6.18 Financial Reforms and Its Impact on Household Investment Portfolio

Sugeeth S. Patabendige
Department of Marketing Management, University of Kelaniya

ABSTRACT

The early contributors to the development theory such as Rosenstein Rodan, Nurkse, Lewis, Prebish, Singer and Myrdal argued that there was a widespread 'market failures' in developing countries, justifying government intervention in almost all the economic activities, including those of the domestic financial market. They firmly prescribed low and controlled interest rate policies and credit rationing to be followed for developing countries. Accordingly, a policy of administered rate of interest was followed in Sri Lanka also up to the introduction of the economic reforms in 1977, making interest rate significantly lower than inflation throughout this period.

This negative real interest rates penalized savers and encouraged the public to hold a larger proportion of their savings in non financial physical assets such as in real estate, consumer durables, precious metals, gems, art works, and whenever possible foreign currency deposits. This phenomenon, contrary to the conventional wisdom, as shown by McKinnon-Shaw Hypothesis (1973) led to reduce the amount of funds that went to banks and the supply of loanable funds becoming the financial market repressed and shallow, requiring credit to be rationed. As such, negative interest rates through government direction for lending to priority sectors encouraged sub-optimal investment at the cost of optimal projects. These trends were identified by many economic and business reviewers as the root course for experiencing an economy-wide inefficiency and macroeconomic instability leading to low rate of financial savings and hindering of achieving a higher economic growth.

Thus, the dismal economic performance shown in the dirigist policy regime paved the way to introduce a far reaching set of economic policies from 1977 onwards including financial sector reforms. Accordingly, at the beginning period of the reforms, bank rates were increased for converting negative real rates to positive real interests. A background was created for some competition in deposit mobilization and interest by facilitating of setting up of branches of foreign banks; opening of foreign currency banking units (FCBUs); permitting merchant banks, leasing companies and unit trusts to be opened; and expanding the secondary market for treasury bills. As a result of these expansions, a larger number of financial instruments such as certificates of deposits, commercial papers, treasury bills, unit trusts etc compared to those in controlled period were available, and the introduction of these instruments permitted the general public to provide with more opportunities to have higher investment in financial assets rather than investing in non-tradables.

In this background, this study attempts to assess how far financial reforms have affected to changing the households' investment portfolio based on the available secondary sources of data, particularly the data available in the Consumer Finance and Socio Economic Surveys carried out in 1981/82, 1986/87, by the Central Bank of Sri Lanka.

The data analysis shows that only in the period just after the economic reforms in 1977 (that is only up to 1982) investment in financial assets has shown a positive value among households, but in the entire ensuing period it continuously shows negative values. Contrary, after the mid 1980s, households have continuously increased their investment in the physical assets, by going against the expectation of the finical market reforms. Thus, increasing investment in physical

assts (non-tradable) suggests that financial reforms carried out in the post reform period have failed to motivate the general publics to invest more in financial assets. This study attributes this failure to the inability of the monetary authorities to contain inflation and maintain positive real interest rate continuously.

Key words: *real interest rates, financial investment, physical investment, dirigist policies, non - tradable assets and financial market reforms.*