial banks, on account of the relatively short-term nature of their deposit base, have in the past been averse to granting medium- and long-term credit. The share of long-term credit (over five years) in the total credit of commercial banks has been slightly less than 10 per cent, while that of the medium-term credit (between 1-5 years) has been around 20 per cent. The lack of interest shown by commercial banks in relatively long-term lending is not purely due to the low profitability and the high risk associated with such lending; rather there are several structural and infrastructural problems that have contributed to this historical development. Structurally, a paucity of viable projects that could be financed by commercial banks has hindered the involvement of these banks on a significant scale in investment financing. Infrastructurally, banks also lack competent staff and trained investment and project analysts to accomplish the range of the detailed work involved in a sound project financing programme: evaluation, technical assistance and the follow-up of a loan programme. Furthermore, lack of adequate training and experience on the part of investors has resulted in a high rate of project failures, adding

an additional risk element to project financing. This factor has caused the profit seeking bankers to penetrate the investment credit market in a very cautious manner. Consequently, even the refinance funds available under the MLCF Scheme of the CBSL remain heavily under-utilized on account of lack of prospective borrowers.

Competition for funds in the non-securities market by the government and the private sectors has shown a significant structural change over the last 15 years. In the early 1970s, a bulk of the funds in the region of around 60 per cent was utilized by the government sector. However, this share recorded a gradual decline over time mainly on account of the expansion in the banking services, making bank credit more easily accessible to the private sector. Accordingly by the mid-1980s, the share of the government in the total credit supplied by financial institutions declined to about 33 per cent. One factor that contributed to this achievement was the substantial inflow of foreign aid to the country facilitating the financing of the budget deficit, on average, by about 50 per cent in the late 1970s and the early 1980s. Consequently, an increasingly larger proportion of domestic credit resources could be made available to the private sector for its economic activities.

(c) *Finance Companies.* Finance companies, though they account for only a relatively lower share of 3 per cent in the total assets of the financial system, have been playing a useful role in providing credit facilities to individuals and sectors which do not normally have access to commercial bank credit. A bulk of such credit which takes the form of medium-term capital investment has been for the private transport sector, both goods and passengers. This area which receives little attention from the organized commercial banks on account of the high risks involved would have faced a severe set-back if not serviced by finance companies. As a result, nearly two third of the total lending of these companies has been granted for such hire purchase business purposes. However, a major defect in their credit operations has been the heavy exposure to subsidiary and other associated companies functioning under parental companies.

Despite these defects, finance companies have been growing at a very fast rate in the last decade. Their total assets grew at an average compound rate of 50 per cent between 1980 and 1985, reaching a level of Rs 4,702 million by the end of the period. The strict competition between the commercial banks and finance companies for deposits has compelled the latter to offer high deposit rates which in turn has led to the maintenance of a comparatively high lending rate structure. Yet, the finance companies are operating within a closely protected market on account

of the speciality they have acquired over the type of business they are normally engaged in.

(d) *Merchant Banks*. Despite the attempts made by the two merchant banks to offer a wider range of financial services, they have not yet been able to establish a strong foothold in Sri Lanka's financial market. Their activities have largely been confined to business consultancy services, though some merchant banks, with the backing of the resources of the parent bank, have entered the local bill financing market on a very limited scale. These trade bills which normally take the form of internal bills of exchange have a maturity period ranging from 30 to 90 days and are usually rediscounted with the parent commercial banks. Apart from this short term business, merchant banks have not yet entered the investment capital market of the country in any significant way.

(e) *Long-term Lending Institutions*. The operations of the three long-term lending institutions in Sri Lanka's financial system have so far been on a very limited scale: total assets accounting for about 2 per cent of the assets of the financial system. Except for the NDB, the growth of the assets in the SMIB and the DFCC has taken place at a very slow pace. One reason for this slow growth in assets has been the relatively low level of resources which these institutions have been able to raise in the market. Consequently, these institutions have relied mainly on foreign and government funds and the Central Bank refinance facilities for building up their resource base. The short supply of funds from these sources has in turn curtailed the lending activities of these institutions.

(f) *Contractual Savings Scheme*. Both the EPF and ETF are compulsory savings institutions set up by statute covering employees in both the private and corporate public sectors. In the case of the EPF, both the employer (12 per cent of the gross earnings) and the employee (8 per cent) contribute to the Fund, while in the case of the ETF, only the employer contributes on behalf of the employee at 3 per cent of the gross remuneration. The EPF acts as a retirement benefit scheme for the employee; the ETF promotes broadbasing of the ownership of the private enterprises by equity participation by employees. Therefore, both these Funds represent potential suppliers of long-term capital to the market. The resources with the EPF has grown on a compound average rate of 25 per cent between 1977 and 1985 reaching a share of 9 per cent in the total gross assets of the financial system. The ETF, on the other hand, has grown much faster than the EPF, recording a compound growth rate of 90 per cent since its inception, though its share is still less than 1 per cent of total assets of the financial system.

The EPF has invested almost all of its resources in government and government-guaranteed securities, thus providing a convenient captive

source for the long-term borrowing requirements of the government. Even though the EPF is free to diversify its assets portfolio so as to generate the highest return on investment, the current facilities available with the Fund debar it from engaging in any investment other than the gilt-edged securities. The ready availability of funds in the EPF to meet the government long-term borrowing requirements on a large scale, has in some way, contributed to delay the development of a market-oriented securities market in Sri Lanka.

Though the ETF has been set up to promote employees' participation in private enterprises, the progress it achieved in this direction in the initial years has been very slow, mainly on account of the lack of manpower to undertake investment analysis and the non-availability of viable projects for investment during the initial period. However, over the years, the ETF has raised its equity investment portfolio from around 19 per cent in 1983 to 42 per cent in 1985.

(g) *Foreign Currency Banking Units (FCBUs)*. The main purpose of introducing Foreign Currency Banking Units (FCBUs) in 1979 as a separate department in the existing commercial banks was the eventual development of an offshore banking centre in Sri Lanka. About 85 per cent of the resources of the FCBUs represents short-term deposits, yet they have managed to grant a sizeable volume of medium- and long-term loans accounting for about 30 per cent of the total advances. However, in the domestic sector, only the Greater Colombo Economic Commission (GCEC) enterprises and a few other approved enterprises have access to FCBU facilities. Advances granted to these institutions amount to about 25 per cent of the total advances of these units. Since the deposits raised from this sector constitute only 10 per cent of the total deposits, there has been a net outflow of funds to the domestic private sector mainly from the Central Bank and the non-resident category.

2. Securities Market

(a) *Market for Government Securities*. In terms of magnitude, Government rupee securities (GRSs) represent the largest sub-market in the securities market in Sri Lanka. The total outstanding GRSs account for about 30-33 per cent of the total loans and advances of the financial system; when compared with the share market, outstanding GRSs are four times larger than the market value of the shares of the 169 companies listed with the Colombo Securities Exchange. However, this sub-market is the least active market in the financial system in Sri Lanka.

The outstanding GRSs increased from Rs 6.6 billion in 1974 to Rs 36.6 billion in 1985, recording an annual compound growth of around 41 per cent over this period. However, the market has been strictly confined to the captive sources whose share rose from about 80 per cent in 1974 to 94 per cent in 1985 reflecting the declining significance of other sources in providing investment capital to the government. Accordingly, the share of the banking sector in GRSs fell from 7 per cent in 1974 to 3 per cent in 1985. Following the same trend, the share of the market sources too declined from about 13 per cent to 3 per cent.

Though GRSs are negotiable instruments, there is hardly a secondary market for them. Consequently, all investors are virtually locked up in these securities until they are liquidated at the time of maturity. The absence of a secondary market for them makes it impossible for an investor to increase his wealth by accruing a capital gain and his only return becomes the coupon rate of interest he receives. As a result, private sector individuals have been compelled to avoid the Rupee Securities Market. Thus, the market sources for the GRSs wholly comprise private provident funds and other private institutions which view these securities as a fairly safe investment in view of the government's guarantee for repayment. The major incentive for commercial banks to invest in GRSs is the collateral provided when they want to borrow from the Central Bank at the Bank rate at a time of a severe liquidity crisis.

b) *Share Market.* Establishment of a formal Stock Exchange in Sri Lanka was initiated only after the incorporation of the Colombo Stock Exchange Limited (CSEL) in 1982 as a private company under the Companies Act. However, on account of certain differences which arose between the CSEL and the Colombo Brokers' Association (CBA), the CSEL never got an opportunity for setting up a Securities Exchange. Meanwhile, the CBA, which hitherto continued its share business within closed doors opened up a trading floor towards the mid-1984 which was subsequently taken over by the Colombo Securities Exchange (Gte) Limited (CSE). The CSE is entirely owned by brokers, though there is a provision for dealers to join. At present, there are seven members and two associate members. In view of the limited volume of business transacted, the Securities Exchange (SE) is open only for two hours from 10.00 a.m. to 12 noon on every working day.

Since the SE is still in its infancy, no final work has so far been done with regard to the rules and regulations concerning listing procedures, disclosure requirements, etc. For practical business transactions, it still

follows the by-laws adopted by the CBA, but these by-laws need considerable updating and revision in view of the changing business climate in the country. For the purpose of listing in the official share list of the SE, a company is required to offer 20 per cent of its shares in the market for a period of at least a week, but the entire 20 per cent need not be offered to the public. There are no effective provisions to compel companies to publish their final accounts in sufficiently detailed form.

In December 1985, the total number of companies whose shares were quoted in the market amounted to 169. Given the large number of limited liability companies in the country, these quoted companies represented only a negligible fraction of the corporate form of private business organizations. Even in these companies, transactions took place in the market rather infrequently, and the number of shares offered in the market was even below 1 per cent of the total issued share capital right throughout the period. This situation reflected an unhealthy feature which hindered the growth of an active share market in the country: the desire of the promoters of a company to retain controlling interest among themselves. As a result, only the minimum number of shares that are required to be offered in the market to get a quotation was placed in the market for trading. On account of these supply constraints, demand for shares continued to play a dominant role in determining the prices of shares traded. A corollary of this market feature was the prevailing market prices providing a misleading indicator of the true financial state of the companies listed in the market.

Reflecting the undeveloped condition of the share market, the total turnover in the secondary market remained very low – at an average of Rs 9 million per quarter during 1981 through 1985. The minimum turnover per quarter was as low as Rs 3.4 million which at times rose up to Rs 26 million due to unusual conditions. All transactions consisted of very small bundles of shares which averaged at 1,174 shares during 1981 – 1985. The smallest bundle consisted of 472 shares, while the largest bundle has some 3,281 shares. The insignificant volume of share trading that took place at any point of time in the market made share trading a rather low profit business causing the brokers to treat it only as a side line of business. This factor too was responsible for the slow growth of the share market in Sri Lanka especially over the last 30 years.

The only instrument traded in the securities market was the ordinary shares of the quoted public companies. Neither the private bonds nor the government securities were listed or traded in the market. In view of the virtual absence of a secondary market, there was no incentive for investors to buy these securities since it amounted to exposing them-

selves to a long-term interest risk. Consequently, private companies too relied mainly on the organized banking sector for their loan capital needs. Whenever such bonds were offered in the primary market, as was in the case of the DFCC Bonds issued in 1985, moral suasion had to be applied to persuade buyers to invest in such bonds.

With the liberalized economic policy that was introduced in 1977, a greater emphasis was placed on the private sector in the economic life of the country. Consequently, there was a renewed activity in the primary share market. As shown in Table 7.1, the total number of new share issues rose progressively from five in 1980 to 37 in 1983. However, with the withdrawal of the tax holiday scheme for approved enterprises in 1983, the new share issues declined to 13 in 1984 and three in 1985. This factor, thus, reveals that the renewed activity in the share market up to 1983 was mainly due to the signals provided to the private sector by way of a generous tax package by the government.

III. THE DEVELOPMENT OF THE NON-SECURITIES MARKET

A. Mobilization of Domestic Savings

1. Need for Domestic Resource Mobilization

In Sri Lanka, total savings of both the government and private sectors have been inadequate to meet the growing investment demand which gained momentum at an unprecedented rate especially after 1978. Total savings which amounted to 18 per cent of GDP in 1977 remained more or less at a level of 18 – 19 per cent throughout the period up to 1983. In 1984, on account of the improved export prices realized by Sri Lanka's major exports, total savings as a percentage of GDP rose to 24 per cent, but it reverted back to its long-term trend level of 17 per cent in 1985 (Table 7.2) The low performance of savings was mainly due to the dissavings that occurred in the government sector except in 1984 and 1985 where government savings averaged 3 per cent of GDP in the respective years. Consequently, almost all of total savings in Sri Lanka occurred in the private sector throughout the period 1977 – 1985.

Against this background, investment demand increased from around 14 per cent of GDP in 1977 to a peak level of 34 per cent in 1980 and remained at an average level of 27 per cent of GDP thereafter. Both the

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Table 7.1 SRI LANKA: NEW SHARE ISSUES IN THE PRIMARY SHARE MARKET

Investment	1980	1981	1982	1983	1984	1985
Engineering	1	7	6	12	5	—
Hotels & Travels	3	3	8	9	4	1
Finance & Loans	—	2	2	5	3	2
Beverages & Food	1	1	1	5	—	—
Miscellaneous	—	—	2	6	1	—
Total	5	13	19	37	13	3
No. of shares offered (Million)	1.39	28.47	37.11	94.0	63.25	8.74
Value of shares (Rs Million)	13.9	284.7	311.1	1004.2	632.5	87.4

Source: Central Bank of Sri Lanka.

Table 7.2 SAVINGS IN SRI LANKA

	Percentage Distribution			Per cent of GDP		
	Private Savings	Govt. Savings	Total Savings	Private Savings	Govt. Savings	Total Savings
1977	98.3	1.7	100.0	17.6	0.3	17.9
1978	107.3	—7.3	100.0	18.9	—1.3	17.6
1979	97.9	2.1	100.0	18.6	0.4	19.0
1980	120.9	—20.9	100.0	21.0	—3.4	17.4
1981	109.8	—9.8	100.0	19.5	—1.7	17.8
1982	107.6	—7.6	100.0	20.3	—1.5	18.8
1983	99.4	0.6	100.0	19.6	0.1	19.7
1984	84.6	15.4	100.0	21.1	3.8	24.9
1985	81.3	18.7	100.0	13.8	3.2	17.0

Source: Central Bank of Sri Lanka.

private sector and the public sector investment was responsible for this phenomenal growth. As shown in Table 7.3, the share of the private sector in total investment increased gradually from 65 per cent in 1977 to 83.8 per cent in 1982 and declined marginally to 79.8 per cent by 1985.

Table 7.3 INVESTMENT IN SRI LANKA

	Percentage Distribution			Per cent of GDP		
	Private Sector	Govt. Sector	Total	Private Sector	Govt. Sector	Total
1977	64.7	35.3	100.0	9.3	5.1	14.4
1978	68.2	31.8	100.0	13.7	6.4	20.1
1979	72.3	27.7	100.0	18.7	7.1	25.8
1980	74.7	25.3	100.0	25.2	8.6	33.8
1981	83.0	17.0	100.0	23.1	4.7	27.8
1982	83.8	16.2	100.0	25.8	5.0	30.8
1983	83.2	16.2	100.0	24.0	4.9	28.9
1984	82.3	17.7	100.0	21.3	4.5	25.8
1985	79.8	10.2	100.0	19.0	4.8	23.8

Source: Central Bank of Sri Lanka.

Against this background, the savings-investment gap continued to widen, reflecting the need for accelerating domestic resource mobilization. However, the behaviour of total savings in the economy during 1977 – 1985 shows that they have been able to maintain the same share of GDP, indicating a more or less constant marginal propensity to save (MPS). With a very low level of savings or dissavings generated by the government sector, the private sector has been able to improve its share of savings from 17.6 per cent of GDP to 21.1 per cent by 1984. This indicates that the MPS of the private sector has marginally improved over the period 1977 – 1985 in response to various savings promotion campaigns launched during this period. As a result, the widening of the savings-investment gap during 1978 – 1985 could be attributed to the growth in investment on a significant scale.

2. Recent Trend and Structure of Domestic Savings

Financial savings of the private sector, defined as the change in money, deposits with various institutions and actuarial reserves and provident fund balances, have accounted for, on average, nearly 50 per cent of total private savings during 1977 – 1985. (Table 7.4). However, these savings as a ratio of GDP have widely fluctuated between 7.3 and 12.0 per cent with the ratio eventually recording a downward trend since

Table 7.4 SRI LANKA: FINANCIAL SAVINGS OF THE PRIVATE SECTOR

	1977	1978	1979	1980	1981	1982	1983	1984	1985
	(Rs. Million)								
Total Savings	2,982	3,744	6,298	7,093	6,677	10,918	12,523	12,704	11,909
1) Currency	711	224	758	407	642	1,165	1,212	1,361	1,255
2) Demand Deposits	489	347	974	1,352	-46	570	1,776	716	683
3) Time & Savings Deposits	1,196	1,605	2,432	3,044	3,990	4,328	3,759	4,095	3,044
4) NSB Deposits ¹	494	713	1,124	693	499	2,427	1,961	2,157	1,797
5) Deposits with Finance Companies	45	21	-23	232	147	467	380	1,189	1,171
6) FCBU Deposits	-	-	-	228	-12	96	1,171	86	328
7) Rural Bank Deposits	47	49	97	66	107	177	35	188	183
8) Actuarial Reserves & Provident Fund Balances ²	-	785	936	1,071	1,350	1,688	2,229	2,912	3,448
1) Percent of GDP	8.2	8.8	12.0	10.7	7.9	11.0	10.3	8.3	7.3
2) Percent of total private savings	45.7	46.1	64.7	52.0	40.2	54.3	52.4	38.8	52.9

¹Includes accrued interest on deposits.²Insurance, Funds, EPF and ETF balances.

Source: Central Bank of Sri Lanka.

1982. This behaviour of financial savings contrasts with the marginal improvement observed in the private savings/GDP ratio during the same period. These data show that there has been a structural change in private savings around 1980 with a renewed significance being attached to non-financial savings.

The year-to-year fluctuations in the financial savings show a very broad correspondence to the movement of real interest rates in the economy. Since 1977, as part of the new economic policy package, Sri Lanka has been pursuing an interest rate policy aimed at maintaining a positive real interest rate structure. However, since the inflation rate in certain years rose much faster than the rise in nominal interest rates, real interest rates showed a mixed performance of being positive in some years and negative in others. The negative real interest rates in 1980 have caused, subject to a time lag of one year, the financial savings to fall in the following year. Similarly, negative real rates in 1984 brought about a similar outcome in 1985.

The growth in financial savings in absolute terms from Rs 2.9 billion in 1977 to Rs 11.9 billion in 1982 has largely been helped by several new developments that took place in the institutional structure of the financial system. While the size and the geographical coverage of deposit accepting institutions expanded significantly, sophisticated savings instruments were introduced to attract new savings. The total number of financial institutions increased steadily from 331 in 1977 to 400 in 1985; commercial banks and co-operative rural bank branches rose from 1,259 in 1977 to 1,567 in 1985. With a network of post offices exceeding 2,500 all throughout the island as collectors of deposits for the NSB, the geographical coverage of deposit taking institutions has been fairly extensive. Against this background, the financial system was sophisticated with the introduction of new instruments such as the Certificate of Deposits (CDs), Negotiable Order of Withdrawal (NOW) Accounts and various long-term savings schemes. Strict competition between commercial banks and non-bank financial institutions for deposits led to the maintenance of competitive deposit rates on the one hand and the adoption of non-price marketing strategies, as is widely prevalent in other countries, to attract customers on the other. Accordingly, commercial banks came out with a full package of financial services to make savings with them more attractive. Such services included easy access to credit for depositors, daily computation of interest on savings, overdraft facilities with variable interest rates, etc.

3. Government Policies and Strategies in Mobilization of Domestic Savings

Raising the level of domestic savings has been a major concern of the authorities in Sri Lanka for over three decades, but a concerted effort to achieve this objective was taken only after 1977. In addition to the expansion of the geographical coverage of the deposit taking institutions, the major thrust of the policy was placed on the maintenance of a positive real interest rate structure by officially manipulating the deposit rates of the National Savings Bank (NSB). Consequently, the NSB acted as the interest rate leader in the financial system up to around the middle of 1984, but subsequently, that role seems to have been assumed by the two state banks, especially the Bank of Ceylon.

The data on the behaviour of the real deposit rates show that the objective of maintaining a real positive deposit rate structure has not been pursued by the authorities to the letter (Table 7.5). During those years which experienced high inflation such as in 1980 and 1984, real

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**Table 7.5 SRI LANKA: REAL INTEREST RATES
(ONE-YEAR DEPOSIT RATES)**

	1977	1978	1979	1980	1981	1982	1983	1984	1985
	(In per cent)								
Average Inflation Rate	1.2	12.1	10.8	26.1	17.9	10.8	14.0	16.6	1.4
One Year Deposit Rate (Min.)									
Commercial Banks	14	14	14	20	20	15	16	14	12
NSB	12	12	12	15	15	12	14	14	13
Real Interest Rate									
Commercial banks	12.8	1.9	3.2	-6.1	2.1	4.2	2.0	-2.6	10.6
NSB	10.8	0.1	1.2	-11	-2.9	4.2	0	-2.6	11.6

¹As per Colombo Consumers' Price Index.

Source: Central Bank of Sri Lanka.

rates became negative inflicting a temporary set-back to the deposit mobilization momentum. Even in years when the real rates were positive, they remained sometimes slightly above the zero level, indicating a very low rate of time preference in inter-temporal choice between consumption and savings. Consequently, the financial savings/GDP ratio, an indicator of the MPS in the economy, did not record an appreciable improvement during this period.

The tax and other incentives offered to savers were mainly institution-oriented and, therefore, discriminatory in practice. Accordingly, in order to attract more savings to the NSB which was not in a position to compete with commercial banks on an equal footing, interest earned on deposits with that Bank was exempted from income tax up to a third of interest income or Rs 2,000 whichever was higher. With regard to the other financial institutions, there was no such exemption, but all individuals were subject to a general tax-free allowance of Rs 27,000 per annum which benefited small savers whose aggregate income was below this level. In addition to this, as from April 1986, a withholding tax of 20 per cent was imposed on interest earned on deposits of more than Rs 50,000. This tax, in effect, did not affect the NSB adversely in view of the small size of the deposit accounts held with it which averaged at Rs 1,286 in 1983 and therefore, was discriminatory against other financial institutions. Consequently, the tax incentives offered by the government to accelerate the savings mobilization momentum in the country merely resulted in a redistribution of deposits within the financial system. This, in turn, led to the adoption of non-price competitive

methods by other institutions in order to maintain the relative competitiveness, thereby raising the cost of financial intermediation.

The need for regulating the financial system to ensure solvency was brought to the attention of the authorities after evidence came to light that the depositors had problems with several finance companies in receiving interest and getting their money back on maturity. The commercial banks in Sri Lanka were already subject to the supervision and the regulation of the Central Bank under the Monetary Law Act (MLA). The deposits of the NSB and the two state banks had been guaranteed by the government. Therefore, in order to safeguard the interests of the depositors with finance companies, the government enacted the Control of Finance Companies Act (CFCA) in 1979, vesting the controlling power with the CBSL. Under the CFCA, any finance company with a capital of Rs 100,000 or more and/or total deposits in excess of Rs 500,000 is required to register with the CBSL before it carries on its business. The books of these companies are periodically examined by the CBSL in order to give an advance warning about their emerging financial state. In addition, the CBSL has imposed several requirements on these companies with regard to disclosure of information in advertisements soliciting deposits, minimum capital and liquidity ratios and rules relating to granting of loans. Despite these controls, several finance companies became bankrupt in recent years creating severe problems for depositors. This factor indicates that the level of control to be exercised by the CBSL on the errant companies has to be intensified with a view to ensuring a smooth functioning of the system, while only a careful watch need be maintained on the companies that run on a sound commercial basis.

The development of new instruments and savings schemes to raise deposits has been largely left to the financial system in Sri Lanka. The involvement of the authorities in this exercise has been limited to final approval of such schemes and in the past, a liberal approach has been adopted to such innovations. Accordingly, many new instruments such as CDs, NOW Accounts, Pension and Investment savings schemes were developed and introduced by various institutions competing for deposits. The emphasis of the present strategy of the authorities has, therefore, shifted from regulation and incentives to a market orientation with a view to minimizing the cost of financial intermediation.

4. Problems, Issues and Prospects

The major problem with Sri Lanka's domestic savings has been its inadequacy when compared with the high level of investment the coun-

try has attempted to achieve in the recent past. Unless the savings momentum is accelerated to reach an acceptable level, the utilization of foreign savings for investment purposes will soon entail its true cost to the economy thus creating problems for debt servicing.² Therefore, the sustenance of the present investment programme will largely depend on the ability of the country to generate domestic resources for this purpose. The continued dependence on concessionary foreign aid to supplement domestic savings will result in a severe curtailment in the investment programme if and when such aid flows run dry in the future.

The contribution of the government sector to domestic savings has shown some erratic behaviour in the past few years. With the exception of 1984 and 1985, the government's savings has been negative in most of the period. The high recurrent expenditure of the government, which on average stands at about 20 per cent of the GDP, is to rise further in the future in view of the growing fixed commitments such as the salary bill and interest payments on public debt. Against this background, it is of utmost importance to raise government revenue faster than the expenditure in order to generate any sizeable savings by the government on a sustainable basis. However, it does not appear to be feasible to raise the present level of tax revenue which accounts for about 20 per cent of GDP, without inflicting adverse repercussions on the other sectors of the economy. Therefore, the curtailment of the recurrent expenditure of the government to be compatible with the revenue level is the only way to raise domestic savings and reduce dependence on foreign savings for investment purposes.

The strategy to be followed by the government to achieve this end is numerous and involves some bold measures. Public enterprises and corporations which have become a burden on the budget will have to be reorganized to run as viable enterprises, possibly with private participation in the share capital. Also, in the future, all government investments in commercial ventures should be undertaken only after a very careful evaluation of the financial and economic viability of the projects involved. Reorganization of the whole government administration to cut down waste and inefficiency will raise productivity, thus lowering costs. This will curtail the expansion of the government recurrent expenditure over and above the levels permissible by the real growth in the economy.

2. Sri Lanka was a beneficiary of a long-term foreign aid programme on concessionary terms supported by the international community. Consequently, her debt-service ratio remained at 26 per cent and the interest payments amounted to 4 per cent of the total outstanding external debt in 1986.

The growing underground economy in Sri Lanka has, to some extent, contributed to the slow growth in domestic savings. Naturally, with the liberalization of foreign trade and payments, the level of the underground economy should decline, but, on account of certain features retained along with liberalization such as high protective tariffs, the divergence between the domestic and foreign prices has induced people to grab unexploited profit opportunities. Though there is no reliable estimate of the size of this economy, a crude estimate has yielded a market size of about Rs 15 - 20 billion or 8 - 10 per cent of the GDP.³ Since the profitability of this market is much higher than that of legal trades, very high incentives will have to be given to participants in the market to divert their resources to the organized sector. However, the successful performance of CDs within a short spell of two years testifies that, given the correct type of incentives, a sizeable proportion of the underground market could be diverted to the organized sector.

The policy stance adopted by the authorities for the development of the capital and money markets in Sri Lanka seems to have shifted from a system of controls and regulations to one ruled by, as far as possible, market forces. Movement towards the market in this manner will remove the distortions that hinder the money market from growing along its long-term trend line and bring about an efficient allocation of resources. To achieve this end, interest rates have been partly deregulated with the Treasury bill rate being determined by market forces and the NSB rates being freed from government controls. Measures have been taken to rid the financial system of the subsidy/concession syndrome which acted as a major hindrance to the development of an efficient capital market. In this manner, it is expected that the non-securities market in raising domestic savings for investment purposes will show satisfactory results in the future.

B. Allocation of Financial Resources

1. Financing the Government Sector

During the period since 1977, allocation of domestic financial resources between the government sector and the private sector became a crucial

3. This figure was arrived at by estimating the annual turnover needed to finance various types of illegal activities: confirmed drug addicts (Rs 2 billion); prostitution (Rs 2 billion); smuggling (Rs 5 billion); illegal liquor (Rs 4 billion), casino and gambling (Rs 4 billion) and others (Rs 3 billion).

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issue on account of the large budget deficits encountered during this period ranging between 8.4 per cent and 24.4 per cent of the GDP (Table 7.6). For the financing of these huge budget deficits, the government mainly relied on the bank borrowings, borrowings from the captive sources and foreign financing.

Table 7.6 shows that a bulk of the budget deficit throughout the period was financed through foreign sources and for the balance, emphasis has been shifted between the bank borrowings and non-bank borrowing from year to year. Of the non-bank borrowing, a large part came from government-owned savings institutions which are known as captive sources and, therefore, there was no competition between the private sector and the government sector for such funds. As for the bank borrowings, the main source was the CBSL which accommodated such credit demand from the government by raising the reserve money base in the economy.

**Table 7.6 SRI LANKA: FINANCING OF THE BUDGET DEFICIT,
1979 – 1985
(Percentage Distribution)**

	1979	1980	1981	1982	1983	1984	1985
Bank borrowing	7.4	43.8	26.3	18.3	2.4	-12.4	19.3
Non-bank borrowing	44.4	15.2	11.7	37.9	46.9	41.5	33.2
Foreign Financing	48.2	41.0	55.0	43.8	50.7	70.9	47.5
Budget Deficit	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Budget Deficit as a per cent of GDP	16.8	24.4	17.5	20.2	17.8	10.3	15.8

Source: Central Bank of Sri Lanka.

Table 7.7 shows that the largest single determinant of the reserve money base in Sri Lanka during 1979 – 1985 was the government's borrowing (net) from the CBSL for budgetary purposes. Consequently, the monetary expansion which was experienced by a compound average growth of 22 per cent during this period was mainly brought about by the government's credit operations. The pre-emption of resources by the government in this manner resulted in a curtailment of resources available to the private sector via two sources. First, the monetary controls imposed by the CBSL since 1980 in order to curb the undue monetary expansion in the economy took the form of quantitative

Table 7.7 SRI LANKA: DETERMINANTS OF THE RESERVE MONEY BASE, 1979-1985
(Percentage distribution)

	1979	1980	1981	1982	1983	1984	1985
From CBSL							
Net Credit to Government	58.8	153.0	168.8	186.2	151.5	97.4	122.1
Credit to Commercial Banks	12.2	17.9	18.8	15.3	25.3	16.2	12.6
Net Foreign Assets	101.1	25.4	14.0	1.4	4.1	52.4	43.3
Other items (net)	-72.1	-96.3	-101.6	-102.9	-80.9	-66.0	-78.0
Reserve Money Base	100.0	100.0	100.0	100.0	100.0	100.0	100.0

credit restrictions over the private sector. Second, the increase in the lending rates as an anti-inflationary measure raised the costs of borrowing of the private sector thus reducing this sector's demand for credit significantly. Accordingly, commercial bank credit to the private sector which rose faster than the growth in the GDP during 1979 – 1983, continued to rise at a slower rate than the GDP in 1984 and 1985. Thus, the credit to the private sector as a per cent of GDP rose from 23 in 1979 to 26 in 1983, but declined to 23 in both 1984 and 1985, indicating the restraint on private sector activities generated by the continuing deficits in the public sector.

2. Financing of the Private Sector

With the credit restrictions imposed by the CBSL as an anti-inflationary measure, it became necessary to ensure that adequate credit flows are made available to the private sector to continue with an unrestrained production in the priority sectors in the economy. For this purpose, industry, agriculture, tourism and exports were recognized as priority sectors by the authorities. To achieve this end, the authorities attempted to regulate credit flows in the economy by the introduction of a National Credit Plan (NCP) as from 1981. Initially, the NCP covered only the credit operations of commercial banks, but subsequently, the coverage expanded to include the long-term lending institutions as well.

The credit planning exercise involves bilateral discussion between the CBSL and the commercial banks concerned to arrive at a common understanding regarding the credit needs of the priority sectors. As an initial step of the exercise, the CBSL estimates the permissible level of credit to the private sector on the basis of the behaviour of the major macro variables in the economy. Then, the credit needs of the priority sectors are estimated independently and the planned credit levels, broken into quarterly targets, allocated among different purposes. These credit targets are compared with individual credit plans prepared by the lending institutions concerned and at the discussion, a common target is agreed upon between the CBSL and the lending institutions. At the same time, a common strategy is also drawn up to realize the targets set for each quarter of the year.

There are many weaknesses in this credit planning exercise as an allocator of credit among different purposes, especially among priority sectors. Even though the priority sectors have been selected very carefully in view of their contribution to the value added and the generation of employment, market intervention to direct credit into preferred sectors will not necessarily result in an efficient allocation of resources. The preferred treatment of one sector as against another sector lowers costs in the former thereby imparting a wrong signal for allocation of resources. The resulting market distortions will lead to the maintenance of inefficient sectors at the patronage of authorities and in the long run, will trap the economic system in a subsidy/concession syndrome. Second, the considerable delay that occurs in the finalization of the NCP and the lack of effective follow-up action reduces it to a pure pedagogical exercise.

As shown by Table 7.8 there has not been any appreciable change in the structure of commercial bank credit to private sector after the introduction of the NCP in 1981. Except tourism where the percentage share of credit has improved marginally, all the other priority sectors identified in the NCP have recorded a declining percentage share over time. On the other hand, contrary to the objective of the CBSL, the share of commercial purposes in the total credit has increased significantly from 43.6 per cent in 1976 to 49.6 per cent in 1985 mainly on account of the vast expansion which this sector experienced in the national economy during this period. It therefore, appears that the distribution of credit by commercial banks has taken place quite independent of the guidelines and intervention of the authorities. Preparation of the NCP purely as a monetary exercise without reference to specifically identified projects and investments in various sectors may have contributed to this development.

**Table 7.8 SRI LANKA: PURPOSE-WISE CLASSIFICATION OF
COMMERCIAL BANK CREDIT IN SELECTED YEARS
(Percentage Distribution)**

Purpose	1976	1980	1981	1983	1985
Commercial	43.6	51.2	48.5	48.6	49.6
Financial	3.3	2.6	1.4	2.3	1.9
Agricultural	13.9	13.3	13.2	10.9	9.3
Industrial	26.8	22.4	22.0	25.6	23.7
Tourism			1.4	1.9	2.1
Housing	4.3	4.5	5.6	6.3	7.5
Consumption	5.0	2.1	1.9	1.6	1.7
Other purposes	3.0	4.0	5.9	2.9	4.1
	100.0	100.0	100.0	100.0	100.0

Source: Central Bank of Sri Lanka.

C. Financial Implications and Regulatory Issues

Regulation of the financial system by the authorities, though carried out with the best intentions in mind, creates an additional constraint on the conditions for the optimal operations of the institutions involved. However, in Sri Lanka's case, regulations have been used as sparingly as possible in order to achieve the desired structural transformation of the financial system.⁴ The strategy of the authorities in this respect appears to be a mixture of controls and incentives.

Both commercial banks and finance companies who raise their deposits on a short-term basis have used a part of their resources for medium- and long-term lending on their own (Table 7.9). The authorities on their part have induced such lending by providing medium- and long-term refinance to lending institutions (except finance companies). Even though the funds available under this scheme is less than 2 per cent of total loans and advances of the eligible institutions, it provides liquidity to these institutions to continue with their credit operations. In addition, the SMIB and the DFCC are helped by the government to raise long-term funds in the market by guaranteeing the bonds so issued, thereby making such bonds as good as any gilt-edged security. Furthermore, the DFCC and the NDB which raise external

4. In Sri Lanka, only the commercial banks and the finance companies come under the direct regulation of the CBSL. The other institutions which are mostly government-owned are free to operate within the broad guidelines issued by the government.

**Table 7.9 SRI LANKA: TERM STRUCTURE OF TOTAL LENDING
(Percentage Distribution)**

Term of Lending	1970	1975	1980	1983	1985
Short-Term	51.2	68.9	66.9	65.3	63.5
Medium-Term	29.8	21.0	22.8	23.3	23.2
Long-Term	19.0	9.8	10.3	11.4	13.3

Source: Central Bank of Sri Lanka

capital for their term lending operations are issued with a government guarantee of the repayment of such loans. These guarantees, therefore, take the form of a subsidy given by the government to these long-term lending institutions. Therefore, the term transformation of lending in Sri Lanka has occurred in a free decision-making atmosphere induced by appropriate incentives and subsidies. The authorities have so far not used regulation to achieve this end.

Even though the financial institutions in Sri Lanka do not maintain a perfect matching of the term structure of deposits and advances, these institutions do not run into liquidity problems very frequently, mainly on account of the practice of depositors to renew their one-year term deposits automatically on maturity. As a result, these deposits carry a long-term element which helps avoid unwarranted liquidity crises. Consequently, although commercial banks do not accept deposits with a maturity of longer than two years, they have been able to maintain a long-term advances portfolio amounting to about 10 per cent of their total advances without facing liquidity problems. Similarly, in the entire financial system, medium- and long-term advances account for about a third of the total lending.

The rudimentary nature of Sri Lanka's money and capital markets has posed a problem for the effective implementation of open market strategies for monetary policy purposes. Among the money markets, the interbank call market remains the only market with considerable activity participated mainly by commercial banks. This market serves to meet the temporary liquidity requirements of deficit banks and, therefore, any attempt by the CBSL to sell bonds as an open market strategy will result in a drying-up of funds available to such banks. The resultant increase in the interest rates previously earmarked for buying CBSL bonds, thereby, frustrating the open market operations exercise. The limited size of the money market, both in terms of the volume and

the number of participants, has been the major cause for these unhealthy inter-actions and substitutions among markets.

Action initiated by the authorities to build the confidence of depositors in the financial system also constitutes a mixture of regulations and incentives. With regard to commercial banks and finance companies, an effective supervisory system has been designed and implemented to give an advance warning about emerging bank failures. Though this is not a guarantee of the solvency of the financial system, it nevertheless provides an opportunity for the authorities to direct the banking system in the right direction so as to avoid crisis situations. While this regulatory system is in force, the deposits of the NSB have been guaranteed by the government, thereby, elevating this institution onto a preferred position. This State patronage together with the wide geographical coverage of branches has enabled these institutions to establish an oligopolistic position in the deposit market of the country.

D. Factors Affecting the Development of the Non-Securities Market

Sri Lanka's non-securities market has recorded a satisfactory growth over the last decade in terms of the volume of business and the coverage of activities. Its total assets have increased by about six times from Rs 28.3 billion in 1977 to Rs 166.3 billion in 1985. At the same time, the number of institutions has expanded from 331 in 1977 to 400 in 1985. In terms of the share in GDP, the total assets of the financial system have varied in a wide range of 78 and 102 per cent. Yet, the growth recorded in the non-securities market during this period cannot be wholly attributable to a high level of efficiency attained by the market as a whole or by individual institutions within the market. Many factors which could be regarded as exogenous to the non-securities market have contributed to this growth.

First, the considerable expansion in the reserve money base during 1977 – 1985 mainly on account of the heavy volume of credit granted by the CBSL to the government contributed to a phenomenal growth in the commercial banking system. The total reserve money base which stood at Rs 3.8 billion in 1977 increased dramatically to Rs 16.9 billion in 1985 recording an average compound growth rate of 21 per cent per annum. The growth in the reserve money base by Rs 13.1 billion during this period was responsible for expanding the broad money supply by about Rs 37.06 billion based on an average money multiplier of 2.8 in the banking system. With an estimated currency leakage of Rs 7 billion, this monetary expansion is thus estimated to raise the assets of the commercial banking system by Rs 30 billion. Going through a

trickling down process, the initial monetary expansion is expected to raise the business activities of the other financial institutions, thus bringing about a corresponding growth in their total assets. In this manner, the expansion of the total size of the financial system in Sri Lanka could be viewed as a corollary of the expansionary fiscal operations adopted by the government, since 1977.

Second, the initiative taken by the authorities to widen the institutional set-up as well as the geographical coverage of the financial system resulted in a steady growth in the non-securities market. New institutions established by the government such as the Employees' Trust Fund (ETF) and the second insurance corporation contributed to raise private savings, while the facilities afforded to the NSB and the increase in the provident fund contribution rates caused the savings momentum to accelerate significantly. Moreover, the entry of the foreign banks and the establishment of FCBUs brought not only the new markets under the financial system but also were responsible for the introduction of many innovations to the market thereby lowering the cost of operations. Commercial banks which were solely confined to the traditional business of commercial banking a decade ago were forced to pursue an aggressive banking and investment policy, by the changing business environment throughout the world. Accordingly, new ventures such as merchant banking, leasing, investment management, offshore banking, loan syndication and consultancy services were added to the routine functions of Sri Lanka's commercial banking system. Thus, the exposure to the external world, a situation created by the change of policy by the authorities, helped commercial banks and other financial institutions to improve the quality of their services and provided an opportunity to offer a full-package of financial services to their customers.

Third, the development of the non-securities market is very closely connected with the growth in the economy, since the latter facilitates an expanded volume of business for the former. During the period 1978 – 1985, Sri Lanka's economy recorded an average real growth of 6 per cent as against an average growth of 2 per cent achieved between 1970 and 1977. Correspondingly, the growth in the financial system also accelerated during 1978 – 1985 along with the acceleration in the economy. Accordingly, the total loans and advances of the financial institutions as a percentage of GDP declined from 32 per cent in 1970 to 28 per cent in 1977, but increased progressively to 50 per cent by 1982 and remained at an average percentage of 47 thereafter. Thus, the new economic policies and the resultant economic expansion have created the necessary business environment for the development of the non-securities market in Sri Lanka.

IV. THE DEVELOPMENT OF THE SECURITIES MARKET

A salient feature of the development of the securities market in Sri Lanka is the lop-sided growth recorded since its inception, with the share market showing some activity while the bond and the government securities markets resort to non-market tactics to raise capital in required magnitudes. Though a well developed securities market is a pre-requisite for mobilizing long-term capital for investment purposes, a concerted effort to develop the market on modern lines was made only in the early 1980s. While the major responsibility for the development of the market was placed with the private sector, the government initiated action to create a conducive atmosphere by undertaking to introduce necessary legislation. Consequently, the securities market in Sri Lanka is still in its infancy, though the birth of the infant took place some 90 years ago.

A. The Stock Exchange and Its Evaluation

During the long history of the share market in Sri Lanka, there was not a formal Stock Exchange to facilitate stock and share transactions. All share transactions were conducted by the CBA under its rules and by-laws on a 'call-over' system with the representatives of broking firms participating in the proceedings. The trading was conducted within 'closed doors' and was not open to the general public.

Since the adoption of the new economic policies in 1977 which assigned a greater role to the private sector in the country's economic life, the need for establishing a formal stock exchange began to be felt by many interested parties.⁵ As a prelude to this, a trading floor was opened by the CBA for the benefit of the investing public in July, 1984. This trading floor was subsequently taken over by a company limited by guarantee called the Colombo Securities Exchange (Gte) Limited (CSE).

The main policy making body of the Exchange is the Executive Committee consisting of seven members elected by member firms. Under this main Executive Committee, several sub-committees have been appointed to decide on subject matter arising in day-to-day operations. These sub-committees cover areas such as Capital Issues, Rules and Regulations, Research and Development, Disciplinary and Arbitration.

5. For details, see Wijesekera (undated) and ADB (1984).

The membership of the CSE is restricted to stock brokers who in turn are permitted to act as intermediaries or agents of buyers and sellers. As at the end of 1985, there were seven full members and two associate members operating on the trading floor and enjoying full member status. In view of the limited volume of transactions, business is conducted only for two hours per day during the week days on the basis of an "open out-cry" system. The brokers are entitled to charge commission of 1.5 per cent of the total consideration both from the buyer and the seller; in addition, an ad valorem stamp duty of 1 per cent is payable by the buyer for the registration of the transaction.

For the operations of the market, the CSE still relies on the by-laws and rules adopted by the CBA. Since these by-laws are not adequate to deal with the issues that arise in a modern day securities exchange, the CSE has initiated action to update them. At the same time, listing requirements and procedures and disclosure requirements are also being drafted by the CSE to suit the present day business requirements.

The low turnover and, therefore, the low profitability of the members have hindered the growth of the CSE, since the existing members have no incentive to improve upon the system, while the would-be new members are discouraged from entering the market. All investments made in the CSE are, therefore, substantially under-utilized, raising the cost of operations. Consequently, unless the volume of business expands considerably, commission charges will have to be raised to enable the existing members to run their business profitably, but such a course of action will be detrimental to the further growth of the Securities Exchange. Therefore, the only option available is the expansion of the volume of transactions so as to ensure a full utilization of the resources invested in the CSE.

B. The Equity Market and Corporate Financing

An active share market, both at the primary and the secondary level is a necessary condition for the growth and the functioning of the private sector economy on a corporate basis. The primary market enables the private companies to raise the needed capital in the market and maintain a safe debt equity ratio; the secondary market, through its subsequent share transaction activities, provides an investment opportunity for the prospective investors on the one hand, and gives an indicator of the likely cost of capital to the private companies concerned by reflecting the true market value of their shares, on the other. Consequently, a company with rising share prices in the market will find itself in a more advantageous position of being able to raise funds at a relatively lower cost, while the declining share prices below the par value would indicate the opposite.

In order to reap maximum benefits by all the parties involved in the market, it is necessary that the market should function purely on the basis of the demand and supply forces generated by free dissemination of information. However, the actual operation of the share markets throughout the world has been far from this ideal, characterized by many features that are essentially unhealthy for their efficient functioning. As Baumol pointed out, (Baumol: 1965: p.83) "the oligopolistic position of those who operate in the markets, the brokers, floor traders and specialists; the random patterns which characterises the behaviour of stock prices; the apparent unresponsiveness of supply to price changes and management's efforts to avoid the market as a source of funds' have raised some questions about the allocative function of the world's most active stock exchange, viz., the New York Stock Exchange (NYSE)". The present state of Sri Lanka's share market is no exception to this comment.

The development of the share market in Sri Lanka is hindered by two problems: limitations on the supply of shares to the market and the imperfections in the information dissemination processes. Public companies in Sri Lanka are very conscious about retaining the "controlling interest" for the original promoters and, therefore, the supply of shares to the market is limited to the bare minimum necessary to obtain a market quotation. As a result, the proportion of the non-tradeable shares of a company is much higher than the tradeables which in many cases stand less than 10 per cent of the total shares issued.⁶ For instance, during the period from 1981 through 1986, the total number of shares traded in each month was less than 1 per cent of the total number of shares issued by these companies. (Table 7.10). This proportion is, by any standard, too low, since there is a possibility of double or multiple counting of the same share traded in the market more than one time during a month. These supply limitations have caused a low turnover in the market, on the one hand, and the demand for shares to play a very important role in determining share prices, on the other.

Though the availability of free and timely information is necessary for the efficient functioning of a share market, Sri Lanka's information generating machinery in the share market does not seem to operate satisfactorily. The information required by the market participants in this respect ranges from the general economic conditions of the country to specific information on the operation of the individual companies. With regard to the general economic conditions of the country, the information on the past economic conditions is mainly disseminated by

6. Listing requires offering 20 per cent of the company's equity for a period of at least a week, although the entire 20 per cent need not be sold to the public.

Table 7.10 SRI LANKA: SHARES TRADED/SHARES ISSUED RATIO

	Percent
1981	0.0225
1982	0.0275
1983	0.0208
1984	0.0483
1985	0.0825
1986	0.1027

Source: Colombo Brokers' Association

the CBSL in its various monthly and annual reports and, to a lesser extent, by foreign agencies which publish country reports. However, the market lacks any information with regard to the future economic conditions of the country, since there is no practice of revealing the forecasts of at least the major macro variables such as the inflation rate, money supply targets, growth rate, etc. Though the authorities prepare tentative forecasts of these macro variables for internal guidance, the general public has no access to them since it is usually kept as a classified set of information. In developed western countries, the lacuna so created is filled by private research organizations which produce and supply the needed economic forecasts to the market at a very low or zero cost. However, in Sri Lanka, private organizations do not have the necessary facilities or competent staff to undertake such services.

The problem of information on the operations of specific companies seem to be more chronic than the previously discussed case. Even though the Companies Act of 1982 has enacted a wide array of disclosure requirements with regard to the profitability, reserves, assets and liabilities of companies, the delay that occurs in publicising this vital information makes it less valuable for prospective investors. The CSE has continued to publish detailed information on the final accounts of quoted public companies in its Hand Book of Rupee Companies, but its usefulness has very largely been diminished by the belated publication. This situation has further been aggravated by the lack of financial journals and newspapers exclusively reporting on the economic and business sector of the country.

An inevitable corollary of these imperfections in the information generating machinery has been the irrational acting by participants on gossip and private knowledge gathered here and there. This situation has given rise to a kind of speculation where a participant follows the market trend in the belief that the other market participants are better informed than himself. As a result, imitation of one participant by another in the market is a very common occurrence. This type of

behaviour on the part of market participants has caused the trading in the market to concentrate in a particular share or a class of shares. Further, the extreme swings in the share prices resulting from these irrational changes in the demand have caused the share prices to rise or fall far beyond the levels justified by the internal conditions of some of the companies.

Given these imperfections, it is of vital importance to invest in the informational infrastructure of the share market for the market to bring about an efficient allocation of resources. The current situation not only hinders the growth in the market, but also keeps away many of the prospective investors. The lack of information also encourages profit seeking participants to pay for exclusive information on inside affairs of companies to make abnormal profits in the market, a practice considered to be injurious to the people who have already invested in these companies. Though such insider trading activities have been made an offence under the common law in almost all the countries, they nevertheless occur in view of the high premium attached to such trading and many loopholes in the enforcement of the law.

C. The Bond Market and Its Development

The entire bond market in Sri Lanka consists of the primary issue market of the Government Rupee Securities (GRS). The private corporations, on the other hand, have used bond issues as sparingly as possible, as a source of raising long-term debt. Even when such bonds are issued by the private companies, as in the case of the recent bond issue of the DFCC⁷, the success of the issue will largely depend on the ability of the company concerned to negotiate with the prospective investors beforehand. There is no secondary market for either type of bonds.

Since a substantial volume of government securities are subscribed to by captive sources, there is no incentive for the authorities to vary the terms of issuing such securities to reflect the changing market conditions. The phenomenal growth of resources with these captive sources during the last decade has enabled them to acquire a higher and higher share of the total GRSs issued over this period. Accordingly, the share of the captive sources which stood at 80 per cent in 1974 increased progressively to 94 per cent by the end of 1985 (See Table 7.11). Since there was a very safe market for GRSs manipulated through administrative decisions, the interest rates offered on the securities were based on the

7. In the case of the DFCC Bond issue, the bonds were made eligible as part of the required reserves of commercial banks, thus inducing commercial banks to subscribe to these bonds.

Table 7.11 (Contd.)

	1980	1981	1982	1983	1984	1985
				(Rs Million)		
1) Ownership						
1.1 Bank Sector	577.8	634.9	726.3	1,105.6	989.1	900.0
1.2 Central Bank	64.4	57.5	46.3	45.1	45.1	45.1
1.3 Commercial Banks	513.4	577.4	680.0	1,060.5	944.0	854.9
2) Non-bank Sector	17,033.2	19,390.6	25,074.2	30,848.0	32,238.4	35,670.2
2.1 Captive Sources	16,068.9	18,045.2	24,093.1	29,868.6	31,229.0	34,468.3
2.1.1 NSB	4,822.2	5,095.0	7,425.3	9,174.5	9,834.2	12,748.9
2.1.2 EPF	4,764.3	5,772.2	7,130.4	8,894.0	10,867.9	13,615.8
2.1.3 Others	5,006.7	6,023.9	8,026.9	10,459.2	90,285.6	7,003.4
2.1.4 Insurance Corp'n.	1,457.7	1,514.1	1,510.5	1,340.9	1,241.3	1,100.2
2.2 Market Sources	964.3	985.4	981.1	979.4	1,009.4	1,201.9
3) Total	17,611.0	20,025.5	25,800.5	31,953.6	33,227.5	36,570.2
				(Percentage Distribution)		
1) Bank Sector	3.3	3.2	2.8	3.5	3.0	2.5
1.1 CBSL	0.4	0.3	0.2	0.1	0.1	0.1
1.2 Commercial Banks	2.9	2.9	2.6	3.3	2.9	2.3
2) Non-bank Sector	96.7	96.8	97.2	96.5	97.0	97.5
2.1 Captive Sources	91.2	91.9	93.4	93.5	94.0	94.3
2.1.1 NSB	27.4	25.4	28.8	28.7	29.6	34.9
2.1.2 EPF	27.1	28.8	27.6	27.8	32.7	37.2
2.1.3 Others	28.4	30.1	31.1	32.7	27.9	19.2
2.1.4 Insurance Corp'n.	8.4	7.6	5.9	4.2	3.7	3.0
2.2 Market Sources	5.5	4.9	3.8	3.1	3.0	3.3
3) Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: Central Bank of Sri Lanka.

Table 7.11 SRI LANKA: GOVERNMENT RUPEE SECURITIES BY OWNERSHIP,
1975-1985

	1975	1976	1977	1978	1979
	(Rs Million)				
1) Ownership					
1.1 Bank Sector	461.7	719.1	681.4	620.9	602.8
1.2 Central Bank	173.3	173.3	147.3	95.0	78.0
1.3 Commercial Banks	288.4	545.8	534.1	525.9	524.8
2) Non-bank Sector	7,098.4	8,282.1	9,710.2	11,428.3	14,326.3
2.1 Captive Sources	6,223.8	7,385.6	8,784.8	10,474.5	13,359.8
2.1.1 NSB	1,694.9	2,019.6	2,419.9	2,793.2	3,915.9
2.1.2 EPF	1,803.2	2,095.9	2,492.9	3,069.1	3,899.4
2.1.3 Others	1,963.1	2,384.6	2,866.3	3,456.4	4,203.9
2.1.4 Insurance Corp.	762.6	885.5	1,005.7	1,155.8	1,340.6
2.2 Market Sources	874.6	896.5	925.4	953.8	966.5
3) Total	7,560.1	9,001.2	10,391.6	12,049.1	14,929.1
	(Percentage Distribution)				
1) Bank Sector	6.1	8.0	6.6	5.2	4.0
1.1 CBSL	2.3	1.9	1.4	0.8	0.5
1.2 Commercial Banks	3.8	6.1	5.2	4.4	3.5
2) Non-bank Sector	93.9	92.0	93.4	94.8	96.0
2.1 Captive Sources	82.3	82.1	84.5	86.9	89.5
2.1.1 NSB	22.4	22.4	23.3	23.2	26.2
2.1.2 EPF	23.9	23.3	24.0	25.5	26.1
2.1.3 Others	26.0	26.5	27.6	28.7	28.2
2.1.4 Insurance Corp.	10.1	9.8	9.7	9.6	9.0
2.2 Market Sources	11.6	10.0	8.9	7.9	6.5
3) Total	100.0	100.0	100.0	100.0	100.0

relative costs of funds of these institutions rather than the prevailing time preference for long-term investments in the market. Consequently, the government was able to offer securities with a maturity of six years at a coupon rate of 16 per cent per annum, when the prevailing one-year fixed deposit rates of commercial banks ranged between 20 – 22 per cent per annum and of finance companies, between 25 and 30 per cent per annum. This was partly reflected by the desire of the authorities to twist the term structure of interest rates downward as the maturity of investment rises to alleviate adverse repercussions of the high short-term interest rate policy. However, the inevitable corollary of this strategy was the non-development of a securities market in Sri Lanka, both at the primary and the secondary levels.

The subsidised lending which these captive sources provided to the government resulted in turn in a restricted fund management in the institutions involved. Since the entire investment portfolio of these institutions consisted of government paper, there was no necessity for them to develop efficient fund management systems within their institutions, even though they were holding about 20 per cent of the total assets of Sri Lanka's financial system. The non-exposure of these institutions to the market in this way caused them to disregard costs and depart from optimality objectives, on the one hand, and channel the entirety of the resources raised from the private sector to the government sector, on the other.

The private companies have been averse to use the bond market as a source of long-term capital mainly because of the supply constraints in the market. Several instances of attempting to tap this market in the past has proved unsuccessful.⁸ Institutions which are capable of supplying such long-term capital are not equipped with trained manpower to carry out the necessary investment analysis before making the investment decisions. Consequently, private provident and pension funds which have a long-term resource base opt to invest their funds in either the government securities or bank deposits which investment does not necessitate such costly analyses. Therefore, the private companies are also forced to meet their long-term loan requirements through the organized banking sector.

8. For instance, in 1986, when the State Mortgage and Investment Bank attempted to issue debentures to the value of Rs 250 million, only a negligible amount was subscribed to, even though these debentures were fully guaranteed by the government.

D. Overall Assessment of Government Policies and Strategies

Even though the Government of Sri Lanka has recognized the need for developing a capital market in the country, its direct involvement in the exercise has been limited to the creation of a conducive legislative environment and provision of tax incentives to encourage private sector to form public companies and invest in company equities. Due recognition has also been given to the role of private foreign capital in the development of the private sector economy and two major schemes have been implemented to achieve this end, but outside the operations of the domestic capital market. Under the first scheme, private foreign investors could, if necessary with local collaboration, set up enterprises within an export processing zone established under the jurisdiction of a free trade zone authority known as the Greater Colombo Economic Commission (GCEC). All these enterprises which produce only for the export market are exempt from income tax and all other commodity and production taxes, thus raising their profitability. In the second case, foreign investors can set up enterprises with local collaboration as approved by a Foreign Investment Advisory Committee (FIAC) set up in the Ministry of Finance and Planning. Both types of these enterprises could raise equity in the domestic capital market, if they so desire.

With the establishment of a stock exchange in Colombo in 1984, the government initiated action to introduce necessary legislation to regulate and govern the activities of such stock exchanges. Under this, a Securities Council Bill was drafted with a view to setting up a Securities Council to achieve the following objectives:

- a) Creation and maintenance of a market in which securities can be issued and traded in an orderly and fair manner;
- b) The protection of the financial interests of investors;
- c) The operation of a compensation fund to protect investors who have suffered financial losses due to failures on the part of brokers and dealers;
- d) The regulation of the securities market and to ensure that professional standards are maintained in such market.

In order to achieve these objectives, the Securities Council has been empowered, *inter alia*, to grant licences to stock exchanges, dealers and brokers, issue directives to licensed stock exchanges and pay compensation from the compensation fund created by the Council.

In order to promote the capital market in Sri Lanka, the government has introduced several tax incentives which aim at enlarging the number of public companies and the share investment in such companies by the

public. History of Sri Lanka's corporate business testifies to the ardent desire of private entrepreneurs to remain "private" even after they transit from sole tradership or partnership to corporate type of business. From a social point of view, this leads to the concentration of ownership in companies in a few hands. From a financial point of view, proliferation of such private companies will impose a severe strain on the resources of the organized financial system since there is no other way of raising the needed long-term capital for the purpose of expansion and modernization of the business. Furthermore, the concentration of private business in private companies hinders the growth of the capital market by limiting the size of the market. Therefore, it has become necessary to induce private companies to go public as part of the national policy towards organizational format of the business.

To achieve this end, the government has introduced the following tax measures:

- a) Corporation income tax was lowered from 50 per cent applicable to private companies, to 40 per cent in the case of quoted companies;

- b) A pre-requisite for all companies approved for tax holiday purposes is the formation of the company as a public company. Profits of such companies are exempt from the income tax for periods ranging from five to ten years.

These measures were intended to induce companies to be broad-based as far as possible and many new companies established since 1980 took advantage of these concessions. Consequently, there was renewed activity in the primary share market with the number of share issues rising from 5 in 1980 to 37 in 1983. This phenomenal growth in share issues slowed down somewhat during the subsequent period, reflecting that the bunching of share issues in 1983 was mainly prompted by the desire to beat the deadline given for investment relief as at the end of March, 1983.

In order to encourage the public to invest in quoted public companies, the following tax concessions were introduced:

- a) When a quoted public company pays a dividend, the dividend tax need not be deducted at source;

- b) The dividend tax was lowered from 33 1/3 per cent to 20 per cent;

- c) Dividends paid by companies that enjoy tax holiday status are exempt from the income tax;

- d) When a quoted public company pays dividends to another company, such dividends need not form a part of the assessable income of the latter company;

- e) Capital gains arising out of share transactions were exempted from the capital gains tax up to November 1986;

f) An investment relief was granted for investors in new shares in approved companies up to a third of the investors's assessable income.

These tax measures helped encourage a greater participation by the public in both the primary and secondary markets. Companies that enjoyed tax holidays did not have any difficulty in raising the needed capital in the market. However, with the withdrawal or limited operation of the tax holiday scheme as from March 1983, the primary share market has gradually declined with only 13 issues in 1984 and three issues in 1985. This reveals that the maintenance of the same level of operations in the primary market necessitated the continuation of these tax incentives for a long period of time.

With the introduction of the tax concessions, activities in the secondary market too have increased sharply. The average monthly value of shares traded in this market remained at Rs 1.5 million in 1981. This value increased steadily to Rs 6.6 million in 1985 and further to Rs 12.4 million in 1986. Similarly, the average value of a transaction in the market also showed a progressively increasing trend from Rs 10,900 in 1983 to Rs 22,500 in 1985 and to Rs 28,360 in 1986. In the meantime, the total number of transactions increased from 1,301 in 1981 to 3,506 in 1985. All these measures indicate a growing level of activities in the secondary share market in response to various incentives given by the government.

V. MAJOR FINDINGS AND CONCLUSIONS

Sri Lanka's capital market, though blessed with a long history, is still in a rudimentary state with an imbalanced development between the non-securities market and the securities market. Even though the capital markets throughout the world recorded substantial advancements especially since the 1960s in terms of volume, coverage, methods and systems, such advancements did not reach Sri Lanka mainly on account of the closed-economy policies pursued and the high priority given to the state sector in production and investment for a considerable length of time. As a result, when a renewed interest was taken to develop the capital market in the late 1970s, Sri Lanka found herself lagging behind many of the other countries with similar background in the region. However, the pace of development and the transformation that takes place in both the securities and the non-securities markets at present seems to bring about desirable results in the future.

Government initiative has always been regarded as the first step in the development of the capital market in Sri Lanka. Accordingly, the

task devolved on the government involved the expansion of the institutional set-up, provision of initial capital, guiding the institutions in the appropriate direction, nurturing and protection of the institutions from adverse competition, etc. With the government willingly undertaking this role as the promoter of the market, the signal imparted to the private sector contributed to build up a psychology which heavily depended on subsidies and concessions for the continued operations in the market. Consequently, the role of the market forces in promoting efficiency in the institutions concerned was given a secondary consideration. Therefore, it is necessary to liberate the financial system from this subsidy/concession syndrome if the capital market is to be developed on competitive efficiency lines.

Since the development in the non-securities market has already overtaken the development in the securities market, it is necessary to adopt appropriate measures to eliminate the imbalance present in the two markets. The non-securities market with basically a short-term resource base should cater to the short-term while the task of providing long-term capital should be left to the securities market which has a greater potential for operating on the basis of changing market forces. To promote market orientation in the non-securities market, the patronage and concessions given to state sponsored institutions should either be withdrawn or kept at a minimum level.

The imperfections in the information generating machinery in Sri Lanka need to be corrected for the successful operation of the securities market. The authorities should give the same priority to the publication of economic forecasts as they now do in the case of the past economic developments. Furthermore, companies listed in the Securities Exchange should publicise their final accounting statements as early as possible, preferably within three months of the closure of accounts. Listing and the disclosure requirements in the Securities Exchange should be updated so as to keep pace with the developments that have taken place in the advance securities markets. A reduction in the cost of information is a necessary condition for the development of the securities market in Sri Lanka. □

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CHAPTER 8

Development of the Capital Market in Thailand*

CHITTIMA DURIYAPRAPAN

I. OVERVIEW OF THE EXISTING CAPITAL MARKET STRUCTURE

As an open economy, Thailand had been adversely affected by the two oil crises and the associated unstable world economic conditions. Economic growth slowed down somewhat to the average rate of 7.0 and 5.1 per cent during the 1970s and 1980-1985, respectively. The current account deficit as a proportion of gross domestic product (GDP) rose to more than double the rate in the previous period. The average inflation rate increased from around 5 per cent before the first oil crisis to nearly 10 per cent subsequently.

Gross domestic savings (GDS) as a percentage of GDP fell, while domestic investment registered a rapid growth. Consequently, the savings-investment gap widened remarkably. The situation became worse after the second oil shock, although inflation came down significantly due to the onset of world recession. The over-reliance of government and private companies on debt finance has become more evident, leading to an imbalanced capital structure, high debt-equity ratio and financial vulnerability.

The thrust of the financial policy during this period was centred predominantly on mobilization of domestic savings, resolving the problem of credit allocation in the commercial banking system and deregulation towards a more liberal regime. Financial institutions, particularly the commercial banks, have adapted themselves to be more flexible and made more frequent adjustments. New money market instruments and arrangement were also introduced, for example, the Baht Interbank

* The author would like to express her thanks to Miss Chantavarn Sucharitkul and Miss Saovalux Srinkapaibulaya for their help in drafting this paper.

Offered Rate (BIBOR) system and the Automatic Transfer System (ATS).

Notwithstanding these reforms, several areas remain to be improved, particularly, the domestic capital market. The inadequacy of the capital market in providing equity funds for business investment has forced business to rely heavily on credits from financial institutions, resulting in relatively high corporate gearing ratio. Business conditions became very vulnerable to volatility in the money market. On the other hand, the Securities Exchange of Thailand (SET) was established as late as 1975. Since then, various measures have been implemented to stimulate the securities market. These included the establishment of two investment funds providing stability and liquidity to the market and the amendment of the SET Act in 1984. When economic and political factors took a turn for the better, coinciding with the attractive price/earnings ratio after a long and substantial stock price slump, the SET began to see better prospects towards the middle of 1982. Since then, both stock prices and trading volume have moved up albeit slowly.

In late 1985, a technical group was set up by the Bank of Thailand to study and find out a package of measures to address some of the problems that have been hindering the growth of the capital market in Thailand. Their recommendations also served as a basis for more intensive follow-up work that is required for the Sixth National Economic and Social Development Plan (1987-1991). Some measures were implemented immediately to improve the activities of the country's capital market after they were approved by the government. In the light of these developments, the capital market will soon become an important contributing factor to the future development of Thailand.

In Thailand, the capital market consists of two segments; the non-securities market and the securities market. The non-securities market comprises a whole range of financial institutions, providing non-negotiable medium- and long-term debt funds. The securities market provides medium- and long-term equity and debt funds which transfer directly from the borrowers to the lenders as well as being traded among investors.

A. Non-securities Market

The non-securities market in Thailand can be divided into two sectors; an organized financial sector which comprises of various kinds of financial institutions including the Bank of Thailand while the unorganized sector refers to all financial transactions which do not go through the organized or legally registered financial institutions.

Financial institutions, particularly commercial banks, play a vital role in the economic development and future growth of the country. Approximately 60 per cent of domestic savings pass through financial institutions while most of the credits are extended by them. Most of the financial institutions are privately owned but there are also a number of specialized financial institutions which belong to the Thai government. There are different institutions which are supervised and regulated by various authorities, namely, the Bank of Thailand, the Ministries of Finance, Commerce, Agriculture and the Interior. Their salient features are summarised in Table 8.1 which are related to capital market activities. Their functions, in general, will be touched upon briefly in this study.¹

1. *The Bank of Thailand*

The Bank of Thailand (BOT) was established in 1942 by the Bank of Thailand Act, B.E. 2485 (1942), with the purpose of assuming central banking functions. Like other central banks, the Bank of Thailand carries out various functions as follows:

- a. As note-issuing authority.
- b. As banker to the government. The Bank of Thailand holds the main accounts of the government and those of government enterprises and also provides normal banking facilities. Apart from financing part of the government's budget deficit through the purchasing of government bonds and Treasury bills, the Bank also provides direct lending in short- and long-term loans to the government for specific purposes.
- c. As banker to commercial banks. The Bank of Thailand's statutory powers include a requirement that all commercial banks are to maintain legal reserves with the Bank. The ratio and the form of the reserves are determined by the Bank and may be adjusted. As the lender of last resort to commercial banks, the Bank provides two channels of lending, through discretionary loans against government and government guaranteed bonds and rediscount window.
- d. Maintenance of monetary stability. In implementing various policies, the underlying objective is monetary stability with a respectable economic growth rate. To ensure that there is sufficient amount of money and credit available for the economy to function smoothly, various measures and instruments, such as interest rate adjustment, reserve requirement ratio and selective credit control have been used to control money and credit expansion and credit allocation.

1. For further details see *Financial Institutions in Thailand*, Money and Finance, and Financial System and Development Sections, Department of Economic Research, Bank of Thailand.

Table 8.1^a SALIENT FEATURES OF FINANCIAL INSTITUTIONS IN THAILAND AS AT THE END OF 1985
(Millions of Baht)

Institutions	Operations began	No.	Branches	Deposits Equivalent	Borrowing	Household Savings Mobilized	Capital Account	Credit Extended	Investment	Total Assets
1) Commercial banks	1888 (1969)	30 100	1,806 29	559,776.3 84,010.7	70,600.8 23,029.1	457,159.6 58,097.4	42,444.9 8,955.6	522,261.1 98,052.9	85,179.9 11,006.7	701,867.0 130,959.6
2) Finance companies										
3) Life insurance	1929	12	660	14,621.5	24.5	14,621.5	425.2	7,240.5	5,534.8	18,358.2
4) Agricultural cooperatives	1916 (1,132)									
5) Savings cooperatives	1946 (611)			(400.6)	(4,474.3)	(1,279.0)	(2,574.5)	(5,818.9)	(142.1)	(7,808.5)
6) Pawnshops	1866	333		(1,545.9)	(513.7)	(11,498.6)	(13,436.5)	(13,864.5)	(9.4)	(15,701.2)
7) Credit foncier companies										
8) Govt. Savings Bank	1946	1	438	2,105.4	1,105.1	2,105.4	649.9	2,813.9	184.1	4,165.3
9) BAAC	1966	1	67	56,630.4	—	56,143.0	4,284.5	1,412.4	57,664.3	64,889.2
10) Industrial Finance Corp. of Thailand				15,344.3	9,757.0	2,591.7	2,659.0	21,631.9	847.0	28,473.7
11) Govt. Housing Bank	1959	1	4	—	9,412.0	—	2,312.5	7,847.9	280.4	14,960.6
12) Small Industrial Finance Office ¹	1953	1	—	7,094.6	4,160.8	7,090.9	2,074.3	11,183.9	82.1	13,695.4
	1964	1	—	—	—	—	56.3	40.6	—	56.5
TOTAL		2,248	3,004	741,529.7	126,261.7	610,587.1	80,808.7	696,762.7	160,930.8	1,006,008.5

^a Figures in parentheses are estimated.

¹ At September 1985.

e. Other functions. The Bank of Thailand is authorized to manage public debt, exchange control and the international reserves, to carry out supervision and examination of commercial banks, finance companies, securities companies and credit foncier companies and to co-operate and deal with international organizations.

2. Commercial Banks

The first Thai commercial bank was set up in 1906, 18 years after the opening of a foreign bank's branch in Bangkok. As time went on, Thai banks grew rapidly both in size and in influence. At the end of 1985, there were 16 Thai banks with 1,835 branches including 26 branches overseas, and 14 foreign banks with 19 branches. Hence, Thai banks dominate the commercial banking business, accounting for 97.7, 95.3 and 95.3 per cent of total deposits, advances and assets of all commercial banks, respectively.

Commercial banks are regulated under the Commercial Banking Act of 1962, 1979 and 1986. Under these acts, the Bank of Thailand is entrusted with the power, among others, to prescribe maximum rates of interest for deposits and loans, the cash reserve ratio, the ratio of capital funds to risk assets ratio, etc.

The commercial banks dominated the financial institutions, both in terms of savings (average of 72.9 per cent of total) and as a source of credits (average of 72.3 per cent of total) to the private sector. For the most part, total deposits mobilized by commercial banks experienced a high growth rate of more than 20 per cent, except for the recession year of 1978-1979, and 1985. At the end of 1985, as a result of economic recession, total deposits with commercial banks expanded at the low rate of 14.6 per cent from the year before, totalling B 457.2 billion. About 73.1 per cent of the deposits are in the form of time deposits, the remaining being divided into savings deposits (20.8 per cent) and demand deposits (6.1 per cent).

Credit extended by commercial banks are mainly in the form of overdrafts which are on short-term basis but may be renewed after negotiation. As at December 1985, credit to the private sector reached a total of B 522.3 billion, a 10.0 per cent increase over the previous year. This was due to the stagnation in the Thai economy. About 46.0 per cent of credit was extended to manufacturing and wholesale and retail trade, whereas those granted to foreign trade accounted for another 15.0 per cent.

3. *Non-Bank Financial Institutions*

(a) *Finance companies* (including securities firms). Finance companies (FCs) started their operations in the Thai money market since 1969. All finance companies are to be authorized and regulated by the Ministry of Finance and the Bank of Thailand under the Act on the Undertaking of Finance Business, Securities Business and Credit Foncier Business, B.E. 2522 (1979), amended by the Emergency Decrees of B.E. 2526 (1983) and B.E.2528 (1985). FCs are authorized to borrow funds from the public through the issuance of promissory notes or similar instruments and lend those funds to other persons. They are not allowed to accept deposits from the public, unlike the case of commercial banks. The maximum rates of interest on promissory notes and loans, have also been regulated and have been at appreciably higher levels than commercial banks'. At the end of 1985, there were 100 finance companies of which 75 companies were permitted to undertake "securities business" as well. Several of the major finance companies are subsidiaries of Thai commercial banks.

Total savings mobilized by the finance companies, which increased remarkably during the 1970s (except for the year of crisis 1979), experienced a slowdown in growth rate during the years 1983, 1984 due to the failure of some of these companies. However, after the implementation of official supplementary measures, especially the life boat schemes, together with their own efforts, their business improved in 1985. The growth rate reversed to an increase of 19.6 per cent in 1985, reaching the amount of B 58,097.4 million.

On the credit front, most credit extended by finance companies is mainly in the form of call loans and discounted bills. During the 1980s, the expansion of credit which registered an average annual growth rate of 70.7 per cent over the past eight years had declined in 1984 and 1985, to an annual growth rate of 4.8 and 3.2 per cent, respectively. Credit was extended to a wide range of sectors including real estate, public utilities, personal consumption and industry.

(b) *Life insurance companies*. The first life insurance company began its operation in Thailand in 1929. At present, there are 12 companies of which 11 are locally incorporated and one is registered abroad. Life insurance companies operate 660 branches throughout the country. All life insurance companies operate under the Life Insurance Act B.E.2510 (1967) and come under the regulation and supervision of the Ministry of Commerce.

During the 1980s, the amount of life insurance premia recorded a high annual growth rate of an average of 25.7 per cent per annum. In

1985, life insurance companies also encountered a slowdown in business, recording a growth of 9.5 per cent during the year. Only 2.4 per cent of household savings were channeled into life insurance companies. Apart from lending (39.4 per cent), most of the funds were invested in government bonds (14.5 per cent), and debentures (12.6 per cent).

(c) *Agricultural cooperatives*. These cooperatives are organized by farmers for the purpose of combining efforts in a range of farming activities as well as making credit available to members. Their principal sources of funds are borrowings (mainly from the Bank for Agriculture and Agricultural Cooperatives), and capital accounts. Deposits have been negligible. During the 1980s, the annual growth rate of credit extension to members have dropped to the average of 6.3 per cent compared to the average rate of 33.0 per cent during the 1970s.

(d) *Savings cooperatives* or registered credit union, are formed mainly on an occupational basis. The major source of funds has been their paid-up share capital from members, which was obtained through a payroll-withholding system. Lending to members can be for a variety of purposes. In 1985, total lending increased at the lowest rate of 7.8 per cent compared to the range of 20-34 per cent during the past 10 years.

(e) *Credit foncier companies*. These companies finance the purchase of immovable property by either making loans secured on that property or buying it with the seller's right of redemption. Under the Act on the Undertaking of Finance Business, Securities Business and Credit Foncier Business B. E. 2522 (1979) amended by the Emergency Decrees B.E.2526 (1983) and B.E.2528 (1985), credit foncier companies must be authorized by the Bank of Thailand. Credit foncier companies are presently allowed to mobilize funds which are not less than one year maturity with a maximum amount of B 1,000 per account. The percentage shares of credit extended by credit foncier companies accounted for only 0.2-0.8 per cent of total credit.

4. Specialized Financial Institutions

There are five other capital market institutions which have been set up by specific statutes enacted by the government. These financial institutions perform specialized functions with the basic aim of providing subsidized credit to government-designated priority sectors. At the end of 1985, the share of their assets was altogether 12.1 per cent of total assets of financial institutions.

(a) *The Government Savings Bank (GSB)*. The GSB operates as a non-profit organization, under the Government Savings Bank Act,

B.E. 2489 (1946) with an autonomous management appointed by the Ministry of Finance. As a typical savings institution, the GSB carries out normal banking operations including mobilizing small savings, which are mainly in the form of savings and fixed deposits as well as premium savings certificates. The share of household savings held with the GSB registered a downward trend from 17.4 per cent in 1971 to 9.2 per cent in 1985, due to the expansion of finance companies. At the end of 1985, total savings mobilized by the GSB amounted to B 56,143 million, an increase of 22.4 per cent from the year before.

On the credit front, the GSB has not been encouraged to make loans to the private sector. In accordance to the guideline set by the Finance Ministry, most of the GSB's fund have been invested in government securities.

(b) *The Bank for Agriculture and Agricultural Cooperatives (BAAC)*. The BAAC was set up by the Bank for Agriculture and Agricultural Cooperatives Act, B.E.2509 (1966). At present the Ministry of Finance owns about 99 per cent of the BAAC's shares; the rest belongs to agricultural cooperatives, farmer groups and individuals. At the end of 1985, the BAAC had a network of 67 branches throughout the country. Most of the funds came from commercial banks (in the form of deposits) and foreign borrowings.

The BAAC grants credit to farmers either directly or indirectly, through agricultural cooperatives. The share of credit provided by the BAAC ranged between 2.9-4.9 per cent of total credit of the entire financial system. At the end of 1985, credit extension totalled B 21,632 million, an increase of 10.3 per cent from 1984.

(c) *The Industrial Finance Corporation of Thailand (IFCT)*. Although set up by a special legislation, the Industrial Finance Corporation of Thailand Act, B.E. 2502 (1959), the IFCT is owned entirely by the private sector, mainly the Thai commercial banks. The major sources of funds are long-term borrowings (63 per cent), its own capital and reserves. From 1971 onwards, rediscount facilities with respect to industrial undertakings have also been made available by the Bank of Thailand to the IFCT.

The IFCT specializes in financing fixed assets through the extension of medium- and long-term loans to industry. In 1972, the Industrial Finance Corporation of Thailand Act was revised so as to enable the IFCT to carry out operations related to the development of the capital market in Thailand. The percentage share of credit extended by the IFCT ranged between 0.8-1.2 per cent of total credit of the entire financial system. At the end of 1985, total credit increased at a rate of 28.8 per cent to the amount of B 7,847.9 million.

The IFCT has also been the manager of the Small Scale Industries Credit Guarantee Fund established in 1985.

(d) *The Small Industries Finance Office (SIFO)*. After its inception in 1964, the Small Industries Finance Office began to finance small industries by extending credit to small industries at relatively low rates of interest, as well as providing technical assistance to these enterprises. SIFO receives funds from the government budget from time to time. Approval of loan applications is made by the SIFO while the Krung Thai Bank (government bank) undertakes the actual lending operation as well as assuming all credit risks. Its share of credit extension declined continuously from 0.2 per cent in 1971 to 0.05 and 0.01 per cent in 1979 and 1985, respectively. This was due to the increase of industrial finance provided by other financial institutions.

(e) *The Government Housing Bank (GHB)*. This institution was established in 1953 under the Government Housing Bank Act, B.E. 2496 (1953). The principal function is to provide housing finance for both middle income and low income families. Credit extended by the GHB at the end of 1985 amounted to B 11,183.9 million, an increase of 10.9 per cent from the year before.

The Government Housing Bank Act was revised in 1973 so as to enable the GHB to accept deposits of any type and maturity from the public. Since then, household savings held with the GHB grew rather spectacularly from B 88.8 million in 1973 to B 7,090.9 million at the end of 1985, with an average annual growth rate of 57.9 per cent, except for the year 1980. Deposits became a major source of funds accounting for about 52.0 per cent in 1985, while the remaining were foreign borrowings (16.0 per cent), borrowings from domestic sources (14.0 per cent) and others. Consequently, the share of household savings has increased from 0.15 per cent to 1.16 per cent.

The Government Housing Bank provided housing finance to the public in the form of individual loans (32.6 per cent), project loans (34.5 per cent) and overdrafts (28.7 per cent). In 1985, the share of credit extended by the GHB was only 1.6 per cent of total credit extended by financial institutions.

B. The Securities Market

Like other developing countries, the securities market in Thailand is far less developed than the non-securities market. The government, in recent years, has recognized the role of securities market in economic development. Since then, many attempts and measures have been implemented to develop the securities market as an engine of economic growth.

The securities market can be categorized into two segments, primary and secondary market. For Thailand, securities come in various forms, such as in the form of debt instruments (government bonds and debentures) and equity instruments (corporate shares and stocks).

1. Primary Market

The primary market involves trading of the issuers and the investors, through financial intermediaries or directly to individual investors. In Thailand, more than 90 per cent of total new issue was government bond, the rest being new shares issued by private companies. Total value of government bonds and shares issued in the primary market increased from B 4.7 billion in 1975 to B 16.0 billion and B 32.8 billion in 1980 and 1985, respectively.

2. Secondary Market

In the secondary market, existing securities are traded among investors. Buying and selling in this market are carried out in the securities exchange and over-the-counter markets. However, most of the transactions occurred in the securities exchange. Trading in the secondary market has been dominated by common stocks of private companies, particularly financial institutions. The turnover value of private stocks and debentures increased from B 1.5 billion in 1975 to B 6.6 billion and B 16.4 billion in 1980 and 1985, respectively.

3. The Securities Exchange of Thailand

In Thailand, trading for existing securities are carried out mainly in the Securities Exchange of Thailand (SET) which officially started its operation on 30 April 1975. Established under the Securities Exchange of Thailand Act, the SET is under the supervision of the Ministry of Finance and the Bank of Thailand. It combines the functions of both a securities market and a securities commission in one body. The main functions of the SET are:

- to provide a centre for the purchase and sale of securities;
- to promote savings and mobilization of capital funds; and,
- to encourage the diversification of ownership of domestic business and industries.

Membership is limited to securities companies licensed by the Minister of Finance to engage in the securities business as stock brokers. By

the end of December 1985, there were 95 listed and two authorized companies with 100 securities. Total capital mobilized through the SET was B 49.5 billion with annual turnover value of B 15.3 billion, an increase of 44.3 per cent from 1984. SET index and market P/E ratio rose up to 134.95 point and 19.59 per cent, respectively.

II. THE DEVELOPMENT OF THE NON-SECURITIES MARKET

A. Mobilization of Domestic Savings

1. Need for Domestic Resource Mobilization

Prior to 1976, Thailand had a very successful record in financing a high proportion of its domestic investment requirement from domestic savings. Gross domestic savings (GDS) and gross domestic investment as a percentage of GDP were almost at the same level, averaging 22.0 and 24.0 per cent respectively. The widening savings-investment gap occurred during the Fourth Economic Development Plan (1977-1981), where a strategy of high investment and growth was adopted. During this period, the savings-investment gap averaged at 6.3 per cent of GDP, in sharp contrast to an average of 2.1 per cent in the 1970-76 period.

In the late 1970s, the rising investment rate was considered the prime cause of the growing current account deficit. Gross domestic investment rose from 23.2 per cent of GDP in 1976, to 28.8 per cent in 1979, while national savings remained roughly in the 20.0-22.0 per cent range. In the early 1980s, a sharply declining savings rate was the major factor for the widening of the savings – investment gap. Investment has fallen to less than 23.0 per cent of GDP but the national savings rate has fallen even more, averaging only 17.7 per cent during 1981-1985. The savings gap was 7.0 and 7.1 per cent of GDP in 1981 and 1983, respectively. (Table 8.2 – 8.4)

2. Recent Trends and Structure of Domestic Savings

Domestic savings comprise two components: public and private savings. Public savings refer to savings of the government and various state enterprises, while private savings include savings of private business and household units. In Thailand, more than 85 per cent of domestic savings are contributed by the private sector.

Table 8.2 THAILAND: THE RESOURCE GAP
(As % of GDP)

	1970	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Capital Formation	26.2	25.3	23.2	26.0	27.0	28.8	27.2	24.7	21.0	23.0	23.9	21.4
(Gross Domestic Investment)												
Gross Domestic Savings	22.3	21.2	20.7	20.4	22.1	21.3	20.7	17.7	18.4	15.9	19.1	17.5
Resource Gap	-3.9	-4.1	-2.5	-5.6	-4.9	-7.5	-6.5	-7.0	-2.6	-7.1	-4.8	-3.9

Source: Bank of Thailand.

Table 8.3 THAILAND: SAVINGS, INVESTMENT AND RESOURCE GAP
(Unit: B million)

Resource Gap	1970	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Domestic savings	30,396	63,494	69,840	80,155	104,013	118,575	141,671	139,579	155,839	146,549	189,474	203,587
Domestic investment (including changes in stock)												
Resource gap	35,606	75,747	78,444	102,240	126,950	160,287	186,258	194,479	177,772	212,271	236,645	244,411
Current account deficit	-5,210	-12,253	-8,604	-22,085	-22,937	-41,712	-44,587	-54,900	-21,933	-65,722	-47,171	-40,824
Household savings	-5,197	-12,368	-8,978	-22,392	-23,445	-42,591	-42,409	-56,049	-23,138	-66,286	-49,468	-41,925
Business savings (excluding statistic discrepancy)	13,401	36,567	39,828	43,832	58,599	68,865	93,656	88,283	92,327	73,890	82,444	81,286
Business savings (including statistic discrepancy)	11,025	24,206	28,570	32,435	38,854	47,764	54,760	62,046	65,018	73,980	80,424	86,637
Government savings	(12,019)	(16,833)	(23,326)	(22,648)	(31,060)	(38,031)	(39,208)	(39,613)	(61,306)	(53,530)	(87,809)	(111,721)
Ratio to domestic savings (%)	4,976	10,094	6,686	13,675	14,354	11,679	8,807	11,683	2,206	19,129	19,221	10,580
- Household savings	44.1	57.6	57.0	54.7	56.3	58.1	66.1	63.2	59.3	50.4	43.5	39.9
- Business savings (excluding statistic discrepancy)	36.3	38.1	40.9	40.5	37.4	40.3	38.7	44.5	41.7	50.5	42.5	42.6
- Business savings (including statistic discrepancy)	(39.5)	(26.5)	(33.4)	(28.3)	(29.9)	(32.1)	(27.7)	(28.4)	(39.3)	(36.5)	(46.3)	(54.9)
- Government savings	16.4	15.9	9.6	17.0	13.8	9.8	6.2	8.4	1.4	13.0	8.0	5.2

Source: Bank of Thailand.

Table 8.4 THAILAND: COMPOSITION OF DOMESTIC SAVINGS
(Amounts in billions of Baht, otherwise in per cent of GDP)

	Household Sector	Business Sector	Public Sector	Statistic Discrepancy	GDP Nominal	Total Savings
1970	13.4 (9.9)	10.9 (8.0)	5.1 (3.7)	1.0 (0.7)	136.1	30.4 (22.3)
1971	13.5 (9.3)	12.0 (8.3)	4.0 (2.8)	1.8 (1.2)	144.6	31.3 (21.6)
1972	18.7 (11.4)	13.9 (8.4)	4.8 (2.9)	-4.8 (-2.9) *	164.6	32.6 (19.8)
1973	34.7 (16.0)	17.9 (8.3)	7.1 (3.3)	-9.1 (-4.2)	216.5	50.7 (23.4)
1974	36.4 (13.4)	21.2 (7.8)	15.6 (5.7)	-7.4 (-2.7)	271.4	65.8 (24.2)
1975	37.8 (12.6)	23.8 (8.0)	9.3 (3.1)	-7.4 (-2.5)	298.8	63.5 (21.2)
1976	42.1 (12.5)	26.7 (7.9)	6.2 (1.8)	-5.2 (-1.5)	337.6	69.8 (20.7)
1977	44.1 (11.2)	32.5 (8.3)	13.4 (3.4)	-9.8 (-2.5)	393.0	80.2 (20.4)
1978	57.4 (12.2)	40.1 (8.5)	14.2 (3.0)	-7.8 (-1.6)	470.8	103.8 (22.1)
1979	67.8 (12.2)	49.1 (8.8)	11.4 (2.0)	-9.7 (-1.7)	556.2	118.6 (21.3)
1980	93.7 (13.7)	53.9 (7.9)	9.6 (1.4)	-15.5 (-2.3)	684.9	141.7 (20.7)
1981	83.3 (11.2)	61.9 (7.9)	11.9 (1.5)	-22.4 (-2.8)	786.2	139.6 (17.8)
1982	92.3 (10.9)	65.8 (7.8)	1.3 (0.2)	-3.7 (-0.4)	846.1	155.7 (18.4)
1983	73.2 (7.9)	79.0 (8.5)	14.1 (1.5)	-19.8 (-2.1)	924.3	146.5 (15.8)
1984	79.5 (8.0)	89.3 (9.0)	10.2 (1.0)	10.3 (1.0)	991.6	189.3 (19.1)
1985	81.4 (7.8)	95.7 (9.1)	10.1 (1.0)	7.3 (0.7)	1,047.6	194.4 (18.6)

Source: *Financial Resources Management*, 1986 TDRI year-end Conference on Resources Management, 13-14 December 1986, p.44

(a) *Savings of the private sector.* As illustrated in Table 8.3, the share of household savings to total domestic savings declined to a rate of 50.0 per cent for the first time after the first and second oil shock. Its share dipped further in 1984 and 1985. At the same time, business savings which comprise depreciation and financial savings, have taken a larger share, rising substantially to reach the maximum of 50.5 per cent of total in 1983.

Household savings as a percentage of GDP, as shown in Table 8.4 declined markedly from its average of 11.1 per cent during the 1970s to 7.9 and 7.8 per cent in 1983 and 1985, respectively. In contrast, business savings ratio increased from the stable rate of around 8 per cent of GDP to 8.5 and 9.1 per cent of GDP, in 1983 and 1985 respectively.

The inadequate growth in savings relative to GDP can be explained by two main factors.² The first factor was the increasing consumption expenditures in nominal terms in the midst of rapid inflation. Inflationary expectations in particular had led to the acceleration in expenditure on fixed assets and investment, hence the reduction in savings rate. The second factor was the lower real rate of return on savings due to the high inflation in the absence of interest rate adjustment.

(b) *Savings of the public sector.* Public savings as a percentage of GDP also experienced a slight decrease from the average of 3.2 per cent during the 1970s to 1.5 and 1.0 in 1983 and 1985, respectively.

The savings of the Central Government have been declining since 1970, due to the continuous rise in expenditure, while revenue collection failed to keep pace. Thus the decline in government savings was due, not only to the economic slowdown, but also the consequence of revenue that failed to keep pace with the growth in GDP.

(c) *Financial savings.* As shown in Table 8.5, the shares of domestic savings mobilized by commercial banks have been relatively stable around 70 per cent of total savings. Finance companies and the Government Savings Bank came second and third with their shares together accounting for 19.0 per cent in 1985.

There has been a structural change in deposits particularly with the commercial banks. There was a shift from demand deposits to savings deposits since the late 1970s. As a result, the percentage share of demand deposits to total deposit declined continuously from 22.2 per cent in 1971 to 13.2 and 5.4 per cent in 1980 and 1985, respectively. In the corresponding period, the savings deposits ratio increased from 8.6 per cent to 13.1 per cent and 21.0 per cent respectively. The shares of time deposits remained around 70.0 per cent.

2. Chaiyawat Wibulswasdi, "Strategies and Measures to Maintain Thailand's Economic Stability in the 1980s", *Bank of Thailand Quarterly Bulletin*, Vol. 23, No. 1, March 1983, p. 34

Table 8.5 THAILAND: HOUSEHOLD SAVINGS AT FINANCIAL INSTITUTIONS
(as percentage share of total)

Institutions	Definition of Savings	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
1. Commercial banks	Deposits	74.16 (21.85)	74.00 (22.63)	73.26 (23.18)	70.62 (16.04)	70.04 (11.25)	70.58 (27.42)	70.25 (21.09)	70.79 (27.76)	73.25 (29.78)	75.62 (21.38)	74.73 (14.56)
2. Finance companies	Promissory notes, etc.	8.22 (16.44)	9.03 (35.03)	10.33 (42.22)	13.65 (59.16)	12.55 (3.13)	12.63 (27.25)	13.75 (32.47)	13.92 (28.31)	12.04 (8.50)	9.20 (-10.17)	9.50 (19.66)
3. Life insurance companies	Life insurance reserve	2.13 (18.39)	2.15 (23.80)	2.10 (21.27)	2.14 (23.17)	2.33 (22.13)	2.33 (26.19)	2.45 (28.14)	2.46 (26.98)	2.48 (26.34)	2.53 (22.01)	2.39 (9.50)
4. Agricultural cooperatives	Deposits and capital funds	0.37 (42.99)	0.37 (24.70)	0.39 (30.23)	0.42 (28.68)	0.44 (17.06)	0.40 (15.01)	0.37 (13.38)	0.34 (17.72)	0.31 (13.01)	0.29 (12.41)	0.27 (7.92)
5. Savings cooperatives	Deposits and capital funds	1.53 (18.87)	1.29 (3.53)	1.27 (22.68)	1.34 (27.09)	1.54 (28.85)	1.59 (30.62)	1.67 (27.55)	1.69 (28.15)	1.75 (29.01)	1.87 (29.00)	2.02 (25.00)
6. Pawnshops		-	-	-	-	-	-	-	-	-	-	-
7. Credit foncier companies	Notes payable	0.57 (-3.82)	0.43 (-7.10)	0.44 (27.60)	0.62 (69.75)	0.73 (32.96)	0.85 (46.97)	0.99 (41.70)	1.01 (-27.85)	0.69 (-2.60)	0.44 (-32.98)	0.34 (-9.22)
8. Government savings banks	Deposits, savings certificates, etc.	12.19 (3.14)	11.85 (11.51)	11.44 (20.04)	10.37 (9.16)	11.36 (22.83)	10.40 (15.80)	9.51 (11.19)	8.90 (18.71)	8.70 (22.56)	8.69 (17.46)	9.18 (22.43)
9. BAAC	Deposits	0.64 (49.70)	0.55 (4.34)	0.45 (1.79)	0.50 (33.94)	0.60 (35.95)	0.55 (15.04)	0.45 (-0.70)	0.43 (22.27)	0.40 (16.44)	0.38 (10.41)	0.41 (27.08)
10. Industrial Finance Corp. of Thailand	-	-	-	-	-	-	-	-	-	-	-	-
11. Government Housing Bank	Deposits	0.18 (21.37)	0.33 (127.19)	0.33 (24.40)	0.34 (23.26)	0.41 (32.76)	0.67 (111.48)	0.55 (-0.07)	0.46 (5.12)	0.38 (5.52)	0.98 (200.16)	1.16 (36.94)
12. Small Industrial Finance Office	-	-	-	-	-	-	-	-	-	-	-	-
Total:		100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Note: Figures in parentheses are annual growth rates.

Several factors were responsible for such a shift. Firstly, the Automatic Transfer System (ATS) between demand and savings deposits facilitated the transfer from non-interest bearing demand deposits to interest bearing deposits. Secondly, savings and time deposit accounts were accepted by commercial banks as collateral for borrowings since the 1970s. Both factors make it less necessary to hold large demand deposit balances. It was also convenient to deposit and withdraw money with commercial banks as there were large and rapidly increasing numbers of branches with better services.

With respect to deposit mobilization, commercial banks regard the retention of market share as their prime objective. Consequently, new banking technology such as the automated teller machine, electronic fund transfer system (EFT), has been employed to attract more depositors and to facilitate their operations. The new financial instruments such as the Transferable Certificates of Deposits, Citinote (issued by the City Bank) and new schemes were introduced to depositors in recent years. Strong competition occurred not only in the commercial banking system but also among other financial institutions, particularly finance companies and life insurance companies to attract as much financial savings as possible.

3. Government Policies and Strategies in the Mobilization of Domestic Savings

As the problem of inadequate savings has emerged in both private and public sector, measures to encourage savings mobilization have been incorporated in both the fifth and sixth National Economic and Social Development plan. The measures recommended to raise domestic savings are as follows:

(a) Savings Mobilization in the Public Sector

(i) *Measures to increase savings of the central government.* As the decline in government savings was due to the rise in expenditures and the revenue shortfall, (see Table 8.6) corrective action has therefore been focused on measures to expand the tax bases, improvement in the efficiency of tax collection, the review of some measures which caused losses in tax revenue, introduction of appropriate new taxes, and adjustments in tax rates.

(ii) *Measures to increase savings of state enterprises.* To improve savings performance of state enterprises, various measures have been implemented, namely, improvement in administrative efficiency, adoption of more realistic public utility rates, and integration of financial planning, particularly on the borrowing size.

Table 8.6 THAILAND: DEFICIT

		1975	1977	1979	1981	1983	1985
CPS	(B billion)	4.99	16.73	25.05	48.46	46.61	61.26
	(% GDP)	1.67	4.26	4.50	6.16	5.04	5.85
CG	(% GDP)	1.74	2.93	3.10	3.31	3.45	3.66
LG	(% GDP)	-0.10	-0.08	-0.08	-0.04	-0.06	-0.09
SE	(% GDP)	0.03	1.40	1.49	2.90	1.66	2.28
CG	(% CPS)	104.17	68.94	68.76	53.67	68.34	62.63
LG	(% CPS)	-5.73	-1.85	-1.75	-0.71	-1.26	-1.59
SE	(% CPS)	1.64	32.92	32.99	47.04	32.92	38.96

Source: Financial Resources Management, TDRI's Conference Paper 1980, p.133

CPS = Consolidated public sector

CG = Central Government

LG = Local government budgets

SE = State enterprise budgets

(b) *Measures to Promote Savings in the Private Sector*

(i) *Interest rate policy.* The major change in interest rate policy on deposits (and loans) by financial institutions took place towards the end of 1979 with the amendment of the Civil and Commercial Code Section 654. The section gave the monetary authorities the power to set a ceiling on lending rate up to 15 per cent. This being a usury law, in effect it limited the authorities' power to make upward adjustment of the ceiling on deposit rate. The amendment empowered the Ministry of Finance and the Bank of Thailand to revise the ceilings on loan and deposit rates in line with economic conditions. As a result, there were two occasions during which the ceilings on the deposit rates were revised in the period 1980-1981. This measure, coupled with the deceleration in the inflation rate towards the end of 1981, made the real rate of return on deposits of financial institutions relatively higher, thus inducing people to save more.

The change in interest rate policy proved to be beneficial for financial savings mobilization, as evidenced by the high growth rate of commercial bank deposits, averaging 24.0 per cent per annum since 1980. The change in policy stance also brought domestic interest rates level more in line with world interest rate; thus preventing capital flight.

(ii) *Contractual savings schemes.* Under the Provident Fund Bill, employers with more than 20 staff members may voluntarily set up a provident fund. Between 3-15 per cent of workers' salaries will be deducted for the fund, while the employers will contribute the same amount or more. The fund is to be registered as a juristic person to be administered by representatives of the employers and employees.

Tax privilege has been given to the Provident Fund set up under the Provident Fund Code B.E. 2527 (1984). For example, contribution to the Fund are tax deductible up to B 7,000 per year, while the payment into the Fund need not be counted as taxable. As for employers, their payment into the Fund are tax deductible up to 15 per cent of the company's total wage payment in the same accounting period. At the end of the first six months since the establishment of the provident funds, that was from 1 January 1984 to the end of June, there were 88 funds in the country, with 16,737 members, and B 98.3 million of total fund. By the end of October of that same year, the number of funds rose to 138, with 24,463 members and B 348.2 million of total fund. During those four months, from June to October, the record showed a 56.8 per cent increase in the number of funds, and a 254.2 per cent increase in the total amount of funds. (Table 8.7)

To enhance the role of life insurance companies in savings mobilization, tax allowance was granted for the payment of life insurance premium in the calculation of personal income taxes. This provides more incentive for people to take on life insurance. In addition, a regulation issued under the Insurance Act in 1985 greatly helped to relax the portfolio management restrictions of insurance companies. Thus, like provident funds, insurance companies can also be expected to grow significantly and play a more prominent role in the capital market in the future.

(iii) *Tax incentives on savings.* In formulating appropriate policy on taxes on interest rates, conflict arises between the monetary objective and the fiscal objective. The Thai government has chosen to compromise the two objectives. In consequence, instead of going ahead with the plan to include interest income with other income in the computation of income taxes at normal progressive rates as prescribed under the Revenue Code effective 1984, the government twice announced the extension of the period of this measure to 1986 and 1988.

(iv) *Protection of depositors.* Protection of depositors is one of the major tasks of the Bank of Thailand. The Bank carries out this function through supervision and examination of commercial banks, finance, securities and credit foncier companies. With a view to improving the inspection and supervision of commercial banks and non-bank financial institutions as well as to protect depositors by avoiding future financial institutions crisis and by encouraging more professional management, the Commercial Banking Act, the Act on the Undertaking of Finance Business, Securities Business and Credit Foncier Business and the Bank of Thailand Act were amended by three Emergency Decrees in 1985.³

3. For details, see *Financial Institutions in Thailand* op. cit. pp. 21-23.

Table 8.7 THAILAND: NUMBER AND SIZE OF THE PROVIDENT FUNDS

	No. of Funds	Members	Amount of Fund (Unit: 1,000 B)	
1984				
March	56	n.a.	32,853	
April	61	n.a.	39,565	
May	62	n.a.	84,552	
June	88	16,737	98,308	
July	102	18,406	194,709	
August	111	21,229	215,751	
September	125	23,138	247,502	
October	138	24,463	348,190	} statistics were compiled as quarterly data
November	n.a.	n.a.	n.a.	
December	159	28,377	562,532	
1985				
January	n.a.	n.a.	n.a.	} statistics were compiled as quarterly data
February	n.a.	n.a.	n.a.	
March	204	32,709	644,890	
April	n.a.	n.a.	n.a.	
May	225	34,454	711,231	
June	228	34,535	737,980	
July	234	34,648	772,787	
August	238	35,814	832,647	
September	247	35,522	930,032	
October	248	38,270	972,089	
November	255	39,108	1,023,501	
December	267	40,832	1,121,682	

The rationale of the Decree amending the Bank of Thailand Act is to establish the Fund for Rehabilitation and Development of Financial Institutions within the Bank of Thailand, but as a separate juristic entity.

The Fund required all banks and finance companies to annually contribute up to 0.5 per cent (now 0.1 per cent) of their deposits to serve as a bail-out fund for any troubled banks. To help restore public confidence in financial institutions, the Bank of Thailand intervened in the management of ailing companies through the Fund who becomes the shareholder of such institutions. As a result of the setting up of the Fund, numerous rescue missions took place whereby huge sums of money have been poured in to rescue troubled financial institutions, rather than allowing the market mechanism to provide for orderly exit.

Under the management pools (or the lifeboat scheme) "soft loans" have been provided directly from the Bank of Thailand to some ailing

commercial banks and finance companies to help alleviate their problems. To strengthen the financial institutions, the authorities also adopted the policy of "merging".

For the unorganized money market, in late 1984, the Emergency Decree Governing the Fraudulent Public Borrowings was enacted to prevent dishonest operation in this market.

(v) *Introduction of new schemes and financial instruments.* The authorities extended the scope of services of financial institutions and the promotion of new savings instruments; such as:

- increasing the number of commercial banks' branches at local levels. In an attempt to step up the mobilization of savings, the Bank of Thailand has guided a well-distributed pattern of bank branches throughout the country. The number of provincial branches has therefore increased rapidly from 188 at the end of the 1970s to 1,888 in 1985.
- promoting new flexible savings instruments, for example, negotiable certificates of deposit.
- increasing the role of life insurance companies as financial institutions to help mobilize savings.
- supporting certain savings instruments and organizations, such as, provident fund, local savings groups, etc.

B. Allocation of Financial Resources

1. *Financing the Government Sector*

The Thai public sector comprises the Central Government, local governments and state enterprises. Over the past two decades, public expenditure in Thailand, on the whole, has increased rapidly, while revenue has remained almost stagnant as a proportion of GDP. As a result, the fiscal deficit of the public sector has doubled from a modest 2 per cent of GDP to nearly 6 per cent in 1985.

The amount borrowed in each fiscal year to finance the budget deficit is, under the present law limited to 20 per cent of the government planned expenditure in that year plus 80 per cent of that part of expenditure earmarked for refinancing maturing debts, both domestic and foreign.

As in most other countries, Thai debt instruments used to finance the government sector include Treasury bills, government bonds with a maturity of up to ten years, and promissory notes. The amount, timing and terms of the issue of each instrument are determined by the govern-

ment's cash flow, estimated demand for bonds of the respective sectors and the market rates of interest, among other things.

Most of the government cash deficits are financed by domestic financial institutions. Of these, the commercial banking system has been the major holder of government bonds with their shares ranging between 27-34 per cent of total domestic debt during the 1975-1985 period. The Government Savings Bank (GSB) which directly serves as government's cash deficits financing contributed around 20-26 per cent of the total financing. After 1980, the financing was mostly in the form of promissory notes. Other financial institutions increased slightly their investment in government bonds, hence their shares rose from 2 per cent in 1976 to 6 per cent in 1985. The Bank of Thailand which financed the government deficits, provided 18-38 per cent of total financing during the 1975-1985 period. (Table 8.8)

2. Financing the Corporate Sector

A striking feature of the institutional finance of corporate businesses in Thailand is its heavy reliance on short- and medium-term lendings, derived mostly from commercial banks on an overdraft basis. They rely heavily upon debt rather than equity financing. This is due mainly to three factors:

(a) Private companies find it easier and cheaper to borrow from financial institutions than from the securities market as the latter often requires complicated procedures and involves high administrative cost.

(b) Interest expenses on debts of private corporations are considered deductible items in the computation of corporate income tax.

(c) Most of the traditional enterprises in Thailand are family-owned. These businessmen believe that borrowing from the stock market entails a loss in the controlling power of the firms. They are also reluctant to disclose companies' profile to the public.

Credit extended by various financial institutions and their shares are shown in Table 8.9.

The specialized financial institutions are typically the most important lenders of medium- and long-term investible funds. However, due to their limited ability to raise domestic resources and their restricted branching system, they have not been able to meet the domestic demand for industrial finance. Commercial banks, therefore, have been required and encouraged to engage in providing medium- and long-term financing as opposed to their traditional short-term financing (see Table 8.10 for distribution of loans by sectors). Thai commercial banks

Table 8.8 THAILAND: GOVERNMENT DOMESTIC DEBT CLASSIFIED BY HOLDERS
(as % of total government domestic debt)

	1970	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Government Bonds held by BOT	31	18	18	24	30	34	32	38	32	32	26	25
Commercial Banks	24	40	34	34	31	29	29	27	31	29	34	32
GSB	25	27	22	18	14	11	9	7	6	5	4	3
Financial Institutions	-	2	2	3	4	3	4	3	4	4	5	6
P/N held by GSB	-	1	4	7	9	10	13	13	14	15	17	19
Treasury Bills	10	5	13	9	8	8	8	7	6	6	5	5
Others	10	7	6	5	5	5	5	5	7	9	9	10

Table 8.9 THAILAND: CREDIT EXTENDED BY FINANCIAL INSTITUTIONS
(in percentage share of total)

Institutions	1971	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
1. Commercial banks	80.93 (12.57)	70.96 (20.13)	69.33 (17.03)	68.96 (27.98)	68.26 (30.25)	70.78	69.53 (12.23)	69.02 (16.22)	69.19 (17.81)	72.70 (33.99)	74.69 (18.26)	74.99 (9.95)
2. Finance companies	5.81	17.89	18.38	19.06	20.72	17.26	17.46	17.74	18.35	16.42	14.94	14.08
3. Life insurance companies	1.32	0.81	0.85	0.75	0.62	0.75	0.86	0.91	0.94	0.92	0.98	1.04
4. Agricultural cooperatives	2.08	1.66	1.66	1.65	1.52	1.40	1.23	1.13	1.05	0.87	0.81	0.84
5. Savings cooperatives	1.60	1.16	1.18	1.11	1.06	1.15	1.28	1.41	1.54	1.56	1.73	1.95
6. Pawnshops	1.48	1.07	0.96	0.81	0.76	0.88	0.89	0.85	0.73	0.59	0.55	0.66
7. Credit foncier companies	7.46	6.60	8.28	8.12	22.86	38.53	14.83	12.15	0.78	3.81	6.87	-5.02
8. Government Savings Bank	0.30	0.55	0.45	0.52	0.58	0.68	0.77	0.79	0.82	0.66	0.47	0.40
9. BAAC	1.03	0.29	0.33	0.38	0.28	0.41	0.36	0.57	0.47	0.60	0.19	0.20
10. Industrial Finance Corp. of Thailand	-4.41	0.67	39.32	45.43	-1.36	73.44	-1.65	86.68	-2.12	60.25	-62.61	15.00
11. Government Housing Bank	3.69	4.11	4.94	4.83	4.18	3.97	3.96	3.84	3.63	3.10	3.08	3.11
12. Small Industrial Finance Office	19.09	77.87	43.77	25.72	13.86	12.76	13.90	13.46	11.31	8.74	14.55	10.32
	24.97	46.04	24.76	-1.03	15.66	29.25	34.50	29.95	9.29	4.66	23.89	28.76
	0.33	0.27	0.65	0.95	1.15	1.78	2.58	2.55	2.19	1.68	1.59	1.61
	-11.07	272.13	187.46	89.34	58.43	82.66	65.77	15.86	0.63	1.95	8.60	10.90
	0.19	0.07	0.06	0.06	0.05	0.05	0.03	0.02	0.01	0.01	0.01	0.01
	3.72	14.26	17.08	25.14	14.53	0.70	19.60	-27.85	-24.66	-21.71	-7.27	-0.49
Total:	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Note: Figures in parentheses are annual growth rates.

**Table 8.10 THAILAND: PERCENTAGE DISTRIBUTION OF BILLS, LOANS AND OVERDRAFTS
OF COMMERCIAL BANKS; CLASSIFIED BY PURPOSES, 1970-1985**

	1970	1975	1980	1981	1982	1983	1984	1985
Agriculture	2.27	3.41	5.61	6.25	7.22	7.39	7.76	7.43
Mining	1.22	0.73	0.76	0.70	0.62	0.59	0.59	0.63
Manufacturing	15.18	19.88	18.35	22.56	21.15	21.54	22.01	23.15
Construction	5.68	4.61	5.29	5.05	5.24	5.29	5.43	5.56
Real Estate Business	6.12	4.08	3.01	2.70	2.76	2.97	3.48	3.67
Imports	21.58	15.05	13.24	9.73	7.82	8.39	7.48	6.46
Exports	9.95	12.28	11.09	10.10	9.45	7.77	8.25	8.50
Wholesale and Retail Trade	21.50	19.51	22.05	22.79	24.94	24.58	23.46	23.09
Public Utilities	1.15	1.11	3.01	2.31	1.84	1.59	1.55	1.80
Banking and Other Financial Business	2.21	6.50	6.46	4.94	5.49	6.24	6.29	6.01
Services	5.44	4.27	3.69	4.66	5.22	4.78	5.03	5.09
Personal Consumption	7.67	8.50	7.39	8.21	8.25	8.87	8.67	8.60
Others	0.03	0.07	0.05	-	-	-	-	-
Total	100	100	100	100	100	100	100	100

Source: Bank of Thailand, Monthly Bulletin (Selected issues).

themselves also wanted to reduce overdraft lending, because of their inherent difficulties in liquidity management. Their effort to reduce the share of overdraft loans is attested to by the introduction in 1983, of the minimum lending rate (MLR) for loan of at least one-year maturity and the minimum overdraft rate (MOR). Initially, the former was fixed at 15.0 per cent per annum and the latter at 16.0 per cent per annum. They were then changed many times to suit market conditions.

To help commercial banks reduce bank overdraft, the authorities announced a policy limiting the overdraft facility to B 50 million per customer, effective from May 1985. This measure reduced the proportion of overdraft loans to total loans (excluding promissory notes) from 62.9 per cent at the end of 1984 to 59.9 per cent by the end of 1985.

However, commercial banks involvement in term lending is a complex issue and depends among other things, on the ability to mobilize medium- and long-term resources, as well as on term-transformation, that is, the acquisition of long-term liabilities on the basis of essentially short-term deposits.

3. Financing the Priority Sector

The government uses the sector's potential share in income contribution, the labour employment scale and the sector's ability to induce backward and forward linkages effect to other parts of the economy as the major criteria to qualify these sectors as priority sectors. Following these criteria, the agricultural sector is considered as a major priority sector. However, for policy purpose, other sectors such as the industrial sector and the export sector are also given priority status because they are expected to stimulate economic growth in the future.

The Government, through the Central bank, has to assure the adequacy of funds for the priority sector. The Bank of Thailand had in fact, implemented various measures including direct lending through financial institutions⁴, rediscounting of promissory notes and providing interest rate subsidies. Rediscount facilities which was firstly granted to rice exports undertakings in 1956, was subsequently extended to cover all exports and industrial undertakings in 1958 and 1963 respectively.⁵

4. Mostly through commercial banks, the Industrial Finance Corporation of Thailand and the Bank for Agriculture and Agricultural Cooperatives.

5. For further details, see "The Role of the Bank of Thailand in Providing Financial Assistance to Priority Economic Sectors", Bank of Thailand, *Quarterly Bulletin*, Vol. 23, No. 2, June 1983.

For the agricultural sector, the Bank of Thailand has, since 1968, extended rediscount facilities to agricultural production and agro-related undertakings. Furthermore, in June 1975, commercial banks were required to lend 5 per cent of their total deposits outstanding as of the end of the previous year, to the agricultural sector. This rate was gradually adjusted upward to the rate of 13 per cent in 1985.

C. Problems, Issues and Prospects

During the 1970s, financial policy was centred predominantly on resolving the problems that arose in the commercial banking system. Firstly, inadequate provision of credits to priority sector activities in general, and to agriculture in particular, had been the major concern to the authorities.

The other concern is that the system has not been able to provide necessary facilities for efficient savings mobilization as well as credit extension to productive sectors of the economy. As a result, the new Commercial Banking Act 1979 was promulgated to take a more sectoral approach to the development of the Thai economy with directives to commercial banks to lend to more productive sectors. In addition, incentives were provided to banks for setting up branches in outlying districts and in areas where access to banking services was still limited. Such policy had led to the increase of commercial banks' branches.

The thrust of financial system policy also aimed at increasing the financial system's ability to cushion off the effects of shocks in a more flexible manner. To strengthen the operation, liquidity position and stability of the financial institutions, existing laws were amended and improved while the Fund for Rehabilitation and Development of Financial Institutions was also set up in 1985. The Bank of Thailand also provided direct finance or soft loans to the troubled financial institutions to ensure stability of the financing system. Merger policy was also directed at ailing finance companies and commercial banks as part of the effort to strengthen the financial sector. These measures altogether are expected to help restore financial institution stability and public confidence in the system, both of which are important keys to a successful development of the non-securities market.

Since the end of the 1970s, the authorities have been conducting its domestic interest rate policy more flexibly, and geared it toward a more liberal regime. Changes in policy have been made in gradual steps. Following the amendment of the usury law in 1980, the ceiling on lending

rates and deposit rates of financial institutions were adjusted upward by 3 percentage points. The Bank of Thailand interventions in setting the ceiling rates have been kept to a minimum ever since. Instead, the Bank has frequently adjusted its basic loan rate with the aim to influence money market rates.

However, the financial institutions were slow in adapting themselves to operate within the new flexible interest rate framework. Until the end of 1982, big commercial banks announced only marginal reduction in maximum loan rates and deposit rates. Rigidities in interest rate movement were visible, particularly in deposit rates. The underlying factors of this rigidity were mostly structural. For instance, commercial banks always aimed at retention of their market share as their prime objective. Consequently, they resisted downward adjustment in deposit rates for fear of losing depositors. On the lending side, liquidity conditions in the financial system, and the differential between foreign and domestic interest rates were the main determinants for the level of lending rates.

As a result of various structural factors, the Thai financial system is not yet ready for a completely flexible system in the near future.

III. THE DEVELOPMENT OF THE SECURITIES MARKET

Like most of the developing countries, the securities market in Thailand has not been well developed. As indicated in Table 8.11, the ratio of total new issue of securities, both government and private, in relation to GNP increased only slightly from an average of 2.5 per cent during 1975-1980 to 2.9 per cent during 1981-1986. As in most developing capital markets, government issues represent a major proportion (more than 90 per cent) of total issue, reflecting the low level of development in the primary market.

Another way of measuring securities market development is to consider the ratio of market value of stock exchange transactions (turnover value) to the value of outstanding shares, market value of shares issued to the outstanding value, market value of outstanding shares to GNP and the ratio of turnover value to GNP. These ratios also indicated very little progress in the Thai capital market, except for the boom period of 1977-1978 and the 1979 crisis. The ratio of turnover value to GNP increased slightly from 0.02 per cent in 1975 to 1.53 per cent in 1985 over a ten-year period. Only the outstanding shares to GNP rose significantly from 1.8 per cent to 4.9 per cent in the same period.

Table 8.11 THAILAND: SELECTED INDICATORS OF CAPITAL MARKET DEVELOPMENT

Years	Total new issues/GNP	Outstanding shares/GNP	Turnover value/GNP	Turnover/ outstanding share value	New shares issued/ outstanding value
1975	1.6	1.8	0.02	10.39	1.86
1976	2.5	2.2	0.03	13.64	3.99
1977	3.2	4.9	6.72	136.66	4.89
1978	3.4	7.1	12.28	172.47	12.09
1979	2.0	5.2	4.11	79.11	10.18
1980	2.4	3.8	0.09	25.67	2.74
1981	0.3	3.1	0.03	10.74	4.60
1982	3.3	3.6	0.07	19.97	7.34
1983	2.2	3.9	1.01	26.21	4.20
1984	4.0	5.0	1.11	22.35	13.70
1985	3.3	4.9	1.53	30.99	8.37
1986	4.4	7.1	2.37	33.23	2.63

Market capitalization of the Thai market also increased from B 5.39 billion in 1975 to B 49.46 billion in 1985, reflecting a significant increase in the supply of securities in the Thai market. The Thai authorities have recognized the importance of the securities market as an instrument to overcome the problem of over-reliance on debt financing of the private sector. Consequently, various measures have already been implemented to develop the country's securities market.

A. The Stock Exchange and its Evolution

The development of the stock exchange has undergone two distinct phases. The first phase was characterized by private initiative with the absence of official intervention. In July 1962, a private group set up an organized stock exchange in the form of a limited partnership which was later changed into a limited company called "Bangkok Stock Exchange Co. Ltd." (BSE). However, BSE was unable to fulfil its role in the securities market, generally due to public ignorance. As a result, trading of BSE was inactive.

The idea of establishing a securities market was first formulated in the Second National Economic and Social Development Plan (1967-1971) which provided for the setting up of a securities market with the aim of mobilizing funds on a long-term basis in line with the anticipated economic growth. In 1969, a working group on capital market

development was formed within the Bank of Thailand with the main task of preparing the groundwork for the eventual establishment of a securities market. In May 1974, the Securities Exchange of Thailand Act was promulgated to establish a new stock exchange and BSE also ceased to operate.

1. Organization, Membership and Method of Trading

In Thailand, trading existing securities is carried out mainly in the SET which officially started its operation on 30 April 1975. The SET is under the general supervision of the Ministry of Finance and the Bank of Thailand. Presently, the SET combines the functions of both a securities market and a securities commission. However, the Thai authorities are considering separating the two bodies. It has been proposed that the Securities Exchange Commission be set up at a division level under the Ministry of Finance.

The SET is operated by a nine-member Board of Directors and seven-member Advisory Board appointed by the Council of Ministers. Rules and regulation prescribed by the board requires prior approval from the meeting of member companies and/or become effective only upon the Finance Minister's approval.

Membership of the SET is limited to securities companies licensed by the Ministry of Finance to engage in the security business as stock broker. Under the SET regulation, members are required to have a sound financial standing, enough capability to conduct securities business and good experience in security trading. The number of member companies is limited to 30. Listed and authorized companies are required to submit information for publicity and to submit quarterly and annual financial statements to SET.

There are two separate boards on the trading floor, the main board for regular trading and the special board for big-lots, odd-lots, special lots and government bonds. On the main board, a transaction must be conducted at least in one board lot⁶ but not more than 20 board lots.

Under the SET regulation, the opening price of each security in each day must not vary more than four price-spreads from the closing price of the previous trading day and the price is not permitted to move higher or lower than 10 per cent of the closing price of the preceding day. The price spread of securities is varied in accordance with its market price as shown in Table 8.12.

6. One board lot on SET is the number of shares of a security amounting to approximately 10,000 baht at market value and simultaneously having no odds, that is, 25,50,100,200 shares.

Table 8.12 THAILAND: PRICE SPREADS

	Market Price (Baht)	Price Spread (Baht)
	50.00 or less	0.25
Over	50.00 to 100.00	0.50
Over	100.00 to 200.00	1.00
Over	200.00 to 600.00	2.00
Over	600.00 to 1,000.00	6.00
Over	1,000.00 to 2,000.00	10.00
Over	2,000.00 to 3,000.00	20.00
Over	3,000.00 to 4,000.00	30.00
Over	4,000.00	40.00

Note: The above price spreads do not apply to debentures, government bonds and government guaranteed bonds.

Securities traded in the SET comprise common stock, preferred stock, debenture, unit trust, government bond and state enterprise bond. A commission is paid for either buying or selling securities to a broker which is fixed at 0.1 per cent of value traded for government bonds, and 0.5 per cent for other securities.

2. Policies and Performances

On its first trading day, 30 April 1975, only 16 securities, comprising 14 corporate securities and two public securities were listed. However, towards the end of its first year, the number was increased significantly to 65, with 27 being corporate securities and the remaining 38 government bonds.

During the first two years of its existence, the trading at the SET was sluggish with the SET Index remaining at the level between 80-85. Trading volume totalled some B 1.6 billion annually on an average. During the boom period of 1977-1978, the SET index reached 266 point and trading volume jumped to B 57.1 billion in 1978. However, the SET experienced some unpleasant events in 1979-1980. A combination of unfavourable political, economic and financial factors had created a serious crisis in the market which led to the failure of a financial firm listed in the exchange. The crisis, which undermined investors' confidence, caused a slump in the securities business for the ensuing years.

The immense impact of the stock market crisis became a concern to the authorities. With the cooperation of the Thai Bankers' Associa-

tion, the Government Savings Bank, the Industrial Finance Corporation of Thailand, two emergency funds were set up to remedy the situation so as to minimize the damaging effects on investors, securities companies and the Securities Exchange of Thailand. Of the two funds, the Capital Market Development Fund was a stabilization fund with the objective of stemming the panic selling by intervening in the market in support of stock prices. The other "Krung Thai Fund" was established to help alleviate liquidity problems and the adverse impact of the crisis upon securities companies and stock investors.

For the long-term development of the securities market, the authorities decided to amend the Securities Exchange of Thailand Act in September 1984. The amendment provided the authorities with sufficient and effective mechanisms to ensure fair and orderly trading of securities in the stock exchange. Moreover, the new legislation also paved the way for the public offering and debentures issuing by companies other than those registered under the Public Company Act, whose stringent conditions have given rise to very few registrations.

The enactment of this new securities law, together with favourable economic and political factors, have strengthened the SET. Trading volume, after hitting the low side in 1981 with only B 2.9 billion also rose to B 16.5 billion and B 29.8 billion in 1985 and 1986, respectively. (Table 8.13).

In late 1985, a technical group was set up by the Bank of Thailand, with the primary task of finding ways and means to boost the securities market which were included in the Sixth Plan. Some of these programmes were immediately carried out after approval by the government. In addition, different tax rates applied for those business firms listed in the Securities Exchange of Thailand, and those general business firms which are not registered. Firms registered in the SET are required to pay 30 per cent income tax, while firms not registered in the SET pay a rate of 35 per cent. This is intended to promote the supply of securities in the stock exchange, thus providing an alternative form of savings mobilization.

B. The Equity Market and Corporate Financing

1. *Primary Market*

The total value of funds raised from the new public issue of common stocks have been very limited compared to borrowings from the financial institutions. The equity capital raised from new equity issues rose

Table 8.13 THAILAND: SELECTED STATISTICS ON QUOTED SECURITIES

Item	1975*	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
Corporate Securities													
Annual Turnover - Volume	(mil. shares)	2.94	5.17	97.12	178.93	97.28	58.24	30.00	60.76	71.20	83.27	99.34	122.64
- Value	(bil. B)	0.56	0.99	26.28	57.07	22.45	6.55	2.52	5.88	9.12	10.60	15.33	24.99
Average Turnover - Monthly	(mil. B)	62.17	82.80	2,190.18	4,755.48	1,870.88	545.77	210.10	489.83	760.05	882.93	1,277.83	2,082.79
- Daily	(mil. B)	3.37	4.01	106.84	231.97	90.53	26.41	10.21	23.89	36.93	42.72	62.59	101.19
Turnover by Types of Securities													
- Common and Preferred Shares	(mil. B)	0.55	0.98	26.05	53.50	21.78	6.30	2.36	5.48	8.76	10.26	14.99	24.49
- Unit Trusts	(mil. B)	+	+	222.64	3,489.90	658.26	246.78	162.31	396.43	364.43	336.53	346.39	497.97
- Debentures ¹	(mil. B)	10.33	12.44	7.65	73.38	7.31	0.02	0.72	+	+	+	+	2.67
Set Index*		84.08	82.70	181.59	257.73	149.40	124.67	106.62	123.50	134.47	142.29	134.95	207.20
Market Dividend Yield*	(%)	10.16	7.28	3.93	5.74	9.18	9.42	9.57	8.53	6.97	9.07	8.15	4.30
Market P/E Ratio*		4.98	5.83	11.34	8.46	5.84	6.40	9.52	11.83	6.54	7.19	9.59	12.34
Capital Mobilized by Quoted Companies	(mil. B)	107.75	294.74	935.28	3,997.80	2,890.09	696.45	1,084.36	2,163.88	1,459.15	6,499.95	4,143.32	1,984.82
Number of Quoted Companies		21	25	39	61	69	77	80	81	88	96	97	93
Listed		16	22	36	57	65	72	76	78	85	93	95	89
Authorized		5	3	3	4	4	5	4	3	3	3	2	1
Number of Issues		27	32	46	71	78	85	86	85	92	99	100	98
Listed		20	27	42	66	73	79	81	81	88	95	97	96
Authorized		7	5	4	5	5	6	5	4	4	4	3	2
Total Capitalization													
Nominal Value	(bil. B)	3.26	3.83	5.03	8.55	12.69	13.86	14.83	16.55	18.08	22.59	24.58	25.75
Market Value	(bil. B)	5.39	7.26	19.23	33.09	28.38	25.52	23.47	29.44	34.79	47.43	49.46	91.21
Government Securities													
Annual Turnover - Volume	(mil. units)	0.96	0.99	0.59	0.29	0.12	0.01	0.92	0.10	1.73	1.85	7.04	6.32
- Value	(mil. B)	963.38	687.61	310.18	206.65	82.57	10.00	376.48	87.75	203.35	276.01	1,148.87	4,854.76
Number of Listed Issues		38	50	55	55	60	71	85	103	124	130	134	138
Total Capitalization													
- Nominal Value	(bil. B)	29.33	35.97	46.85	57.64	66.13	78.05	89.67	110.38	135.92	152.74	180.46	205.64

*End of year

+ No listed issues

a SET started trading on 30 April 1975

1 The enactment of the Public Companies Act in 1978 prohibited all limited companies, except public companies, from issuing debentures. However, since the proclamation of the Securities Exchange of Thailand Act No. 21 in September 1984, the quoted companies on SET and the limited companies whose securities are under consideration for acceptance as quoted securities are entitled to issue debentures again.

Sources: Development and Planning Department, Securities Exchange of Thailand

from B 101.0 million in 1975 to B 292.5 million and B 451.8 million in 1976 and 1977, respectively. Following a boom in the SET, total new issues recorded a high level of B 2,432.6 million and B 2,471.4 million in 1978 and 1979, respectively. After two quiet years, equity investment from new shares issues increased substantially in recent years in 1984 and 1985, with B 3,281.5 million and B 2,880.9 million of new shares respectively being raised with an increase of more than three times that of 1983.

Common stocks dominate the primary equity market and most of them belong to financial institutions, particularly the commercial banks.

2. Secondary Market

During the first two years of the SET operation, the market for private equity was not active, with an annual turnover value of only B 0.56 billion and B 0.99 billion respectively. However, after the establishment of a new government in 1977, general investors' confidence in the stability of domestic politics improved. The high liquidity in the money market which caused a declining trend of domestic interest rates also contributed to the improved share market performance. The rapidly rising capital inflow into the stock market further strengthened the market boom. The average daily trade value of corporate securities shot up from the preceding year's record of some B 4.01 million to about B 106 million. Moreover, quoted companies and issues rose in 1978 from the preceding year's number of 39 and 46, to 61 and 71, respectively, while capital for speculation began flowing into the market. Trading volume and SET index reached the highest level in 1978. However, the stock market faced a severe crisis in 1979, caused by massive speculation, manipulation and insider trading, and finally the collapse of a large finance company's "Raja" whose shares were actively traded on SET. After the quiet activity experienced during 1980-1981, caused mainly by the tight money situation, high interest rates and inflation, trading picked up again in 1982.

In the second half of 1986, a severe decline in interest rates and oil prices, an excess liquidity in the commercial banking system, an economic recovery and an increasing number of foreign investors together reactivated brisk trading in the SET. Corporate securities trading in 1986 jumped to B 101.19 million per day with SET index closing at 207.2, thereby gaining 72.25 points from the preceding year's close level. Trading value reached a peak of B 24.99 billion, an increase of 63 per cent from the year before. The same trend also continues to occur in 1987.

Trading in the secondary market is typically concentrated in the equities of a few firms, particularly financial institutions. Eight largest financial institutions represent over 50 percent of market capitalization. Moreover, only 20 per cent of the listed securities are actively traded.

3. Factors Affecting the Development of the Equity Market

On the supply side, the problem of limited supply of securities has become more evident in recent years. One of the factors for the limited supply is the nature of equity ownership. In Thailand, traditional enterprises are largely family businesses which are often reluctant to give management authority to hire professionals and are resistant to non-family equity participation. Besides, information and disclosure requirements as required under the Public Company Act, B. E. 2521 also deter family-oriented firms from going public. Secondly, the stringent SET regulations and requirements for listing as well as complicated administrative procedures have discouraged somewhat the private companies from listing in the SET. Furthermore, under the present situation, borrowings from financial institutions is also relatively cheaper than raising funds through issuing new equity.

Even though tax incentives are granted to listed companies, they are by and large not attractive enough. The corporate tax levied on listed companies is only 5 percentage points lower than that levied on unlisted companies.

On the demand side, demand for securities holding depends significantly on monetary and economic conditions which affect the rates of returns on securities. On top of this, there is a high degree of risk in buying shares. This high risk has deterred those who are risk-averse from participating in stock exchange activity. Furthermore prior to 1986, there was an uncertainty of the government tax policies towards investment in the SET. Many tax benefits such as those on dividend and business tax are given on a temporary basis. These uncertainties were not conducive for investment in shares. To make matters worse, the deficiency of real investors had led to the SET being dominated by short-term investors rather than long-term ones.

C. The Bond Market and Its Development

1. Government Bond Market

(a) *Primary Market.* The Bank of Thailand manages the government bonds on behalf of the Finance Ministry. The amount, timing and terms of the issue of each series are determined in relation to the government's cash flow. From 1968 onwards, there have been two categories of government bonds – loan bonds and investment bonds with a ten-year maturity. Financial institutions are allowed to purchase only investment bonds while individuals and other legal entities are free to choose any kind of bonds.

The government bond market in Thailand is largely a captive market. Commercial banks invest in government bonds because they are obliged to meet the reserve requirements and conditions for opening new branches. Non-bank financial institutions, the GSB and individuals also invest in government bonds. Any remaining amount which are not sold out through the primary market network are then taken up by the Bank of Thailand. Commercial banks are the major government bond holders.

As noted earlier, government bonds dominate the securities primary market, with a proportion of more than 90 per cent (see Table 8.14). To raise funds from domestic capital market, state enterprises occasionally issue their investment bonds in the primary market.

(b) *Secondary market.* The purpose of the secondary government bond market is to provide liquidity to the existing bonds which in turn help support the primary market. So far, the functions of the secondary government bond market have been carried out by the SET, the BOT and some commercial banks.

As for the liquidity aspect of the bonds, the Bank of Thailand has given individual investors the right to redeem "loan bonds" before maturity at a fixed pre-determined price. This practice has been an obstacle to the development of a secondary market trading which could otherwise have taken place in the SET. However, holders of investment bonds who are mostly institutional investors, were never entitled to such facility. Commercial banks also provide over-the-counter secondary market facilities for government bonds but have not yet been active.

In the SET, except for the first two years, bond trading accounted for a small proportion of the SET transactions. In 1985, the turnover value of government securities accounted for only 7.0 per cent of the total.

Table 8.14 THAILAND: NEW GENERAL PUBLIC SHARE OFFERINGS IN THE PRIMARY MARKET
(Millions of Baht)

Type	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
1. Government Bonds	4,000.0	6,895.0	11,930.0	13,300.0	8,500.0	14,400.0	23,200.0	24,500.0	18,700.0	35,020.0	26,265.3
2. Bonds issued by State Enterprises	590.0	1,150.0	-	-	-	1,500.0	2,577.5	500.0	-	100.0	3,413.0
	4,590.0	8,045.0	11,930.0	13,300.0	8,500.0	15,500.0	25,777.5	25,000.0	18,700.0	35,120.0	29,678.3
3. Debentures	50.0	40.0	100.0	50.0	90.0	-	100.0	-	-	200.0	290.0
4. Common Stocks	101.0	292.5	451.8	2,432.6	2,471.4	548.4	798.7	1,723.4	1,051.8	3,281.5	2,880.9
	151.0	332.5	551.8	2,482.6	2,561.4	548.4	898.7	1,723.4	1,051.8	3,481.5	3,170.9
Total	4,741.0	8,377.5	12,481.8	15,782.6	11,061.4	16,048.4	26,676.2	26,723.4	19,751.8	38,601.5	32,849.2

Source: Bank of Thailand.

(c) *Factors affecting the development of the bond market.* As government instruments, the conditions of government bonds issued, that is, volume, maturity and timing depend on the nature of government cash deficits financing. As a consequence, the public interest in the issuance of government bond may sometimes not coincide with the private requirements. For instance, in times of high liquidity, the private needs may be for the issuance of government bonds but the public deficit financing does not warrant it. This had led sometimes to an excess demand for or under-supply of government bonds in the market. Secondly, government bonds are limited to only a few categories and the market is captive because of various legal requirements. Hence, the secondary market is adversely affected as most of the institutional investors tend to hold the government bonds till maturity.

To induce more investors to purchase more bonds, yields have been made more attractive by raising the coupon rates to the same level as the other domestic interest rates. But the response from the public seems to be less encouraging. This is mainly because of the uncertainty over the tax treatment. Investors do not know exactly how much they will be taxed for their bond investment. Sales network are also limited only to the Bank of Thailand, the provincial treasury, the GSB, the BAAC and the post offices which act as agencies for the entire country.

2. Corporate Debenture Market

Before 1978, there were six listed companies issuing ten lots of bonds at a total value of B 565 million. Value of each lot ranged from B 20 million to B 180 million with minimum and maximum par value of B 100 and B 50,000 respectively, with 5-11 years maturity. However, after the Public Companies Act was enacted in 1978, no private company could distribute its new shares or debentures to the public except for the public companies only. So during 1978-1985, there were no new debentures registered in the SET. (Table 8.15). Listed and authorized companies are able to issue bonds again after the amendment of the Securities Exchange of Thailand Act in 1984. However, there has been only one listed company that issued debentures ever since, with a total value of B 40 million.

Transactions in private bonds in the SET were very low, never exceeding 2 per cent of the market volume. The bond market has been less popular than the common stock market partly because raising funds by issuing bonds has legal commitment to pay interest to debtors. The interest expenses can be avoided instead by issuing common stock. Apart from this, unfairness of the tax structure is also a factor which

Table 8.15 THAILAND: DEBENTURE ISSUES OF LISTED COMPANIES

	Name of the companies	Number of shares	Value (B mil)	Par Value Baht	Interest rate (%)	Redemption
1968	IFCT (1)	30,000	30	1,000	7	Dec. 31, 1978
	IFCT (2)	50,000	50	1,000	7	Dec. 31, 1978
1970	BJC (Convertible)	100,000	10	100	11	Aug. 31, 1978
1972	SCC	1,800,000	180	100	10	Sep. 15, 1978
1974	GF	500	25	50,000	11	July 1, 1983 250 shares
	BIC	400	20	50,000	11.5	July 1, 1984 250 shares
1975	IFCT	150,000	150	1,000	9	Sep. 15, 1979
1977	JCC (1)	600,000	60	100	10.5	Dec. 31, 1980
	JCC (2)	200,000	20	100	10.5	Jan. 31, 1981
	JCC (3)	200,000	20	100	10.5	Dec. 31, 1981
1978-84	No Bond Issuing According to the Public Companies Act					
1985	DTC (1)	200,000	20	100	13.2	Dec. 31, 1982
	DTC (2)	200,000	20	100	13.2	Nov. 15, 1989 Nov. 15, 1990

Source: Securities Exchange of Thailand.

hinders the development of the bond market. In particular, the exemption of capital gains tax on shares will make share investment much more attractive than bond investment.

D. Investors

So far, SET trading has always been dominated by a combination of individual investors and member firms' own trading. Institutional and foreign participation has been extremely limited.

Ever since the inception of the securities exchange, private investors expecting long-term benefits have been scarce. Most of the transactions have been done by speculators expecting short-term gains. During 1978-1979, the massive flow of speculators into the SET caused the collapse of the market. Since then, the authorities have stepped in to promote private long-term investment.

In Thailand, however, the institutional investors have played a limited role in the securities markets. Attempts have been made to encourage institutional investors to be more active. For example, tax incentives have been granted to corporations and their employees to set up their provident funds. With the revised regulations, insurance companies are also allowed to invest more in the securities listed with the SET.

At the moment, only one company, a subsidiary of the IFCT, is permitted to undertake mutual fund management. It has launched six funds, with a total subscription of approximately B 2,619.2 million. Such a development would definitely benefit the market by encouraging greater efficiency, competition and specialization in the securities market.

In the past, efforts to attract direct foreign investment have been much more elaborate and ambitious than the efforts to attract portfolio investment. Consequently, foreign portfolio investment were kept at a very low level.

In 1986, apart from the tax incentive the authorities streamlined the remittance procedure to boost foreign investment. Of utmost importance, two foreign funds have been established, namely, the 'Bangkok Fund' and the 'Thailand Fund' to encourage more portfolio investment from abroad.

The Bangkok Fund was organized as an offshore fund; in the form of company type, with the capital value of U.S.\$ 10 million at the initial stage and later in 1986 increased to U.S.\$ 25 million. On the other hand, the Thailand Fund was organized as an onshore fund, a contractual type in accordance with Thai Law, with the value of around U.S.\$ 30 million.

In response to the incentives, coupled with favourable economic conditions, foreign investment in the SET increased significantly from B 1,596 million in 1985 to B 4,617.2 million in 1986, an increase of almost three times. Foreign investment as a percentage share of total trading in the SET increased significantly from 4.3 per cent in 1985 to 7.8 per cent and 8.3 per cent in 1986 and the first quarter of 1987, respectively (see Table 8.16).

It is expected that foreign portfolio investment in the Thai capital market be increased further as the price to earning ratios of most of the Thai securities are relatively low and dividend yields are relatively high when compared with those securities in some other countries.

IV. CONCLUDING REMARKS

In Thailand, it is the government's firm intention to develop the capital market as an institution with an ever increasing importance with regard to its role in the economic development of the country. To maintain financial and economic stability, the country should rely to a greater extent on the domestic capital market as a source of funds for both private and public sector financing. This could be achieved only if

Table 8.16 THAILAND: FOREIGN INVESTMENT IN SET
(Baht Million)

Year	Purchase Value	Sale Value	Net Purchase	Total Trading of Foreigners	Foreigners' Trading/Total Trading (%)
1982	168.33	70.02	+98.31	238.35	2.05
1983	166.25	172.66	-6.41	338.91	1.83
1984	1,023.21	162.06	+861.15	1,185.27	5.51
1985	1,150.68	445.37	+705.31	1,596.05	4.34
1986	3,443.66	1,173.54	+2,270.12	4,617.20	7.76
Q1	104.14	242.61	-138.47	346.75	5.79
Q2	131.62	187.72	-56.1	319.34	4.02
Q3	957.28	277.52	+679.76	1,234.80	7.11
Q4	2,250.62	465.69	+1,784.93	2,716.31	9.63
1987 Q1	845.51	196.66	+648.85	1,042.17	8.29

the authorities adopt appropriate strategies in the capital market development.

Therefore, the first important step should be to increase domestic savings mobilization to meet increasing investment needs and to narrow the savings-investment gap. The public sector, especially the state enterprises, must raise its savings rate. Household savings must also be raised through both the securities and non-securities markets, by providing savers more alternative instruments with a wider assortment of equity and fixed income securities. This would also lead to an increase in the proportion of equity financing and the reduction in the over-reliance on debt financing of the corporate sector.

As the Thai securities market has yet to reach the higher stage of development, the authorities need to work very hard to speed up the development of the securities market. Various measures have been implemented, such as the relaxation of regulations, the enhancement of investors protection, and the provision of tax incentives. Furthermore, strengthening public confidence in the stock market and market stability have been the prime objectives since the collapse of the market in 1979.

Finally, it should be emphasized that the development of the capital market cannot be achieved without supportive political and economic stability. In turn, an efficient capital market complements and supports the productive activities of the economy. □

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