A possible means of encouraging development: mobilization of savings capital in third world countries

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Capital formation is a prerequisite for development. However, in Third World countries the inadequacies of the financial systems often prevent the accumulation of financial resources. These systems need to fulfil their role as agents between (abundantly available) savings and investments to a greater extent. (ed.)

Economic development in Third World countries means growth and the participation of the poor in such growth. This requires large investments and thus capital. This is not something that has been discovered recently but something that was already recognised at the start of development co-operation about 40 years ago. However, nowadays many development aid organisations are bemoaning cash shortages. Moreover, capital aid within the scope of development co-operation has often led to the recipient country becoming overborrowed. Is it possible to promote capital formation *in the developing countries themselves*?

Capital formation via intermediation

When economists address this subject, they like to point out that a national economy can o-nly invest to the same extent as it also saves - and saving means *foregoing consumption.* Statistics show there are major differences from country to country when it comes to their ability to forego consumption. For example, between 1980 and 2000 the national savings rates were between 23% and 58% in Singapore, between 34% and 42% in The People's Republic of China, between -5% and 24% in Ghana and between -4% and 14% in Senegal. As a rule of thumb, there will o-nly be economic development if the savings rate is over 20%; above 25% it is classed as "good" and above 30% as "very good".

If savings from the national economy are mobilised by the financial sector and then used for investments o-ne speaks of *"intermediation".* Various variants are possible and make economic sense:

A government can use income to invest in its infrastructure. The problem with developing countries is that for the most part this form of intermediation functions very badly. Usually, the public administrative system is too weak.

A funded social security system, in which each person insured saves for his pension via a capital account, is a second important alternative. However, it o-nly exists in a limited number of developing countries, with Singapore (since 1959) and Chile (since 1981) as pioneers. The savings collected in this way can be sunk into portfolio May 31, 2003 investments o-n the capital market and thus channelled into investments that are important for the economy.

Voluntary pension funds (e.g. company pensions) or life insurance companies accumulate considerable quantities of savings, which they also sink into portfolio investments. However, this approach has also not been widely adopted in most developing countries.

The mobilisation of savings via the sale of securities is widespread in Anglo-Saxon countries but is still in its infancy in developing countries.

Savings accounts and the like are often the most common method of creating savings. Banks, which mobilise these resources and pass them o-n in the form of loans to investors, are the focal point of national intermediation. However, this form of savings also needs to be expanded further in developing countries.

Underdeveloped financial system

There is a need for comprehensive *development of the financial system* that extends over all five forms of intermediation if the process of intermediation is to be encouraged in a country. We will concentrate here o-n the last three, the private forms of saving. The “financial system” describes the financial sector (financial institutions and markets) and its institutional superstructure; the latter includes the central bank and its monetary policy, legislation covering credit control, bodies that control banking and insurance, etc. For a long time, this *superstructure* was neglected in many developing countries and in addition the development of the financial sector was often o-nly successful to a limited extent. Classic errors were:

• neglecting bank supervision and credit control legislation

• abusing the central bank, viz. printing bank notes to finance the budget

• politicising the financial sector (nationalisation of banks, political management of banks, government-controlled interest policy, political control of credit)

• neglecting the domestic mobilisation of savings (with refinancing abroad instead – as well as part of development co-operation)

• neglecting important areas of credit (long-term loans, small companies, rural areas, women);

• neglecting important financial services such as cash remittances

A key question is what *the priorities* should be for the development of the financial system. In each developing country, this decision has to take into account that there is a need in the long term for a diversified financial sector that provides all the necessary financial services but which first and foremost fulfils its function locally with respect to capital formation via intermediation. And a second strategic question is whether and to what extent a country opens itself up for foreign direct investments in the financial sector in order to thereby press ahead with the development of its financial system and capital formation.

Dead money . . .

The idea that saving in the sense of foregoing consumption is the prerequisite for investing in an economy should not obscure the fact that there is an *alternative* here. The *creation of credit* can also be the starting point for development; loans enable investments to be financed. The prerequisite for this, however, is that the borrower can provide sufficient *collateral*, above all tangible securities, e.g. “property deeds” (mortgage, land charge).

But that is precisely the problem. In developing countries, o-nly larger companies are usually part of the “formal sector”. They are the o-nly o-nes who have formal rights of ownership to land and buildings. In developing countries, not o-nly are two-thirds to three-quarters of the population – depending o-n the country – part of the informal sector, but usually more than 90% of the companies as well. Above all, this is the case for most of the small and very small companies that are operated informally, e.g. as a backyard workshop in a hut.

In his book *The Mystery of Capital; Why Capitalism Triumphs in the West and Fails Everywhere Else* (2001), Hernando de Soto, the Peruvian development economist, has used a number of countries to illustrate the level of *informal assets* in the Third World. The figures are put at $240bn for Egypt and $74bn for Peru. Hernando de Soto described these informal assets as dead capital because they cannot be used to obtain credit, in other words for capital formation. And this dead capital is to be found primarily in the hands of the poor. They are thus prevented from participating in the formal sector.

. . . and how it might be stimulated

The task is thus clear: to *formalise* informal ownership as much as possible – regardless of whether it is from households or companies. Hernando de Soto has shown how o-ne can do this cost effectively. In addition to the development of the financial system, the formalisation of informal ownership is thus the key to capital formation in developing countries. This has the great advantage that capital formation will be primarily in the hands of the poor, which will give them the strived-for opportunity to participate in the growth and development.

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