

Some Aspects of the Development of Capital Markets *

Over the past two years or so, the development of capital markets has virtually become headline news, at least in the world's financial press. Much of the discussion has related to the possibilities of expanding the facilities available to borrowers in the European capital markets. It was sparked off by an official Report produced by the United States Treasury,** itself a by-product of American difficulties in resolving their recalcitrant balance of payments problem. At the same time, the discussion has a wider relevance, especially for those developing countries that already have an established banking and financial infra-structure. In this article, it is proposed to look more particularly at the problem of capital market development from the point of view of the "users" of investible funds, though this will necessarily lead us on to consider the possibility of institutional innovation and/or extension as a means both of assisting in the formation of saving and of its allocation between alternative uses. Consideration will also be given to some of the difficulties "users" may encounter in obtaining access to financial resources adequate to meet their needs. Nor is this only a matter of availability. Price considerations, too, are highly relevant. It may

* This article is based in part on the results of field work undertaken both in Western Europe and in Asia. All the major financial centres in the former were visited during the summer and autumn of 1965 and a number in the latter during the period December 1963 to January 1964. Reference will also be made to United States experience, with which the author is likewise conversant.

** See *A Description and Analysis of Certain European Capital Markets*, being Paper No. 3 of *Economic Policies and Practices*. (Materials prepared for the Joint Economic Committee, Congress of the United States Government, 88th Congress, 2nd Session, Washington, D.C.). United States Government Printing Office, 1964. Interest has also been expressed by several international organizations as well as by research groups organized by private financial and other interests. Finally, there has been a developing academic interest in this field and, in addition, certain University economists have been associated with enquiries initiated elsewhere.

sometimes be the case that needs are being substantially met but at a relatively high level of interest rates. Likewise, it may sometimes be the case that, given the objective of maintaining the existing relatively low level of rates, important user needs are not in fact being adequately met.

I. The Bases of Analysis

Prior to discussing "user" problems in greater detail, it is pertinent to remind ourselves of certain fundamental considerations basic to any study of capital markets. It is an economic axiom that resources — human and material — are scarce in relation to the ends to which they might be applied. Choice is therefore of the essence of the economic problem, the basis of our decisions (to the extent that we do resort to the price mechanism) being a comparison of cost and monetary return. One of the choices which it is open to us to make is whether to consume today or to defer part of our consumption until tomorrow. While it is true that in general we produce only in order to consume, we — or our successors — may be able to consume more in the future provided we are prepared to consume less today. That is the purpose of investment and, to the extent that we accept the tests of the market place, we shall choose as projects in which to invest those that offer the highest net returns, after due allowance has been made for risks of various kinds, including the risk of obsolescence, sometimes of expropriation. In the nature of things, all investments must be based on expectations of one kind or another since nothing is ever certain. In deciding upon whether to make particular investments, much depends on the information available to the potential investor, on his judgement, on his confidence in that judgement, and on his attitude to risk. Finally, both in the fields of domestic and international investment, decisions may well be influenced by extra-economic criteria (and especially by considerations of social policy).

In order to invest, resources must be made available for the purpose. Both within the individual enterprise and for the national economy as a whole, this postulates an ability to command the appropriate resources, and, whether the real resources have been accumulated already or are yet to be acquired, in a monetary economy this means a continuing access to finance. Hence, it is the availability of financial capital that makes possible the acquisition

and retention of real capital resources in the form of the buildings and equipment and stocks of raw materials essential to production. It is with the provision of financial capital and its allocation to alternative uses that a capital market is concerned. The most prominent source of financial capital is the flow of funds originating in private and corporate savings, but not every ingredient in this flow is permanently available for investment. Hence, if funds are to be fully utilised, there must be some mechanism that will facilitate a withdrawal of funds as well as their commitment to medium- or long-term investment. Again, this is a function of the capital market, which provides the means whereby securities (or claims to financial capital) can be bought and sold, so that the holdings of those who wish to withdraw funds by selling securities can be absorbed by those who wish to invest funds by buying securities, the supply of and demand for the several types of securities being equated by appropriate fluctuations in their respective prices. In addition, there will be movements of funds and shifts in demand as between the several sub-markets for securities and this will tend to establish a degree of consistency between one price and another. This same market can also be used for the purpose of floating new issues, in that way providing financial capital for the initiation of new economic enterprises, or the maintenance and further development of those already existing.

The primary source of funds for investment is private and corporate savings, which where they exist are likely to be supplemented by the undistributed profits of the nationalised industries (really only another form of corporate savings) and — from time to time — by any budgetary surpluses arising in Government accounts including those of local government. So far as private saving is concerned, the motives are various and sometimes very complex, but an obvious prior condition (of considerable relevance for the poorer countries) must be sufficient income to ensure that there is a margin available for saving. Where saving is possible, it can only become actual if the parties concerned abstain from consuming part of their income.

Yet saving may take place but not be made readily available for investment either because of conservative social attitudes or because the appropriate institutional machinery is absent. This kind of situation is not confined to the less developed countries; to some extent, it obtains in a large number of countries. However, where

an adequate infra-structure exists and incomes are more or less sufficient to provide a margin for saving, making available a supply of funds is likely to present a much less serious problem than obtains in the less developed countries where one must first stimulate the growth of income such that it will exceed the minimum level at which saving becomes possible.

Given a sufficient level of income, what are some of the motives that prompt individuals and corporations — even governments — to save? Individuals save in order to provide for contingencies, or retirement, or the possibility of early death. Because the future is uncertain, some saving will take place, simply as a precautionary act. The amounts actually saved will depend largely on the attitudes of respective individuals, some of whom will be more provident than others. Even so, a great deal of saving by individuals has today become institutionalised — in the form of the regular payment of insurance premiums, superannuation provision, or the gradual repayment of a house mortgage loan — and to that extent is virtually automatic. In the case of business corporations, saving is seen to be the result of an even more automatic process. It is a condition both of survival and growth. Gross corporate saving must at least provide for the maintenance of a firm's capital equipment and for its ultimate replacement whether this be necessitated by wear and tear or by obsolescence. But for a firm to survive, it must also usually grow and some positive net saving must, therefore, be included in the gross figure. How much a firm will save (and re-invest) will depend largely on profits, i.e., on its income, but, subject to some fluctuations from one year to another, a large part of corporate saving is clearly "automatic".

There remains the question of the importance we should attach to the level of interest rates as an inducement to save. Automatic and semi-automatic saving will be little affected by the level of interest rates. This is virtually certain so long as changes in the level of rates remain of modest proportions. In the modern world, that would seem to be quite a reasonable assumption. There may be some marginal influence, if there is a sharp rise (or fall) in rates, but even so it is likely to be small. Given relative stability in the value of money, the level of income — and therefore ability to save — remain the primary determinants. But changes in interest rate differentials *can* have an important effect on the particular form or means of saving that is chosen. For example, if a new savings

bond is issued carrying a relatively higher rate, it is likely to attract funds previously held elsewhere, though there need not necessarily be any net increase in total savings. Indeed, not infrequently, fiscal considerations (i.e., the relevant tax arrangements) may well be quite as important as the actual interest rate and will, therefore, be incorporated in any calculations of yield.

Yield doubtless measures in some degree the marginal inconvenience of abstaining from consumption, without which abstinence there could be no saving. The individual interest rates that together make up the structure of rates will measure much more directly the marginal inconvenience of parting with different degrees of liquidity for a specified period, i.e., the less quickly and easily a holding of funds can be converted without substantial loss into actual cash for purposes of expenditure, the higher the rate that will have to be offered in relation to other rates currently obtaining.

Likewise, one might expect that the several interest rates at which funds are being supplied would play their part in rationing out total available resources as between the various possible uses, and it remains broadly true that the structure of interest rates does serve as a kind of sieve, by means of which capital projects are subjected to a process of sifting.

In simple terms, the sifting effect is achieved within the private sector by comparing with the relevant rate of interest the earnings likely to be derived from a projected investment in real resources, i.e., by comparing the relevant rate of interest with the expected rate of profit. If the rate of interest is low in relation to the expected rate of profit, there will be an incentive to increase the rate of investment in that particular economic sector. This will mean an increased demand for finance and a tendency for the relevant rate of interest to rise. But as the rate of investment increases, the marginal cost of producing capital goods and of securing additional labour and raw materials will tend to increase. This will tend to reduce the expected rate of profit. Moreover, the greater availability of capital equipment will also tend to depress the prospective yields of existing capital assets. It is the convergence of these two sets of forces — the one tending to push up the rate of interest and the other to depress the expected rate of profit — that tends to bring about equality between the two rates.

Conversely, if the relevant rate of interest is high in relation to the expected rate of profit, there will be a tendency to curtail invest-

ment. As a result, the prospective yield of existing capital assets will gradually be raised as these assets wear out and become more limited in supply. The cutting back of investment will mean some reduction in the demand for finance and this will tend to lower interest rates. Again, there will be a movement towards equality between the rate of interest and the expected rate of profit.

At all times, however, the shape of the capital structure in the country must be borne in mind. For example, new investment may be the means of using in a new and more profitable way existing and complementary capital resources. Similarly, if capital assets are allowed to run down, their prospective yields may not in fact rise in consequence of the reduction in their supply, because the relevant capital items may no longer be available in the appropriate proportions. Again, new investment may be the only means of restoring their profitability. But it remains true that if investment is pushed to its ultimate limits, prospective returns must be forced down, since eventually one would reach a situation in which all goods would be "free".

There can be little doubt that if interest rates were pushed high enough, only the most profitable — or risky — investment prospects would be followed up. There will always be a proportion of lenders and investors prepared to accept a high degree of risk in the hope of a considerable gain. But this kind of speculative investment is probably no more than a bubble on the "steady stream of enterprise". It is only when the "capital development of a country becomes a by-product of the activities of a casino" that there is any real danger and this the authorities must aim to prevent. More generally, expectations as to yields are likely to have a more solid foundation, though risks there always will be, because of the uncertainties of the future.

This is likely to lead businessmen to act "bearishly" in their investment decisions and many of them will only be induced to invest if they can reckon to get their money back in two or three years, although they must know that the useful life of their asset is much longer. The probability of obsolescence is one important reason for the tendency to operate only on the basis of a very short "time horizon". The prospective rate of profit based on expectations and the "state of confidence" will tend to become the active influence in the making of a business decision and considerations

based on the calculation of interest costs are likely to be somewhat swamped by these other factors.

Yet it would be wrong to suppose that changes in the level of interest rates have no influence whatsoever. Expectations and the "state of confidence" are themselves the product of current experience and of expected future experience. In this context, price experience is particularly relevant and the prevailing structure of interest rates will quite obviously be part of this price experience. Indeed, the significance of the rate of interest is likely to be much greater than might be indicated merely by the proportion that interest payments bear to total business costs. Because the rate of interest is still regarded as one of the most "strategic" prices in the economy, current and expected levels of interest rates can be assumed to exert an important psychological influence on the formation of business opinion. Moreover, the current level of interest rates will usually reflect the extent to which finance and credit are likely to be available and, despite the size of corporate savings, the availability of financial capital remains a highly relevant consideration when a new investment project or a business expansion programme is being planned. In many ways, it is this rather than the rate of interest that borrowers are prepared to pay which provides the framework of the sieve through which all projects that come to the market must pass.

There are frequently two aspects to this. In many countries, at least part of the public issues is subjected to some kind of vetting — official or otherwise — in order to establish a "queue" or arrange a "calendar" of dates for the approach to the market. In addition, even when a realistic rate is fixed as the basis of the offer before the launching of a new issue, not infrequently such issues will either be underwritten or their marketing facilitated by arrangements for placing the relevant securities through the agency of a group of banks and/or other financial intermediaries. By these means, the borrower will usually be assured that the required finance or a high proportion of it will in fact be available.

Even when a firm finances an investment from internal sources, one might expect that some attention will be paid to market rates of interest. If the businessman acts rationally, he should debit himself in his internal accounts with interest charges for the use of his own funds, at a rate determined by the alternative opportunities

forgone as a result of employing his own funds within the business, instead of investing them outside, due allowance being made for different degrees of risk. It is true to say that few businessmen demonstrate quite this degree of rationality. It is also probable that not infrequently internal rates of return are somewhat lower than the best available outside alternative as evidenced by market yields.

The decision to plough profits back into the business and to maintain and expand one's equipment so far as possible on the basis of one's own financial resources can usually be justified by arguments based on the advantages of some degree of financial autonomy, on more direct knowledge of the relevant risks, on fiscal considerations, and on the need to grow — a firm that does not grow can only stagnate — though admittedly there may be some empire-building and prestige considerations thrown in. At the same time, it is important to appreciate the consequences of any such action. Part of the supply of funds that might have found its way into the capital market will not now become available and, because funds have been diverted from the market for the purpose of self-financing, rates to borrowers who do approach the market may tend to be higher than they would have been otherwise. On the demand side, this may well mean that some investment projects that promise relatively higher yields than many that are currently being launched will be starved of the financial resources necessary to implement expansion and development. Hence, to the extent that the capital market proper is by-passed and firms are prepared to invest in anticipation of prospective returns lower than the highest available outside rate (due allowance being made for different degrees of risk), an optimum utilisation of economic resources is unlikely to be realised.

In addition, there is often a whole range of social considerations that must be accommodated within the framework of any study relating to capital markets. Quite apart from the organisation of a "queue" or a "calendar", there will be various other forms of intervention by the government or its agencies calculated to supplement, to influence, or even actively to regulate the distribution of investible funds, such that the final result is different from what would have been achieved through the relatively unfettered operation of market forces. In other words, the investible resources available in each economy will be allocated by means of machinery that represents a combination of market mechanisms and government

intervention. The latter may take several forms. Direct action to supplement the availability of funds (most frequently to certain favoured economic sectors) may take the form of creating new specialised financial intermediaries, or of directing savings towards certain privileged users, or of furnishing "guarantees" in order to buttress the creditworthiness of the borrower, thereby enabling him to raise more readily a larger quantity of funds than would otherwise have been possible, or of regulating either domestic access to foreign funds or the availability of domestic funds to foreign borrowers. It is also possible to supplement the resources likely to be available for self-financing, e.g., by generous depreciation allowances or accelerated amortization provisions. Again, action may be taken to influence the costs of financing — by resorting to subsidised interest rates for approved purposes, as is in fact done in a number of countries. Fiscal concessions, too, favouring certain forms of financing (e.g., bond or share issues) or certain uses of funds (e.g., for residential construction) may be employed as a means of reducing the costs of raising finance and of developing the use made of a capital market. Likewise, restrictive action might be applied to investment demand — e.g., as a result of decisions affecting budgetary expenditure, or controls imposed on the expenditures of the local authorities or of the nationalised industries, or a reduction in the granting of building licences. Furthermore, the monetary authorities can exert pressure both generally and sectionally by implementing quantitative and qualitative (or selective) credit controls.

The relevant social considerations will vary — often to quite a significant extent — from one country to another. Nor in the light of the considerable differences that obtain in the social philosophies of various countries is this very surprising. However, it is no part of our present purpose to attempt an explanation of variations in social attitudes. It is sufficient here to emphasise their importance as part of the environment within which a capital market has to operate. Moreover, it is largely as a result of introducing social considerations that the policy-makers face a real dilemma, when it comes to the choice of an appropriate level and structure of interest rates. It is useful, therefore, to consider what in this context the implications of the policy choice are for the ultimate users of investible funds.

While freely admitting that it is dangerous to think in terms of water-tight compartments and acknowledging that one category

necessarily merges into the other, there would nevertheless seem to be three main possibilities: (a) a highly regulated interest rate structure, with the object of pursuing a low rate policy (Norway is the leading example in Europe and even there the control is by no means complete); (b) relatively free capital markets, which because of the pressure of demand sometimes experience higher rates of interest than the authorities are prepared to countenance (Denmark, and to a lesser extent Western Germany, might be cited as appropriate examples under this head); and (c) the large number of countries that fall somewhere in between and which attempt to influence interest rates to a rather greater extent than under (b) so that the level of rates is more directly related to the current requirements of the economy; even so, certain rates may be actively subsidised or regulated in order to ensure that particular forms of economic activity are accorded the priorities that society is thought to demand.

In a way, a closer look at the third category, which in a sense is an amalgam of the other two, will help to highlight the nature of the dilemma. Given the current state of the economy in a country at any particular time, it may be appropriate on occasion to raise the level of interest rates as a whole, and at other times to reduce them to lower levels. But, if a country persistently pursues a low rate policy (i.e., in effect, largely rejects price as a regulatory mechanism), it can only maintain this policy when the pressure of demand for funds is considerable, provided it is prepared to regulate directly the allocation of funds between their several possible uses (1). In these circumstances, extra-market criteria must be invoked; necessarily these will be arbitrary in character and will reflect chosen social priorities. Moreover, there are limits to what direct regulation can achieve and, once the pressure begins to build up beyond the levels of tolerance, either leakages (e.g., black markets with high prices) begin to develop, or a political demand for some modification of the low rate policy may emerge. In any event, there are doubts

(1) In Norway, not all credits are in fact subject to regulation and, as a result of the pressure of demand, rates of interest in the unregulated sector have tended to drift upwards. In these circumstances, banks and other financial intermediaries have found it more profitable to lend in these directions and the priority sectors (such as housebuilding, municipalities, and issues of bearer bonds), which it was intended to "protect" by keeping the relevant interest costs at a low level, have as a result found it difficult to secure access to sufficient funds. At the same time, the maintenance of low interest rates in these sectors has tended to stimulate a somewhat larger demand than might otherwise have originated on this account.

and at least some consideration will be given to possible policy modifications.

Alternatively, if it is decided to allow market processes to operate freely, at times when the pressure of demand is high, interest rates also are likely to rise. Moreover, the increase in rates will affect the whole range of economic activity and, to the extent that high interest rates do exert a restrictive influence, activities such as the provision of housing are likely to suffer quite as much as others that might be thought to have a lower social priority. Hence, if (as in Denmark, for example, during 1965) the effective interest rates on mortgages rise to high levels, the authorities are apt to become concerned and to lose some of their enthusiasm for the virtues of the free market. In various ways, they then begin to intervene to ensure that specific social priorities are in fact met and the operation of the market mechanism becomes less free. This is the dilemma: at both extremes, circumstances may force a departure from accepted policy and the tendency, therefore, is for more and more countries to follow a pragmatic approach based on a relatively free working of the price mechanism, though subject to the constraints of a social framework based on priorities that in their very nature are arbitrary.

Indeed, if one were to insist on an objective test of adequacy of supply for particular uses of funds, it could only be ability to pay the market price. Clearly, this is not a test that is universally accepted. At the same time, where it is rejected, there can only be two main grounds for such action: (a) the imperfections of the market (due to frictions and other possible impediments to the free flow of funds); or (b) for reasons of social policy involving a political decision. Yet existing imperfections in the working of the market mechanism may be the result of previous political intervention (e.g., by fiscal or monetary action) calculated to achieve stated social objectives. If this is not so, there will be scope for improved efficiency in the working of the market machinery. It might be thought that another relatively objective test could be based on a statistical comparison with experience in other countries. While such a comparison may be useful in a general way, it is unlikely to provide the kind of test we are looking for, because socio-economic attitudes and conditions (as well as the scope of market arrangements) can vary very considerably from one country to another.

What we seek is an objective means of deciding whether the available financial resources are "adequate" to satisfy the investment demands being made upon them and — if, on the basis of the structure of market prices obtaining, these funds are being effectively rationed out amongst the several competing demands — there will be no "areas" where financing needs are not being "properly satisfied", in the sense of there being an unsatisfied demand at current prices. Furthermore, the existence of a coherent and consistent structure of price relationships would ensure that a "balance" was maintained between the uses made of the various sources of financing, and especially between own funds and external funds, and between bonds and equity financing.

Nevertheless, the market place will only be capable of providing the basis of an objective test of the "adequacy" of supply, if we can assume a minimum degree of rationality on the part of businessmen and the absence of major "frictions" or impediments to the free flow of funds. If the market mechanism does not in fact work freely because of "frictions" and other imperfections, the reliability, if not the objectivity, of its tests will be called in question. In these circumstances, a coherent and consistent structure of prices is unlikely to be established and there can therefore be no reliable basis of reference. For example, some businessmen may not push their investment activity far enough to take full advantage of the possible opportunities that are offering and the tendency will be for their expected rates of profit to remain higher than the relevant rate of interest. Other businessmen, in employing their own internally generated investible funds, may use as a basis of reference notional rates of interest that are lower than the best available outside investment alternative as evidenced by market yields. Here again, though for a different reason, there is a failure to use the available resources to the best advantage. In the one case, insufficient funds are being employed to take full advantage of the investment opportunities that already exist; in the other, funds are being misdirected in the sense that they could be more profitably employed elsewhere.

Even if we can demonstrate that in a freely working market price and profitability do provide the basis of an objective test, by no means everyone (as has been indicated) would accept this as an appropriate criterion. It may be, for example, that the level of interest rates necessary to ensure that the available investible funds are effectively rationed out to potential users is thought by an elected

government to be too high and that some other means must be found as a basis of allocating scarce resources. Such a government may well decide to establish a list of social priorities, but that kind of decision cannot be subject to any known objective tests. Necessarily, it is arbitrary in character and must be accepted — or rejected — on frankly socio-political grounds. But if, under these circumstances, some sectors of the economy are able to secure access to more funds than would have been the case on the basis of an approach to a free market, it is certain either that other sectors will now only be able to command a smaller quantum of resources than would have been the case in a free market, or that within the framework of an "administered" price structure they will now be obliged to pay more for the use of investible funds than under free market conditions, with the probability that they can only afford to use a smaller quantum of investible resources. There can be no means of providing an objective test as a basis of reference for arbitrary administrative action, whether this is calculated to achieve a direct use allocation of investible resources or a new structure of administered prices that will encourage a re-allocation between users.

II. Problems Relating to the Corporate Sector

In the context of developing a capital market, the essence of the problem is how to "transform" savings (which usually become available in liquid form (2) and are therefore virtually the same as investible funds) into actual investment. In varying degrees, this remains a problem in all countries. In some, the institutional machinery is more efficient than in others and there may therefore seem to be no problem, but even within the most sophisticated of market structures difficulties may be experienced from time to time, blockages may occur, or the flow of funds in certain directions be retarded. In other contexts, improvements could undoubtedly be made in the working of the machinery. Sometimes, it may be necessary to set up new machinery, or to provide fiscal inducements to change. But always there remains the problem of how best — within a particular environment — to "transform" such savings.

(2) This is most obviously the case when savings are held (however temporarily) in the form of cash balances or bank deposits. But there are also other means of holding funds at short-term.

into investment. Whether the mechanism employed is a direct equation of corporate saving (resulting in the generation of cash flows) with industrial investment (by means of self-financing) or an equation achieved through the operations of the market as such, one is concerned in both cases with the problem of "transformation". It is fruitless to maintain (as some do) that there is no real dearth of savings in this or that country (e.g. in France, Japan, or Austria) — the problem of "transformation" remains: how to canalise the flow of funds towards and transform it into actual investment. There is also a risk factor to be considered. When banks (and other financial intermediaries) accept funds from the public (e.g. by way of deposit), they offer in return (and contractually) a degree of liquidity and/or security. But, in the process of "transforming" such funds into investments (e.g. through the agency of a bank loan or a "participation"), they are incurring a risk (this is in the nature of their business) and, in the event of a loss, it is the financial intermediary that will be liable. But before attempting to outline ways in which the transformation problem might be resolved, there are one or two specific problems that deserve our attention.

Self-financing

As already indicated, self-financing is a means of securing a direct equation between corporate saving and actual industrial investment. Since notional rates of interest are seldom applied (and where conventional rates are employed, they rarely reflect current or expected market rates), self-financing virtually represents a by-passing of the market mechanism. In this matter, there seem to be two rather opposed views: (a) those who believe there should be more self-financing and who deplore any tendency for the proportion of total investment that is self-financed to flag (these tend to be the "practical industrialists" or those who represent their views); and (b) those who maintain that, given the failure to refer to market rates, rather too high a proportion of total investment tends to derive from corporate savings that are ploughed back into the same concern (this view is accepted by many economists and by financial operators — sometimes by governments; in short, by all those who for whatever reason — be it a vested interest or not — wish to see the development of a broader and more active capital market proper).

To put it as baldly as that is to oversimplify, but usually there *is* a policy emphasis one way or the other; it is largely a matter of degree.

In fact, therefore, it is not a simple choice between one view or the other. The matter is also complicated both by past history and by local environmental factors (such as legal conventions and the structure of industrial ownership) and these vary from one country to another. If one is to attempt a summary of some of the more significant factors, the evidence suggests that in recent years there has been a redistribution of income in many economies (in consequence of the upward revision of wage levels). As a result of the related increase in wages costs, profits have been squeezed and there has been less corporate saving. This does not necessarily imply a diminution in the total supply of saving, though if the marginal propensity to consume of wage-earners is relatively high, it may do so. Should there be a decline in voluntary saving, some would suggest that the deficiency be made good by more public saving. But not everybody would accept that solution. Indeed, some would regard it as having dangerous implications — in terms of excessive interference by the State. Even if there is no decline in saving, such redistributions of income may complicate the processes of transformation.

Alternatively, there may on occasion be an attempt by firms or corporations to re-establish the former pattern, initial increases in wages costs being followed where possible by rises in retail prices, though if this were pushed too far the prices of domestically produced goods would soon become uncompetitive even within the home market. But any such attempt would operate to re-absorb the increase in wages incomes (3) and thereby to limit the allocations that employees could make to savings. At the same time, firms would be able to restore profit margins to the old levels and to revert to the former emphasis on self-financing. Nor would it be easy for the monetary authorities to prevent this. If they restricted the supply of money and reduced the liquidity of the economy, this would tend to depress the levels of employment and of incomes. The

(3) This would be so to some extent even in the most affluent societies, but the consumer may refuse to buy at the higher prices and, in this way, still maintain his savings. In less affluent societies, where the range of commodities affected is less likely to include "luxuries", consumer resistance is less possible. There is in any event less margin for saving and this margin will now be reduced even further.

margin available for saving out of income — whether corporate or personal — would shrink and there would tend to be a reduction in investment. An alternative possibility that might cushion corporations against the effects of a profit squeeze would be the revision of tax arrangements (e.g. larger amortisation allowances) such that the generation of cash flows by corporations was restored to its former level, provided only these funds were used for the purpose of self-financing the corporation's investment programme.

As has been noted, a fairly general criticism of self-financing by industry is that companies which rely to a large extent on internal funds are subject to no real check on the relative profitability of their investments, such as would be imposed if they were obliged to compete for the necessary funds in the open capital market. More generally, self-financing operates to restrict the free flow of capital by confining its use to particular companies, instead of releasing it for allocation through the agency of the capital market to firms that might use it more effectively. It is not without significance that the most dynamic companies in the United Kingdom are among those that rely least on self-finance (4). On the other hand, in both the United States and in Switzerland it was maintained that the more aggressive (and, by implication, more successful) corporations were inclined to rely *more* than the others on self-financing. This diversity of experience no doubt reflects in part differences in business attitudes; it may also be due to environmental differences and especially to the respective fiscal arrangements that obtain in the several countries.

While it is difficult to conceive of optimal limits to the amount of self-financing that might be undertaken, business firms certainly tend to think in terms of a minimum resort to external sources of finance, if only because many firms tend to equate self-financing with a capacity to grow without losing their "independence". This is true both of small family firms and of some of the great indus-

(4) There could be several reasons for this. First, in order to grow, it is necessary to be competitive and this doubtless means greater emphasis on turnover and less on gross profit margins (i.e., prices will tend to be kept down to lower and more competitive levels). Second, whatever the absolute level of undistributed profits, rapid growth may also require access to increasing amounts of external finance, so that as a proportion retained profits will fall. Third, and again in consequence of rapid growth, wear and tear of equipment, if not the rates at which it becomes obsolete, will tend to increase, so that a higher proportion of the cash flows will have to be devoted to making good capital consumption.

trial giants (in some of which the capital is also tightly held). From a capital market point of view, this has clear implications. If one is to develop a broader and more active market in negotiable securities (bonds and shares), there must be an inflow of savings for new issues to tap; whereas, if firms insist on financing from internal sources a relatively large proportion of their investment programmes, it is apparent that fewer new issues will be on offer. Likewise, the flow of savings into the securities markets will be less. Moreover, if the capital market (in this sense) is starved of funds and firms are obliged from time to time to seek external finance, there is the danger that they will become over-dependent either on the banks or on foreign loans, which will inhibit further the development of a healthy domestic market in securities.

At the same time, it is not intended to suggest that self-financing should as a matter of course be actively discouraged. If this were to happen, there might well be a sharp reduction in the total flow of savings in a country, since corporate saving is usually a significant part of the whole and additional income that passes into the hands of shareholders (by way of dividends) is likely to be spent largely on consumption. Furthermore, in some countries, there may be a case for more self-financing so that firms can grow to the size that will enable them to go to the new issues market. But in countries that are already highly industrialised, there may also be a case for pursuing a "neutral" policy towards self-finance (i.e., not actively encouraging further resort to it at the expense of developing the markets in new issues of bonds and shares). Clearly, pursuance of the goal of economic growth postulates a need to draw investible funds from both sources — from corporate savings that will on the whole be employed in self-financing and from the financial intermediaries and the general public by attracting savings into the purchase of issues of new securities.

The "Gearing" of Capital

In the United Kingdom and the United States, business and financial economists and accountants have been much concerned with the problem of maintaining an appropriate balance between that part of a company's resources that derives from equity capital holdings and that representing debt (including loan capital such as

bonds or debentures) (5). What is regarded as "appropriate" will certainly vary from one economic sector to another — indeed, from one country to another and, in any event, is not something that can be regarded as fixed. Where conventions obtain, they are necessarily somewhat elastic, but in general terms what is appropriate to an industry or firm can be related to the degree of risk that applies to the undertaking concerned — the greater the risk, the stronger the case for equity financing (6).

The notion of capital "gearing" also has practical implications. Usually, there is a fiscal advantage as a result of resorting to debt rather than equity finance; in an age of inflation, too, the burden of debt becomes less and less with the effluxion of time. Hence, if a company is under-borrowed, there are likely to be advantages in increasing the ratio of debt to equity. (Yet it is sometimes the faster growing firms that resort most to equity finance (7), no doubt because their rate of growth renders it easier for them to make new share issues). On the other hand, whether one borrows from a bank or through the market against the issue of bonds or debentures,

(5) Though the Americans (and some Europeans) might put it somewhat differently. For example, the American investors (and therefore corporation treasurers) seem to be more concerned with the extent to which the cost of debt (e.g. as a result of issuing bonds) is covered by additional income rather than with the debt/equity ratio as such (if the related additional income is likely to be high, this will permit a larger volume of corporate saving, more self-financing, and — in the longer run — a further building up of the equity by additions to reserves that relate to the growth in assets consequent upon self-financed investment). In this context, there is evidence in most countries of an increasing emphasis on the "cash flow" approach, though for bankers in particular the ratio between debt and total capital resources undoubtedly remains an important consideration.

(6) There are a number of references available on capital gearing. See, for example, F. W. PAISH, *Business Finance* (London, 1964), Chapters II and III; EZRA SOLOMON, *The Theory of Financial Management*, Chapters VI-IX, Columbia University Press, 1963; MERWIN H. WATERMAN, "Trading on the Equity" - *Essays on Business Finance*, Masterco Press, 1957; MYRON J. GORDON, *The Investment, Financing and Valuation of the Corporation*, Chapters 8, 14, 15, Richard D. Irwin Inc. 1962; A. J. MERRETT & ALLEN SYKES, *The Finance and Analysis of Capital Projects*, Chapters 4 and 15, Longmans, 1963; DAVID DURAND, *Cost of Debt and Equity Funds for Business*, National Bureau of Economic Research, 1952; F. MODIGLIANI & M. H. MILLER, "The Cost of Capital, Corporation Finance and the Theory of Investment", *The American Economic Review*, June 1958; F. B. ALLEN, "Does Going in'o Debt Lower the Cost of Capital?", *Analyst's Journal*, August 1954; B. GRAHAM, D. L. DODD and S. CORTLE, *Security Analyst*, Chapters 37 and 45, McGRAW-HILL, 1962; ALEXANDER A. ROBICHEK, *Optimal Financing Decisions*, Prentice-Hall, 1965; J. P. HERON, "The Capital Gearing of Companies", *The Investment Analyst*, December 1964; and Joint Economic Committee, Congress of the U.S., *A Description and Analysis of Certain European Capital Markets*, U.S. Govt. Printing Office, 1964.

(7) See R. F. Henderson in Brian Tew and R. F. Henderson (Editors): *Studies in Company Finance* (Cambridge, 1959), pp. 65-68.

there are limits to the amount of debt accommodation that lenders will countenance even in the case of a reputable and well-established public company. As has been indicated, these limits may be elastic, but lenders will insist on the owners of the borrowing company maintaining at all times a sizeable and related equity interest. To ignore this rule is to court disaster. Moreover, one form of debt will generally be regarded as an alternative to all others. If a company has borrowed heavily on the security of issues of bonds, it is unlikely that its bankers will be willing lenders for large amounts; and, if its bank loans are at a high level, it will be difficult for a company successfully to make large bond or debenture issues on the market. Countries in which the capital gearing of its industry is regarded as a problem include France, Greece, Italy and Japan. The dangers of under-capitalisation become most obvious during times of credit squeeze and financial stringency.

Gaps in the Term Structure

The authorities' concern with the provision of medium- and long-term finance for a wide range of industries and the proliferation of institutions to meet these needs, which sometimes relate to the provision of accommodation for specific sectors, suggests (a) that gaps have certainly existed in the past, but (b) that they are no longer thought to exist to any significant extent in the present.

Yet this concern with "gaps" in the term structure almost certainly reflects the existence of a problem that has a much wider relevance, viz., the problem of the "shifting temporal gap". Identification of this problem resulted from the author's field enquiries; it is a matter for further research to discover how general it might be. In London, for example, it was emphasised that where companies became over-dependent on loan finance, there was a danger that they might be embarrassed from time to time by the appearance of gaps in the debt structure. While it is true that fixed-interest debt with definite arrangements as to term can often be renewed, subject to re-negotiation of the rate, this is by no means always so and a company places itself in a highly vulnerable position in cases where the more or less automatic renewal of debt is assumed. Wise financial management postulates the maintenance of some kind of balance between short-, medium-, and longer-term debt.

In London, very frequently the kind of loan finance that is most readily available is short-term, subject to changes in rate that can make it expensive. Bank finance is probably the most readily available, but resort to hire purchase finance and leasing are two other ways of gearing up capital, though they are both rather more costly than bank finance. In an appropriate gearing operation, one will need some short-term finance, and medium-term finance (when required) can be obtained (say, for 3 to 5 years) from the hire purchase finance companies. However, debenture issues tend to be for from 10 to 20 years and this means there may be a gap (in the United Kingdom, if not elsewhere) within the 5 to 10 year range (sometimes, it is within the 7 to 15 year range). It is said to be in the medium-term area that it is most difficult to obtain adequate supplies of money in the City of London. The Industrial and Commercial Finance Corporation may come in with loan finance for a term of 10 years; and ship mortgage finance (with the assistance perhaps of certain of the merchant banks) may provide funds (when required) within the 7 to 15 year range. Even so, there remains a gap in the term structure. Furthermore, its actual location appears to shift from time to time. Presumably, its existence is due primarily to variations in the willingness to lend of the several types of financial institution, and the precise location of the "gap" at any one time is partly a function of interest rate expectations; it may equally — and perhaps more directly — relate to the current state of confidence in the economy as a whole, or be occasioned by official directives that themselves derive from current economic circumstance.

Something similar to this has also been experienced in the United States. It is true that the Americans have their "term loan" arrangements, whether such loans be made by the commercial banks themselves or by means of a shared loan between a bank and an insurance company (e.g. the bank taking the first 5 years and the insurance company the remainder). There have been occasions when the banks have been prepared to go out further than 10 years, though in principle they prefer to restrict themselves to a limit of (say) 5 to 7 years. Likewise, the insurance companies vary both in their appetite for term loans and in their willingness to exploit the advantages of a sharing arrangement with a bank. Hence, primarily because of variations in the willingness to lend of the several types of financial institutions, a "shifting temporal gap" also appears from time to time in the United States and there is evidence to suggest that

it lies somewhere in the 5 to 15 years range (depending on the banks' attitudes to term loans, it may at times be concentrated in the 12 to 15 years range).

In Denmark, business firms have some difficulty in raising "medium-term capital" and, for largely institutional reasons, there is a gap beyond the 3-year limit. The banks are willing to provide a fixed line of credit for up to 3 years; usually, such lines of credit are made available for one year in the first instance, but are renewable. There appears to be no official limitation on medium-term lending; the restriction is self-imposed as a matter of ordinary banking prudence. Similarly, in Norway, banks do not like lending for longer than 5 years (8).

In the last two cases, there may be an institutional gap to be filled, but, where there is a "shifting temporal gap" largely due to changes in the degree of willingness of institutions to make "term loans" even to creditworthy customers (for whatever reason), this suggests that the gap is not merely a matter of institutional inadequacy. Nor is it desirable that every "gap" should immediately be filled by setting up a new type of institution. There is far too great a tendency to proliferate institutions as the "easy way out" — politically, if not financially. There is much to be said — especially in a relatively sophisticated market — for using more effectively the institutions that already exist. Furthermore, if every conceivable gap is to be filled, there is little left for the art of financial management to achieve and, in organising our economic and financial resources, it is desirable that from time to time companies should be obliged carefully to consider both current investment expenditures and their plans for growth. In other words, it is important that they be obliged to test their proposed investment programmes against market criteria, whether it be by applying the discipline of a higher rate of interest or of reduced availability of finance. Moreover, if companies wish partially to avoid the inconvenience of the "shifting gap" and have a growth programme that is really soundly based and sufficiently tempting to investors, the remedy is in their own hands — they can go to the market for equity finance. Although they will still be subject to market tests, an issue of new shares will

(8) The experience in Switzerland suggests the existence of a 15 year "limit" on lending, but there appears to be no "gap" in between. Even beyond 15 years, the potentialities of the "indefinite" mortgage can be explored.

provide them with capital on a "permanent" basis (the alternative — and this is really the only way to avoid the dictates of the market — is to build up the company's equity by self-financing; indeed, this is its attraction).

This discussion gives rise to two observations: (a) whatever the attractions of debt finance (e.g. on fiscal grounds), the fast-growing industries are not likely to experience any difficulty in launching new share issues — the opportunity is certainly there — and this will enable them largely to avoid the problem of the "shifting gap"; alternatively, they may resort to self-financing, though if their growth is really rapid internally generated funds may not become available to an extent capable of providing them with all the resources that they need; (b) the very existence of the "shifting gap" places an additional limit on the extent to which capital gearing (i.e. resort to debt finance) is possible and safe.

In less sophisticated markets, there may still be gaps in term structure that are due primarily to institutional inadequacies. More than once, in the course of his enquiries, the author was told that industrial concerns had difficulty in obtaining access to adequate long-term capital, while on occasion the "gap" was described as medium-term in character (e.g. in Denmark and in Norway). It may be thought that the simple solution is to establish a new financial institution specially to cater for this type of need. Sometimes this is the appropriate short-run answer, but in the longer run the only true solution lies in the development of a broader and more active capital market, capable of meeting the short- and medium-term needs of industry (and, for that matter, of the economy as a whole) through the agency of the banking and quasi-banking structure, long-term requirements being catered for by new issues of shares and of industrial bonds (or debentures). Some of the means that will assist in achieving this will be outlined in the final section below.

The Claims of the Public Sector

There is a suspicion in many countries, in some cases almost amounting to a certainty, that the volume of investible funds absorbed by the public sector (whether by the State itself, the nationalised and semi-nationalised industries, or those activities — e.g. housing — that benefit from some form of State guarantee, sub-

sidy, or privilege) seriously interferes with the possibilities of growth in the private industrial sector. This is not to deny the importance of social priorities and of social investment, nor the inadequacy of market criteria as a basis for determining how much shall be invested in schools, hospitals, housing, roads, and other social amenities. But it does mean a frank recognition (a) that resources are scarce; (b) that social priorities must also take this into account; and (c) that both the social investment programme and its related time scale should be spelt out in some detail in order that those who plan the investment programmes of the private sector should know on a continuing basis within what framework they are expected to operate. At all times, expectations exert an important influence on capital market activity; to the extent that these are based on the fullest and most accurate information currently available, the efficiency of the capital market as a piece of machinery capable of effecting a distribution of investible funds that is consistent with both the broad lines of Government policy and the requirements of the private sector is likely to be increased. This is the age of the "mixed economy" (even the economy of the United States should be so described) and, for this type of economy to operate with maximum fluency, it is inevitable that there should be continuous and flexible planning with the maximum possible consultation between the public and private sectors.

Nor are the pressures always in the same direction. Sometimes, it is the social priorities that may be placed in jeopardy. For example, it may be argued that Japan will soon be obliged to take appropriate measures to assist the authorities to secure adequate funds for public investment and this contrasts strongly with the situation in France, where the authorities actively operate a "*calendrier*" or queue, which whatever their protestations does seem to favour public rather than private investment.

There is another aspect of this problem that relates much less, if at all, to matters of social priority and where activities in the public sector are much more nearly analogous to the operations of private industry. Indeed, sometimes it is a matter of historical accident whether an industrial concern is privately-owned or has become a nationalised or quasi-nationalised undertaking. Thus, in France, a large automobile manufacturing enterprise like Renault is State-owned; and, despite some de-nationalisation, Volkswagen is still largely owned by the State in Western Germany. But in both these

cases, the concerns are run strictly as commercial enterprises and in effect are part of the private sector. In Italy, IRI, which again owes its origin to an accident of history (viz., the Great Depression of the 1930s), operates as the holding company and agency for managing much of the sector of industry that is government-controlled. In this case, IRI enjoys virtually the power of a government agency when it goes to the capital market, though the concerns that it controls are operated almost entirely on strictly commercial lines. For the most part, the history and the consequence is similar in Austria, where the Creditanstalt, a nationalised bank, largely owns the major concerns in important sectors of industry.

When it comes to the large public utilities, and especially the big users of capital — gas (whether natural or manufactured), electricity, and (in Italy) petroleum — there can be little doubt that, however they are financed, they compete directly with private industry for the scarce resources available and from a position of considerable strength, with the inevitable result that rates and yields are pushed up to levels higher than would otherwise have obtained. Even the operation of a queue will not wholly avoid this. The strict rationing of private sector issues, where this occurs, will only drive these borrowers into the tertiary and more expensive markets that lie beyond the boundaries of official regulation.

On the other hand, the nationalised industries can go to the market with a new issue of bonds that is backed by a Government guarantee; in some cases, they derive sizeable financial resources from direct government subvention (the Government itself either borrowing in the market or providing itself with funds by imposing compulsory saving through the agency of a budget surplus on current account); or they may (as in the case of electricity generation in the United Kingdom) adopt a pricing policy calculated to raise profits to higher levels as a means of increasing significantly the absolute amounts of capital investment financed from internal sources. "The industry believes, however, that consumers will endorse the decision to improve the reliability of electricity supply, and will accept that security is worth paying for" (9). It is possible

(9) See *The Electricity Council - Annual Report and Accounts 1963-64*, (H. M. Stationery Office, 1964), page 7. As indicated in the same Report (at pages 6-8), the objective agreed with the Government (in accordance with the White Paper on "The Financial and

that a proportion of the corporate saving drawn off in this way may be effected fairly painlessly, but its direct investment in expanding the capacity of electricity generation still represents effective competition for scarce resources and must have its repercussions in the private sector. In addition, the consumer is very often another industry and higher tariffs have the effect of driving up its costs. Either they can pass this on to the final consumer in higher prices, or they may absorb it wholly or in part by squeezing their own profit margin (in which case, their capacity to self-finance will be reduced). Moreover, the position is essentially similar whether the consuming industries are in the private sector or are nationalised (like British Rail) and it could be argued that use of "monopoly power" for the purpose of building up a profit surplus out of which to self-finance a large part of a major capital expenditure must result in some distortion of the structure of prices in the economy as a whole. There is therefore a case not only for incorporating the proposed expenditures of all the more important public utilities in a national capital budget, within the framework of a National Plan, but also for allocating a realistic order of priorities as a means of relating the several categories of demand to the resources that are likely to become available over time. In this context, the organisation of some form of queue is an important ingredient, but it is something that should not be left to the authorities alone. If regular direct consultation with private interests proves not to be practicable, there is something to be said for instituting co-ordinating machinery that is representative of both official and private interests.

Economic Obligations of the Nationalised Industries") was that "the electricity supply industry as a whole would earn a gross return of 12.4 per cent in the five years to March 1967".

"Since the objectives were first agreed, the estimate of capital requirements over the quinquennium... has risen from £2,035 million to £2,830 million. Whereas it was planned to secure £1,150 million of the original sum out of revenue from electricity charges to consumers, and to borrow £885 million, now £1,270 million will have to come from revenue, leaving £1,560 million to be borrowed.

"... To meet the industry's financial obligations, the average level of Balance of Revenue to be earned in the remaining years of the quinquennium must be substantially higher than the average achieved in the first two years". Nevertheless, price increases in electricity had to be seen in perspective (they had gone up significantly less than other prices) and there was every determination that "electricity shall remain a keenly competitive source of power".

Relations with Foreign Capital Markets

This raises a related problem, though not one to which it is possible here to devote very much space. To take Norway as an example, one of the country's main problems is to ensure that she can maintain access to foreign capital markets (e.g. to help finance her purchases of shipping and of materials for certain of her other large industrial complexes). Clearly, it is a big disadvantage to be so dependent on capital markets elsewhere. In the case of the Netherlands, the situation is rather easier, since several of her large concerns have virtually become international companies — similarly in Belgium — and these companies, being international, enjoy ready access to the world's major capital markets. The reverse has been true of Austria and — at times — of both Switzerland and Western Germany; on occasion, both the volume and the rate of inflow of capital have been embarrassing. It would seem that, both as a means of protecting "minority" interests (e.g. Norway) and of tapping the excess funds that flow into economies like Switzerland and Austria, the case for international regulation of capital flows, at least within the European complex of markets, is overwhelming. An extension of the existing co-ordinating machinery has also become increasingly urgent because of the growing number of foreign issues that are being made on the capital markets of Europe by United States corporations operating through subsidiaries (10).

III. The Special Problems of Small and Medium-sized Enterprises

Special attention will be given in this section to some of the problems that face the small- and medium-sized firms, though it must be emphasized that the concept of what is "small" or "medium-sized" can vary a great deal between different countries. There is no need to labour further the problems of definition, except to say that where the small enterprises are based virtually on handicraft

(10) In their defence, the Americans would argue that the subsidiaries have an interest which is essentially similar to that of the "indigenous" firms; they are just as much concerned to assist in the expansion of the local economy as the Europeans (e.g. by ploughing back profits). Yet, despite the sometimes significant inflows of capital experienced by certain of these countries, it remains true that the additional demands being made on European capital markets by American subsidiaries have at times resulted in a sizeable increase in the pressures on domestic resources in the countries concerned.

activities, the related financial problem may be rather different (and require separate treatment) (11) from that confronting a small industrial enterprise that already possesses a built-in potential to grow to medium-size and, in economies where the average size of enterprise is truly small, much of what follows (though not all) will relate more particularly to medium-sized firms.

The main economic reason why so much attention continues to be paid to the problems of the small- and medium-sized firms is their relative aggregate importance, especially in economies that are still moving towards a more highly industrialised society. Even in countries that have already carried their industrialisation — and, often, the concentration of industrial control — to considerable lengths, in total, the smaller enterprises still represent an important sector of the economy and this is not infrequently reinforced by frankly political considerations.

But the problem is likely to be more acute in societies where, in terms of numbers and aggregate business done, the small enterprise is a highly important ingredient in the industrial structure — for example, in Italy and Greece, Denmark and Norway. Indeed, in such societies, economic and political factors can become very much intertwined. In the highly industrialised countries, one might argue that the available resources will be utilised more economically if they are allocated to the more efficient and enterprising firms and that it is economically desirable to force out the weak and the inefficient. That may be an acceptable policy in a highly industrialised country. It is a completely unacceptable doctrine — politically and, in the short run, economically — in a developing country, where it is not only necessary to "create" employment but even to maintain it. In Italy, for example, there is a lot of under-employed manpower to be absorbed. At the same time, greater investment often leads to a reduction in the number of men required by particular firms. It is only in the longer run, as a result of general economic expansion, that the problem of absorbing displaced manpower begins to become more manageable.

In other contexts (e.g. the Netherlands, Belgium, and Switzerland, where concerns of international importance are based), the

(11) Such as a special institution to provide a large number of small loans, often at subsidised rates, though the advisory services referred to below have a general relevance and may (in this case) usefully be linked with the provision of finance.

problem of the medium-sized firm, if anything, tends to become increasingly important; likewise in Sweden, where a surprisingly large part of the total number of firms is still small-sized and where there are relatively few really large corporations, which tend to go on getting bigger.

The difficulties experienced by the smaller enterprises may be due to a number of factors. Usually, such concerns satisfy their requirements largely by borrowing from the commercial banks. Nevertheless, sometimes, as in Denmark, with many small banks (especially in the provinces), medium-sized industrial firms experience considerable difficulty in securing access to the resources they require because they are obliged to depend largely on local banks (the details of banking structure are as relevant as those that relate to industrial and economic structure and even the sharing of loans by small banks with bigger banks as in Denmark, Norway and the United States only partially resolves the problem). Moreover, in many countries at times of credit restriction, the smaller firms appear to suffer most, mainly because they tend to fall outside the priority classifications; they also find it more difficult to tap such alternative sources of supply as remain (e.g., the larger undertakings usually find it easier to insist on the maintenance of trade credit). Even where special facilities exist to help finance small- and medium-sized firms (as indeed they do in almost all countries), they are often (in the words of a witness giving evidence before the United Kingdom Radcliffe Committee enquiry) "miscellaneous, dispersed, and not very obvious to the industrialist or his advisers".

The essence of the problem in the context of a developing capital market is that such firms — even those that are medium-sized — are often still insufficiently large to go to the capital market with an issue of industrial bonds or shares. There are two aspects to this: (a) the firm concerned is too little-known to attract sufficient interest from potential subscribers and, in these circumstances, the issue could have little chance of success; and (b) there are certain minimum costs (fees, taxes, commissions, promotional expenditure), which postulate a certain minimum size of issue if the terms on which money is to be raised are to be economic. Moreover, if a firm is relatively unknown, the costs of promotion (i.e. of making it better known) are likely to be prohibitive and, if they were to be incurred, would raise total costs well above the minimum.

Even when the medium-sized firm becomes sufficiently large to approach the market with a good chance of making a successful issue, the owner-management is often extremely reluctant to do so, fearing loss of "independence" and freedom of manoeuvre. When there is a willingness to accept assistance, there is almost always a strong disinclination to make an equity issue or to accept a "participation" on the basis of an option that will give an "outsider" a subsequent share in the equity. There is an inbuilt conservatism that has to be overcome. There are, too, fiscal reasons for preferring debt to equity finance, but the attempt could be made to discourage this preference by fiscal experiment (as in Norway). Finally, this conservatism is reinforced by the desire for privacy and a reluctance sometimes to publish information relating to trading results.

Another reason why this represents a considerable problem is the rarity with which an individual can, in these days of fiscal severity, himself build up by sheer enterprise and competent management a small family business until it can hold its own with the established giants. It does sometimes happen, but very rarely and never without external assistance (12). If one wants to develop quickly, one must secure access to outside funds; if self-financing alone is depended upon, growth is likely to be rather slow. The problem arises because it is not infrequently these smaller to medium-sized firms that are the most enterprising and that are willing to experiment with innovations, some of which may pay off quite spectacularly, though these will doubtless be offset by a considerable number of failures.

Usually, the small firm will be obliged to depend on assistance either from the banks or specialist financial intermediaries. If these are unable or unwilling to help, all the small man can do to ensure that his innovation is developed and put on to the market is to bring in other partners (by way of a capital participation), in which case there is some loss of "independence"; or sell the rights to the patent to a larger concern; or sell out completely to a bigger business, hoping to participate to some extent in its management (it is rare for the last arrangement to work out at all happily). The difficulty is that as concerns become increasingly large, enterprise tends to

(12) Sometimes, small firms fail to grow because the owners themselves draw too much out of the business and make insufficient effort to add to their capital.

atrophy and, even when new ideas are fed into such an organisation, it is often slow to seize its opportunities.

A further cause of difficulty for the smaller and medium-sized firms may be the pace of technological change in a modern economy, i.e. as a result of other people's innovations the rate of obsolescence is materially higher and it becomes necessary — if one is to remain competitive — to replace machinery rather more frequently. This requires finance and, again, it is likely to hit the small man much harder than his larger counterpart. The big firm tends to invest more continuously and has a large and relatively steady (often growing) flow of cash coming in (deriving ultimately from profits and depreciation allowances); the small firm tends to make block investments in machinery at somewhat irregular intervals and the flow-back of cash is also less regular. Sudden obsolescence (as the result of the unexpected emergence of a revolutionary new process) could quickly place the small man in a quite uncompetitive position, even put him out of business.

Despite all the alleged difficulties, it is frequently maintained (in most countries) that the vast majority (if not all) of creditworthy firms (whatever their size) will be adequately catered for, provided they themselves have a reasonable equity in the business and can offer reasonable security. The provisos are important, because it is in this context that the banks and other financial institutions are sometimes too conservative. On the other hand, there are banks which, after careful scrutiny of a balance sheet and some enquiry as to the market possibilities of the final product, contribute materially to the success of the borrowing operation by examining sympathetically the whole question of security in the broadest possible terms, so that whatever security is available will be harnessed to its fullest potential capacity for the purpose of providing a basis for a loan (13). Such banks will also advise on the various other, often official or quasi-official, sources that might be tapped with a view to supplementing whatever the bank is able to provide. While it is true that a man with technical expertise may have no head for business, it is also true that, unless a man has security to offer and

(13) For example, banks may accept a mortgage (not infrequently a second mortgage) as their basic security; this might be supported by a personal guarantee, or a banker's lien (or its equivalent) whenever the customer has other pledgeable assets (such as bonds or other financial securities).

can obtain access to finance, he may never get the chance to develop a good technical idea.

Hence, the nagging suspicion remains that there is a "gap". Nevertheless, there is also a suspicion that in some cases too much credit is being made available to small and inefficient businesses and that this finance could be put to very much better use by larger, more progressive, and more efficient firms. Countries in which possibly too large a share of total resources is being devoted to support small and largely inefficient enterprises include the United States, Sweden, and Italy (14).

When one comes to consider solutions to these problems, the several possibilities resolve themselves into *self-help* (e.g. self-financing, which for many concerns is their only real basis of growth, or — in order to get access to the products of large-scale research that would otherwise be beyond their own means — manufacturing under licence, i.e. buying know-how) (15); *external help* (so far largely financial help by banks and specialist financial institutions; it will be argued that in many ways a much more positive approach might be to develop a range of advisory services); and *fiscal incentives* to encourage modifications to and a strengthening of the financial and industrial structure of such firms. It will be apparent that at all times there should be a close relationship between the amount of external help that might be provided and the willingness of the relevant concern actively to help itself. One might add that, in the case of all medium-sized companies enjoying a fair rate of growth, they do eventually get to the stage where they can (if they so wish) readily obtain a public listing and make an issue of shares through the agency of the stock exchange.

Where a family business, in terms of size and growth potential, is "ready" to go to the market but reluctant either to make its affairs too public or to sacrifice its "independence" by sharing its equity with a large number of shareholders, a middle path might be found, in order to assist its continued growth, by resorting to a much greater extent to the "private placement". This technique is used a great deal by large businesses (e.g. funds are often made available in this way in the United States and the United Kingdom

(14) But note the "creation of employment" argument referred to earlier.

(15) Enterprising firms both in developing and in highly industrialised countries already do this.

by insurance companies and pension funds); more use might be made of it in the context of medium-sized business. In some countries (e.g. the Netherlands), it is probably the only way of helping the private unquoted companies.

Although it is perhaps a little unrealistic to expect the development of an active "secondary" market in such "private placements" (16), there are enthusiasts who believe not only that such a "secondary" market is possible but that it is desirable as a means of making the capital market as a whole broader and more active.

Commercial banks likewise can help, especially the smaller men, with "term loans" of five to ten years, as has long been the case in the United States and, by means of their medium-term credit procedures, in France. It has also been experimented with in Belgium and, more recently, in the United Kingdom and Sweden. Nor must one forget that so far as the small man is concerned the activities of the commercial banks are supplemented in many European countries by *banques populaires* or their equivalent, and sometimes by savings bank lending. So far as the commercial banks are concerned, there is clear evidence that in a number of countries they are now much less conservative in this matter than they were (say) ten years ago. Some will even help in financing an innovation, if it seems to be a good risk. Always a banker will regard management (or the man) and his market as more important than the security. However, even where "term loans" are employed, the banker can only help in the relatively short run and very soon a "ceiling" will develop beyond which he is unwilling to go — the amount of debt in relation to equity imposes the ultimate limit. In these circumstances, the banker will usually advise that the borrower attempt to find a wealthy backer (outside the banking system) and may even assist in finding one. Nevertheless, not infrequently at this stage, the only effective solution is to be taken over by a larger company.

For short- to medium-term supplementary assistance (e.g. to purchase a fleet of lorries, or certain types of other equipment), the smaller firms may employ some of the newer facilities now being

(16) It would be necessary to establish publicly the reputation of the borrower and the strength of his security, since if ownership of the "private placement" changes hands, so must the security (e.g. a mortgage, guarantee, or pledge of bonds); immediately, this would invade the very "privacy" the borrower is anxious to protect.

offered in a widening range of countries (though in many very experimentally at this stage). For example, industrial equipment may be purchased on the basis of a hire purchase (instalment credit) contract. Leasing is another technique meeting a similar need. It is a means of expanding operations, turnover and profits, while financing the necessary investments on a "pay as you go" principle. But it is an expensive way of raising finance and it is only appropriate to resort to it for marginal (i.e. supplementary) requirements. Likewise with factoring, which is a means of keeping one's available working capital more fully employed (virtually by selling one's accounts receivable to a factor who then takes over the task — and risks — of collection; in this way, the small man can disengage his working capital and re-employ it quickly, but again these facilities are expensive).

Against this background, it is not difficult to see why the authorities in many countries have sought to set up specialist financial institutions to serve the needs of the smaller firms, whether by medium- and long-term loans, or by means of "bridging operations" and an ultimate approach to the new issues market. Alternatively, the smaller and medium-sized firms might be formed into *groupements* in order to make a collective approach to the market.

If, in particular cases, specialist institutions are not yet in existence, their early establishment is certainly being actively considered; where the relevant funds are felt to be less than adequate (e.g. Norway), attempts are being made to secure supplementary resources. Usually, these institutions operate partly on the basis of their own capital, partly by themselves going to the market (sometimes on the basis of an official guarantee) with an issue of bonds and thereby obtaining the advantages of size and of acceptable security. Clearly, there is a continuing need for such institutions — to fill the MacMillan-type "gap" — and these might be developed further but, with some minor exceptions, little advantage could be served by their proliferation.

One problem that can be especially worrying to the small family business is the inability to finance growth (largely by ploughing back profits) and also to provide for the fiscal burden of estate and inheritance taxes, when the head of the firm dies. On occasion, the incidence of the tax can be avoided, but in countries with sophisticated machinery for tax collection this becomes increasingly difficult. If a family business wishes to remain "independent" and

is to avoid having to sell out to a larger firm (or, as in Sweden, to an "investment promotion company"), it will need help and this could be provided by the EDITH type of institution as set up in the United Kingdom (17). Usually, the technique is for the institution to purchase a part of the equity, the relevant moneys being paid over in satisfaction of the duties levied by the tax authorities. In principle, it is usually open to the family business to repurchase its equity at a later date, but it is understood that this rarely happens. Nevertheless, these facilities do offer such businesses the means of retaining their identity and continuity of operation.

Under the heading of external assistance, it remains to consider the variety of advisory services that might be offered with advantage to the smaller and even medium-sized businesses. As a result of his enquiries in the field, the author is convinced that in many cases the major need of such firms is not finance but *advice*. This may take a number of forms. If the small man is technically competent, he may require help on the management and accounting side (the business consultant can assist directly in these matters). Even if the small man is technically competent — *a fortiori* if he is technically-minded — he can be considerably assisted by being advised (e.g. by an industrial specialist or engineer consultant) of the latest technological developments and how they might best be implemented, within his own particular industrial environment. (It may be a question of several firms pooling their resources in order to utilise to full capacity the services of particularly expensive items of equipment or "hardware" — e.g. a computer) (18). There is a need here for an "industrial extension service" somewhat similar to that provided in many countries for the farmers. In the financial field, advice might be sought on where finance is to be found (19), where the best terms are likely to be on offer, and what — in particular circumstances — are likely to be the best methods or techniques to employ. In this context, it would certainly be more economic to provide this range of advisory services through the agency of a

(17) Estate Duties Investment Trust Limited; similar facilities are also offered by several other institutions.

(18) The possibilities of centralised buying and selling — e.g. in the grocery trade — might likewise be explored and implemented in much the same way.

(19) In the United Kingdom, a handbook entitled *Financing Your Business* has recently been prepared on behalf of the Engineering Industries Association setting out in detail all the possible sources of finance that might be employed in developing a business.

single large Industries Advice Bureau (or Institute) and this might be established on a co-operative basis or with official or semi-official sponsorship. All the progressive small firms want is equality of opportunity, *not* a privileged position or subsidy. No doubt, many small businessmen would remain unwilling to accept advice even when it was freely offered and advisory services would clearly need to be supplemented by a concerted educational campaign as well.

Finally, on the fiscal front, there are two possible objectives: tax concessions to encourage (a) the building up of the equity interest in the smaller and medium-sized firms and (b) the financial reconstruction and merging of small firms into larger and medium-sized firms, so that they become capable of securing at least some of the economies of scale. There is a developing interest in both these fields (e.g. in Norway and Greece, and the "merger solution" for small firms has recently been discussed in the Netherlands) (20). For example, a flat rate (say 30 per cent) of tax on dividends, which would then not have to be included in the income tax submission, would be a direct means of tempting into equity participation the "wealthy backer" so essential to development from small to larger medium-sized. Once firms have been brought to that level (and assuming they wish to "go public"), tax concessions that will place new equity financing on much the same basis as bond and debt financing (as in Norway) could be the means of establishing and maintaining a better "gearing" between equity and debt than often obtains in European countries. Under the second head, finance provided to assist in the consummation of small firm mergers might be similarly treated — whether the income earned on such financial provision took the form of interest or dividend. In both cases, no doubt the authorities would wish to apply limits to the concessions offered (this is so in Norway) and, in Greece, possible limits that have been discussed include tax exemptions for up to ten years on dividends that do not exceed (say) ten per cent, with a six year and a 6 per cent limit where the objective is financial re-organization and merger. (For socio-political reasons, one could not tax-exempt dividends altogether, especially in countries where bonds and savings bank deposits are the major forms of financial investment and where shares tend to be held by the very wealthy or "capitalist" class. In due course, however, one would expect a more diversified structure

(20) See Professor D. Koolen, as quoted in *The Times* (London), 22-3-66.

of financial assets to develop, by which time the tax concessions may no longer be necessary).

Meanwhile, the wider distribution of equity holdings might in any event be encouraged by insisting on the observance of certain "rules" before a tax exemption would be conceded — e.g. 25 per cent or more of the share capital in a concern to be held by at least 50 shareholders; in addition, a minimum-sized capital might be required before a firm would be permitted to qualify for such tax exemption. But by fiscal inducements it should be possible to provide a basis for a radical and wide-ranging re-organisation of the financial and industrial structure of the smaller firms in a number of countries.

IV. Means of Developing a Broader and More Active Capital Market

What, finally, are the means of developing a broader and more active capital market? It will be sufficient in this article to concentrate on the domestic aspects of the problem; the author has already attempted to deal elsewhere with some of the complications of internationalisation (21).

In general terms, it is probably true to say that the range and scope of the facilities offered by the financial intermediaries in most countries are adequate to meet the more obvious needs. In a number of cases, the existing institutions could no doubt be used more intensively and not always do their potential customers appear to realise what facilities are already on offer. To overcome what is often no more than a paucity of information should be a relatively simple matter. More effort must be put into the development of

(21) See J. S. G. WILSON, "The Internationalisation of Capital Markets", *The Three Banks Review*, June 1964. Quite apart from normal business and political risks, some of the obstacles to greater integration of capital markets include the existence of different national currencies; sometimes, the fixity (rather than the possible instability) of their exchange rates; limitations on the freedom to transfer capital to (and therefore to invest in) other countries; fiscal differences (not only in the level of taxation but also in its structure); variations in legal requirements (especially in the field of company law) and ignorance of what is required; the tendency for existing price rigidities to become imbedded and therefore difficult to shift (internationalisation implies greater all-round price flexibility); the lack of co-ordination in economic and monetary policies; the existence of vested interests (of all kinds); and so on. All of these will impede the shiftability of funds, and on the freedom to move funds from one country to another without excessive cost the possibilities of integrating capital markets must ultimately depend.

educational and advisory services (and especially the latter), so that firms large and small become better acquainted with what is available and the several ways in which these facilities might be employed. In certain cases, it may be necessary to supplement the resources of particular institutions (e.g. by increasing their capital provision or by raising their borrowing limits, so that they can attract additional funds by issuing bonds on the open market). Only occasionally should it be necessary to establish a new institution; usually, a "gap" can just as readily be filled by extending (or adapting) the functions of an institution already operating in a related field (and much more economically, since it avoids the unnecessary proliferation of overheads; these will increase to some extent, but not in proportion). The potentialities of this approach have been repeatedly illustrated by developments over recent years in the merchant, commercial, and private banking fields, where there has been much evidence of enterprise, new initiatives, and the introduction of more flexible policies and procedures. For the rest, it is primarily a question of increasing the size and the activity of the several types of markets in securities.

If we are to develop broader and more active capital markets, it will be necessary to achieve two things: (a) to break down the conservatism both of potential market borrowers and of investors; and (b) over the longer run, to provide a range of facilities as nearly as possible calculated to satisfy the requirements of both sides of the market. These objectives are intimately inter-related; so, too, must be the solutions. Educational propaganda may assist in breaking down the conservatism, but the parties must also be tempted into the market by the facilities on offer. There must be a willingness to experiment on both sides of the market. As already indicated, this need not mean the endless proliferation of new institutions. What it does postulate is an emphasis on more flexible policies and the encouragement of institutions that will favour their adoption.

Many of the problems of "capital users" derive quite directly from excessively conservative attitudes. For example, in family firms, there is often a disinclination to "go public", or, if formally a public company, to place new issues of shares on the open market for fear of losing control over policy and sacrificing "independence" — even if they have to forgo growth in the process. The emphasis therefore tends to be on self-financing or on debt finance (often by borrowing from the banks, or — if the market is approached —

by offering only industrial bonds or debentures to the public). Clearly, there are limits to the possibilities of financing by the creation of debt — this is the problem of maintaining a correct “gearing” between total debt and the equity interest of the shareholders. There are also dangers — over-dependence on borrowed moneys is the surest way of losing control over policy decisions, unless one can successfully sustain such a rapid rate of growth that profits will provide a sufficiently regular generation of cash virtually to convert the debt component in the financing programme into a revolving fund. In this way, a measure of independence can be retained. Moreover, this disinclination to share responsibility for policy by making available new issues of shares to the general public (and the conservative attitudes it reflects) is, by no means confined to the smaller and medium-sized businesses. It is also true of some of the largest industrial complexes in Europe, the capital in which is often very tightly held. Indeed, there is sometimes a single large shareholder (22), who (with the assistance of members of his family) can dominate a company’s policies and, in particular, its willingness to make equity issues. Furthermore, and in the more general case, whenever new issues of shares are launched, the offer is usually made in the first instance to existing shareholders and, although there is a market in “share rights”, the tendency is for the existing shareholders not to sell, but themselves to exercise those rights. As a result, the equity capital continues to be tightly held and, in consequence, activity in the market for shares is rather less than it would otherwise be.

Yet the conservatism is by no means one-sided. Even if the issues were available for purchase on the open market, it is questionable in some countries whether there would be a demand for them from the investing public. Here the conservatism tends to operate more strongly in the context of equities than for industrial bonds or debentures. Where this is so, the attempt is often made — sometimes successfully — to build a bridge between debt and equity financing by issuing “convertible bonds” (23). But the basic difficulties are (a) the continued preference of many private investors for highly

(22) In some cases, large businesses are still owned by a single individual. It requires more than enterprise or salesmanship before his financial advisers are likely successfully to persuade him to “go public”.

(23) Note that these may *not* legally be issued in the Scandinavian countries.

liquid earning assets, such as savings bank deposits; and (b) the disinclination, even of institutional investors in some countries, to invest more heavily in equities, sometimes in industrial bonds. The remedy for the first would seem to be a concerted programme of educational propaganda (in collaboration with the stock exchanges and the whole range of financial institutions) and an increase in the number of securities that are offered in relatively small unit amounts; and, for the second, propaganda, fiscal encouragement, and (in some cases) permissive legislation with a view to a progressive increase in the proportion of equities (and industrial bonds) held — albeit up to a specified limit — by institutional investors (such as insurance companies, pension funds, and savings banks) (24) in their investment portfolios. (Permissive legislation would seem to be much more likely to produce long-term improvements in market activity than any attempt at compulsion). Further, if greater institutional investment interest is to be maintained, it will be necessary to develop a “secondary market” in securities. Institutions (even those like insurance companies with an appetite for long-term investments) will not readily hold large quantities of securities (especially types they might still consider somewhat experimental), unless they can feel fairly certain that such securities are saleable on a regular basis in a market, where the level of activity is such that the risk of substantial loss is minimised. In other words, there must be a “secondary market” to ensure ultimate liquidity. Further reference will be made to this matter below.

What next are the institutional changes most likely to assist in broadening a capital market and creating an environment within which an increase in turnover is probable? As already indicated, the main objective here is to provide a range of facilities that will, as far as possible, satisfy the requirements of both sides of the market.

On the supply side of the market, i.e. the offer of securities for purchase, what seems to be required is not merely a *greater volume* of new issues but also a *wider range* of types of securities. To a not inconsiderable extent, the achievement of both kinds of objective would be assisted by greater resort to institutions like the

(24) In some countries (e.g. Western Germany), the authorities would prefer to persuade *individuals* to buy (and hold) more shares. If anything, they would wish to see the market influence exerted by institutional investors somewhat diminished.

French *banques d'affaires*, the British Industrial and Commercial Finance Corporation and similar private organisations, whose functions are at least partially pump-priming in character, with a view to "creating" in due course a supply of new marketable securities, a proportion of which they will endeavour to float off to the public by direct sale through the banking system or on the open market. To be more specific, the process of "creating" new securities would begin with an interim loan; then, when the details of a project's requirements had been firmed up, this might be converted into a "participation"; eventually, when the investment had had a chance to demonstrate its profitability, permission might be sought from the authorities to convert the participation into a marketable security by making an issue of shares — from the proceeds of which the original participation could be liquidated, so that the process could begin all over again. Where these "pump-priming" institutions exist already, greater use might be made of them (e.g. of the *banque d'affaires* in France, or in Italy of *Medio-banca*) and a larger number of similar institutions be established in order to encourage greater competition and flexibility of approach; in countries where they do not exist, there is a case for considering the adoption of similar techniques and the establishment of appropriate institutions, albeit with some modification to accord with local requirements. Two very important respects in which such institutions could assist in broadening the market and, directly or indirectly (25), in serving to develop the demand for shares by individual members of the general public would be (a) by encouraging more medium-sized businesses to "go public", thereby greatly enlarging the *number* of shares listed on the several stock exchanges; and (b) by ensuring that the *individual share units* that are issued are relatively *small in amount*, so that the modest investor will be able to spread his purchases (if he so desires) over a relatively wide field (this would be an advantage whether the institution handling the new issue were acting for a large established corporation or for a medium-sized business "going public" for the first time; in the latter case, in order to create the basis of a more attractive security, two or more related businesses of medium size might be merged to form a larger

(25) E.g., indirectly through the medium of unit trusts.

company). For the rest, what the investing public presumably wants is a wider *range* of maturities (which, incidentally, may also be one means of trying to fill the "shifting temporal gap" referred to earlier), plus greater flexibility in the terms offered (primarily, this amounts to the related rates and yields, but — as any market man will confirm — subtle manipulation of the precise content of the issuing terms themselves is also often a highly successful means of persuading people to buy; if official regulation prevents this, this is a barrier that may have to be removed).

Basically, there are only three types of marketable securities that can be issued to the general public — shares, bonds (or debentures), and convertible bonds — but there is considerable room for experiment in offering a variety of maturities and related terms of issue; in addition, much more use might be made of the convertible bond and of issues (whether of shares or bonds) made up of smaller individual units. When it comes to institutional investors, the scope is wider. For example, more emphasis might be put on private placements (as in the United States and the United Kingdom), whereby debt issues are taken up directly by the ultimate lenders (e.g. the insurance companies and the pension funds). Term loans, though they are not evidenced in bond form, are somewhat similar, in that they represent a security that is virtually non-marketable but which does cater for an institutional demand and especially for the investor who is looking for a security with a definite date of maturity, which fits in with his own schedule of projected out-payments (as in the case of an insurance company or pension fund).

In considering the relative attractiveness of bonds and shares, the fiscal advantages usually enjoyed by the former tend to be a major consideration and this helps to explain why it has often been so difficult to encourage a growth in equity investment and greater activity in share transactions on the stock exchange. In this context, the Norwegian fiscal experiment might be studied with advantage — for a period of seven years (and subject to certain conditions) companies are allowed a deduction for the purpose of company tax (as they would with interest on a bond) in respect of dividends up to 5 per cent distributed on new share capital issued, thereby making it as attractive to raise capital by issuing shares as by issuing bonds, with the advantage that resources obtained by issuing shares are in the character of risk capital and permanently available to the company concerned.

Share issues might also become a more attractive investment in certain countries if less was ploughed back by way of self-finance (26) or the building up of "hidden reserves" and a higher proportion of profits was distributed as dividends. In any event, where the creation of hidden reserves is common practice (as in Western Germany), company accounts fail to reflect, even approximately, the results of a company's operations and the paucity of information made available can greatly impede any approach that might eventually be made to the market. Indeed, this is part of a much wider problem and fuller, more accurate information in connection with corporate results would certainly assist sound and well-managed companies to make greater use of the resources that can already be tapped through the agency of the capital market.

Having considered in general terms some of the factors that might affect the supply of securities, it is appropriate now to turn to the demand side of the equation. If we can assume that a reasonably attractive range of securities is on offer in the markets, how might we expect to encourage greater activity on the demand side? There would seem to be two possible approaches: (a) to stimulate an increased demand for securities both by the general public and by the institutional investors; and (b) to develop (where necessary) an active "secondary market", so that securities can be readily bought and sold, and in some volume.

In countries like the United Kingdom and the United States, where a proportion of the general public is already accustomed to hold part of its wealth in a wide range of earning assets (27) includ-

(26) This is not a view that is universally held. For example, in France, Italy, and Japan, it is felt there is a need to place even greater emphasis than at present on the necessity for self-financing and that this might well be encouraged by fiscal means. This may be true, but to the extent that firms are able to secure investible funds from internal sources, they are less likely to resort to public issues and this must hamper the development of the bond and share markets. On the other hand, many firms (e.g. in Japan) have become overdependent on the banks and, if a proportion of these credits could be consolidated as long-term debt by conversion into bonds, this would be a means of developing a greater supply of bonds. Although the overall debt/equity ratio of a firm would remain unaffected, the position of the borrower would certainly become much less vulnerable.

(27) In the United Kingdom, this would certainly be true of the so-called "middle classes", but in the United States this tends to be true only of the wealthier investor; it was also true in the United States that individuals were by far the largest holders of shares (only the very wealthy would tend to hold bonds and then mainly tax-exempt "municipals", because corporate bonds are usually issued in units of such large amounts); the small saver in the United States (as elsewhere) tends to favour placing his funds with the intermediaries

ing marketable securities (and even subscribes directly to new issues), the further broadening of this demand might be achieved by increased advertising and educational propaganda. But even in sophisticated environments, an additional means of interesting the small and conservative saver in more direct investment in industry (especially equity investment) is by setting up "unit investment trusts" (or "open-ended" investment trusts). By this means — and especially when their operations are linked to a contractual saving plan (as is the case in a number of instances in the United Kingdom) — the small saver, who might normally have thought of a savings bank, building society, or savings and loan association, can be encouraged to place his savings in "units" that can be redeemed if he so desires, but which through the unit trust (so long as he continues to hold his units) give him an indirect interest in industrial investment (including equities, and therefore a hedge against inflation), plus a spread of risks that in a well-run unit trust also gives him a reasonable degree of protection against sudden loss of income and/or capital. In other words, he enjoys the benefits of investment decisions made by a sophisticated professional management, holds a security with a reasonably high degree of liquidity and, depending upon his choice of unit trust, with some built-in safety as well (28). Indeed, this can be so even though the number of securities quoted on his local stock exchanges is quite limited, since unit trusts (provided the authorities are agreeable) can readily invest a proportion of their funds in the securities of well-established foreign concerns; many of them do so and thereby assist (if only in a small way) the integration of the several national capital markets into a larger whole.

Stimulating interest in the unit trust movement would seem to be an excellent way of inducing a conservative public to invest more adventurously and, even if indirectly, in industrial equities. Moreover, if a little "pump-priming" is necessary in setting up such unit trusts, there is a strong case, if not for a State unit trust, at least for a major unit trust sponsored by the leading commercial banks

(the savings banks, savings and loan associations, insurance companies, and pension funds) and they are primarily concerned with debt financing, including the purchase of corporate bonds (the small saver may indirectly purchase shares through a unit or investment trust).

(28) How best to guard the interests of investors in unit trusts has recently (though not for the first time) been the subject of some discussion in the United Kingdom. (See "Giving Protection to Unitholders", *The Times*, London, 30-4-66).

in a country; nor need they fear unduly the indirect competition for savings, which might be thought to hamper the expansion of their own traditional business of lending to industry at short-term, since the probability is that development of a unit trust movement will result in eliciting additional savings both from old and new sources. In the longer run, the operations of these institutions are likely to be supplementary rather than competitive. Indeed, there is already evidence that the idea is catching on. Besides broadening the market and assisting in the absorption of new issues, it is also a means of developing greater market activity, since a unit trust — whether seeking income and/or growth — will necessarily re-shuffle its portfolio from time to time and by buying and selling will operate to increase the total turnover on the stock exchange.

In a number of the countries surveyed, there has been a great dearth of institutional investors (29) — no further reference will be made to the unit trusts in this context, but they likewise can be so classified. Insurance companies and pension funds, in particular, often seem to be quite small in comparison with United Kingdom and United States experience. Where this is due (as in Western Germany and Austria) to the existence of a good social insurance scheme, there is little prospect of encouraging any significant growth in this quarter. Again, where (as in Sweden) a National Pension Fund exists, or (as in Norway) a National Pension Scheme is being launched, this will tend to have two effects. Certainly, it will help to widen the scope of institutional demand, but it also tends to concentrate it largely in the hands of one authority (30) and this clearly has its dangers for the healthiness of the market. In addition, because of legal limitations, the Swedish Fund tends to acquire mainly the bonds issued by the larger concerns. If it were desired to favour the smaller and medium-sized businesses, the Fund might be encouraged to deposit with the banks a sizeable proportion of its moneys for re-lending to this sector. In Norway likewise, the funds will eventually become quite large in relation to the local market and this provides the managers of the scheme with a

(29) Even in the United States, it can be argued that the demand for securities by institutional investors needs to be further developed and the role of the intermediaries considerably widened.

(30) In Sweden, the National Pension Fund absorbs 40 to 50 per cent of all new issues of bonds. It is permitted to buy industrial as well as government bonds; it also makes loans to local authorities.

masse de manoeuvre capable of exerting a more than significant influence both on the prices of individual securities and on security prices in general. The managers of such funds quite apparently carry a heavy responsibility and it is difficult to conceive of their being able to formulate a policy that could in any sense be regarded as "neutral". With such a big block demand, the great danger is that the market may become "skewed"; instead of a large number of separate individual demands, there is now a semi-monopsony and rather less inter-play than previously obtained between the conditions of supply and demand. On the other hand, at times when the demand may be inclined to flag, this same semi-monopsony may become a major stabilising influence. Presumably, in matters that concern debt management, there will be regular consultations between the managers of the Fund and the central bank.

Where there is still ample scope for greater institutional investment, it may be possible to influence the ways in which insurance companies, pension funds, and savings banks invest their funds and to encourage a larger flow towards investment in industrial bonds — whether convertible or not — and in equities. The authorities, for example, might exercise a degree of moral suasion, but *not* (it is to be hoped) compulsion. For the rest, they can assist these developments by passing permissive legislation that enables such institutions (if they so desire) to invest a higher proportion of their funds in bonds and shares (by increasing the maximum permitted ratio of total investments that may be so applied, or by lifting an absolute ceiling where such exists). In this context, it is again a matter of breaking down conservative attitudes — in terms of the savings at their disposal, the purchases of securities by these institutions are often quite low and their choice of investments unadventurous and traditional.

Whether one is attempting to stimulate the private or the institutional demand for securities, a potent consideration will be the extent to which a "secondary market" in such assets already exists. Few investors are likely to want to hold securities to their ultimate maturity — or indefinitely, as the case may be — and their demand for securities will therefore tend to be enhanced if they know there is a ready market available in which they can sell for cash or (if they so desire) purchase alternative securities. This is what a "secondary market" in securities implies. It provides opportunities for shifting and the chance to convert one's assets into liquid form. If such a

market does not exist, there is a clear case for encouraging its development as a means of stimulating both market activity and, in the longer run, a growth in the demand for bonds and/or shares. Broader and more active markets in securities can only be achieved by encouraging an increase in the supply and the demand for such instruments. Action must concern itself with both sides of the market.

The development of a secondary market might be promoted in a number of ways. It is important, for example, that fiscal barriers (31) to transactions in shares and bonds, as well as fees and commissions — i.e. the costs of shifting — should be kept at minimal levels. Equally, there is a case for encouraging firms to satisfy their longer-term requirements by making new issues of securities (bonds and/or shares), with a view to reducing the amount of long-term accommodation sought from the commercial banks, which might be expected to provide primarily interim financing (including medium-term credits), leaving it to specialised institutions (like the *banques d'affaires*) to take up the "participations" that could lead, in due course, to the issue of marketable securities. In some instances, there may also be a case for opening up the capital market to a larger number of underwriters (whether these be drawn from existing institutions or from new establishments specially set up for the purpose); this would expose underwriters currently in the field to increased competition and lead to greater flexibility in terms and rates. At the same time, in the interests of maintaining a healthy market that continues to be soundly based, the authorities may feel that directly or indirectly (e.g. through a

(31) One of the dangers of a "capital gains tax", though it may have many other virtues, is that it is likely to reduce the mobility of capital transfers and to render more difficult the tasks of effective portfolio management. This type of difficulty might possibly be overcome by exempting from the tax wholly or in part the operations of certain types of financial intermediaries (e.g. banks and unit trusts) for whom portfolio management is an essential aspect of their business. It is appreciated that exemptions are always difficult to define and to apply, and the appropriate solution might well be to retain a "capital gains tax" but to keep it at moderate levels. In any event, once such an impost has been introduced, the taxed tend to adjust their policies in order to accommodate its incidence. For example, in the United States, in a year of falling markets, a bank may sell securities and take its losses. With tax rebates at 48 per cent (for banks in the highest corporation tax bracket), these losses will be much less net than gross. The funds released in this way will then be re-invested in similar securities standing below par. As the maturity date approaches, the securities will appreciate in value and when the profit is realized this will attract a capital gains tax of only 25 per cent.

specialised agency) some degree of regulation or control should be exercised over entry and they may wish to insist on some form of "prior authorisation" before freedom to operate in the capital market be accorded. In addition, the commercial banks might be obliged to work within the limits of a specified loan/deposit ratio (as a further curb on their lending activities). So far as the borrowers are concerned, they might be asked to subscribe to "guiding rules" (32) to ensure an appropriate balance between debt and equity financing, as a condition of being permitted to raise further finance by way of a bank loan and/or a bond issue. On the other hand, savers might be encouraged to invest more positively. This could be done by applying relatively low interest rate ceilings to balances in savings bank and time deposit accounts (33), the purpose being to divert such savings (say) either to the unit trusts or — whether by way of deposits or premiums — to the insurance companies, since these institutions are already geared to making a proportion of their investments through the agency of the stock exchanges. Alternatively, savings banks might be encouraged to invest a proportion of their funds in industrial bonds, if not in equities.

So far as direct private investment through the capital market is concerned, there is little one can do about shares, but, in the case of Government and semi-government bonds, the emergence of a "secondary market" could be assisted by offering higher rates (which would be even more effective if there were a ceiling on time deposit rates) and, if necessary, by fiscal concessions. For the rest, it is a matter of giving every encouragement to the institutional investors, since it is they that are most likely (in pursuit of profit) to be concerned periodically to reshuffle their portfolios and in that way

(32) These could be formulated either by the central bank as part of its general surveillance of economic, monetary and credit policy, or by a specialist semi-official institution specifically charged with responsibility for capital market transactions; where more than one official or semi-official body has responsibility in this field, there must clearly be provision for liaison and, where a national planning authority exists, this would seem to be the appropriate agency for effecting the necessary degree of co-ordination.

(33) Where this suggestion is thought to be inappropriate (e.g. in Japan, where the public's preference for time and savings deposits is very deep-rooted), presumably the only way to wean them away from such preferences is by pursuing a long-term educational propaganda programme, to which might be added the inducement of a relatively higher yield on bonds. But for this policy combination to produce effective results, it would have to be maintained over a period of years. There is no short-term solution to a problem that derives basically from established habit.

to provide the turnover that is of the essence of a "secondary market".

In summary, there can be no effective broadening of a capital market if institutions merely hold securities indefinitely in their own portfolios. One needs to develop not only an appetite for securities — by the general public and institutional investors — but also a desire periodically to buy and sell existing securities, and thereby to increase the turnover of the market, in that way fostering the emergence of a flexible and consistent structure of rates and yields. It is not a question of encouraging speculation, but of promoting the basis for informed portfolio management, such that institutions seek to hold those securities that offer either the best current returns or the best prospects of future return. In an uncertain world, not everybody can be right in their judgements, but given the fullest possible information and operational experience, there will be an increased probability that market prices will reflect the underlying real earning trends and prospects of the concerns and industries to which the securities traded in relate.

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