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THE ROLE OF CENTRAL BANKS IN THE DEVELOPMENT OF SECURITIES MARKETS

by

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The growth of a secutities market is an essential element in the economic development of countries in which investment is to be financed voluntarily from private savings. As is well known, such a market provides the machinery for the transfer of funds (either directly or with the help of financial intermediaries) from those who hold more than they need to satisfy their current requirements to those who desire additional funds, beyond what they may be able to generate internally, to finance their activities.

Logically, one would think that any securities market would develop and grow without intervention by the authorities in general or the Central Bank in particular, that those with excess funds and those desiring additional funds would seek and find each other and make the necessary arrangements for the transfer of funds, either directly or through financial intermediaries, and for the transfer in the opposite direction of securities evidencing the financial claims created by the transfer of funds, and that the profit motive would be a sufficient incentive to bring about the emergence of specialized enterprises acting as dealers and brokers in securities and generally working as market-makers to facilitate the resale of securities by their original buyers.

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This is the way that securities markets in the advanced countries have developed and grown, and it would seem that this model could be followed also in other countries.

But, many factors have interfered with this spontaneous growth of securities markets in countries where economic development in general has only recently (i.e. in the last thirty years) begun to gather momentum. Those with surplus funds have been reluctant to risk their savings in ventures fraught with uncertainties, or to make them available to enterprises about which they had incomplete information, over which they had little or no control, or in which their interests as minority owners were not adequately protected. They have been afraid of being unable to liquidate their investments at a time of their own choosing because of the paucity of other potential investors to whom they might sell their investments, of seeing the real value of their securities eroded by inflation, and of finding that the earnings on their share holdings were squeezed between rising costs and government controlled prices while ceilings on interest rates prevented their incomes from debt obligations(those with a contractually determined return) from maintaining their real purchasing power in the face of inflation.

On the other side of the securities markets, those desiring additional funds to finance their activities have often not been willing to share their profits with outsiders and for this reason have generally tended not to sell ownership instruments. Some have offered debt obligations, but the preferred method of business financing, apart from the reinvestment of retained earnings, has involved the formation of business financial groups whereby close links were forged between business interests and financial institutions, enabling the former to borrow with greater ease from the latter. In these circumstances, securities offered by financial institutions (bonds of various types and maturities, promissory notes, or time certificates of deposits) have tended to account for a larger proportion of the total value of publicly issued private securities in many developing countries than in the developed countries, and in a given country this share has also generally exceeded that of the securities issued directly by business enterprises.

With a paucity of business securities, the opportunities for profit from underwriting new issues have been limited. Underwritings of securities offered by financial institutions have not been necessary, as these securities were made available to the public on tap. Specialized firms acting as dealers and brokers and generally working as market-makers developed in some countries, but not on a scale sufficient to promote the development of a flourishing secondary market. In some countries, the financial institutions undertook to redeem their own securities at par on demand in order to reassure the public about the complete liquidity of its holdings, and this deprived the brokers and dealers of an opportunity to earn a profit from handling these securities, thereby further inhibiting the growth of a secondary market.

In these circumstances, if an efficiently functioning securities market is to develop and grow, a number of actions must be taken by the public authorities to overcome the obstacles inhibiting this process. Some actions, such as those which might encourage business enterprises to offer ownership shares to the public, or those pertaining to the protection of the interests of minority shareholders, are not within the sphere of activity of a central bank, although a central bank might play a useful educational role in these matters. Other actions, such as the establishment of procedures to promote the disclosure of information about the business affairs or the management of private enterprises desiring to issue securities, so that the public will be better able to judge the risk involved in investing in these securites, may be entrusted to whatever institution may be most appropriate in the environment prevailing in each country including, possibly but not necessarily, the Central Bank. Still other actions, particularly those aimed at overcoming the obstacles associated with the consequences of inflation, are the responsibility of many agencies, including the Central Bank. A final group of actions, pertaining to interest rate policy and focussing particularly on the securities issued by financial institutions (bonds, promissory notes, or time certificates of deposits) are primarily the responsibility of the Central Bank.

Indeed, the Central Bank has a role to play in the development of a securities market, not only because it is understandably anxious to do all it can to promote the healthy development of the country, and in particular to facilitate the financing of investment from private savings, but also because, once such a market becomes fairly well developed, the Central Bank may use it in the conduct of its monetary policy by undertaking open market operations aimed at achieving macro-economic objectives.

It is well known that an important prerequisite for the development and efficient functioning of securities markets is confidence in the political, social, and monetary stability of the countries where they are located, and that inflation has inflicted severe damage on these markets in countries where it has flourished unchecked for many years. It follows, therefore, that, at the macroeconomic level, a central bank interested in promoting the development of securities markets should work to fight inflation and to promote confidence in the monetary stability of the country. There are, of course, many other reasons why a central bank will want to fight inflation and promote confidence in monetary stability, and the Central Bank is not the only public authority that has a role to play in the pursuit of this objective. In view of this, and also because space limitations demand that the subject be defined narrowly, this paper will not deal with this macroeconomic problem. Instead, it will focus on what has been described as the micro-economic aspects of the question.

It is evident that a securities market will not develop or prosper unless the negotiable financial instruments that are offered provide an appropriate combination of attractive return, adequate liquidity, and reasonable assurances against risk of loss. Otherwise, those who hold funds not needed for their current requirements will not find it advantageous to place them in these instruments. What, concretely, can a central bank do to establish and preserve the conditions that will induce investors to buy and hold securities? What should it avoid doing? How should it correct past mistakes? Finally, what can it do to persuade the ultimate users of funds to finance their activities by offering attractive financial instruments to the public? These are the principal questions to which this paper will attempt to provide answers.

An Attractive Return

Perhaps the most important contribution that a Central Bank can make toward the development of efficiently functioning securities markets is to promote the acceptance of market determination of interest rates on negotiable debt instruments so that the return will be high enough to represent a real incentive to investors to place their funds in these instruments, and flexible enough to adjust this incentive to changing market conditions.

Unfortunately, many Governments have long insisted that public sector borrowers and favored private borrowers should pay preferential interest rates that have proved totally inadequate in view of the inflation that their country has suffered or in view of the persistent rise of world interest rates in the past 20 years. In line with this policy, many central banks have maintained ceilings on interest rates that may be paid by financial intermediaries at levels that became increasingly out of touch with financial realities. Where the rate of inflation has been high, even high nominal rates of interest have been powerless in attracting savings to these favored borrowers or to the financial institutions in anything like the amounts that might otherwise have been forthcoming. In a growing number of cases, the rates of interest became negative in real terms and, even when they were raised, they were not raised enough to restore a real (positive) incentive for investors.

In these circumstances, an efficiently functioning securities market could not develop, or, if one already existed, it could not continue. Financial instruments offered by financial intermediaries retained appeal only for investors who had no access to better means of holding their savings, for those who managed to use them in place of sight deposits to meet their current requirements, and for those who may have gained access to bank credit by acquiring them.[1/] Public sector securities ceased to be attractive and found their way into the hands of financial institutions and other reluctant buyers only when this was required by law or regulation. In some cases, the Central Bank was forced to absorb them even when the requirements of monetary policy indicated a contrary course of action, and this turned it into an engine of inflation.

Often, new forms of financial institutions not subject to regulation would spring up and offer attractive returns on funds placed with them. But, sooner or later, the interest rate they paid and other

1/ For this group, the necessary real yields were paid partly in explicit and partly in implicit form.

aspects of their operations would be brought under regulation and savings would cease flowing into them and even begin to flow out of them. The funds would instead be channeled toward a "parallel" money market involving intermediaries which did not offer the assurances of safety and sound practices offered by the regulated institutions, but where interest rates were realistic, i.e., higher than the annual rate of inflation. Alternatively, the funds would be invested in real estate or other speculative activity, or be transferred out of the country.

Nonfinancial firms, long accustomed to raising funds by borrowing from the financial institutions at relatively low rates rather than by issuing negotiable debt instruments, found it increasingly difficult to obtain all of their needed funds from this source and were forced to turn to unregulated financial intermediaries or to the "parallel" money market for financing at much higher rates.1/ They may have issued commercial paper or other negotiable debt instruments to obtain funds from these sources, but the nature of the intermediaries with which they dealt did not lend itself to the emergence of an organized secondary market in these instruments, although there may well have been some secondary trading in them in an unorganized manner.

Where ceilings on interest rates that may be paid by financial intermediaries were accompanied by ceilings on their lending rates, it became necessary for the regulated financial intermediaries to ration their concessional loans. This made them very vulnerable to the influence of personal or political favoritism or to corruption. More often than

1/ They may even have turned to external sources of funds, to a greater extent than would otherwise have been the case.

not, too much credit would go to the more influential borrowers and not enough to those employing capital most productively.[1/]

To overcome the obstacle that negative real rates of interest represent to the mobilization of savings through securities markets, the Central Bank has a choice of liberating interest rates paid by financial intermediaries and allowing them to find their own level, or of introducing adjustable instruments, that is, instruments linked to a price index, and of course it may adopt both methods in combination. Both methods have been tried in recent years in a number of Latin American countries with a considerable amount of success. The complete freeing of interest rates is comparatively simpler and less subject to official manipulation than is indexation. On the other hand, indexation may be preferred in cases in which there are political obstacles to the complete freeing of rates.

Of course, if the rates paid by financial intermediaries are allowed to rise, by freeing them completely or by means of indexation, the rates charged on loans extended by these institutions must also be allowed to rise. In practice, indexed lending rates may be difficult to institute because borrowers, whose loans extend well into the future, often object to the variability and unpredictability of the monetary correction factor and prefer the certainty of a fixed predetermined rate. Whatever method is used, the higher lending rates will usually

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1/ The result was an inefficient allocation of capital and a smaller total real output than would have been possible, given the level of domestic savings.

apply only to new loans, since there will often be no way to charge the higher rates on loans made previously at a concessional rate.[1/] This is an especially serious problem for institutions specializing in loans with relatively long maturities and operating with shorter-term or even liquid funds. Since these institutions must operate for a long time with a fixed return on a large proportion of their total assets, they may be unable to raise the rates they pay for funds. The result may be disintermediation, that is, an outflow of funds from these institutions into higher yielding instruments. Alternatively, if these institutions raise the rates they pay for funds, they must accept losses which inevitably will lead to capital impairment, if not bankruptcy, unless some emergency assistance is provided by the authorities.

This problem has prevented some countries from raising rates paid by financial institutions to realistic levels. In others, these rates have been raised and the authorities have stepped in with emergency assistance. To the extent to which this assistance was on a large scale and could not be offset by other Central Bank actions, it contributed to the perpetuation of inflationary pressures, at least while it lasted.

The removal of interest rate ceilings is sometimes intertwined with the question of how best to provide assurances to the investors that their claims on the financial institutions offer them an adeuqate degree of liquidity. This issue will be considered in greater detail in the next section of the paper.

1/ However, if the concessional rate on previously made loans is contractually subject to change on a periodic basis, as, for example, under a floating-rate arrangement, it may be possible to apply the new higher rate to this type of loan as well.

While a Central Bank may use its regulatory powers to remove ceilings on interest rates paid by financial institutions, it is limited to using its persuasive power to induce the ultimate users of funds to finance their activities by offering attractive securities to the public.

As regards the financing of the public sector, it may give advice to the Finance Ministry as to the proper types of securities to offer to the public. It may point out the importance of realistic, market determined interest rates as an element in the fight against inflation. It may also point out that public investments undertaken without taking into account the real cost of the funds involved represent an inefficient allocation of real resources. It may even discuss government financing and spending in its published pronouncements, such as its annual report or speeches by its highest officials. It may use similar methods in an effort to secure the elimination of laws and regulations that discourage or prevent the private sector from issuing attractive securities and to promote the adoption of laws and regulations that will induce the private sector to offer such securities. This is an educational role, which may be tedious and may be slow in producing results, but it is potentially of the utmost importance and should not be neglected.

Once the Minister of Finance agrees that public sector securities should be offered with a realistic interest rate, the Central Bank may, as agent of the Government, find itself in the position of having to make all of the arrangements to offer Treasury securities to the public. Once securities are issued, it should refrain from supporting their price[1/] and it should not attempt to conduct its monetary policy through open market operations in these securities until a sufficiently large volume is outstanding so that these operations will not cause unduly wide fluctuations in their price. Several Latin American Central Banks are now successfully selling Treasury securities to the public as agents of their Governments and their experience constitutes a valuable lesson for others.

Adequate Liquidity

In general, investors considering whether to place their funds in negotiable financial instruments look not only for an attractive return but also for assurances that, when they decide to sell, they will be able to dispose of their claim readily and preferably without taking a loss. An efficiently functioning securities market should provide assurances about the ease with which securities may be resold, but not regarding the resale price.

Unfortunately, in the absence of well developed securities markets, financial intermediaries have often taken it upon themselves to provide a "market" for the bonds, promissory notes, and time certificates of deposits they have issued by offering to repurchase them

1/ This would not preclude some short-run intervention to smooth out erratic fluctuations and to counter disorderly conditions.

at par on demand. By providing a price guarantee, they have in fact prevented a genuine market from emerging, since the essential characteristic of such a market is precisely that the price of what is traded there should fluctuate as required by changing supply and demand conditions. The availability of buyers with whom to negotiate the resale of securities should constitute a sufficient assurance of liquidity. A price guarantee, protecting investors against the possibility of suffering losses, but also keeping them from perhaps realizing gains, has no place in an efficient market, and indeed does not normally exist in organized markets for most goods or for such alternative uses of funds as foreign exchange (not even under a system of fixed exchange rates where experience has shown that parities must be changed from time to time).

The removal of price guarantees for securities is an important element in the creation of efficiently functioning securities markets in that it restores the essential flexibility of interest rates without which these markets cannot contribute to the rational allocation of resources. The Central Bank has a dual role to play in this: it must restore the flexibility of interest rates without damaging those financial intermediaries whose assets are largely in the form of long-term fixed interest loans, such as mortgages, and it must devise alternative methods of reassuring investors that buyers will be readily available when they decide to resell their securities.

The Price Guarantee Problem. The Central Bank may prohibit the redemption at par on demand of any security issued by financial institutions,[1/] and require that new securities be issued without the advance redemption privilege and with an interest rate determined by market forces. If the market interest rate is higher than the rate corresponding to the previously guaranteed redemption price, the holders of previously issued securities from which the advance redemption privilege was withdrawn would stand to suffer losses if they should sell before maturity. This may make it politically impossible to withdraw the advance redemption privilege from existing securities.

If existing securities continue to enjoy the advance redemption privilege while new higher yielding securities are issued without it, there is a possibility that holders of the former will use their redemption privilege to convert them into the latter. Whether this will happen and to what extent will depend on the characteristics of the new securities, their maturity, interest rate, and ease with which new buyers might be found if resale were desired. It is possible that these characteristics may be incorporated in the new securities in such a combination that not all of the holders of the previously issued securities will want to convert them into the new securities. If so, the two types of securities may continue to coexist for some time, perhaps until all of the old securities have reached maturity.

1/ This should not preclude the possibility that financial institutions might issue callable bonds and, having done so, might exercise the call privilege.

The issuance of new securities carrying no advance redemption privilege and paying higher interest rates than did the old securities may create solvency problems for the financial institutions whose assets are largely in the form of long-term fixed interest loans, such as mortgages, since outstanding loans dating back to earlier periods will continue to yield only the fixed interest rates specified in the past.

At the very least, the mortgage banks and other institutions with a substantial amount of long-term fixed interest loans in their portfolio must be authorized to charge higher rates on new loans extended after the prohibition of the advance redemption privilege goes into effect. If there is a usury law and if the usury ceiling would prevent the financial institutions from raising their lending rates, an appropriate legislative change should be sought. Failing this, the effort to introduce flexibility in interest rates may succeed only if it is possible to circumvent the usury ceiling by introducing special fees that borrowers would pay and lenders would collect for the privilege of concluding a loan agreement.

But the financial institutions may not be able to extend new loans carrying higher interest rate as fast as their liabilities are converted from the old type (with advance redemption privilege) to the new type (without this privilege and with a higher interest rate). A transitional measure may be necessary to avert insolvency of these institutions. This might consist of a temporary interest rate subsidy payment from the Central Bank[1/] to those institutions which agreed to restrict

1/ To avoid the possibility that payment of this subsidy would generate inflationary pressures, the Central Bank would have to take appropriate offsetting actions.

the increase in their lending rates on new loans to an amount related exclusively to the rate they would be paying on their new securities (i.e. which did not attempt to recoup losses on old loans through higher lending rates on new loans).

The subsidy payment would have to be determined as objectively as possible, perhaps according to a formula that would take account, among other things, of the relative magnitude of each individual institution's holdings of loans extended before the date when the prohibition of the advance redemption privilege took effect and loans extended after that date, and of the volume of its old securities redeemed in advance of maturity. It would have to be clearly understood from the start that the subsidy was temporary, that it would decline each year, and that it would terminate in a fixed relatively short period of time announced at the start.

Since the problem is likely to be particularly acute for institutions extending long-term mortgage loans, it may be desirable, as a long run solution, to seek a reform of the mortgages themselves, to provide for the flexibility of the rates carried by each individual mortgage during its lifetime. Variable mortgage rates have been discussed from time to time in the United States and have been introduced in 17 of our 50 states on a limited basis, but a number of obstacles standing in the way of their nationwide adoption have not been overcome up to now. The problem should be studied in the context of each country where the withdrawal of the advance redemption privilege presents difficulties.

In the absence of variable mortgage rates, it seems likely that the effort to introduce interest rate flexibility by prohibiting advance redemptions at par will only succeed in transforming the problem into what it essentially is in the United States. That is, to protect the institutions extending mortgage loans against the likelihood of insolvency, the authorities will be obliged to reintroduce ceilings on interest rates paid on the new securities, and to be content with raising these ceilings gradually over a period of years. Even with gradually rising ceilings on interest rates paid on the new securities (those without any advance redemption privilege), the mortgage banks would be vulnerable to disintermediation, to the extent that investors were able to shift into higher-yielding money market or foreign currency instruments.

It may be possible for the financial institutions to offer their new securities (those without any advance redemption privilege) in a variety of maturities, so as to take advantage of the respective preferences of different groups of investors for different types of instruments. However, this may weaken the financial institutions' liquidity position and threaten them with insolvency or disintermediation whenever short-term interest rates rise sharply, unless, once again, interest rates on outstanding long-term loans are adjusted to reflect the current costs of raising funds in the market.

The Development of Secondary Markets. Apart from prohibiting the advance redemption at par of new securities issued by financial institutions and at the same time protecting these institutions against the threat of insolvency or disintermediation, the Central Bank must devise alternative methods of reassuring investors that buyers will be readily available when they decide to resell their securities. By adopting an appropriate method, the Central Bank will promote the development of a secondary market not only for the securities of financial institutions, but also for government securities and for securities issued by nonfinancial firms. Five possibilities come to mind, four of which are open to serious criticisms.

One possibility would be for the Central Bank itself to act as the buyer of last resort. But this is probably the least desirable alternative, as it would not only tend to generate inflationary pressures, but also discourage the emergence of private individuals and firms willing to take risks in securities markets.

Another possibility would be to declare specified securities eligible for use as collateral for Central Bank loans and advances to financial institutions. If the financial institutions have access to Central Bank credit as a matter of right, this method will closely resemble the previous one, and there will be little to recommend it. But, if the financial institutions regard access to Central Bank credit as a privilege rather than as a right, the inflationary potential of this measure will be small, at least so long as the privilege is used sparingly. However, this is not a very direct way of reassuring holders of securities that there will be ready buyers for them when they decide to sell. The financial institutions may be somewhat more willing to purchase the specified securities, and this may help to encourage others to acquire them as well. But the effect is likely to be rather limited.

Still another possibility would be to permit the financial institutions to hold a portion of their required reserves in the form of specified securities. The opportunity to earn an income on a part of their reserves that would otherwise be held in the form of deposits at the Central Bank earning no interest would be a strong incentive for financial institutions to acquire and hold these securities. As in the previous case, this would indirectly encourage others to some extent to do so also. But, if the permission to hold securities in the reserves were to involve a reduction in the cash reserve ratio, the consequence would be an expansion in total credit extended by the banking system that might generate additional inflationary pressures, unless appropriate offsetting actions were taken.

More important, this method of promoting the development of a secondary market may be counterproductive. Once specified securities become part of the required reserves of the financial institutions, there will be a strong temptation on the part of the issuers of those securities to neglect the need to adjust the interest rate at which new issues are offered to reflect current market conditions. In an environment characterized by a rising inflation rate, this may mean that new issues of the securities in question continue to be brought out bearing an unchanging interest rate which becomes increasingly unattractive to the general public as inflation intensifies. Since the financial institutions undoubtedly prefer to earn some income on their required reserves, even an inadequate income, rather than no income at all, the issuers of these securities are likely to be able to place these new issues in the portfolios of the financial institutions and may well lose sight of the broader market which is sure to dwindle as a result. Even if there is no intensification of inflation, the inclusion of specified securities in the required reserves of financial institutions is likely to immobilize large amounts of the securities in question in the institutions' portfolios and therefore to restrict the volume available for trading among other interested investors. This does not appear to be a desirable or effective way to promote the development of a secondary market.

A fourth possibility would be to set up a small autonomous fund, using as far as possible non-inflationary resources, and to give it the responsibility of underwriting the issuance of new securities and of intervening on a selected basis to facilitate the resale of existing securities. In both of these roles, this fund would be encouraging banks, businesses and individuals to buy and hold the securities in which it would deal. The Central Bank might provide all or part of the resources of such a fund, using the profits from its ordinary operations, or, alternatively, the Central Bank might guarantee the borrowings of the fund, or even ownership shares issued by it, up to a specified limit,to enable the fund to raise resources from the private sector. Here again, the inflationary potential would have to be offset by other appropriate Central Bank actions.

The operations of this fund would be on a limited scale because of its small size, and its role would be primarily that of a marginal buyer and seller, i.e. a market-maker. In order to succeed, the fund would have to be able to resell to the general public within a reasonably short time the securities that it acquired, since it could not function with its resources tied up in securities that could not be resold. Therefore, it would have to limit its support to those securities meeting generally accepted standards of soundness. In forming this judgment, it might depend on its own analysis or on the analysis of some reliable independent body, perhaps a reputable market research organization, or possibly an official regulatory entity. The list of eligible securities would have to be kept under continuing review, with provisions for frequent up-dating, and great care would have to be exercised to achieve and maintain objectivity in selecting the eligible securities.

Because of the limited scale of operations, the encouragement for others to buy and hold securities that would result from this arrangement would probably not be very great. More important, it would probably be very difficult to avoid the intrusion of personal or political favoritism in the decisions whether or not to support particular securities, and this could result in failure for the fund, should it find itself holding securities that no one else wanted. Finally, there would always be a risk of conflict between (a) pressures to expand the activities of the fund in support of the securities of individual borrowers with the help of increased resources provided, at least in part, by the Central Bank, and (b) the requirements of monetary policy relative to the overall credit needs of the economy. Since the Central Bank must be concerned primarily with the latter, it should not be subjected to influences which might weaken its effectiveness in achieving desired macroeconomic objectives. On the whole, therefore, this is a rather dangerous way of promoting the development of secondary markets, one which is likely to have a number of undesirable consequences.

A fifth possibility, perhaps the most promising of all of the alternatives examined here, would be to set up a mechanism to provide credit to underwriters and dealers as a means of encouraging them to create a market for securities.1/ This would be particularly useful in cases in which, even though relatively free market conditions prevailed, and adequate sources of credit were available, these types of activities did not develop spontaneously. To make sure that those receiving credit under this plan would have an incentive to distribute the securities in the market rather than hold them, the interest costs

1/ A proposal for such a mechanism was developed by Professor David T. Kleinman, of Fordham University, and submitted by him to the Central Bank of Brazil in 1968 while he served as a consultant to the U.S. Agency for International Development.

involved would increase as the credit was used for longer periods of time. The Central Bank might provide resources to this mechanism using the profits from its ordinary operations or other non-inflationary forms of financing, and/or encourage others to do so by guaranteeing the mechanism's borrowings from them, or even ownership shares issued by it, up to a specified limit. Other financial institutions might also provide some of the resources without Central Bank guarantee, especially if the mechanism should be allowed to operate on a profit-making basis.

The agency administering the plan might require the underwriters and dealers receiving credit from it to use their own resources along with this credit in their operations. It would want to assure itself that they were managing their affairs in accordance with sound financial practices and, to this end, it might conduct periodic examinations of their business, requiring that they meet professional standards of operational efficiency as a condition for extending credit to them. As an additional incentive to the security dealers to bring more of their own capital into their operations and to improve their operational efficiency, the Central Bank might let it be known that, when the time came to undertake open market operations to achieve macroeconomic objectives, it would conduct them exclusively through dealers meeting minimum standards in these respects. By stimulating the growth of well managed specialized security underwriters and dealers, the suggested mechanism and the policies adopted to implement it would help to establish firm foundations for a securities market, and in the process give concrete assurances to investors that they could readily resell securities when they chose to do so, thereby reducing their reluctance to acquire them and hold them in the first place.

Reasonable Assurances Against Risk of Loss

The third element that investors consider important when deciding whether or not to acquire securities is the risk of losing their investment. No investor should expect absolute guarantees of safety from this risk but some degree of protection against it may help greatly to overcome the reluctance of investors to acquire securities. The Central Bank may provide reasonable assurances in this regard in four ways.

First, the Central Bank may institute an insurance plan covering the funds placed in the instruments issued by the financial institutions. In the United States, insurance exists for the liabilities of banks, of savings and loan associations, and of credit unions, up to specified amounts for each individual account. The insurance is not provided by the Federal Reserve but by specialized agencies set up for the purpose, the Federal Deposit Insurance Corporation, the Federal Savings and Loan Insurance Corporation, and the National Credit Union Association. When a financial institution fails, the insurance pays the account holders what is owed to them up to the maximum specified under the plan. The insurance is financed by premiums which are paid by all insured financial institutions. In theory, there is nothing to prevent an insurance plan of this type from being operated by a Central Bank. But if there are legal obstacles, it may be necessary to obtain appropriate enabling legislation. Failing this, the Central Bank should use its influence to persuade the authorities that an insurance plan is needed and that an appropriate agency should be given the responsibility to implement it.

Second, the Central Bank may develop procedures to reduce the risk that financial institution offering securities to the general public will fail. To this end, it may strengthen its periodic inspection and supervision of financial institutions or, if this is a responsibility of another agency, such as the Superintendency of Banks, it may use its influence to persuade that agency to strengthen its performance. The objective should be to have sufficiently frequent inspections by examiners applying sufficiently high standards so that in so far as possible, the financial institutions will not build up portfolios of doubtful quality. If some financial institutions nevertheless run into difficulties, the Central Bank may undertake to keep them in existence by extending credit to them and even appointing official supervisors to operate them until they are again in a sound condition, in effect ensuring that they would meet their obligations to investors. If, in spite of all efforts, it becomes necessary to close a financial institution, the Central Bank may seek to arrange for another financial institution, whose position is sound, to take over its assets and liabilities. Knowledge that the Central Bank follows these policies should strengthen the market for the securities of financial institutions.

Third, the Central Bank may seek to bring about an improvement in the scope and content of the information available to the public concerning the affairs and management of financial institutions and business enterprises desiring to issue securities to the public or whose securities are to be traded on organized stock and bond markets, so that the public will be better able to judge the risk involved in investing in particular securities. The first step might be to require the registration of all new security issues with an appropriate official agency. The information required for registration might be gradually expanded until all relevant matters bearing on the business prospects of the institution or enterprise desiring to issue securities would be obtained. This information could be compiled, perhaps in the form of a booklet similar to the "prospectus" required under the system in force in the United States. The prospectus would not represent an official approval of particular securities, but would offer potential buyers as much information as possible to help them make up their mind about them.

Periodic updating of the prospectus, either by publishing a complete new version from time to time, or by publishing brief reports on relevant changes in the basic data of the prospectus as they became available, might be required of the financial institutions and business enterprises desiring to have their securities traded on organized stock and bond exchanges. The official agency responsible for the registration of all new security issues might also be given the responsibility of securing publication of the follow-up information by the issuers of the securities.

These steps should greatly help in overcoming the reluctance of investors to place funds in securities. At the very least, the Central Bank should use its influence to persuade the authorities that full disclosure to the public of detailed information about securities and their issuers needs to be assured, and that an appropriate agency should be given the responsibility to perform this function. The Central Bank itself might be designated to carry out this function with respect to the securities of financial institutions. It might not be the most logical entity to do so also for the securities of business enterprises, but might accept the additional responsibility if the authorities should prefer such an arrangement.

Fourth, the Central Bank may attempt to minimize the effects of speculation in the securities markets in order to avoid the excesses which, in the long run, tend to discourage many investors from acquiring securities, especially shares of stock. In the United States, the Federal Reserve has the power to prescribe the maximum percentage of the value of shares that the purchasers may borrow, using these shares as collateral, to acquire and hold them and, therefore, the minimum percentage that they must invest from their own resources. The lower the maximum loan percentage, and therefore the higher the minimum cash percentage (we call it a "margin" requirement), the greater will be the restraint on speculative stock market activity. This particular technique may be applicable also in countries that are attempting to promote the growth of a securities market and are concerned over the adverse impact on investors of market speculation. However, difficult questions arise in attempting to distinguish between healthy market activity and unhealthy speculation. For this reason, the technique should be used with caution. The Federal Reserve itself has changed the "margin" requirements six times in the last ten years, and not once since January 1974.

Conclusion

The preceding pages have examined the more important specific functions that a Central Bank may perform in attempting to promote the development of a securities market. It was made clear, on a number of occasions, that the Central Bank does not have a unique position in this endeavor, and that the cooperation of the Government itself and of some of its autonomous agencies is needed in order to crown the effort with success. Indeed, measures entirely outside the competence of Central Banks have an important role to play, particularly if a market in ownership shares of private businesses is to develop. In this respect, the influence of tax policy deserves special mention.

However, while the development of a market in ownership shares would undoubtedly add to the diversity of financial instruments available to the general public and would offer business firms one more channel to raise needed funds, from the standpoint of national economic and financial management, the development of an efficiently functioning market for negotiable debt instruments has special significance. Its influence on the allocation of resources among competing uses is far greater than that of the market for ownership shares, because the latter does not serve as a channel for the Government and other public sector entities and for financial intermediaries to raise funds, except for the relatively small amount of equity capital of the financial intermediaries. Moreover, if a Central Bank is ever going to conduct open market operations to achieve macroeconomic objectives, it will do so in the market for debt instruments, and not in the market for ownership shares. For this reason, it is appropriate that much of the discussion in this paper should have revolved around issues related to debt instruments.

An efficiently functioning market for debt instruments offers at least two important benefits. By promoting an efficient allocation of funds among competing uses, it provides an opportunity to maximize the real output for any given level of domestic savings. In addition, an efficiently functioning market for debt instruments maximizes the flow of domestic savings toward the ultimate users of capital, and as such reduces the country's dependence on external sources of funds to meet investment needs.

If any conclusion emerges from these pages, it is that, to promote the development of securities markets, moving toward fewer restrictions is the most desirable path to follow. What matters most is to establish an environment in which negotiable debt instruments become an attractive medium to channel funds, in accordance with market forces, from those who have more than they currently require to those who desire more than they are able to generate internally. If this environment can be created and maintained, a long step will have been taken toward the development of an efficiently functioning securities market.