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BOOK REVIEW

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The Evolution, Characteristics and Growth of Certificates of Deposit (CDs) in Selected Foreign Countries

S.L. Shetty

[This paper has a limited objective, namely, one of chronicling the evolution of Certificates of Deposit (CDs) as deposit substitutes (and as money market instruments) in selected foreign countries. The requisite information has had to be culled out from diverse sources, and in doing so, the Paper may have, in certain instances, used extracts from books and documents without specific citations. However, a fairly exhaustive list of references which have been drawn upon for building the connected account of history concerning CDs in individual countries has been presented at the end of the article. The attempt to distil an assessment of the broader financial and other economic environment under which CDs came to be introduced in major markets, their main characteristics and growth, common features discernible in them and lessons to be drawn therefrom, is the author's own and not attributable to those sources mentioned above. The author wishes to place on record his sincere appreciation of the help received from Shri S.J. Salvi, Director and Dr. C.B. Tripathi, Assistant Adviser, Division of Banking Development, Department of Economic Analysis and Policy, in studying country experiences from varied sources].

This Paper makes an attempt to study the evolution, main features and growth of certificates of deposit (CDs) as deposit substitutes (and as money market instruments) in selected foreign countries - developed and developing. CD markets in all the five top developed countries, namely, the USA, Japan, France, the UK and West Germany as well as in Australia and New Zealand, have been chosen for the study. Amongst the developing countries, the three countries in South-East Asia, namely, South Korea, Malaysia and Indonesia, which have adopted substantial financial liberalisation, have been included. While Part I presents an overall assessment of the genesis, the financial and economic environment contributing to the introduction of CDs, their growth, and the

lessons to be drawn therefrom; Parts II and III present country-wise details.

Part I : An Assessment

Genesis and Features

In the chronology of instrument development, CDs have generally been the ones to be issued in the initial phase (in almost all countries except West Germany). It was so even in the USA which was the first to issue CDs as early as in 1961. Though CDs played a major role in the money markets of developed countries in certain phases and experienced large day-to-day turnover, their outstandings generally remained within 12 to 15 per cent of broad monetary aggregates. Once financial development reaches a far advanced and mature stage (as in the case of the USA, the UK, Germany and Japan), CDs become one amongst many other financial instruments and are deprived of their special attraction.

Different factors and forces have contributed to the evolution of CD markets in developed countries. A widespread factor in this regard relates to the process of disintermediation and threat to bank deposits arising from sophistication desired by corporate fund managers who acquired large cash flows after periods of rapid economic growth (USA, Japan, France and UK). Hence banks and monetary authorities have responded to the threat by introducing CDs with a view to restoring the intermediation function of commercial banks. In the case of Germany and also Japan, the issuance of CDs coincided with periods of financial innovation. Among the LDCs, South Korea introduced CDs as part of mopping up excess liquidity in the system as an anti-inflationary measure. Malaysia and Indonesia introduced them as part of financial reforms.

CDs have been initiated both under regulated (USA, Japan, and France) and free interest rate (UK and Germany) environments, though it is found that their growth has been substantially facilitated generally in a free environment. The latter is, however, true of the period before the emergence of new competing money market instruments. Once the system has become much more

advanced and mature as stated earlier and once a deregulated environment sets in with hardly any distinction as to the yield rates between transaction balances and other assets, CDs have ceased to possess any special attraction.

The general run of experiences in CDs has been in the form of wholesale large-size issues with a focus on funds of corporate bodies. However, in the case of the USA, where small-size issues are cited as a success story, they related to small-scale businesses in regional centres other than New York. Any significant mobilisation of personal savings (i.e., funds other than cash flows of corporate bodies) through the medium of the CDs is unknown and unthinkable.

CDs have all been marketable and negotiable instruments. They have been generally in bearer forms (in some cases registered) and actively traded in secondary market. Their yield rates have always exceeded the Treasury bill rate or other rates on money market instruments. In a regulated regime, interest rates for primary issues were fixed at comparable rates for bank deposits. Maturity periods have ranged from two weeks to even five years but common maturity has varied from 3 months to one year and a preponderant part has been for 90 days. CDs have generally enjoyed exemptions from stamp duties. They have always been subjected to reserve requirements.

The Paper does not survey the literature on monetary policy implications of the operations of the CD market. Quantitative studies in this area have generally concerned themselves with the totality of money market instruments or deposit substitutes and not with the impact of individual instruments. Taken together, the results of a case study on Philippines are typical: "It is found that the appearance of deposit substitutes has not made any material difference to the impact of monetary policy on real variables except that the size of the impact multiplier in the presence of deposit substitutes is smaller than in their absence and also that they are stable over the short and medium ranges. This implies that the magnitude of changes in monetary policy instruments required to achieve the target level of real variables will have to be larger than when deposit substitutes are not present" (Khatkhate and Villanueva, 1979).

Substantive Lessons

These country experiences have been delineated with a view to exploring the relevance, scope and prospects for the development of CDs market in India. Before doing so, the substantive lessons discernible from the various country experiences may be highlighted.

In this respect, *firstly*, it is relevant to note that the initial impulse for the CDs to emerge elsewhere came, almost universally, as a response to the process of disintermediation and the threat to bank deposits because of the sophistication desired by corporate fund managers who also tended to possess large cash flows. This was particularly so when a regime of regulated interest rates prevailed. *Secondly*, the presence of large floating funds put pressures on the ingenuity of the financial operators within or outside the financial system, which resulted in attempts to bypass monetary regulations relating to interest rate and reserve requirements or other prudential norms. A *third* aspect is that for the success of CDs as an instrument, there should not only be short-term surplus corporate funds seeking sophisticated investment outlets, but there should also be a fairly well-developed money market without which a secondary market for CDs cannot be cultivated and without a secondary market, CDs will lose their attraction. *Finally*, if the USA's early experience for about a decade of the 1960s is any guide, the environment of a regulated interest rate regime need not be a hindrance for the healthy growth of primary issues of CDs as well as for their secondary transactions. What is required though is appropriate, quick and flexible changes in regulated rates of interest in response to relevant market conditions.

CDs to Arrest Disintermediation in India

Judged against this background, the inexorable logic of the current Indian economic and financial setting is for providing the banks with instruments with which they can effectively compete for mobilising deposit resources. In this respect, CDs become an easy and prior candidate as compared with many other instruments for a variety of reasons.

First, large public sector undertakings as well as private corporate bodies have tended to acquire, to some extent in an infla-

tionary environment, substantial cash flows which float around the money market even if for short periods. Also, partly because of these corporate funds and partly because of significantly high household savings, bodies like the UTI have acquired large investible funds without there being comparable ready investment outlets in the capital market. *Second*, the commercial banking system, particularly with the entry of a larger number of foreign banks, has begun to face a competitive environment. *Third*, the above two factors have combined to put pressures on the banks to compete for corporate funds. With a view to providing better return on short-term surplus funds, the Reserve Bank raised the deposit rate for short-term maturities of 46 days and above to 8.0 per cent (applicable now for all maturities up to one year). *Fourth*, it is reported that inter-corporate funds market is growing, though, like in other informal markets, its limitations arise from its unorganised and insecure character. Also, dealings in the market are generally restricted to units within individual business houses. Estimates suggest that inter-corporate market may have advanced far beyond the estimated Rs. 800 crores to Rs. 1,000 crores indicated in the Vaghul Committee Report and that the rates of interest prevailing in such a market reportedly range from 18 to 20 per cent per annum. A part of these funds could be mopped up by scheduled commercial banks through such ready instrument as CDs. *Lastly* with the Reserve Bank initiative, institution and instrument development in the money market has augmented money market operations and has also introduced some degree of sophistication. In the Discount and Finance House of India Ltd. (DFHI), we now have in place a sound institutional framework for the development of a secondary market for all money market instruments.

Part II : CD Markets in Developed Countries

1. The United States of America (USA)

An Overview

The market for negotiable certificates of deposit (CDs) in the United States has passed through many phases in response to dif-

ferent types of regulatory and financial conditions. It began in the early 1960s, in competition to other money market instruments, to mop up corporate surplus funds, in the presence of Regulation Q which imposed ceiling on interest rates on saving and time deposits. Besides, banks were not allowed to open savings accounts for business corporations.

The attractiveness of CDs, until 1973 when the ceiling rate on longer maturity CDs was suspended, depended on whether the short-term open market rate rose above or even approached the prescribed ceiling; their fortunes accordingly fluctuated until 1973. Thereafter until the beginning of the 1980s, the CD market grew rapidly in an environment of market-determined interest rates.

Since the beginning of the early 1980s, however, there has been a metamorphosis, with financial deregulation leading to the widespread introduction of chequable deposits earning market-related rates of interest free from any legal ceiling. As a result, the CDs have ceased to possess any special attraction for savers, for there are now, in the US money market, a wide variety of instruments with market-determined yield rates and with liquidity as good as in the case of regular checking accounts such as, money market deposit accounts (MMDAs), money market mutual funds (MMMFs), negotiable order of withdrawal (NOW) accounts, and Super NOW accounts - all insturment development initiated by the regulatory authorities themselves. They have tended to blur the distinction between transaction balances and other financial assets.

Genesis

The process for the creation of the CD market was set in motion in the USA in February 1961 when the First National City Bank of New York introduced for the first time negotiable certificates in large denominations and when a major Government securities dealer had agreed to make a secondary market for them. Other banks and dealers operating in the money market quickly followed suit, which paved the way for the phenomenal growth of this new instrument[1].

1. This history of CDs is based on Richmond Federal Reserve Bank (1974), pp. 51-59, and Federal Reserve System (September 1974), pp. 85-86.

Traditionally, New York banks were reluctant to accept time deposits from corporate bodies for they were natural depositories of meagre excess cash of corporate entities in demand deposit accounts. Post-war industrialization tended to augment cash flows in the 1950s and the corporate treasurers looked for more sophisticated cash management by seeking to invest in such available money market instruments as Treasury bills, commercial and financial papers, and to retain liquidity, preferring repurchase agreements with dealers. With this the short-term interest rates rose and so did the opportunity cost of holding corporate cash in demand deposit accounts. This caused a loss of deposits by New York banks. The negotiable CDs were thus designed specifically to attract corporate funds and offer competition to other money market instruments.

CDs' Characteristics

CD was introduced as a marketable receipt of funds deposited in a bank for a specified period at a specified rate of interest. Liquidity and marketability are the hallmark of CDs. CDs may be in registered or in bearer form, although the latter was considered more convenient for secondary market trading. When it was introduced in the US, denominations ranged from $25,000 to $10 million. Initially, banks tended to set a high minimum in the hope of attracting only those funds which were destined for the money market, for smaller denominations would compete with corporate demand account balances. However, very soon even the large money market banks began issuing smaller denomination CDs. The maturity period for CDs, though technically ranging from 1 month to 18 months, was typically short. A survey in December 1973 revealed that over 87 per cent of total CDs outstanding with reporting member banks had matured within 4 months. CDs bearing typical maturity dates, such as the dates for the payment of taxes and dividends, could compromise on yield rates. Likewise, contrary to normal yield-maturity pattern, small denomination CDs of less than $1.0 million carried a slightly higher yield rate than larger CDs of comparable maturities. The large prime-name banks ordinarily paid lower rates than those paid by smaller banks (all variations within the prescribed ceilings).

It was interesting that CDs were, initially for about 10 years, exempt *neither* from Regulation Q on interest rate control *nor* from Regulation D on reserve requirements. Thus, the initial impetus for the emergence and successful growth of CDs essentially came from the need for a new deposit instrument with scope for secondary dealings and liquidity characteristics to be offered by banks for their large corporate customers who possessed short-term funds. However, the relationship between the maximum rates set under Regulation Q and the short-term open market rates always determined the attractiveness or otherwise of CDs. The Federal Reserve System as expected used the instrument of deposit rate regulation to influence the expansion of bank loans by restraining or encouraging placement of funds in CDs.

CDs are Sensitive to Interest Rate Prescriptions

During the initial period from 1961 to 1964, banks were forbidden by Regulation Q to pay more than 1 per cent for time deposits (and for CDs) of 30 to 89 days. In November 1964, this rate was raised to 4 per cent. Again from December 1965, uniform rates were applied to all CDs. In June 1970, interest rate ceilings were lifted on CDs maturing in less than 90 days, while in May 1973, the ceilings were lifted on larger maturities "to enhance the role of market forces in restraining credit growth" (Richmond Fed, 1974, p.85). Around the latter period, in a series of related policy actions, the Fed amended Regulation D to impose additional reserve requirement on CDs.

The Fed's Regulation Q thus became the fundamental consideration in the market for CDs. CDs ceased to be competitive in periods of rising short-term money market rates. With large corporate bodies being sensitive to rate differentials, the amounts of CDs issued experienced large swings in response to small changes in the rates offered. Two distinct historical situations of 1966 and 1969 are cited in literature (Fed System, September 1974, pp. 85-86). The volume of all negotiable CDs outstanding rose from $1.0 billion at the end of 1960 to $18.6 billion by end-August 1966, second only to Treasury bills amongst money market instruments. During the last four months of 1966, however, the volume outstanding shrank by about $3.0 billion as market rates of interest on

competitive instruments surpassed the ceiling rates permitted on CDs by Regulation Q. With the start of 1967, interest rate relationships again made the issuance of CDs far more attractive. The volume of CDs outstanding rose sharply, reaching a peak of $24.3 billion in December 1968. Shortly after this, a spectacular run-off of CDs began as monetary policy was tightened and market rates again pierced through the Regulation Q ceilings. At the close of 1969, only $10.9 billion of CDs were outstanding. In June 1970, Regulation Q ceilings were lifted on CDs maturing in less than 90 days, and in May 1973, the ceilings, as stated above, were lifted on longer maturities. From 1969, negotiable CD volume at weekly reporting banks had expanded rapidly. By the end of 1973, CDs outstanding amounted to $64.4 billion, equivalent to one half of federal securities, or greater than the combined total of acceptances, dealer loans and repurchase agreements (RPs), and commercial paper (Table II.1).

Table II.1:
Selected Money Market Instruments :
Volume Outstanding, December 1973

($ billions)

Instruments (1)	Volume Outstanding (2)
U.S. Government securities :	
Treasury bills	107.8
Other under 1 year	33.8
Federal Agencies, within 1 year	21.6
Negotiable certificates of deposit	64.6
Bankers' acceptances	8.9
Commercial paper placed through dealers	13.1
Finance company paper	28.0
Dealer loans and repurchase agreements (RPs)	6.6*

* Covers financing only for Government Securities and CDs.

Source: Federal Reserve Bank of Richmond (1974), *Instruments of the Money Market*, p. 10.

Secondary market

Sensitivity of CDs to interest rate changes was also reflected in the turnover in the secondary market. Vast and rapid fluctuations in the dealers' positions in response to interest rate regulations and the consequential changes in yield curves during the first decade of CD operations tell an interesting story. During 1961 to 1964 when the banks were prevented by Regulation Q from offering more than 1.0 per cent per annum on time deposits (and CDs), of 30 to 89 days, the declining yield curve helped the market participants to extract a margin and hence the dealers were willing to hold large stock of CDs. But this position was reversed when in November 1964, the banks were permitted to pay as much as 4 per cent per annum on the above short-term maturities and dealers became reluctant to hold CDs. This was further reinforced, when Regulation Q was amended in December 1965 to permit banks to pay uniform rates on CDs of all maturities; banks opted to pay maximum rates on shorter and shorter maturities. With a flattening of the yield curve, dealers lost incentives to hold CDs in their portfolio. Daily average dealer positions declined sharply in 1966 to about $103 million from an average of about $230 million in 1964 and 1965, while daily average transactions dropped to $33 million from about $58 million (Richmond Fed, 1974, p.57). As short-term market rates fell below the Regulation Q ceilings in late 1966, dealers preferred to hold larger stocks of CDs. Their daily average positions increased to $307 million in the first eight months of 1967. In 1969, the Fed again desired (as in early 1966) to curtail the expansion in bank credit and hence decided not to raise the ceiling rate of 6.25 per cent even though the short-term rates were much higher. Hence, daily average dealer positions fell from $78 million in January 1969 to $7.0 million in December 1969. In the 1970s, with the lifting of the Regulation Q ceilings, the dealers' interest in CDs depended on the behaviour of the short-term market rates. By 1973, daily average dealer positions had reached a level of $735 million, and average daily transactions had increased to $369 million.

Yield Rates

Subsequent to the removal of the ceiling rates, the interest rate

on large CDs has been determined by current money market conditions, and their yields ruled generally several basis points more than Treasury bills and other money market instruments (see Table II.2).

Growth during 1975-81

Prior to the lifting of interest rate ceilings, CDs were an unstable source of funds for banks as corporate treasurers were quick in shifting to other money market instruments like Treasury bills to fetch higher yields on their funds. This situation, however, changed after May 1973 when the ceiling rates on longer maturity CDs were suspended following the firming up of the market rates beyond the ceilings, making longer maturity CDs non-competitive. By early 1975, the volume of CDs outstanding had stood at $90 billion and the size of the CDs market was thus second only to Treasury bills. Between 1975 and the early 1980s, there was a further impetus to the issuance of CDs. As a result, the quantum of CDs of all maturities outstanding reached a level of $300 billion by the end of 1981, constituting about 39 per cent of the total money market securities outstanding then. Of the $300 billion, about $132.6 billion represented large certificates of deposit (See Table II.3).

Deregulation and the Growth of other Money Substitutes

With the process of financial deregulation gathering momentum in the 1980s, and with the introduction of new money substitutes, the importance of CDs had tended to decline. It may be recalled that the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980 and Garn-St Germain Act of 1982 brought about revolutionary changes in the US financial industry. The general perception at that stage was that the incentives to elude regulatory constraints had again intensified during the inflation years of the 1970s [Evanoff, Douglas, D. (1985)].

Under the Monetary Control Act, the interest ceilings on all deposit accounts except demand deposits were to be phased out over a six-year period (i.e., before March 1986). The Garn-St Germain Act of 1982 broadened the powers of thrift institutions by expand-

Table II.2 - Interest Rates - Money Market in the US

(Percent per annum)

Year	Commercial paper			Bankers acceptances			Certificates of Deposits : secondary markets				US Treasury Bills			
											Secondary Market		Auction Average	
	1 month	3month	6month	3 month	6 month	1 month	3 month	6 month	3 month	6 month	1 year	3 month	6 month	1 year
1978	-	7.94	7.99	8.11	-	-	8.20	-	7.19	7.58	7.74	7.221	7.572	-
1981	15.69	15.32	14.76	15.32	14.66	15.91	15.91	15.77	14.03	13.80	13.14	14.029	13.776	13.159
1986	6.61	6.49	6.39	6.38	6.28	6.61	6.51	6.50	5.97	6.02	6.07	5.98	6.03	6.18
1987	6.74	6.82	6.85	6.75	6.78	6.75	6.87	7.01	5.78	6.03	6.33	5.82	6.05	6.33
1988	8.38	8.66	8.55	8.55	8.46	8.43	8.78	8.81	7.76	7.86	7.87	7.68	7.76	7.92

Source : Various issues of *Federal Reserve Bulletin*.

Table II. 3: Large Certificates of Deposit and Money Stock

(In $ billions)

End-December (1)	M4* (2)	M3 (3)	Large CDs (4)	Total CDs (5)
1965	-	-	16.0	-
1975	745.8	-	-	90.0
1976	803.0	-	62.4	-
1977	883.1	-	73.7	-
1978	972.4	-	96.6	-
1979	-	1758.4	93.3	-
1980	-	1936.7	116.6	-
1981	-	2167.9	132.6	300.0
1983	-	2602.9	91.9	-

* Up to 1978, large CDs were included in M4.

ing their investment powers and also enabling them to offer transactions accounts which were similar to demand deposits.

As a result, financial deregulation resulted in the nation-wide introduction of NOW (negotiable order of withdrawal) accounts essentially in the form of interest-bearing checkable deposits, the creation of new deposit instruments such as money market deposit accounts and Super NOW accounts, and the elimination of interest ceilings on all types of accounts[2]. The almost total elimination of

2. "In December 1980, depository institutions nation-wide were authorized to offer NOW accounts-essentially interest-bearing checking accounts subject to a legal deposit rate ceiling (currently 5 1/4 percent). Depository institutions were authorised to offer money market deposit accounts and Super NOW accounts beginning in December 1982 and January 1983, respectively. Super NOW accounts are fully checkable deposits, earn market-related rates of interest free from any legal ceiling, but are subject to the restriction that, if the account balance falls below a minimum of $ 1,000; the interest rate on the deposit becomes subject to the regular NOW account deposit rate ceiling. Money market deposit accounts are similar to Super NOWs except that they have limited transactions characteristics. Recently, congressional legislation has been proposed that would remove any rate restrictions on demand deposits." [Kasriel, Paul L. (1985)].

interest rate regulations have tended to blur distinctions between transactions balances and other financial assets.....

These developments have generated a picture of liquid assets and money stock in the US financial system that looks considerably more diversified than ever before (See Table II.4). Separate data on CDs are not available but the details of the U.S. banking and monetary data suggest that CDs as an instrument of deposit liabilities have almost become extinct in the face of financial deregulation.

2. Japan

Background

During the period from the 1940s to the early 1970s, Japan's investors, both individuals and corporations, held most of their financial assets in deposits at heavily regulated and highly specialised (and segmented) banks while in turn lent the funds to domestic industry. The Japanese authorities controlled interest rates and thereby influenced credit allocation for 30 years of the post-war period. Secondly, they emphasized functional separation as instrument of financial regulation as, for example, between banks and securities companies (Article 65, Japanese equivalent of America's Glass-Steagal Act), between ordinary banks and trust banks and long-term banks, and between banks and postal savings system.

Since the beginning of the 1970s, in response to both domestic and external pressures, Japan has been moving towards a more diverse, less tightly controlled system offering investors and borrowers a broad range of options; interest rates on many forms of financial instruments have been deregulated, many more new types of financial instruments have become available, and the strict differentiation or segmentation of roles and responsibilities among the various financial institutions has been allowed to be weakened. Although Japanese financial markets still do not have the breadth, flexibility, or freedom of those in the United States, that does not detract from the importance or extent of the continuing rapid

Table II.4 - Money stock, Liquid Assets and Debt Measures in the US

(Billion of dollars, average of daily figures)

Item	December 1979	December 1980	December 1981	December 1982	December 1983	December 1984	December 1985	December 1986	December 1987	January 1988
M_1	398.8	424.7	452.1	491.0	535.3	564.5	633.5	740.6	765.9	764.8
M_2	1,502.1	1,635.0	1,799.6	1,964.5	2,191.4	2,373.2	2,573.9	2,821.5	2,915.0	2,937.3
M_3	1,766.1	1,944.9	2,175.9	2,385.3	2,611.4	2,991.4	3,210.5	3,507.2	3,679.5	3,701.6
1. Non-transactions components						2,426.9	2,577.0	2,766.5	2,913.6	2,936.8
(i) M2 (A)						1,808.7	1940.3	2,080.8	2,149.1	2,172.5
(ii) M3 only (B)						618.2	636.7	685.7	764.5	764.3
2. Money market deposit accounts	N.A.	N.A.	N.A.	43.2	372.4	416.8	513.6	572.5	525.2	524.1
(i) Commercial Banks						267.4	332.8	379.6	358.2	358.9
(ii) Thrift institutions						149.4	180.8	192.9	167.0	165.2
3. Small denomination time deposits (C)	633.1	728.3	824.1	853.9	786.7	885.1	881.5	855.0	914.5	929.8
(i) Commercial Banks						386.9	384.0	365.3	385.2	389.3
(ii) *Thrift institutions*						498.2	497.5	489.7	529.3	540.5
4. Money market mutual funds	42.9	76.3	186.9	229.8	178.2	230.2	241.0	292.4	311.8	320.6
(i) General purpose and broker-dealer	33.4	61.4	150.9	182.2	138.0	167.5	176.5	208.0	222.2	226.2
(ii) Institutions - only	9.5	14.9	36.0	47.6	40.2	62.7	64.5	84.4	89.6	94.4
5. Large denomination time deposits (D)	226.0	262.4	305.9	336.5	330.8	417.7	437.3	439.8	485.3	484.9
(i) Commercial Banks						270.9	285.4	289.1	323.6	321.1
(ii) Thrift institutions						146.8	151.9	150.7	161.7	163.8

Notes: (A) Sum of overnight RPs and overnight Eurodollars money market fund balances (general purpose and broker - dealer) MMDAs and savings and Small time deposits.

(B) Sum of large time deposits, terms RPs and term Eurodollars of U.S. residents, money market fund balances (institution only) less the estimated amount of overnight RPs and Eurodollars held by institution only money market-funds.

(C) Small-denomination time deposits - including retail RPs - are those issued in amounts of less than $100,000. All individual retirement accounts (IRA) and keogh accounts at commercial banks and thrifts are substracted from small time deposits.

(D) Large-denomination time deposits are those issued in amounts of $100,000 or more, excluding those booked at international banking facilities.

Source: *Federal Reserve Bulletin*, Vols. 71 and 74.

transformation (Takaji, Shinji, March 1988, see also Koichi Takata, 1988).

Until the 1970s, virtually the only short-term market was the call market, which limited participation to financial institutions. Treasury bills could not really be counted since almost all were held by the Bank of Japan or the Trust Fund Bureau (which invests the funds collected by the postal savings system and other similar sources). In an era which focused on economic growth in *real* sectors, the lack of short-term instruments suited the financial system and did not worry the authorities. With individuals concentrating their savings in bank deposits and corporations relying on only bank loans to cover short-term borrowing needs (commercial paper had not been allowed), financial intermediation was the kingpin of the Japanese financial system.

However, during the 1970s the structure saw rapid transformation. In the money market, as an adjunct to the call money market, the bill discounting market was inaugurated in May 1971 and took over from the call loan market trading in funds for longer-term use (Federation of Bankers' Associations, 1984). Secondly, with the fiscal position of the Government deteriorating during the recession following the quadrupling of oil prices in 1973, the authorities encouraged the development of a large secondary market in Government bonds. As a result, the private holdings of Government bonds shot up. Alongside the development of Government bond market, the *gensaki* market[3] (a bond repurchase market involving condition sales and purchases of public and private bonds), which had already existed for many years, expanded as a major short-term money market. *Gensaki* market was the only short-term money market in Japan in which general business corporations could participate, in addition to banks and other financial institutions and securities companies.

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3. *Gensaki* is a short-term money market (having 1 to 6 month-period) for conditional sale/repurchase of bonds (public bonds, debentures with coupons, etc.) for raising funds on the security of bonds or investing surplus funds. It is a free money market which is not subject to intervention by the Bank of Japan in determining rates and the operators are: business corporations, banks, private financial corporations and securities companies.

An important factor in the above developments was that interest rates on loans and yields on bonds were in general free to fluctuate and thus interest rate control in Japan focused on the regulation of deposit rates (See Koichi Takata, 1988). Even as late as March 1988, after considerable signs of deregulation, deposits with free interest rates constituted only 32 per cent of the total deposits with banks (See Table II.5). As a result, there were large outflows from regulated bank deposits. This prompted the authorities to allow banks to issue negotiable certificates of deposit in May 1979.

Table II.5: Composition of Deposits with Banks as of the end of March 1988 (Y trillion)

Total Deposits	294	(100%)	Rate of increase (%)
Deposits with free interest rates	94	(32%)	70.8
a. CDs	12	(4%)	24.7
b. MMCs	16	(5%)	2.0 times
c. Large-scale time deposits	44	(15%)	2.6 times
d. Foreign currency deposits	22	(8%)	6.3
Deposits with regulated interest rates	200	(68%)	-3.5

Source : Takata, Koichi (1988).

CDs as Part of Financial Innovations

Negotiable certificates of deposit (CDs) were initially proposed to serve the needs mainly of foreign banks. At that time in 1979,

both domestic and foreign banks were subjected to limits on the amount of foreign currency they could convert into Yen, which restricted the ability of foreign banks to use funds raised elsewhere for Yen-denominated lending in Japan. Foreign banks also had very limited number of branches in Japan, thus effectively restricting their Yen-denominated deposit base. The creation of CDs was promoted as an instrument for foreign banks to increase their Yen-denominated deposits, with a financial instrument of longer maturity than the inter-bank call market.

Another reason for the introduction of CDs was the domestic banks' concern over the growth of *gensaki* market and the resulting loss by banks of large corporation deposits, the rates on which were regulated. *Gensaki* had been existing since 1949, but it gained importance in the 1970s when corporations began to possess large surplus funds. As financial corporations invested a major portion of their funds in the *gensaki* market, banks were naturally perturbed, and the authorities, seeing the continuing importance of financial intermediation and being wedded to a regulated framework, allowed the introduction of CDs in May 1979. The relative stagnation of *gensaki* market during 1979 to 1984 suggests that the effort was successful. Research studies have also supported the view that one of the reasons for the introduction of CDs was to improve, or to restore, the competitive balance between banks, especially the city banks, and the securities companies.

Condition Stipulated for Issue of CDs in Japan

Initially, in 1979 the minimum denomination was set at Yen 500 million with a maturity period of 6 months which was reduced later to 3 months; the maximum amount that could be issued by any single bank was set at 25 per cent of net worth for Japanese banks and 10 per cent of yen-denominated assets for foreign banks. These restrictions meant that the market was limited to large corporations only and that due to many conditions stipulated for the issuance of CDs, banks were requesting for relaxations of conditions. These initial conditions represented caution and desire of authorities to maintain careful control over the speed of change. Over the years, the conditions were relaxed.

The minimum denomination of CDs was reduced later from Yen 500 million to Yen 300 million and further to Yen 100 million in April 1985 and the minimum maturity period was reduced from 3 to 1 month. The maximum maturity period of CDs was raised from 6 to 12 months in April 1986. In addition, the ceiling on the amount of CDs and money market certificates (MMCs) (described below) each bank is allowed to issue was increased in stages to 2.5 times its net worth in September 1986.

Since their introduction in 1979, negotiable CDs have grown rapidly from Yen 1,853 billion constituting 12 per cent of the total short-term money market balances outstanding to Yen 8,461 billion accounting for 34 per cent of the total short-term money market balances outstanding in 1984 (See Table II.6). Although the subsequent period witnessed continued increases in the absolute amount of CDs issued, its percentage share in the total short-term balances outstanding declined to 20 per cent, by end-1986, as the Japanese financial system entered generally a deregulated regime and following the US pressures, new financial instruments, such as, banker's acceptances and money market certificates (MMCs) were created in March 1985.

Although initially CDs were introduced to meet the need of foreign banks, they never represented more than a small share of the CD market. At the end of 1979, foreign banks accounted for 14 per cent of the market share, which fell and stabilised around 8 per cent after 1982. From 1981 to 1984, the amount of foreign bank issues stagnated at Yen 400 billion, and in 1986 these banks actually began withdrawing from the market, reducing their outstanding issues to Yen 200 billion and their market share to less than 2 per cent.

Emergence of other Money Market Instruments

The Yen-Dollar Agreement of May 1984 provided for the opening up of the Japanese financial market and with that end in view, the creation of such instruments as money market certificates (MMCs) and banker's acceptances. Accordingly, MMCs were introduced on March 1, 1985 and banker's acceptances were worked out and put into effect in April/June 1985. The creation of these in-

Table II. 6 : Short-term Money Market – Year and Balances Outstanding by Type of Market in Japan

(Billions of Yen)

Year	Call Money		Bill Discount		Gansaki		Certificates of deposit		Money Market Certificates	
	Billions of yen	Percent of total	Billions of yen	Percent of total	Billions of yen	Percent of total	Billions of yen	Percent of total	Billions of yen	Percent of total
1971	1,472	63	-	-	882	37				
1975	2,332	28	4,403	52	1,679	20				
1979	3,473	22	6,327	41	3,960	25	1,853	12		
1983	4,456	21	6,763	32	4,288	20	5,665	27		
1984	5,037	20	7,998	32	3,562	14	8,461	34		
1985	5,110	13	14,656	36	4,642	11	9,657	24	6,325	16
1986	10,226	21	13,544	28	7,117	14	9,926	20	8,168	17

Source : Bank of Japan, *Economic Statistic Annual Issues*.

struments was urged by the United States, out of a conviction that one of the problems for foreigners desiring to hold part of their financial portfolios in Yen-denominated assets was the lack of relatively liquid, short-term instruments (Lincoln, Edward, J. 1988).

As finally established, money market certificates (MMCs) bear maturities of one to six months, with Yen 50 million minimum denomination and with the total issue of CDs plus MMCs to be equal to or less than 150 per cent of a bank's net worth. Small financial institutions preferred this sort of combined limit on maximum issue amounts so that they could enjoy some flexibility in expanding into the new business; the big-size city banks were already close to their limit of CD issues (100 per cent of net worth). Subsequently, in April 1986, the MMCs were made further attractive with the increase in the maximum maturity period to 12 months and the reduction in minimum denomination to Yen 30 million; this minimum was further reduced to Yen 20 million in October 1986.

Interest rates on MMCs were to be set 0.75 percentage point below CD rates which implied that interest rates were not exactly market-determined; CD rates were to be reset each week, so that the MMC rate would be flexible, but the rigid formula preserved a constant differential between the two instruments, a policy stance consistent with the entire post-war history of the Japanese financial regulation [Lincoln, Edward, J (1988), p. 193]. The principle was that with a larger minimum denomination, CDs ought to fetch a higher interest rate, and if money market conditions tended to push MMCs' rates closer to the CD rate, that principle would have been violated (Table II.7).

As for the banker's acceptances, provisions for creating Yen-denominated banker's acceptances were also included in the May 1984 Yen-Dollar Agreement on the assumption that if a short-term, trade-related financial instruments were available, a rising portion of Japan's trade would be Yen-denominated. Such a condition, it was believed, would bring about Yen appreciation of foreign exchange markets. The rules for banker's acceptances were worked out by April 1985, and the instruments came into existence in June that year.

Comprehensive set of data on short-term money market instruments presented in Table II.8 show that the outstanding amounts of MMCs (Yen 18.46 billion) have overtaken those of CDs (Yen 10.83 billion) as at the end of 1987. Yen-denominated bankers' acceptances have, however, not taken off the ground. Commercial Paper (CP) is yet another short-term instrument that has made some headway in the Japanese domestic money market.

3. France

Background

Amongst the large developed countries, the French domestic money market generally remained narrow till recent years which is attributed to the prolonged reliance, since 1972, on direct credit controls (*encadrement*) and administered interest rates as instruments of monetary control. As late as 1984, it was recognised that an active interest rate policy was severely constrained by two more specific institutional factors besides the narrowness of the domestic money market; they were the heavy reliance on debt capital by business enterprises, and the dichotomy between the institutions with large surplus funds (typically the savings banks and the *Credit Agricole*) and bigger banks who borrow within the financial system. Therefore, the new banking law, which came into force in July 1984, sought to unify the legal framework for all credit institutions and create a new institutional arrangement for regulation and control.

In the meantime, the system of directed credit and regulated interest rates on deposits and advances resulted in attempts to circumvent controls and the process of disintermediation became very conspicuous. The authorities responded to the situation by permitting financial innovations by banks and by introducing flexibility in credit control measures. The new system of credit control (*encadrement*), effective January 1, 1985, exempted bank lendings financed from non-monetary sources (banks' own capital, subordinated loan stock and long-term bond issues) from the operation of credit ceilings with the quantitative limitation on bank credit to enterprises and individuals financed from monetary sources being continued. Likewise, the system of administered interest rates on

Table II.7: Relaxation in the Terms of Issue of Deposits

	CDS				MMCs			Large time deposits
	Minimum issuance amount	Terms	Issuance limit (ratio of the limit to capital)	Interest rate	Minimum issuance amount	Term	Issuance limit (ratio of the limit to capital)	
1985 spring	(Y 300 million to Y 100 million)	(3-6 months) 1-6 months	(75% to 100%)	CD rate -0.75%	Y 50 million	1-6 months	75%	
85 Oct.			150%				150%	Y1 billion (3 months -2 years)
86 Apr.		1 month -1 year	200%			1 month -1 year	200%	Y500 million
86 Sept.			250%		Y30 million		250%	Y300 million
87 Apr.			300%		Y20 million	1 month -2 years	300%	Y100 million
87 Oct.			abolition		Y10 million		abolition	,, (1 month - 2 years)
88 Apr.	Y 50 million	2 weeks -2 years						Y50 million
88 Nov.								Y30 million

Note : These relaxations in respect of CDs are as under:

1) *May 1979:* Initiation of CD issuance (Y500 million minimum and 3-6 months term)
2) *January 1984:* Reduction in minimum CD issuance amount (Y500 million to Y300 million)
3) *December 1984:* Lifting of the ban on issuing Euroyen CDs (with less than 6 months term)
4) *April 1985:* Reduction in the minimum CD issuance amount (Y300 million to Y100 million) and term reduction (3 months to 1 month)
5) *June 1985:* Entry of securities companies to the Secondary market for CDs
6) *March 1986:* Initiation of purchases of CDs by the Bank of Japan
7) *April 1986:* Term expansion of CDs (6 month to 1 year)
8) *October 1987:* Abolition of issuance limits on CDs and MMCs
9) *November 1987:* Inauguaration of CP market, lifting of the ban on issuing Euroyen CD by non-residents.
10) *April 1988:* Reduction in the minimum CD issuance amount (Y100 million to Y50 million) and term extension (from 1 month to 1 year, from 2 weeks to 2 years)

Source : *Takata, Koichi (1988).*

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Table II.8 : Outstanding Amount of Sh

	1980	1987	Notes
(a) Interbank market	66.714	243.450	
	(40%)	(18%)	
(1) Call money	41.333	160.379	(unsecured call money)
(2) Bill discounts 1/	25.381	83.071	29,410
(b) Open market	84.035	327.785	
	(50%)	(25%)	
(3) RPs (Gensaki)	45.068	69.223	
(4) CDs	23.574	108.328	initiated in May 1979
(5) Conversion of foreign exchange into yen	15.393	71.636	relaxed since Dec. 1980
(6) Short-term governement bills 2/	--	24.522	started in May 1981
(7) Short-term government bonds	--	27.212	issued in Feb. 1986
(8) Yen-denominated BA	--	91	inaugurated in June 1985
(9) CP	--	16.952	inaugurated in Nov. 1987
(10) Overseas CP and CDs	--	9.821	
(C) Deposit market (free interest)	17.357 (10%)	757.647 (57%)	
(11) Large time deposits	--	500.334	relaxed since Oct. 1985
(12) MMCs	--	184.598	inaugurated in March 1985
(13) Foreign currency deposits by residents	8.195	57.006	relaxed since Dec. 1980
(14) Non-resident yen deposits	9.162	15.709	relaxed since March 1980
Short-term money market (narrow definition) (= (a) + (b))	150.749	571.235	
Short-term money market (broad definition) (= (a) + (b) + (c))	168.106 (100%)	1,328.882 (100%)	

1/ Excludes BOJ operations. 2/ Average for the year.

Source : Takata, Koichi (1988).

time deposits with maturities below six months and on pass-book savings accounts remained.

CDs as Part of Financial Innovation

Initially during the years between 1981 and 1983, the process of financial innovation concentrated on savings instruments essentially targeted on individuals[4]. However, concurrently with the operation of the new system of credit control during 1985 and 1986, a series of financial instruments, primarily at the short end of the maturity spectrum, were introduced. CD was one of the first to be launched in March 1985[5]. In the French financial system known for its **dirigisme**, for the first time, a freely negotiable money market instrument enjoying ready liquidity as well as open money market rates got introduced.

Initially, with the minimum issue limit having been placed at French Franc (FF) 10 million, the CDs were conceived as wholesale instruments in effect open only to larger enterprises. However, even with the reduction in its minimum limit to FF 5 million in 1986, the CDs have, by and large, remained as investment outlets for corporate bodies and not suitable for private individuals. The maturity period initially permitted was fixed between a minimum of 6 months and a maximum of two years, with no early redemption allowed by the issuer; this minimum maturity period was

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4. In late 1981 and early 1982, special short-term mutual funds *(FCP)* and short-term investment trusts *(SICAV* a court terme) were offered to the public. In June 1982, popular savings books *(LEP)* were introduced as a first liquid investment offered to the French public with a price-induced and tax exempt interest rate. In October 1983, industrial development accounts *(CODEVI)* were introduced, similar to savings banks' pass-book accounts (immediate liquidity and 6.5 per cent tax-exempt interest); funds so collected are earmarked for low interest loans to industry and for the financing of the Fonds Industrial de Modernisation (FIM).

5. What was called a potentially more revolutionary development was the introduction of a commercial paper *(billet de tresorerie)* at the end of December 1985. In early 1986, a financial futures market (MATIF) started operation in the Paris Stock Exchange and a secondary market for mortgages was also established.

adopted so that it did not conflict with the regulated term deposits for maturities below six months.

In the first year, CD issues were limited, with the bulk being held by banks themselves. Purchase by enterprises was restrained in the first year due to the high minimum limit, the relatively long minimum maturity and a yield not exceeding the money market rate and thus below that offered by short-term mutual funds and investment trusts (explained in footnote 4).

In the initial phase, the size of the CDs market remained small at around FF 25 billion up to mid-1986 whereupon a reduction in the minimum maturity was effected as from June and further to 10 days from March 1987; as from the latter date the maximum maturity period on CDs (and of commercial paper) was also raised from two to seven years. Thereafter, there was a sudden spurt in the CD market in France, with the outstanding CDs reaching more than FF 120 billion by the end of April 1987 and FF 154 billion by the end of December 1987. It is said that for those who can afford the FF 5 million minimum deposit, CDs are now almost equivalent to interest-bearing sight deposits.

As may be observed from the accompanying Table II.9, CDs have been the most successful money market instruments, accounting for over one-half of the increase in the demand for short-term securities in 1987. Preliminary data for 1988 suggest that CDs have grown further at the cost of sight deposits.

The impetus for growth of CDs still exists because financial diversification in France is said to be as yet limited. For the same reason, most CDs in France are held by banks and the secondary market is not well-developed. Holding of CDs by banks is also a feature of the United Kingdom where CDs have existed for more than 20 years. However, in the United States, where CDs have existed for even longer period, holdings are more widespread. This is because while French CDs are of a wholesale nature, in the US, smaller minimum subscriptions have facilitated possible investment by private individuals (though now with diverse instruments available in the US financial system, CDs have lost their special attraction).

Table II.9: Money Market Securities held by Non-financial Agents in France

(In billions of French francs)

Items	1985	1986	1987	May 1988
(1)	(2)	(3)	(4)	(5)
1. Commercial paper *(billets de Tresorerie)*	3.3	22.5	38.7	. .
2. Treasury bill *(bons du Tresor)*	10.5	24.1	90.2	. .
3. Certificate of deposit	8.7	37.0	154.4	. .
4. Financial institution certificate *(bons des SF et IFS)*	0.3	1.8	7.7	. .
5. Total (1 to 4)	22.8	85.4	291.0	. .
6. Relevant Monetary Aggregate (M_3)	661.8	709.8	894.1	1020.5

(. .) not available.

4. The United Kingdom (UK)

Background

Prompted by the successful introduction of CDs in their home market, the London branches of several New York banks issued similar wholesale negotiable CDs in dollars on the London market in 1966. This was made possible because of two main reasons : first, banks and bank branches in the UK traditionally enjoyed a

free market for interest rates[6]; and second, an active Euro-dollar market had developed with the principal centre in London where a highly developed foreign market operated. Around this period, with the persistent US balance of payments deficits, the New York banks had to look for dollar funds outside their domestic economy. As it is, funds were flowing out from the USA due to reasons of higher interest rates elsewhere, as the US rates were held down by official regulations. Some of the measures resorted to by the US government to deal with the BOP deficits, such as the interest equalization tax and voluntary restraint on bank lendings, tended to induce borrowers, deprived of the domestic market, to turn to the Euro-dollar market.

Bank of England's Close Interest

The Bank of England took a close interest in the introduction of Euro-dollar CDs both because of its supervisory responsibilities and because of its powers and responsibilities under the Exchange Control regulations. The first dollar CD issues were made in 1966 only "when the Bank has been satisfied that the banks generally felt that such instrument would constitute a useful addition to their range of liabilities and that a viable secondary market would develop" (Cooper, John, 1984). As the CD (dollar or sterling) was a bearer instrument, exchange control approval was required; the maturity period of a CD was not to exceed 5 years.

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6. Except for the long-standing collective agreements on interest rates amongst the London and Scottish clearing banks which were in vogue between 1955 to 1971. The deposit rate applying to all time deposits, that is predominantly at 7 days' notice, had been fixed by agreements between the clearing banks since 1955 at 2 per cent below the Bank rate. Agreement on rates for advances was much as comprehensive in form, though a minimum rate to be charged to "blue chip" borrowers was established; this minimum and other lending rates changed automatically with the Bank rate. Foreign banks and their branches were not a signatory to the agreements. Under the *Competition and Credit Control* arrangement, the London and Scottish clearing banks were also made to abandon these collective agreements effective from September 16, 1971.

Dollar CD Characteristics

The dollar CDs were issued as negotiable instruments in bearer form and in the minimum denomination of $25,000; they were also unsecured. The maturity period varied between 30 days and 5 years. They became very popular, mainly amongst the US banks but also, to an extent, amongst the Japanese and other overseas banks. Some of the subsidiaries and associates of the UK clearing banks also participated in the market but not the clearing banks themselves.

Dollar CD growth

The dollar CDs grew rapidly from £81 million at end-December 1966 to £1,026 million at end-June 1969. In the recycling process of petro-dollar funds, the market registered a phenomenal growth. The acceleration in the growth, particularly after 1980, also coincided with the abolition of the Exchange Control in the UK in 1979. Banks began to issue CDs not only in dollar but in other important currencies as well. The volume of outstanding CDs reached £61,296 million in January 1986 and further to £74,372 million at the end of September 1988 (including small amounts of other short-term paper, separate figures being not available) (see Table II. 10).

Sterling Certificates of Deposit

As a logical follow-up, banks had started making available sterling certificates of deposit since October 1968. Sterling certificates have been generally similar to those issued in the dollar market, they are fully negotiable bearer documents and are transferable by delivery. They are issued for a minimum period of three months and a maximum period of five years. The minimum denomination of a certificate is £50,000 and the maximum is £500,000. Unlike in the United States and unlike even in the dollar CD market in London, the sterling CD has been kept as a large wholesale market.

The UK authorities took some unusual steps to help the development of the market. Initially as in other countries CDs were not eligible for last resort borrowing by the discount market and the

Table II.10: Liabilities of Banks in the U.K.

(£ millions)

Period/ Year End	Sterling Liabilities			Other Currency Liabilities		
	Total deposits	Certificates of deposits	CDs and other short-term paper@@	Total deposits	Certificates of deposits	CDs and other short-term paper @@
1.	2.	3.	4.	5.	6.	7.
1966	-	-	-	6,807	81@	-
1968	13,591	165	-	-	597@	-
1969	21,647	442	-	21,647	1,541@	-
1970	27,528	1,089	-	27,528	1,649@	-
1975	44,266	2,983	-	85,165	6,419	-
1980	90,351	5,727	-	193,348	20,946	-
1985						
June 19	197,164	11,380	13,952	492,942	68,093	70,918
Sept.18	204,251	12,694	15,194	504,699	69,667	73,196
Dec.11	208,575	12,818	15,467	498,677	64,125	67,726
1986						
Jan.15	210,662	12,172	14,912	496,324	61,296	65,153
Feb.19	214,505	14,587	17,455	505,022	60,991	65,475
Dec.31	253,556	-	19,828	591,380	-	77,363
1987	304,220	-	29,682	543,860	-	71,276
1988						
Sept.30	366,688	-	36,642	592,715	-	74,372

@ Denominated in dollars only.
@@ Other short-term papers comprise promissory notes, bills and other short-term paper.

Source: Various issues of Bank of England *Quarterly Bulletin.*

clearing banks' CDs holdings obtained from the secondary market were not treated as liquid assets for maintaining liquidity ratios. Subsequently, the Bank of England allowed the treatment of CDs of less than six months maturity 'near cash'. They were also made eligible for discounting with the Bank of England. In the meantime, Building Societies have also been permitted since 1983 to issue CDs so as to augment their resources. However, sterling CDs have always been subject to the minimum reserve ratio and the erstwhile Special Deposit requirements prescribed by the Bank of England. CDs have also been included under M_3 for the purpose of monetary targeting (whenever targets have been so prescribed). A significant and active secondary market for CDs has been developed, particularly by the discount houses, "with sufficient depth to make it reasonable for a bank to regard CDs with a maturity of up to, say, six months as being very nearly cash" (Cooper, John, 1984, p.222).

Although the Bank of England does not generally participate in the sterling CD market, it exercises its power of supervision for the orderliness of the market. Prudential supervision is also carried out through a Code of Conduct issued by the Bank of England for transactions in the market and a Joint Standing Committee representing brokers, banks and principals in the market has been instituted.

Growth of Sterling CD Against Euro-dollar CD in London

It is significant to note that the growth of sterling CD market has been far less pronounced than its dollar counterpart. This disparity in growth has widened particularly after the abolition of the Exchange Control in 1979. At the end of September 1988 outstanding sterling CDs stood at about £36,600 million, while other currency CDs amounted to £74,300 million.

Yield Rates

Interest rate on sterling CDs has generally been higher by several basis points than inter-bank sterling market lending rate (for comparable maturity) as well as Treasury bills. On deposits accepted by local authorities, interest rate offered was marginally

higher than those on CDs (Table II.11).

Table II.11 : Short-term Money rates in U.K.

(Rates for Sterling)

Period end	Treasury bill (discount rate)	Inter-bank Sterling market (3 months)	Sterling Certificates of deposit (3 months)	Local authority deposits (3 months)
(1)	(2)	(3)	(4)	(5)
April 1973	7.67	9 9/32	9 5/16	9 1/4
December 1975	10.64	11 1/8	11 1/16	11 5/16
December 1980	13.02	14 3/4	14 11/16	14 13/16
December 1985	11.17	11 7/8	11 3/4	11 15/16
October 1988	11.55	11 29/30	11 27/30	11 7/8

Restructuring of the UK Financial System and the Emergence of Competing Instruments against CDs

During the past five years, the UK has instituted a comprehensive and far-reaching restructuring of its financial markets, institutions, and regulations. The Financial Services Act, which became law in November1986, created a comprehensive system for the securities and investment industries. With this, the distinction between activities of banks and securities dealers and jobbers became blurred. The new Banking Act, 1987, which came in to force in October 1987, confers a new and expanded role for the Bank of England as banking supervisor in addition to its traditional role as a Central Bank.

Competitive pressures on banks and other intermediaries have resulted in expansion of activities traditionally served by other institutions. First, with the removal of credit controls (the CORSET) in 1980, the commercial banks have entered in to mortgage lend-

ing, while building societies have started providing unsecured commercial loans. As stated earlier, the Building Societies were also allowed to issue in 1983 sterling CDs so as to enable them to tap the money market. The Government's decision to make banks pay interest net of tax in April 1985 was a blow depriving banks of a key weapon in their battle with Building Societies for the saver's money (which were already deducting tax). In response, the clearing banks began accepting high-cost deposits. Secondly, the introduction of sterling commercial paper for the first time in the UK in May 1986 introduced competition for the short-term bank lending for the corporate sector. Simultaneously, the growth of mutual funds has further cut into the deposits of banking intermediaries. Thirdly, new instruments, such as futures and options and interest and exchange rate swaps, have diluted the differentiation in the roles of different domestic financial markets. Finally, the competition for bank deposits has reached such a fierce level that major clearing banks have begun paying interest on their current account deposits and offered free banking services for accounts kept in credit, an overdraft facility, and use of debit or credit cards. With such metamorphosis in the banking and financial system, the role for traditional instruments like CDs is getting limited in the face of a wide menu of free instruments available for corporate treasurers and savers.

5. West Germany

The CDs in West Germany is comparatively of recent origin (i.e., in May 1986). The main steps towards liberalisation of financial markets were taken much earlier in Germany than in most other OECD countries (OECD, June 1986). Interest rate regulations were abolished in 1967 and monetary policy since then has been relying on market-oriented instruments. Even capital movements were largely freed in the late 1950s.

However, certain restrictions were retained until more recently, primarily because of the concern about the possible weakening of monetary policy control. It was only in early 1985 that Bundesbank took the view that the country's financial market was so developed that further diversification in use of instruments could be attempted without any significant problems for monetary policy.

This was also necessitated by fresh concern about the international competitiveness of the German financial system. Therefore, in May 1985 several financial instruments, which had already been used in international financial markets, such as, zero-coupon bonds, floating-rate bonds, dual currency bonds and bonds linked to interest rate and currency swaps, were introduced. Earlier, in order to increase the efficiency and international competitiveness of German financial markets some important steps were taken. For example, in 1984, 25 per cent withholding tax on interest earnings of non-resident holders of German bonds was abolished and subsequently, foreign-owned banks operating in Germany were allowed to lead manage issues of foreign DM bonds.

One of the principal instruments of monetary policy in West Germany is the minimum reserve requirement (MRR) for different types of financial instruments. The principal decision to allow the issuance of CDs was taken in December 1985 in connection with the subsequently expected revisions of the MRR. New MRR rates came into effect in May 1986 and CDs were introduced simultaneously. Foreign institutional investors in particular had expressed an interest in such short-term investment instruments. The issuing of DM-denominated CDs is confined to Germany as the Bundesbank "attaches importance to any future markets for such papers being based in Germany" (*Ibid*). It was thought that the effectiveness of the Bundesbank in guiding the monetary conditions would naturally be reduced if deposits were replaced by their close substitutes which are not subject to MRR.

Bank's attitude towards CDs has been rather lukewarm. First, CDs are close substitutes to deposits which earn relatively low interest and constitute cheap funding for the banks. Secondly, West Germany is essentially an economy with large liquidity and relatively low interest rates and DMCDs have been introduced at a time when a series of other money market instruments are already in place. Thirdly, the existence of transaction tax continues to impede the growth of short-term negotiable markets including the market for CDs. Loss of revenue to the exchequer is an apparent difficulty in removing this tax. The principal decision taken to abolish the transaction tax has again been deferred. For not abolishing this tax, another reason believed to be is that the

authorities do not intend to widen the scope for developing the secondary market of CDs. On the contrary, they expect the main secondary market in D-Mark denominated certificates of deposit to be developed abroad. Finally, MRR being the same as for bank deposits and no secondary market being encouraged, banks are reportedly reluctant to issue such certificates.

6. Australia

Interestingly, in the Australian situation too, the introduction of what was called "an innovation in Australian trading bank practice (Reserve Bank of Australia, 1968-69, p.21) in March 1969 in the form of marketable CDs was in the context of the increasing pressures faced by the banking system from growing competition from other financial intermediaries because the former were subject to interest rate and other regulations (and also owing to rapid developments in the international financial markets). The issuance of CDs received further impetus in September 1973 when the interest rate ceiling on CDs was abolished. This trend continued till the end of the 1970s by which time CDs also had lost their optimum potency, given the market structure, as a competitive instrument in the armoury of trading banks and hence pressures for deregulation of all deposit rates were being articulated. The Reserve Bank of Australia recognised that "the banks' ability to attract funds *via* fixed deposits was restricted by the interest rate ceiling on these deposits" (RBA, 30 June 1980, P.19). Once the discriminatory regulations on bank deposit rates were done away with in December 1980, the banking system could compete for short-term fixed deposits at market-related rates of interest and hence the CDs lost their special attraction for investors. In recent years, the emergence of "bank accepted bills" as a major financing medium for non-financial companies, has further reduced the importance of CDs in the total interest-bearing deposits of trading banks. This loss of special attraction of CDs following interest deregulation, innovation and reform in the financial system fits into a typical pattern observed in other countries like USA, the UK and Japan (described earlier).

Till 1979, the Australian financial system was operating under a regime of strict regulations and rigidly differentiated set of in-

stitutions. The banking system consisted of trading banks and savings banks (with the latter not subject to the statutory reserve deposit system), which faced competition from a number of non-banking financial intermediaries (building societies, finance corporations, life and non-life insurance offices, money market corporations, and pension funds). The Central bank regulations, essentially covering the banking system related to :

(a) ceiling on bank deposit rates and lending rates, prohibition of interest rates on short-term maturity deposits, and consequential prevention of payment of interest on current account balances; and

(b) strict control on entry of new banks (with foreign banks debarred from entry and no new Australian licences issued for 35 years). Banks responded to this scenario by a series of mergers, with major mergers taking place in 1968 (Ibid.,p.20-21); this resulted in concentration amongst trading banks; as a result, by June 1980, only four banks had accounted for about 87.3 per cent of all trading bank assets. Secondly, the trading banks began diversifying into merchant banking ventures and to setting up, or participating in saving banks, finance companies, nominee companies and unit trust (RBA, 1970-71, pp. 24-25). Thirdly, overseas banking and other financial organisations acquired equity interests in local non-banking financial institutions. As the Reserve Bank of Australia reported in its 1970-71 Report (p.24), the number of non-banking financial public companies (excluding insurance) in which overseas concerns held substantial equity interests had reached around 60; a decade ago the corresponding figure was about 10. As a result, the relative importance of the banking system declined rather perceptibly; their share of assets held by all financial institutions fell from over 80 per cent in the early 1950's to 45 per cent in 1965 and further to 41 per cent in 1970 (Rowan, D.C.,p.52).

Introduction of CDs in March 1969

"The introduction of these certificates, which combine the characteristics of interest-bearing deposits with those of marketable assets, was designed to help maintain the competitiveness of banks in markets for short-term funds" (RBA,1968-69, p.21). The marketable CDs were allowed to be issued in March 1969 in amounts of Australian $50,000 or over for terms ranging from

Table II.12 : Australian Interest Rates

(percent per annum)

	End-December 1967	End-December 1968	End-March 1969	End-June 1969
(1)	(2)	(3)	(4)	(5)
Trading banks				
Fixed deposits				
3 months	4.00	4.25	4.25	4.25
6 months	4.00	4.25	4.25	4.25
12 months	4.25	4.50	4.50	4.50
24 months	4.50	4.75	4.75	4.75
CDs*				
3 months	-	-	4.62	4.74
3-6 months	-	-	4.70	4.75
6-24 months	-	-	4.72	-
Savings Bank deposits	3.50	3.75	3.75	3.75

* Weighted average of issue yield: prescribed ceiling 4.75%.

Source : Reserve Bank of Australia, *Report & Financial Statements;* 1968-69, pp. 48-49.

three months to two years at yields of upto 4.75 per cent (which was equivalent to the ceiling rate prescribed then on bank fixed deposits for two years maturity). Banks were not permitted to buy back certificates issued by themselves. As data presented in Table II.12 would suggest, the interest on CDs issued by trading banks generally ruled some what higher (within the prescribed ceiling) than those paid on corresponding denomination fixed deposits.

Simultaneously, the Australian Resources Development Bank Limited (set up in March 1968 for the development of Australia's natural resources with local equity and refinancing of trading banks' term loans) was also permitted to issue such marketable CDs

subject to the same terms on minimum denomination and maximum yield as trading bank issues. However, a novelty in this regard related to the issuance by the Australian Resources Development Bank of longer-term *transferable* certificates of deposit in the form of non-bearer securities, in multiples of AS100 (which eventually became the major source of finance for this institution). Subsequently, the Primary Industry Bank of Australia, or the Commonwealth Development Bank, also raised funds mainly through *transferable* certificates of deposit, but to an extent also through *negotiable* certificates of deposit.

To develop the secondary market for CDs, authorised dealers in short-term money market were permitted to deal in the instrument and to hold a limited proportion of their portfolios in them. That pressures on the secondary market for CDs were high are evident from a set of data on short-term money market rates published in a special study (Table II.13). The study states thus: "..... for one element in the response was the banks' willingness to offer remarkably high rates on NCDs. For the banks as a whole, this aggressive bidding creates no additional funds, ---------. The high NCD rates are nevertheless an index of the pressure felt by individual banks ------" (Rowan, D.C., 1980, pp.217-219).

Growth of Negotiable CDs in a Regulated Environment

Despite a strict regulation of the maximum interest rate, the negotiable CDs grew rather rapidly (Table II. 14). This growth was particularly sharp following the removal of the ceiling rate (of 6.5% existing then) on interest rates on CDs in September 1973; simultaneously, the maximum maturity period was extended from two to four years. The following description of the consequences of the ceiling removal is illuminating: "The response was quite spectacular; average issue yields on these claims rose quickly from just over 6 per cent to between 9.0 per cent and 9.5 per cent, and by the March quarter (1974) the rise in certificates of deposit outstanding averaged around S300 million a month; the amount of issue rose by about 470 per cent over the year. Most new issues were for terms of less than six months, and as these claims began to fall due for renewal, growth in outstandings tapered. By end May, when banks were heavily pressed for funds, average yields on short-term

Table II.13: Selected Short-term Market Rates, 1972-75: Selected Periods

(Per cent per annum)

	NCDS (3-6 months)	Bank bills (90 days)	Commercial bills (90 days)	Inter-Company Market (90 days)	Official Short-Term Market@
(1)	(2)	(3)	(4)	(5)	(6)
1972					
January	5.25-5.50	6.68-7.10	6.25-6.50	6.00	5.25
1973					
January	3.90-4.70	6.00	4.75	4.75-5.00	4.10
October	8.75-9.00£	10.85	10.00	9.50	7.50
1974					
May	18.20	21.00	22.00	19.00	8.25
1975					
January	9.32	9.00	10.50	11.00	7.75
December	7.84	7.65	9.00	9.00	7.25

£ CD rates were freed from official ceiling prescriptions in September 1973.

Source: D.C. Rowan (1980), op.cit., p.218.

@ The official short-term money market was created in 1959 when four dealers (since raised to nine in 1960 and described as authorised or official dealers equivalent to discount houses) were granted recognition as operators in the short-term money market. Such recognition gave a number of privileges, the most important one being access to lender-of-last-resort loans from the Reserve Bank or Central bank. The Reserve Bank of Australia was, in return, effectively able to exercise control over the movements in the official money rate.

certificates of deposit approached 20 per cent for a short period. Subsequently yields fell, and at the end of the year were averaging around 16 per cent; yields fell further in July. A good deal of the growth in certificates of deposit was at the expense of banks' existing holdings of other deposits. The maximum rate on fixed deposits was raised from 6.5 per cent to 8 per cent in September, but this increase did not match the growth in rates on competing assets,

Table II.14 : Growth of Certificates of Deposit (CDs)

(A$ millions)

Period End June	Trading banks (NCDs)		Australian Resources Development Bank		Commonwealth Development Bank		Primary Industry Bank of Australia $		Holdings of CDs by Money Market Corporations as Assets
	All trading banks	Four major trading banks	Transferable CDs	Negotiable CDs	Transferable CDs	Negotiable CDs	Transferable CDs	Negotiable CDs	
1.	2.	3.	4.	5.	6.	7.	8.	9.	10.
1970	145	-	-	-	-	-	-	-	-
1975	1,141	-	-	**	-	-	-	-	-
1976	1,077	721	429	-	-	-	-	-	-
1977	978	683	445	-	-	-	-	-	248
1978	812	398	473	-	-	-	-	-	124
1979	621	219	449	-	96		55	10	93
1980	3,365	2,478	457	-	120		141	-	340
1981	2,576	1,620	448	-	140		202	10	263
1982	3,410	2,381	457	-	167		254	29	343
1983	3,637	2,361	563	29	202		358	30	647
1984	4,086	2,968	663	*	288		353	41	1,091
							288 £	@	
1985	5,878	4,105	664	*	546		546	@	
1986	5,269	2,556	526	*	354	209	354	209	1,468
1987	3,028	833	413	*	585	359	585	359	1,001
1988	3,346	1,026	290	*	632	484	632	484	746

* Means nil.

** CD figures for June 1971, June 1972 and June 1973 are A$1.6 million, 2.7 million, and 1.2 million, respectively.

@ Separate data not available.

£ For 1984 below the line and for subsequent years, data are for Commonwealth Development Bank (which was prior ro January 1960, Industrial Finance and Mortgage Bank Departments of Commonwealth Bank).

$ In September 1978, Primary Industry Bank of Australia was granted authority to conduct banking business in Australia.

Source: *Reserve Bank of Australia Bulletins*.

especially in the tight monetary situation which developed in the final months of the financial year; in July 1974 the maximum rate on fixed deposits was raised further to 10 per cent. Current deposits with trading banks tended to decline after the September 1973 quarter" (RBA,1973-74, p.34). By then CDs had also lost their potency as a competitive instrument in the armoury of banks and there arose pressures to deregulate interest rates on all bank deposits. The Reserve Bank of Australia had accepted the case for deregulation of bank interest rates. "For a considerable time, it did not succeed in obtaining the necessary governmental concurrence with such action" (RBA, 30 June 1981, p.8). The growth was thus particularly rapid upto the end of 1980 (when the process of deregulation began)[7]. As shown in Table II.10, amongst the total interest bearing liabilities of trading banks (which were the major primary issuers of NCDs), NCDs constituted 5.2 per cent at end-June 1970 and this proportion gradually improved to 14.5 per cent in June 1975 and further to 21.0 per cent in June 1980, after which the proportion fell rather sharply. This loss of importance is associated typically with the financial deregulation which began in the year 1979-80.

The Martin and Campbell Reports on Financial Deregulation

During the 1970s, the Australian economy faced a series of disturbances; relatively high inflation rate, large budgetary deficits, considerable pressure on the Australian dollar, closer links between the domestic and international markets, and impetus for change from advancement in communications and data processing technology. Meanwhile, the rapid growth of non-banking financial intermediaries (NBFIs), the provision of a fairly wide range of financial services including provision of business finance by them, and in-

7. "There was a strong demand for funds to finance the sharp increase in lending and the banks' ability to attract funds *via* fixed deposits was restricted by the interest rate ceiling on these deposits. Yields at which certificates of deposit were issued moved beyond the 10 per cent level (which is the maximum rate banks may pay on fixed deposits) in October/November and then rose to over 13 per cent in the June quarter. Certificates of deposit comprised 10.9 per cent of total deposits at the end of the year compared with 1.1 per cent at the end of the previous year". RBA Report; 30 June 1980, p.19.

creasing links between domestic and international markets, had tended to erode the influence of monetary policy. In the early 1970s, the Reserve Bank of Australia had sought to shift the emphasis of monetary policy away from direct controls and "towards measures that operate more widely through the market" (Rowan, D.C., 1980, p.123), which gave rise to open market operations as the key instrument of monetary policy. A detailed study on the Australian monetary policy had said : "It is also plain that Governor Phillips saw the availability of funds from non-bank financial intermediaries as a function of relative prices" (*Ibid.*, p.122).

The above developments and the shifting perceptions of the monetary authorities finally led to the setting up of the *Committee of Inquiry into the Australian Financial System* (The J.K. Campbell Committee) in 1979. As the Committee's deliberations were under way, the Reserve Bank of Australia introduced certain important reforms: (i) For issuing Treasury notes and Commonwealth Bonds, a tender system replaced the earlier system of sale at predetermined prices, in December 1979 and April 1980, "which offered the prospect of funding the Government's need for finance responsibility" (RBA Bulletin, August 1984, p.69) and (ii) In December 1980, maximum interest rates on term deposits payable by trading and savings banks were abolished. Subsequently, in December 1983, following an upheaval in the foreign exchange market, the Australian dollar was allowed to float and most parts of the existing exchange controls were abolished (RBA ,30 June 1984, pp.11-12).

The process of deregulation received further impetus by the assessments made by the Review Group on the Australian Financial System (the Martin Group), which was specially asked by the new Labour Government to take a fresh view of the recommendations of the Campbell Committee with a view to further improving the efficiency of the financial system. Following its recommendations, in August 1984 all deposit rates and maturity restrictions applying to trading and savings banks were removed[8]. Finally, competition

8. For details of these reforms, see *Reserve Bank of Australia Bulletin*, April 1985. The only interest rate regulation that remained related to controls on bank interest rates on small loans of under A$100,000. In April 1985, even such interest rate ceilings were abolished except for owner-occupied housing. In April 1986, even this last piece of control was done away with.

Table II.15 : Liabilities of All Trading Banks in Australia

(A$ million)

End-June	Fixed Deposits	Negotiable Certificates of Deposit	Col. (3) as percentage of Col. (5)	Total Deposits (Fixed Deposits + Interest bearing Current Deposits + CDs)
(1)	(2)	(3)	(4)	(5)
1970	2,617	145	(5.2)	2,762a
1975	6,739	1,144	(14.5)	7,883a
1976	8,701	1,077	(10.0)	10,705
1977	10,486	978	(7.9)	12,455
1978	10,784	812	(6.4)	12,641
1979	11,957	621	(4.5)	13,737
1980	11,391	3,365	(21.0)	16,003
1981	14,612	2,576	(14.0)	18,406
1982	18,204	3,410	(14.9)	22,875
1983	20,007	3,637	(14.3)	25,346
1984	20,943	4,086	(15.0)	27,164
1985b	26,332	5,878	(16.5)	35,708c
1986b	33,381	5,269	(12.4)d	42,298
1987	35,014	3,028	(7.0)d	43,247
1988	35,566	3,348	(7.4)d	45,461

a. Does not include current deposits bearing interest liabilities.

b. Break due to establishment of new banks, which may have caused the switching of assets and liabilities from NBFIs to banks.

c. Break in series due to change in accounting procedures.

d. The decline in CDs share in the total deposits may be attributable to the sudden growth in "Bank Accepted Bills" of Trading Banks from June 1986 onwards.

Source: *Reserve Bank of Australia Bulletins*.

was further enhanced by the authorisation of 21 new banks including the granting of licences to 16 foreign banks.

Deregulation, Intermediation and NCDs

An OECD study has reported that "since deregulation, the trading banks have been able to win back market shares from non-bank financial intermediaries. More generally, intermediation within the financial sector would seem to have increased, at the expense of direct financing" (OECD, March 1987, p.13). This was as expected, for the regulatory measures were particularly discriminatory against trading and savings banks *vis-a-vis* non-banking financial intermediaries. With deregulation, the banks have received the freedom to adopt more aggressive measures to mobilise short-term deposits and other liabilities and to expand credit. Within the banking industry also, the share of four major trading banks in total assets fell gradually to 73.3 per cent in June 1988.

However, even as this broadening of the financial system has taken place, the share of the negotiable CDs in interest-bearing liabilities of all trading banks declined, as shown in Table II.15. This proportion fell from the peak of 21.0 per cent in June 1980 to 14.0 per cent in June 1981; it remained at around 15 to 16 per cent until 1985, but fell further rather sharply to about 7.0 per cent during June 1987 and June 1988.

Two factors are responsible for the above phenomenon: competitive rates of interest offered on fixed deposits (see Table II. 16) and the emergence of "bank bills" as a major instrument of financing from early 1986 onwards (see Table II.17). Unlike in the USA, the UK and the Japanese situations, the Australian financial markets have not yet developed width and depth in terms of any large number of money market instruments and deposit substitutes and hence competition has remained between fixed deposits and negotiable CDs, with the former, freed from interest rate regulations, tending to compete with the latter rather effectively.

As may be seen from Table II.16, the effective yield rates on CDs were generally 1.5 to 2.0 percentage points more on, say 30 day -

Table II.16: Interest Rates and Yields
(All Trading Banks)

Period	Certificate of Deposit(a) Issued for A$ 50,000 and over — Average weekly issues during period ($million)								Fixed Deposits of A$50,000 and over accepted or renewed (d) — Average weekly amount ($ million)							
	1 day to less than 7 days (a)	7 days to less than 14 days (a)	14 days to less than 30 days (a)	30 days to less than 3 months (a)	3 months to less than 6 months	6 months to less than 12 months	12 months and over (a)	Total	Period	1 day to less than 7 days (d)	7 days to less than 14 days (d)	14 days to less than 30 days	30 days to less than 3 months	3 months to less than 6 months	6 months to less than 12 months	12 months and over (d)	Total
1977-78*					32	10	1	43	1977-78*				389	98	29	13	529
1978-79*					15	9	2	26	1978-79*				470	123	38	15	646
1979-80*					56	30	3	89	1979-80*				454	120	37	16	627
1981-82	-	-	61(b)	80(b)	62	18	2	169	1981-82(e)	-	-	-	725(f)	197	49	17	989
1982-83	-	-	54	110	76	24	2	266	1982-83(e)	-	-	-	983(f)	192	61	19	1,255
1983-84	-	-	43	123	105	25	-	297	1983-84(e)	-	-	260	718	142	93		1,213
1984-85	16(b)	8(b)	43	146	157	33		401	1984-85(e)	1,688	111	299	842	169	120		3,229
1985-86	26	15	39	155	229	34		498	1985-86(e)(g)	4,646	258	307	1,151	213	120		6,695
1986-87(g)	63	8	27	112	148	18		377	1986-87(e)	5,838	376	349	1,393	229	111		8,296
1987-88(g)	143	9	16	95	111	31		406	1987-88(e)	13,562	553	336	1,082	180	129		15,842

Period	Weighted average Issue yield (a) (per cent per annum)								Period	Weighted average interest rate (percent annum) (c)							
	1 day to less than 7 days (a)	7 days to less than 14 days (a)	14 days to less than 30 days (a)	30 days to less than 3 months (a)	3 months to less than 6 months	6 months to less than 12 months	12 months and over (a)	Total		1 day to less than 7 days (d)	7 days to less than 14 days (d)	14 days to less than 30 days	30 days to less than 3 months	3 months to less than 6 months	6 months to less than 12 months	12 months and over (d)	Total
1977-78*					10.31	10.19	10.00	10.27	1977-78*				9.55	9.63	9.59	9.33	9.56
1978-79*					9.54	9.64	9.47	9.57	1978-79*				8.87	9.04	9.03	8.96	8.92
1979-80*					11.92	11.71	10.80	11.81	1979-80*				9.27	9.37	9.49	9.34	9.30
1981-82	-	-	19.72(b)	17.83(b)	17.62	16.87	16.56	17.82	1981-82(e)	-	-	-	15.45(f)	15.58	15.25	14.54	15.45
1982-83	-	-	14.98	15.21	14.69	14.03	15.67	14.91	1982-83(e)	-	-	-	13.65(f)	13.89	13.52	13.54	13.70
1983-84	-	-	11.32	12.29	12.02	11.80	11.88	12.01	1983-84(e)	-	-	10.88	11.40	11.51	11.41		11.30
1984-85	13.21(b)	14.34(b)	13.80	13.47	13.23	12.83		13.40	1984-85(e)	14.63	12.80	12.55	12.46	12.47	12.03		13.60
1985-86	15.66	15.12	16.84	16.81	16.44	16.50		16.51	1985-86(eXg)	16.36	15.67	16.17	15.97	16.00	15.08		16.22
1986-87(g)	*16.17*	*14.81*	*15.87*	*16.21*	*15.85*	*15.33*		*15.96*	*1986-87(e)*	*15.10*	*14.67*	*15.14*	*15.22*	*15.16*	*14.58*		15.09
1987-88(g)	11.25	12.36	12.14	12.03	12.07	12.17		11.78	1987-88(e)	11.16	10.52	10.81	11.08	11.39	11.59		11.14

* Required break-ups not available.

Notes : a) Maturity restrictions were removed from 1st August 1984. Prior to that date certificates of deposit could be issued for terms of 14 days to 4 years; the minimum term for the issue of certificates of deposits was reduced from 3 months to 30 days on 11 August 1981 and from 30 days to 14 days on 19 March 1982.

b) Based on period over which issues of these maturities were available.

c) Maximum rate 10.0 per cent per annum until 2nd December 1980.

d) Maturity restrictions were removed from 1st August 1984. Prior to that date fixed deposits of $ 50,000 and over could be issued for terms of 14 days to 4 years.

(e) Year ended second Wednesday of July.

(f) 14 days to less than 3 months.

(g) Break due to establishment of new bank(s) or commencement of reporting by new bank(s).

Source: *Reserve Bank of Australia Bulletin*, August 1984 (p. 104), August 1986 (P. S/13) and August 1988 (P. S/15).

3 month maturity than the corresponding interest rate on fixed deposits during 1981-82 and 1982-83, but thereafter this differential steadily declined and stood at less than 1.0 percentage point. Between June 1980 and June 1985, while fixed deposits grew by 18.2 per cent per annum, CDs rose by 11.8 per cent per annum. Subsequent absolute reduction in the size of the CDs is attributable to a different story.

Importance of Bank Accepted Bills

Around the first half of 1986 there came yet another Australian peculiarity in the share of 'bank accepted bills' which have some of the characteristics of a loan (in Australia, a bill accepted by a bank, whether or not the bank discounts it, appears on the accepting bank's balance sheet) and some of the features of securitisation in that the funds are provided through the market, i.e., not necessarily by a financial intermediary (See "Bank Bills", *Reserve Bank of Australia Bulletin*, August 1988, pp. 15-21). With a bank bill, the bank accepts the credit risk. Thus, the NCDs have faced, to the extent the funds originate in large business cash flows, competition from bank bills under acceptance, endorsement or discount commitments. While fund holders have found receiving higher yields than CDs, borrowers have found bill finance cheaper than loans: "The tendency now is for larger companies to have small overdraft limits for day-to day requirements, while bank bills are used for on-going and large-scale requirements" (*Ibid*, p.16). The use of bank bill finance to achieve share market acquisitions and corporate restructuring added to its rapid growth in 1986. As shown in Table II.17, financial intermediaries, although they undertake the bulk of the daily trading, account for less than one-third of the bill holdings. Once issued, most bank bills (70 per cent) are held outside the intermediaries. The study on the subject cited above has revealed that institutions managing pension and other funds, businesses and individuals account for these bank accepted bill holdings, thus offering an obvious source of competition for the negotiable CDs: "Investors -- treat bank bills as little different from bank deposits, especially negotiable certificates of deposits" (*Ibid.*, p. 19), or, as argued in a recent paper dealing with alternative measures (M_1 or M_3) of money stock, "The

Table II.17: Bank Bills Outstanding Classified by Holder (a)

($ million)

(1)	Trading banks (2)	Savings banks (3)	Permanent building societies (4)	Money Market corporations (5)	Cash management trusts (6)	Other non-bank financial intermediaries (c) (7)	Other investors (d) (8)	Total bank bills outstanding (9)	Per cent change (f) (10)
1984 June	886	759	1,872	3,491	769	875	7,770	16,421	25.3
1985 June (b)	779	500	1,411	2,739	736	943	11,861	18,968	15.5
1986 June (b)	2,230	291	2,176	3,623	1,776	980	17,321	28,396	49.7
1987 June (b)	2,233	951	2,261	4,817	1,927	1,493	25,927	39,610	39.5
1988 June (b)	3,596	850	2,711	5,808	2,337	3,012	43,079	61,393	55.0

a) Bills outstanding under acceptance, endorsement or discount commitments by banks as at the last Wednesday of the month. For trading banks, data are as at the last Wednesday of the month; for savings banks, data are end-month or near end-month. For NBFIs, data are end-month.

b) Break due to establishment of new bank(s).

c) Finance companies, general financiers, authorised money market dealers, pastoral finance companies and credit unions. Includes data on some holdings of non-bank bills and promissory notes.

d) The holdings of other investors are understated to the extent that holdings of non-bank bills, promissory notes are included in the figures for non-bank financial intermediaries.

f) Percentage changes in the twelve months to the month shown.

Source: "Bank Bills", *Reserve Bank of Australia Bulletin, August 1988*, p.18

problem can be seen most clearly in relation to the public's holdings of CDs and bank bills. The former are included in (M_3), but the latter are not, even though the holder of a Bank Bill is unlikely to view it as being very different, if at all, from a CD" (RBA Bulletin, May 1989, p.23).

7. New Zealand

Background

The financial institutions in New Zealand operated under tightly controlled regime till 1962. Although ceilings on deposit interest rates were removed in 1962, controls on trading bank advances through the reserve ratio system and limits on selective advances continued. These controls constrained their growth *vis-a-vis* non-bank financial institutions, resulting in decline in their share of activity. The authorities instead of following a more active interest rate policy tried to control non-bank sector in several ways.

Subsequently, the easing of direct controls were initiated in 1970, wherein, among others, trading banks were given some freedom to compete for deposits, though at the higher end of the market, by the removal of interest rate ceilings on deposits of over NZ $25,000 and for periods longer than two years (October 1970). Controls on interest rates on bank deposits were reimposed in March 1972 by promulgating Interest on Deposits Regulations, 1972, which embraced all deposit-taking institutions as a part of overall stabilisation package, "to contain what it (Government) saw as rapidly rising interest rates being offered by finance companies" (Deane, at al, p.310). Even so, these controls affected the trading banks more severely, while other financial institutions tended to carve out a lot of new business and expanded at much faster rates.

Against this background, the trading banks were first given authority to issue Transferable Certificates of Deposit (TCDs) in November 1971. However, it was only after the liberalisation of financial controls in March 1976, when interest controls on deposits were revoked, that the growth in TCDs was really significant.

Transferable Certificates of Deposit (TCDs)

The primary objective of introducing the TCDs in November 1971 was to broaden the range of term deposit facilities available from the trading banks to improve their competitive position *vis-a-vis* other deposit taking institutions (*Ibid.*, p.37).

The TCDs are term deposits from the point of view of the banks in that their maturity period is fixed; they are, however, non-bearer in character. However, they have a measure of liquidity not possessed by an ordinary term deposit because the asset may be realised before the maturity date by the depositor by selling the TCD to a would-be holder. Name of investor, interest rate and maturity date are recorded on a TCD. Holder has the option to transfer the instrument to another investor by registered transfer, i.e., issuing bank must be advised of the transfer. Thus, TCDs combine the advantages of security of a bank deposit and have at the same time a degree of marketability. The initial terms for TCDs limited them to maturities of twenty-five months and over, and a minimum amount of NZ $7,000. In November 1973, the conditions were revised, the maturity period being reduced to six months and the minimum amount increased to NZ $25,000. In March 1978, the minimum issue term was reduced further to 30 days and minimum amount was decreased to NZ $12,000.

The growth of TCDs from 1971 to 1981 is given in Table II.18 below:

"Their growth was particularly rapid when a period of relatively flexible interest rates prevailed in New Zealand from March 1976 to November 1981" (*Ibid.* p. 309). Although they showed an erratic trend, nonetheless this instrument became much popular after many controls on interest rates on term deposits were lifted from 1976 onwards. The outstanding amount of TCDs rose markedly from NZ $90.5 million in 1975 to NZ. $165.1 million in 1976 and further sharply in subsequent years to touch around NZ $ 500 million by 1981 (later data are not available). After re-introduction of interest rate controls for a brief period between 1981 and 1982, the financial system was again liberalised, resulting in complete abolition of interest rate controls on deposits and lending from mid-

Table II.18: Transferable Certificates of Deposit and Time Deposits with Trading Banks

End of Year	Certificates of Deposit		Time Deposits	
	Amount in NZ$ million	Growth Rate %	Amount in NZ$ million	Growth Rate %
(1)	(2)	(3)	(4)	(5)
1971	1.6		340.4	29.7
1972	21.0		500.1	42.7
1973	77.5	269.0	781.7	56.3
1974	86.4	11.5	960.0	22.8
1975	90.5	4.7	1,042.5	8.5
1976	165.1	82.0	1,329.1	27.4
1977	147.5	-10.6	1,772.9	33.4
1978	287.9	95.1	2,293.3	29.4
1979	443.0	53.9	2,966.9	29.4
1980	374.3	-15.5	3,626.8	22.2
1981	475.6	27.1	4,253.2	17.3

Source: Deane, R.S., et al., op. cit., pp. 35 and 36.

1984. Two long-standing controls on interest rates which prevented trading banks from paying interest on deposits for less than 30 days, and which restricted the savings banks to paying not more than 3 per cent per annum on ordinary saving accounts were abolished (Reserve Bank of New Zealand, 1985, p. 23).

Yet another revealing aspect is the fluctuation in interest rates offered on TCDs depending upon monetary conditions and current and expected inflation rates. "For example, average trading bank TCD rates peaked at almost 16 per cent in November/December, compared to levels of less than 13 per cent at the beginning of the financial year. With the easing of monetary policy in the March

quarter of 1980, short-term interest rates generally fell a little. Average TCD rates, for example, were around 14 per cent in February/March" (RBNZ, 1979-80, p. 12).

Negotiable Certificates of Deposits (NCDs)

In addition to the TCDs, banks were permitted to issue Negotiable Certificates of Deposits (NCDs) in November 1977. This was done around the period when from March 1976 onwards several far reaching measures were taken to remove distortions between the institutions and to improve competitive efficiency of the financial sector. Interest rate controls were removed in March 1976 and the Government accepted the need to move to higher interest rate structure in order to successfully market its debt; it issued a new retail saving stock. Each bank sets its own conditions of an NCD issue subject to a minimum term of 30 days; these are issued on a discount basis for minimum term of 30 days and with minimum amount ranging for the banks between $12,000 and $50,000. Their outstanding level grew steadily till September 1978 reaching $ 99.5 million. However, their popularity has since declined mainly because they are a security risk if lost or stolen (being a bearer instrument) and because, as in the case of Australia, Bank Bills have become a more popular form of investment. The popularity of Bank Bills is, in turn, explained by the fact that they are guaranteed by banks and therefore payments are assured. Consequently, the outstanding level of NCDs declined sharply to $4 million by end of 1982.

The NCDs differ from TCDs in that the former are bearer instruments and no transfer deed is required as in the case of TCDs. TCDs, on the other hand, have become popular, and as stated earlier, their outstanding amount had reached around $500 million by the end of 1981. It is, however, surprising to find that unlike in other countries where NCDs have become popular being a bearer instrument, the very same feature should have stiffled their growth in New Zealand. Despite being an authorised trustee investment and despite there being an active Secondary market, NCDs have faced stiff competition from Bank Bills and TCDs.

Part III : CDs in Selected South East Asian Countries

In this section, the position in regard to the instrument of CDs in selected South East Asian Countries, viz., South Korea, Malaysia and Indonesia is reviewed on the basis of available data. CDs were introduced in these countries during the 1970s mainly in order to activate the money market, while in Korea, the new instrument had an added objective of serving as an anti-inflationary measure to mop up excess liquidity. Details of CDs introduced in these countries have been tabulated and presented in Table III.1. CDs in all these countries are negotiable large time deposits at banks and are issued for various maturities depending upon market conditions obtaining in each country.

1. South Korea

CDs were introduced in South Korea in May 1974 following the activisation of the money market on the basis of Capital Market Promotion Act, 1968. The background for the introduction of CDs in South Korea in May 1974 was the raging inflationary conditions around that period and a series of measures taken with a view to augmenting savings and thereby constraining demand-pull inflationary factors. Under the *Temporary Measures on Maximum Deposit Interest Rates of Banking Institutions*, radical upward adjustments were made of interest rates on saving and time deposits. In January 1974, the maximum interest rate on time deposits was raised to 15 per cent and a special Household Time Deposits scheme with an interest rate of 16 per cent per annum was newly introduced; the latter was further raised to 18 per cent in December 1974 and interest rates on all time deposits of over 3-month maturity were uniformly stepped up to 15 per cent per annum.

In the above *milieu*, negotiable certificates of time deposits were introduced to absorb temporary excess funds of firms and households by providing customers with the convenience of transferability of those time deposits (Bank of Korea, Annual Report 1974). CDs with maturity periods ranging between 91 days and 180 days were instituted to absorb temporary excess funds of firms and households by providing customers with the convenience of trans-

ferability of time deposits. The objective was to absorb excess liquidity in the economy in line with a series of other measures to contain inflationary pressures. While the interest rate on CDs at the level of primary issue was regulated, they were allowed to be traded freely at the secondary market. Denomination of issuance was kept at a high level of 100 million won and the banking system as a whole was assigned a limit of 1400 billion won.

After a brief lull from December 1981 to June 1984, the market for CDs got revived in full swing beginning in 1984.

"CDs which had been created in 1974 and then lay dormant, were reactivated in June 1984 to help staunch the outflow of funds from commercial banks to non-bank financial institutions" (Pyung Joo Kim, 1988, p.22). This happened after steps were initiated to introduce gradual deregulation of interest rates. With the replacement of uniform rates by a narrow band flexibility in lending rates got introduced. Certain deposit rates applicable to non-banking financial intermediaries (NBFIs) were raised to make them more competitive to bank deposits. In turn, to facilitate banks to attract investment in CDs, the rate of interest on the instrument was liberalised in March 1986. Earlier the CD rate was fixed at 11.0 per cent in 1984 when the banks' term deposit rates were 6 per cent for maturity upto one year and 10 per cent for over one year. In 1985, the CD rate was raised to 11.75 per cent even though the term deposit rates remained unchanged. After the liberalisation of interest rate on CDs, there was a slight reduction in the rate from 11.75 per cent in 1975 to 11.0 per cent in 1986 and further to 10.75 per cent in 1987. However, the CDs issued by commercial and specialised banks made a steady improvement from 684 billion won in 1984 to 1,081 billion won in 1985, and finally to 1,758 billion won in 1988.

2. Malaysia

By the late 1970s, Malaysia became a net exporter of petroleum and an exporter of natural gas in the early 1980s. In the second half of the 1970s, buoyant commodity prices improved the terms of trade and generated massive balance of payments surpluses. In that economic environment, Malaysia adopted liberal financial policies.

Table III.1 Data on Certificates of Deposits (CDs) in Selected Asian Countries

Country	When financial liberalisation started	Year of introduction of CDs	Denomination	Maturity period	Experiences before and after liberalisation	Rate of interest (per cent per annum)	size of market	Treatement in Money supply	Remarks
1	2	3	4	5	6.	7.	8.	9.	10.
1. South Korea@	From 1984 most lending rates were liberalised. In March 1986, the interest rate on CDs was liberalised. From Dec. 1988, interest rates on deposits and loans are deregulated.	1974	Denomination was from 100 million won to 50 million won, effective Feb. 13, 1988	91 days 180 days	CD accruals improved on interest rate liberalisation	1986 1987 11.00 10.75	1987 Won 1.6 billion	Broad money plus CDs (Billions of won) 1987 Narrow Money 10,107 Quasi money 30,172 CDs 1,621 Total 41,900	i) Originally introduced to absorb excess liquidity with money savings in line with series of measures to contain inflationary pressures ii) The Bank of Korea raised banking institutions, total insurance limit of CDs in two stages form 1400 billion won to 2,600 billion won.
2. Malaysia	In 1978, freeing of the interest rate regime took place. In the last quarter of 1986 and during 1987 steps were taken for covering lending rates and costs of funds.	1979	M$2,50,000 for financial institutions (including insurance cos.) M$ 1 million for corporations	3 months 6 " 9 " 12 " 24 "	CDs were introduced as part of free interest rate regime; rapid growth has been noticed	A shade lower than those fixed for term deposits of similar maturities	1987 $7.3 billion	Forms part of M2, M1 (Currency + demand deposits) plus fixed and savings deposits with Central Bank & commercial banks, CDs and central Bank, Certificates	NCDs increased by 7 per cent in 1987, greater flexibility was provided by NCDs in matching term loans, there was active trading of NCDs in secondary markets
3. Indo-@@ nesia	In 1983, financial reform was initiated and lending and deposit rates of state banks were decontrolled	1971		14 days to 12 months	As the freeing of interest rate was followed by the introduction of competing instruments, CDs lost their special importance	March 1986 14 days 7-10 1 month 12-14.5 2 " - 3 " 12.5-14.75 6 " 13-15.5 9 " - 12 " 13-16 24" 11.5-17.4	1986 Billions of Rupiah 243	Forms part of quasi moneyre. time and savings deposits	Except from stamp duties on securities; however, subject to general stamp duty for purpose of promotion of their development

@ Money market was activated on the basis of Capital Market Promotion Act, 1968.
@@ Introduced for paying way for substitutions of Bank Indonesia Certificates.
N.A.: Not available.

Table III.2: Trends in Aggregate Deposits & CDs : KOREA

(In billion won)

(1)	1984 (2)	1985 (3)	1986 (4)	1987 (5)	1988 (6)
I. Commercial Banks					
Domestic liabilities	27274.8	31097.3	35701.3	44834.0	52540.6
Deposits	17072.1	18389.2	20738.6	26380.7	34042.0
CDs	580.8	735.1	942.4	959.4	897.2
Deposits in foreign currency	491.0	595.7	1297.1	2967.1	4001.0
II. Specialised Banks					
Domestic liabilities	17758.9	20228.5	24505.2	31950.2	38791.7
Deposits	11172.8	12872.5	15541.0	19691.3	23851.8
CDs	103.5	345.8	365.6	695.9	860.6
Deposits in foreign currency	285.6	343.8	496.1	2234.6	3151.7
Aggregate CDs	684.3	1080.9	1308.0	1655.3	1757.8

Source : The Bank of Korea Annual Reports, 1987 and 1988.

Important amongst them was the freeing of interest rates in June 1978.

As part of such liberalisation, negotiable certificates of deposit (NCDs) were introduced in may 1979, initially with four maturities, viz.,6,9,12 and 24 months. Its features were considered similar to those of fixed deposits but arrangement to negotiability and marketability were its special features. The minimum size of NCDs issued was fixed at MS 250,000 for financial in-

stitutions including insurance companies, while for non-financial corporations it was set at M$ 1 million. The minimum maturity period was subsequently fixed at 3 months and not more than 5 calendar years. In general, interest rates payable on CDs were a shade lower than those for fixed deposits of similar maturities. Unlike in other countries, CDs in Malaysia are not issued on a discount basis. Instead, CDs are issued at par on an interest rate to maturity basis. On issues within one year, interest is paid at maturity and on longer issues interest is paid annually on the anniversary dates of issues with the final payment on maturity (Bank Negara Malaysia, 1986). As a group, foreign incorporated banks were initially more active in the issue of NCDs, while local banks were adopting a cautious approach towards this new instrument. As at the end of 1979, outstanding amount of NCDs issued was equivalent to only about one quarter of the limit set by the Central Bank.

The market for new instrument expanded slowly; in terms of maturity structure, the popular maturity period was 12 months, followed by 3 and 6 months. In order to enhance the development of money market, six merchant banks were allowed to issue NCDs with effect from February 1,1987, while ten finance companies were allowed to participate in the inter-bank market (seven with effect from October 1 and three with effect from December 1,1987), which made the secondary market for NCDs active. The minimum size of NCDs was the same as fixed for commercial banks. The amount of NCDs that may by issued by each merchant bank is determined by the size of its capital funds. As NCDs are deposit substitutes, those merchant banks which have been allowed to issue this instrument are required to observe a higher liquidity ratio of 12.5 per cent of total eligible liabilities, compared with 10 per cent for the other merchant banks. As at the end of 1987, a total of M$ 355 million of NCDs had been issued by six merchant banks. Available information for the end of 1987 suggests that over 95 per cent of the outstanding NCDs were issued by domestic banks, representing 69.5 per cent of the authorised limit set for the commercial banks as a whole by the Central bank.

As regards the treatment given in monetary aggregates, NCDs are included in M2, i.e.,M1 (Currency plus demand deposits) *plus*

fixed and savings deposits, NCDs and Central Bank Certificates (as shown in Table III. 3).

Table III. 3: Money Supply and CDs: MALAYSIA

(M $ million)

(1)	Annual change 1986 (2)	1987 (3)	1988 (4)	At the end of 1987 (5)	At the end of 1988 (6)
1) Money supply (M_1)	378	1,811	2,301	15,768	18,069
2) Broad money (M_2)	*5,370*	*2,692*	*3,895*	*56,459*	*60,354*
a) Quasi-money	4,992	881	1,594	40,691	42,285
i) Fixed deposits	3,633	-3,816	685	25,261	39,000
ii) Savings deposits	916	4,365	1,966	10,226	14,678
iii) Negotiable certificates of deposit	443	61	611	4,674	4,482
iv) Central Bank certificates	-	-	-	530	30

Source: Annual Report of Bank Negara Malaysia (1988).

3. Indonesia

In Indonesia, the Central bank had been issuing its Bank Indonesia Certificates to regulate domestic liquidity. This policy was sought to be reversed and in order to pave the way for the substitution of its own Certificates, the Bank Indonesia granted its approval from January 1971 to several banks to issue CDs having maturities from 14 days to 12 months. These CDs were to be in bearer form and negotiable. Interest rates varied between 1 per cent and 1 3/4 per cent per month computed on the basis of discount; CDs were exempted from stamp duty on securities but were subjected to a general stamp duty.

Subsequently, in the early 1980s Indonesia emerged as a major

exporter of petroleum products, as a result of which substantial foreign exchange assets began to be created. In this environment, the Indonesian authorities initiated a series of financial reforms in 1983 and decontrolled lending and deposit rates of state banks. This was, however, followed by the reintroduction of the Bank Indonesia Certificates (SBI) in February 1984 with a view to mopping up additional liquidity in the system. In addition, Bank Indonesia introduced a rediscounting arrangement for money market securities (Surat Berharga Pasar Uang or SBPU) in February 1985. Since then, the Indonesian Central bank has been influencing interest rates in economy indirectly through the modifications of the discount rate on SBI and the rediscount rate on SBPU. The available range of SBPUs was also enlarged, effective from August 1986.

With the freeing of the interest rates in the recent years and the introduction of, and encouragement to, the other money market instruments, the importance of CDs began to recede in the latter half of 1985, as may be seen from Table III.4.

Subsequent to the sharp loss in oil revenues and consequential sluggishness in business activity, the money market rates tended to decline after 1985-86; both the interest rates offered on CDs and time deposits of comparable maturity fell rather sharply during the year; and interest rates on CDs remained even marginally lower than those of relative time deposits. As a result, the amount of CDs issued by banks recorded a decline of 45.4 per cent (by Rp 202 billion) during 1985-86 and dropped further by 50.6 per cent (by Rp 123 billion) during 1986-87 and the outstanding amount stood at Rp 120 billion at end-March 1987 (Table II.4). During 1986-87, CDs issued by state commercial banks decreased by Rp. 98 billion, and those by foreign and private national commercial banks declined by Rp 25 billion. The outstanding amount had earlier risen to Rp 590 billion at the end of September 1985. Even so the willingness of private national banks to issue CDs continued to increase and 3 additional such banks were granted approval as issuers of CDs during 1985-86 and 4 during 1986-87. As at the end of March 1987, there were 26 banks permitted to issue this instrument, comprising 5 state banks, 11 foreign banks and 10 private national commercial banks.

CDs are included under quasi-money (consisting of time and savings deposits as well as foreign currency deposits held by the domestic private sector) and form part of the broad money.

Table III.4 Money Market Instruments (Outstandings) : INDONESIA

(Billions of Rupiah)

End of Period	CDs			Bank Indonesia Certificates (SBI)	SBPU (By Securities House)
	State banks	Foreign banks	Total		
(1)	(2)	(3)	(4)	(5)	(6)
1973	24	8	32	-	-
1980	52	27	79	-	-
1984	112	18	130	212.8	-
1985					
March	418	27	445	242.9	213.8
June	485	37	522	2.7	89.3
September	557	33	590	407.2	56.8
December	279	42	321	966.0	441.4
1986					
March	184	59	243	1394.0	656.0
June	110	53	163	2056.8	513.6
September	94	40	134	1135.2	268.4
December	94	37	131	746.2	1086.0
1987					
March	86	34	120	161.4	966.0

Source : Annual Reports of Bank Indonesia.

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Private Non-profit Institutions Serving Households - A Profile

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A large number of private non-profit institutions such as trusts, charitable institutions, welfare associations, etc., render a wide range of social services to the community at large, which will, *inter alia* influence the economic status of the various segments of the household sector. However, very little information about the structure, financial performance, etc., of these institutions is currently available. With a view to obtaining such information, a sample survey of Private Non-profit Institutions (hereinafter referred to as PNP institutions) was undertaken by the Reserve Bank of India in September 1988 with 1986-87 (April-March) as the reference period. Although the survey was designed to obtain reliable quantitative estimates of different characteristics, the response to the enquiry was rather low. Filled-in schedules were obtained only in respect of 365 institutions out of a planned sample of about 2000. Many selected institutions did not furnish the required information to the desired extent. The scrutiny of filled-in schedules indicated that the data furnished by only 187 PNP institutions were found to be admissible for tabulation. This study may, therefore, have to be viewed more as a type study to get some broad picture of the organisational and financial aspects of the PNP institutions

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The survey was conceived and planned under the guidance of late Shri S.P. Gothoskar, Ex-Principal Adviser of the Department. Shri R. Nagaraja Rao and Dr. S.N. Prasad were also associated with the survey at different stages of work. The author is thankful to Shri W.S. Saraf, Principal Adviser of the Department for his valuable suggestions. In the preparation of the article, the author was assisted, among others, by Shri M.V.S. Murti and Shri R. Satyanarayana. The staff in the selected offices of banks helped in collecting data and field operations were supervised by the Regional Offices of the Department.

rather than an attempt at estimating the values of the selected characteristics.

Organisational and other Characteristics of the PNP Institutions.

Of the 187 PNP institutions covered in the survey, 75 institutions (40 per cent) were registered under Societies' Registration Act, and another 73 (39 per cent) were registered under Public Trusts Act; 17 institutions were registered under various other Acts. In respect of the remaining 22 institutions such information was not available.

The age structure of the responding institutions revealed that as at the end of March 1987, 52 PNP institutions (28 per cent) were registered during the previous decade and an equal number, 11 to 20 years ago (Table 1). Another 50 of the selected institutions (27 per cent) were registered 21 to 50 years ago. Twenty four institutions were found to be 51 to 100 years old, while only 2 of the selected institutions came into existence more than a century ago. Thus only about 28 per cent of the institutions studied would be regarded as of recent origin, they having been setup in the past 10 years previous to the reference year.

Table 1: Distribution of PNP institutions according to age of the institution

Age of the institutions	No. of institutions	Percent to total
1	2	3
1. Upto 5 years	20	10.7
2. 6 - 10 years	32	17.1
3. 11 - 20 years	52	27.8
4. 21 - 50 years	50	26.7
5. 51 - 100 years	24	12.8
6. Above 100 years	2	1.1
7. Date of establishment not reported	7	3.7
Total	187	100.0

Two of the 187 selected PNP institutions were non-resident institutions and while another 17 institutions were aided mainly through foreign funds; the rest 168 were supported by the domestic funds.

Organisation-wise, of the 187 institutions, 77 were trusts, 57 societies (sanghs, samithis, mandals, etc.) and 47 associations of the members.

About one-third (58 institutions) of the selected institutions had 5 members or less and another 28 institutions (15 per cent) had a membership varying from 6 to 10 members (Table 2). There were 28 large institutions with a membership of 101 to 500 and 22 very big institutions whose membership exceeded 500.

Table 2: Distribution of PNP institutions according to number of members

Number of Members	No. of institutions	Per cent to total
1	2	3
1. 5 or below	58	31.0
2. 6 - 10	28	15.0
3. 11 - 25	24	12.8
4. 26 - 50	14	7.5
5. 51 - 100	13	7.0
6. 101 - 500	28	15.0
7. Above 500	22	11.8
Total	187	100.0

A little over half of the selected institutions (54 per cent) reported 5 employees or less on a full-time basis (Table 3). Most of the selected institutions (170 institutions) reported employment of 5 persons or less on a part-time basis. One hundred and fifty-three PNP institutions reported 5 or less honorary workers and 162 institutions had voluntary workers in the same range during the year 1986-87. The 187 institutions reported sizeable work force

of 11,869 persons working for them, of whom 7,732 were full-time employees (65 per cent), 1,179 part-time employees (10 per cent), 720 honorary workers (6 per cent) and the rest 2,238 were voluntary workers. On an average, a PNP institution worked with 41 full-time and 6 part-time employees; it was also assisted by 4 honorary workers and 12 voluntary workers.

Table 3: Distribution of PNP institutions according to number of employees

No. of employees/ workers	Category of Employees/Workers				
	Full-time (paid)	Part-time (paid)	Honorary workers	Voluntary workers	Institutions reporting persons belonging to one or more of the categories.
1	2	3	4	5	6
1. 5 or below	101	170	153	162	61
2. 6 - 10	16	5	12	6	22
3. 11 - 20	14	6	11	11	23
4. 21 - 50	21	1	10	5	34
5. 51 - 100	18	2	1	1	25
6. 101 - 200	10	1	-	1	13
7. Above 200	7	2	-	1	9
Total number of institutions	187	187	187	187	187
(Total employees/ workers)	(7,732)	(1,179)	(720)	(2,238)	(11,869)

Classified according to major activities, 71 of the 187 selected PNP institutions (38 per cent) reporting educational services formed the largest group, followed by 28 institutions engaged in activities relating to health and medicine (15 per cent) and 26 institutions rendering welfare services (14 per cent). Those engaged in religious activities numbered 23 (12 per cent) and the remaining institutions were extending miscellaneous social services. Nearly one-third of

the selected institutions reported two or more activities during the year. Twenty eight institutions, however, did not report any activity during the reference year and hence appeared to be dormant. It was found that 24 of the selected PNP institutions rendered services to the economically weaker sections of the society and 31 institutions served the students. Bulk of the selected institutions (105 of them) reported services to all households irrespective of caste, creed or religion.

For the purpose of this study, net value added* by the institutions in a year is taken to be the same as salaries and wages paid to the employees. Classified according to this criterion, 61 institutions reported net value added as "nil" during 1986-87 (Table 4). Sixtytwo institutions (33 per cent) reported net value added less than Rs.50 thousand each and another 36 institutions fell in the range of Rs. 50 thousand to Rs.5 lakhs. The net value added by each of the remaining 28 institutions exceeded Rs.5 lakhs.

Table 4: Distribution of PNP institutions according to net value added

Net value added (Rs.) (1)	No. of institutions (2)
1. Nil	61
2. Less than 50,000	62
3. 50,000 - 5 lakhs	36
4. 5 lakhs and above	28
Total	187

Classified according to the deposits received by the institutions from the public, 158 institutions (84 per cent) constituting the bulk, reported receiving deposits of Rs. 10,000 or less (Table 5)

* According to the guidelines provided by the UN System of National Accounts, the value added of this sector is taken to be equivalent to the cost of producing the services, viz., compensation to the employees.

Table 5: Distribution of PNP institutions according to deposit received

Deposits received (1)	No. of institutions (2)
1. 10,000 or below	158
2. 10,000 - 1 lakh	11
3. 1 lakh - 5 lakhs	13
4. Above 5 lakhs	5
Total	187

and at the other end of the scale, 5 institutions reported deposits of above Rs.5 lakhs each. The inflow of funds by way of deposits was therefore meagre.

On the basis of size of total net assets, it is observed that about one-third of the institutions (65 institutions) reported total net assets less than Rs.5 lakhs each (Table 6). Another 43 institutions reported assets ranging from Rs. 5 lakhs to Rs.15 lakhs each and almost an equal number had assets in the range of Rs. 15 lakhs to Rs. 50 lakhs. The remaining 37 institutions reported total assets of Rs.50 lakhs and above each.

Table 6: Distribution of PNP institutions according to total net assets

Total net assets (Rs.) (1)	No. of institutions (2)
1. Upto 5 lakhs	65
2. 5 lakhs - 15 lakhs	43
3. 15 lakhs - 50 lakhs	42
4. 50 lakhs and above	37
Total	187

The distribution of units according to size of total income indicated that 66 of the selected institutions (35 per cent) reported total income less than Rs.1 lakh during the year 1986-87 and another 72 of them (38 per cent) reported income ranging from Rs.1 lakh to Rs. 10 lakhs (Table 7). Of the remaining, 15 institutions reported total income above Rs. 50 lakhs.

Table 7: Distribution of PNP institutions according to total income

Total income (Rs.) (1)	No. of institutions (2)
1. Upto 1 lakh	66
2. 1 lakh - 10 lakhs	72
3. 10 lakhs - 50 lakhs	34
4. 50 lakhs and above	15
Total	187

Financial characteristics of the PNP institutions

The total income of the 187 PNP institutions stood at Rs.33.2 crores in 1986-87 as against Rs.31.5 crores in 1985-86 registering an increase of 5.4 per cent during 1986-87 (Table 8). The average total income during 1986-87 per PNP institution thus worked out to Rs. 17.8 lakhs. Income by way of receipts for services rendered was Rs.10.6 crores -a rise of 52 per cent- as against Rs.7.0 crores in 1985-86. Grants from Government and local bodies at Rs. 3.7 crores, interest receipts at Rs. 3.2 crores and receipts by way of membership fee at Rs. 2.5 crores were other important sources of income for these institutions.

On the expenditure side, salaries and wages at Rs.9.1 crores in 1986-87 accounted for 27 per cent of the total expenditure whereas 'other expenses' at Rs.12.2 crores were quite substantial accounting for 37 per cent. Other provisions (9 per cent), interest paid (5 per

Table 8: Combined Income and Expenditure of 187 PNP Institutions, 1985-86 and 1986-87

(Rs. thousands)

Expenditure (1)	1985-86 (2)		1986-87 (3)		Income (4)	1985-86 (5)		1986-87 (6)	
1. Raw materials	9503	(3.0	12987	(3.9)	1. Grants from Govt./Local Bodies	32030	(10.2)	36791	(11.1)
2. Power, fuel & lubricants	4043	(1.3)	4733	(1.4)	2. Donations in cash/kind	95099	(30.1)	78554	(23.6)
3. Maintenance of assets	9903	(3.1)	9757	(2.9)	3. Sale of products	1991	(0.6)	2892	(0.9)
4. Salaries and wages	80704	(25.6)	90793	(27.3)	4. Receipt for services	69774	(22.1)	106210	(32.0)
5. Rates, taxes, cess etc.	2569	(0.8)	2371	(0.7)	5. Receipt from membership etc.	40210	(12.7)	25105	(7.6)
6. Depreciation provision	7887	(2.5)	12147	(3.6)	6. Interest	27924	(8.9)	32353	(9.7)
7. Other provisions	27230	(8.6)	31064	(9.3)	7. Dividends	617	(0.2)	1177	(0.4)
8. Rent paid	3491	(1.1)	1888	(0.6)	8. Rent received (Total)	9998	(3.2)	11109	(3.3)
9. Interest	8011	(2.5)	17020	(5.1)	9. Income from other sources	37791	(12.0)	38274	(11.5)
10. Other services purchased	11287	(3.6)	12053	(3.6)					
11. Other expenses	128641	(40.8)	122173	(36.8)					
12. Total expenses	293269	(93.0)	316985	(95.3)					
13. Excess of income over expenditure	22165	(7.0)	15481	(4.7)					
Total	315434	(100.0)	332466	(100.0)	Total	315434	(100.0)	332466	(100.0)

Figures in brackets are percentage to total.

Total may not tally with details due to figures being rounded off.

Table 9: Combined Balance Sheet of 187 Private Non-profit Institutions for 1985-86 and 1986-87

(Rs. thousands)

Liabilities (1)	1985-86 (2)		1986-87 (3)		Assets (4)	1985-86 (5)		1986-87 (6)	
1. Corpus Fund	767135	(73.7)	901485	(72.7)	1. Gross fixed assets	304982		347928	
2. Provisions	9321	(0.9)	11879	(1.0)	i) Land	28170		55813	
3. Borrowings	53780	(5.2)	49165	(4.0)	ii) Buildings	183188		190850	
4. Deposits from individuals					iii) Plant and machinery	8339		8985	
and others	158013	(15.2)	216958	(17.5)	iv) Others	85285		92280	
i) National	158013	(15.2)	216780	(17.5)	2. Depreciation to date	36928		46796	
ii) International	-		178	(0.0)	3. Net fixed assets	268054	(25.7)	301132	(24.3)
5. Other liabilities	53223	(5.1)	60922	(4.9)	4. Inventories	5753	(0.6)	9376	(0.8)
					5. Loans and advances	110187	(10.6)	132220	(10.7)
					6. Investment	265943	(25.5)	333981	(26.9)
					7. Advance of income tax	1663	(0.2)	1118	(0.1)
					8. Other Assets	159003	(15.3)	227302	(18.3)
					9. Cash and bank balances	230869	(22.2)	235280	(19.0)
Total liabilities	1041472	(100.0)	1240408	(100.0)	Total assets	1041472	(100.0)	1240408	(100.0)

Figures in brackets are percentage to total.

Total may not tally with details due to figures being rounded off.

cent), raw materials and depreciation (4 per cent each) were other important items of expenditure. Excess of income over expenditure at Rs. 1.5 crores in 1986-87 (5 per cent of total income) showed a substantial decline from Rs. 2.2 crores in 1985-86. Net value added per employee worked out to Rs. 10,189 during the year 1986-87.

The total net assets of 187 PNP institutions rose from Rs. 104.1 crores in 1985-86 to Rs.124.0 crores in 1986-87 registering a growth of 19.1 per cent during the year (Table 9). The average value of total net assets as on 31st March 1987 per PNP institution worked out to Rs.66.3 lakhs. Corpus fund which constituted about three-fourths of the total liabilities in 1985-86 rose by 17.5 per cent to Rs. 90.1 crores in 1986-87. Next in importance was 'deposits received from individuals and others' (Rs.21.7 crores) which accounted for 18 per cent of the total liabilities; these deposits registered a substantial rise of 37 per cent during the year. Average deposits per PNP institutions worked out to Rs. 11.6 lakhs. Borrowings declined by 9 per cent from Rs. 5.4 crores to Rs. 4.9 crores forming about 4 per cent of the total liabilities.

Investment in shares and securities was the major component in total assets of the selected PNP institutions and amounted to Rs.33.4 crores in 1986-87 forming 27 per cent of the total assets, followed by net fixed assets at Rs.30.1 crores (24 per cent), cash and bank balances at Rs.23.5 crores (19 per cent) and 'other assets' at Rs. 22.7 crores (18 per cent). During the year 1986-87, investments registered a growth of 26 per cent, while net fixed assets increased by 12 per cent over the previous year.

Summary of observations

The private non-profit institutions like trusts and charitable institutions render wide range of social services to the community at large. In view of the low coverage, the results presented in this article have to be viewed as indicative for this class of institutions. Trusts registered under the Public Trusts Act and societies registered under the Societies Registration Act formed the most important types of the PNP institutions as on 31st March 1987. The age-wise distribution of the institutions indicated that proportion of

units falling in each of the age groups of 10 years or less, 11 to 20 years and 21 to 50 years was of the same order of about 28 per cent. About 90 per cent of the institutions were funded by domestic sources and the rest were aided mainly through foreign funds. On the average, a PNP institution functioned with 41 full-time and 6 part-time employees and was also assisted by 4 honorary and 12 voluntary workers. PNP institutions reporting educational services formed the largest group followed by those engaged in services relating to health and medicine.

Average total income and total net assets per institution for year ended 31st March 1987 worked out to Rs. 17.8 lakhs and Rs.66.3 lakhs, respectively. The total net assets of all 187 PNP institutions showed a rise of 19.1 per cent during 1986-87 while the total income rose by 5.4 per cent.

Income by way of receipts for services rendered constituted about one-third of the total income while donations in cash and kind accounted for about 24 per cent. Salaries, wages and 'other expenses' were major items of expenditure accounting for 27 per cent and 37 per cent of the total expenditure. Net value added per employee was estimated at Rs. 10,189 during the year 1986-87.

Corpus funds of all the selected institutions accounted for about 73 per cent of their total liabilities. Investments in securities and shares, etc., net fixed assets and cash and bank balances, were major items of assets accounting for 27 per cent, 24 per cent and 19 per cent, respectively.

It would be desirable if State-level administrative agencies like the State Statistical Bureaux conduct periodically comprehensive surveys to get reliable estimates of various economic characteristics of these organisations in their respective states. This will go a long way in filling data gap pertaining to this segment of the economy in National Accounts Statistics.

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BOOK REVIEW

The Ethical Dilemmas of Managers

[La Rue Tone Hosmer : The Ethics of Management (Richard D. Irwin, 1987 - First Indian Reprint, 1989)]

The case histories (all real-life but adequately masked) are temptingly quotable. The style: disarmingly simple and direct. The focus: on the individual manager as he faces day to day decisions in an organisational set up. Sample this one:

Price it would seem, should be a purely economic decision based upon cost and demand. Yet the pricing level selected can have harmful effects upon some customers. In banking, for example, under the combined impact of deregulation by the Government and competition from other financial service firms (in the US) it has become common to pay fairly high rates of interest on customer deposits. But the benefit of those rates go primarily to the customers with the larger bank balances. To offset the increased interest that must be paid to attract the large deposits and to reflect the actual cost of service, most banks have raised the fees they charge smaller customers.

(Case) "I have been asked to do a study of the pricing for our checking account services. Other banks in the area now charge $0.10 for each transaction for accounts that don't maintain $1000 balance and an additional $5.00 per month for the very small accounts with a balance that falls under $300. That makes a lot of sense, economically. We just barely break even now servicing the medium-sized accounts, and we lose money in the smaller ones. The proposed price change would mean that our returns would be equal for all the sizes of accounts. But there is a problem. We are an urban bank. Many of our customers are retired, on Social Security. Five dollars a month is a major expense for them; it

represents a couple of meals they are not going to eat. Most of them don't have the money to maintain a $300 balance. They are older, and frightened of carrying cash. I don't think it is right to, in essence, deny checking account services to older people. But I don't know what to do about it. You see, if we don't have the same rate structure as the other banks, we will get all these older and unprofitable customers.

When I left (name of the business school) I was determined that I would maintain my personal standards in everything that I did. Yet in the first year I am going to recommend a policy that I think is morally wrong" (statement of former student).

The Nature of Ethical Problems in Management

The case histories reveal that ethical problems in management have 5 major characteristics:

i) Most ethical decisions have extended consequences : bribes change governmental processes, pollution affects environmental health, unsafe products destroy individual lives.

ii) Most ethical decisions have multiple alternatives: contrary to the common perception that ethical issues in management are dichotomous, multiple alternatives have to be considered in making ethical choices.

iii) Most ethical decisions have mixed outcomes: social benefits and costs as well as financial revenues and expenses are associated with almost all of the alternatives in ethical choices.

iv) Most ethical decisions have uncertain consequences: a deterministic model-that is, one without probabilities -simplifies the process of analysis, but does not accurately describe the managerial dilemma.

v) Most ethical decisions have personal implications: managerial controls are designed to record financial results, not the ethical quality of the decisions, and most incentive systems are based on these controls: maintain the dollar sales of imported goods at ex-

pected levels, and despite slightly increased expenses for indirect bribes, the quarterly review will be pleasant and remunerative.

In short, ethical problems in business are the dilemmas faced by managers (and not by 'corporate' entities, which term in relation to ethical problems is strongly decried by some authors[1]) as they mull over the continual conflict between the economic performance of the firm measured by revenues, costs and profits, and the social performance of the firm, much more difficult to measure but represented by obligation to employees, customers, creditors, suppliers, distributors and members of the general public. And these problems have multiple alternatives and mixed and uncertain outcomes. So how does one come out of the maze? The book does not intend an answer, but by examining various economic, legal normative and organizational approaches to the problem, tries to heighten one's appreciation of the dimensions of the problem, and hence to assist in arriving at a personal ethic when faced with such dilemmas. The case studies even have small exercises at the end to help us in the process.

The Economic Approach

Microeconomic theory in its complete form is more a normative theory of society than a descriptive theory of the firm. And the ethical substance of microeconomic theory is encapsulated in Pareto Optimality. Pareto Optimality refers to a condition in which the scarce resources of society are being used so efficiently by the producing firms, and the goods and services are being distributed so effectively by the competitive markets, that it would be impossible to make any single person better off without harming some other person. Hence, the ethical prescription is: produce the maximum economic benefits for society, recognising the full personal and social costs of that production, and then broaden the receipt of those benefits if necessary by political, not economic, actions.

The theoretical construct of microeconomic theory is awesomely complete, and it has such champions as James Mckie[2] and Milton Friedman.[3] The pragmatic objections to microeconomic theory, (such as those raised by Manuel Velasquez[4]) that most industrial markets are not 'perfectly competitive', that several profit maxi-

mizing measures are actually injurious to society, that the wants of the poor and disadvantaged are not necessarily met because they cannot participate fully in the marketplace, etc., are waved aside by the proponents as imperfect applications of the theory, or faults of the political process and not the economic system. Then, is the business manager to adopt Pareto Optimality as his guiding star, and seek only to maximise profits?

The microeconomic approach is based on two unrealistic assumptions:

(i) An exceedingly complex and unlikely view of the nature of human beings, which requires all members of society to be actively concerned with the charitable distribution of social benefits and imposition of social costs (political process) at the same time as they are actively concerned with the personal maximization of material goods and services in the product markets and of financial wages, rents and interest payments in the factor markets, solely for themselves.

(ii) It is an impersonal model in which the worth of human beings per se is at a discount; for they work as agents of a system meant to be in perfect equilibrium.

The Rule of Law

Numerous attorneys and business executives believe that you can base ethical decisions and actions on the requirements of the law. If a law is wrong, it should be changed, but that until it is changed it provides a meaningful guide for action. It provides this guide for action because each law within a democratic society represents a combined moral judgement by members of the society on a given issue or problem. Should the business manager, therefore, stick to the rule of law as his guide in ethical dilemmas?

The requirements of law overlap to a considerable extent, but do not duplicate the probable moral standards of society. This is so because the requirements of law tend to be negative, while the

standards of morality are more often positive. In the law, we are forbidden to assault, rob, or defame each other, but we are not required to help people even in extreme situations. There is no law that we must go to the aid of a drowning child. Also, the requirements of law tend to lag behind the apparent moral standards of society. Slavery, of course, is the most odious example, but sexual and racial discrimination, environmental pollution and foreign bribery can all be cited as moral problems that were belatedly remedied by legislation. Moreover, the moral standards of members of society may be misrepresented in the consensus of groups and large organization, and hence suffer mutation before becoming law.

The law is a basic minimum guide to managerial decisions and actions, but it is not enough; and certainly absence of law is not enough to excuse some of those decisions and actions. We need something more.

Normative Philosophy

Philosophy being the study of thought and conduct, normative philosophy is the study of proper thought and conduct; that is, how we should behave. Philosophers have attempted many first principles for behaviour, but there is no universally acceptable norm. Differences of culture and background give rise to what is called ethical relativism. Fortunately, one principle is a common component of all ethical systems; that members of a group bear some form of responsibility for the well-being of other members of that group. In Eternal Law this takes the form of 'Do unto others as you would have others do unto you'. In Utilitarianism (teleological theory) it takes the form of 'greatest good of the greatest number', while in Universalism (deontological theory) it takes the form of Kant's Categorical Imperative: an act or decision can be judged to be right only if everyone must, without qualification, perform the same act or reach the same decision, given similar circumstances. In Rawls theory of Distributive Justice it implies that everyone should act to ensure a more equitable distribution of benefits in society, and in Robert Nozick's ethical system it means that everyone should act to ensure greater freedom of choice.

The common element of responsibility for the well-being of others notwithstanding, each ethical system expresses only a portion of the truth. Each system has adherents and opponents. And each, it is important to admit, is incomplete or inadequate as a means of judging the content of individual actions or decisions. Eternal law has several interpretations but no method to choose among them beyond human rationality. Bentham's utilitarianism can lead to brute majorities (greatest number) and Kant's categorical imperative can be justified even by persons prone to self-deception. Rawls justice is dependent upon acceptance of the proposition that an equitable distribution of benefit ensures social cooperation, and Nozick's liberty is dependent upon acceptance of the proposition that a market system of exchange ensures social productivity.

Ethics and Individual Decisions

If there is no single system of belief, with rationally derived standards of reasoning that can guide executives fully in reaching difficult ethical decisions, what's the way out? "Instead of using one ethical system, which we must admit is imperfect, we have to use all five systems and think through the consequences of our actions on multiple dimensions..... moral reasoning of this nature, utilizing all five ethical systems, is not simple and easy, but it is satisfying. It does work. It works particularly well when combined with economic and legal analysis". But can such multiple analysis work? Is it practicable? Hosmer believes it is. And he goes on to analyse several cases from economic, legal and normative angles, and arrives at reasoned conclusions in some (including the Lockheed Bribery case) while in others he admits he is not certain (which includes the case of checking account services quoted at the beginning).

So, finally, the manager is alone with his dilemmas, but he has certain reference points against which he can knock in his uncertainty. And if nothing else, he would not have nagging unfocused doubts about his actions, but a heightened awareness of the issues involved and the ability to explain and support his decisions on a rational basis.

Organizational Arrangements :

The involvement of major pristine corporate names like General Electric, EF Hutton, ITT etc. in acts of ethical misdemeanour have led to consideration of devising organizational checks for the recurrence of such mortifying incidents. Two strategems that have been tried are those of the Ethical Code and the Ombudsman. Ethical Codes are the statement of norms and beliefs of an organization, stated in general terms e.g. Credo of Johnson & Johnson mentions responsibility to users, reasonable price, high quality, fair profit, besides responsibility to employees, communities, stock holders etc. The basic difficulty with Codes of ethics is that they do not establish priorities between the norms and beliefs. In case of a conflict between the interest of, say, employees and stock holders, the Code is not very helpful. The Swedish concept of Ombudsman is a person within the organization, often an old and respected manager, who has been releived of operating responsibility and assigned the task of counselling younger employees on career problems, organizational difficulties, and ethical issues. The Ombudsman has not been successful because he who refers to the Ombudsman, is easy to identify, and is open to retribution.

Structural causes of unethical behaviour are traced to the indirect benefits which executives and managers perceive to accrue from such actions. Indirect benefits result from divisionalised and decentralised organizational structure that has become common to large corporations. The Strategic Business Unit of General Electric, and the strategic planning model of the Boston Consulting Group, work on a matrix of market share and profitability. The Division which is no longer profitables, or large, needs to be "harvested". The fear of being harvested leads managers into tight corners and unethical practices. Design changes, inventory reductions, employee discharges, slow payments, price deterioration, work place neglect, and environmental decay can all be used to improve personal performance measures, at the cost of employees, customers, suppliers, distributors, and General Public.

What is the role of senior management, in resolving the conflict between the economic and social performance of a firm? It is senior management that sets the standards of behaviour in an organiza-

tion. So how does senior management take hard ethical decisions? Hosmer responds "with character and courage".

Isn't there more to it?

The business manager faces ethical dilemmas because there is an inherent conflict between the economic performance of the firm, and it's social performance. But *why* is there an inherent conflict? Is not the prescription to be bold and brave, to take the help of economic, legal and normative reference points, a prescription without diagnosis? It is a little like an exhortation in the wilderness. Undoubtedly the intent of the book relates to the 'how' of ethical dilemmas in management, and not the 'why'; perhaps because that could take us into the realm of questions of radical restructuring of society, if so required. That is not the scope of the book. The approach to the problem is more existential. It is practical, in the sense, that as long as the larger picture does not improve, what is the individual manager to do? And, no doubt the dilemmas of managers have the spur of immediacy pricking them all the time- "If we discharge our employee who has 28 years of service but is no longer needed, our costs will go down, but his life may be ruined".

The literature on ethical issues in management has greately burgeoned in the US in the last 10 to 15 years, and the issue has invaded academia and business schools substantially (Ethics at Harvard Business School, p. 39, *The Economist*, 30 Sept. -6 October 1989). But most analyses are descriptive or symptomatic. La Croix[5] identifies three major pressure sources on the ethics of middle managers. First is the pressure from business superiors, which takes the form of 'produce or else', 'act questionably' or 'do the right thing but also produce'. The second major pressure source is the pressure from family related obligations. The middle manager may succumb to the temptation to cooperate in unethical practices out of a sense of family responsibility and a fear of losing the job. The third pressure is from peers within the company.

The case of the multinational corporations is also often discussed in the literature on the subject. (Lockheed in Japan, Northrop in Europe, ITT in Chile; and now will be added - Bofors

in India). Curiously, most write-ups give it out as an extenuating factor that while bribery, payoffs and kickbacks are reprehensible by Western standards, elsewhere in the world they are considered as natural tools of negotiation. Hosmer also, while analysing the Lockheed case, points out that Carl Kotchian (President) was forced into payments of $3.8 million to government officials, because he did not speak Japanese, had to rely on Japanese agents, and was foxed by the Byzantine complexity of Japanese manoeuvres for 70 days while he waited in a downtown hotel room in Tokyo. Of course, he also mentions that Lockheed had a declining order backlog, a deteriorating competitive position, and badly needed a large foreign order to bring unit sales above the break even volume and repay the engineering expense (a curious similarity with the situation of AB Bofors in Sweden at the time of selling its howitzer to India). And Hosmer goes on to label the payment as wrong, because although it appeared economically profitable and not illegal (this payment was one of those acts that led to the passage of the Foreign Corrupt Practices Act in the US), it fails against the tenets of Universalism, justice and liberty.

An expose of the causative evolution of the concern with ethical issues in business, especially in the US, would have been instructive. There is, no doubt, a general awareness that the debate hotted up with environmental issues, and that the coming of the affluent society has shifted the focus from economic to social, environmental and ethical issues. Yet it would be fruitful to discover why and how the citadel of the free-market and the individual corporation has been compelled to think of social responsibility, at about the same time that the Eastern Bloc has found it imperative to depart from social concern only to a little free enterprise and competitiveness.

The judgement passed on divisionalized or decentralized corporate structuring as being the cause of unethical actions, is probably a little inaccurate. The reason why managers are tempted to overstate the performance of a division or a business unit by resorting to short-term measures that harm the interests of stakeholders or the general public, is the reward and motivation system. As Hosmer himself later says "Because under current managerial systems, their (managers') performance is measured by

economic criteria and their future is dependent upon economic results". But once again Hosmer stops short of asking the next logical question : why does top management persist in prescribing economic criteria ? And the logical answer : because the criteria of success of a business firm in a market-driven system can only be economic.

In the discussion on organizational devices for measuring social performance, the concept of social audit could also find a place. Broadly the purpose of social audit is to help break down the broad term "social responsibility of business" into identifiable components and to develop scales that can measure these components. Varying taxonomies for audit approaches have been suggested. For example, the social indicators approach, the constituent impact approach, and the corporate rating approach. The social indicators approach evolved out of the concept of developing some form of quality-of-life index which would monitor the ups and downs of the nation's health. The constituent impact approach is an effort to set out in traditional balance sheet form all of the numerous inter-relations between a company and its various constituents-customers, employees, suppliers etc. The corporate rating approach is an effort by individuals and groups outside the corporate structure to assess which companies are responding appropriately to social demands. There are also varying viewpoints whether the social audit is for management use only, or should be made a public document.

Ethical issues are probably as old as history itself. But the ethical dilemmas of private corporations are significant; significant if we view them as indicators of the change that is overcoming a society which, for the first time, is seriously grappling with problems like equality of outcome rather than equality of opportunity. The book represents an attempt to come to grips with the problem in a practical way. An excellent introduction to the subject, especially for managers. And the case histories, liberally thrown in, contribute brilliantly to stimulating thoughts, and feelings, on the issue. One is tempted to close with a problem; "Everyone hates airports: they are the most loathsome of neighbours, assaulting the decencies of human life for many miles around. Yet, everyone, or almost everyone, wishes to travel by

air; either to make money or to spend it" (JWM Thompson, London *'Sunday Telegraph'* (Feb. 11, 1973).

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