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THE DEVELOPMENT OF AN EQUITIES MARKET IN GUYANA

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INTRODUCTION

This paper is an attempt to explain why given certain conditions, for example the unavailability of long term funds, and the presence of tax incentives, an active equities market has not yet emerged in Guyana. Section 1 therefore discusses some of the role and benefits of equities markets; Section 11 the credit patterns of the financial sector and the operations of the call exchange, while Section 1V discusses some of the factors responsible for the failure to develop these markets in Guyana. Section V presents some recommendations and a conclusion.

SECTION 1

THE ROLE OF EQUITIES MARKETS

The importance of financial deepening to the development process has been long recognised. This process of financial deepening also encompasses the development of equities markets at both the primary and secondary levels. These equities markets it is hoped will provide a source of long term investment funds for those desirous of borrowing such funds and a wide array of long term financial assets, which can be made liquid with relative ease, for those wanting to hold such assets.

Notwithstanding this there has been some controversy as to whether the development of such markets is in fact necessary condition for economic development. Some writers, particularly

Drake (1977; 1985) are convinced that the development of equities markets are imperative, however Calamaute (1983) appears skeptical. Samuels and Yacout (1981) argue that capital markets in LDCs are inefficient, and because of this more harm than good will be done by encouraging their development. Wai and Patrick (1973) concede that LDCs should have capital markets, but argue a case for limited government aid in developing these markets, because of the opportunity costs involved.

Nevertheless, there has not been much reason to dispute the benefits to be derived from establishing equities markets. These benefits include:-

(1) an improvement in the savings ratio;
(2) the possibility of long term investment, independent of the firms' ability to save;
(3) an increase in capital flows from abroad;
(4) an improvement in the allocation of investible resources;
(5) the protection of savings from inflation;
(6) the enlargement of the financial sector, thereby facilitating greater competition, specialisation, and innovation, all of which assist in bringing about a reduction in the cost of financial services;
(7) encouraging the merger of formal and informal capital markets.

The realisation of these benefits is however dependent on

several conditions, for example:-

(1) **an increase in the savings ratio** only becomes possible if the holding of equities is done in addition to regular saving. However, in many instances equities are bought out of current savings, hence there is no improvement in the savings ratio;

(2) **the separation of acts of saving from acts of investment** may not necessary follow since savers are generally reluctant to take up equities in firms which do not have a financially sound track record, including a sizeable pool of retained earnings. Thus firms are still compelled to save in order to boost their chances of acquiring equity capital. This fact can be re-enforced by the failure of the Laparkan bonds issue earlier this year;

(3) as argued by Wai and Patrick (1973) there are **other close financial substitutes** which would offer the same or even better protection against inflation, e.g the holding of foreign currency, or investment in real estate. Moreover with positive interest rates, inflation is taken care of;

(4) **an improvement in the allocation of investible resources** only occurs if resources are channelled to the most efficient firms. Evidence however suggests that the

(7) as noted in (4) above the larger and more profitable firms usually have more access to equity capital, particularly because of the risk averse nature of the public. Hence smaller entities - especially those in agriculture related lines of production - are forced to maintain a dependence on informal money lending. Once this dependence is there, it becomes difficult to **absorb informal money lending into the formal structure.**

SECTION 11

GUYANA'S FINANCIAL SECTOR AND CREDIT ALLOCATION

Guyana's Financial Sector encompasses seven commercial banks, with twenty-three branches and sub-branches, eleven insurance companies; four trust companies; and two mortgage institutions. Because of the narrowness of the sector financial intermediation is limited, hence the average growth rate of the value added by the financial sector was a mere 1.8 per cent between 1980-90 and 1.7 per cent between 1990-93.

Notwithstanding this, and the fact that Guyana has the lowest per capita income in the English speaking Caribbean, commercial bank deposits increased by over seven hundred percent in nominal terms over the period 1988 to 1994. The increase in saving was of such magnitude that beginning in 1989, the Central bank was forced to frequently implement liquidity sterilisation measures, in an effort to control inflation.

Surprisingly, however, this increase in saving had little or no effect on the development of the industrial or manufacturing sectors. As Table 1 shows, private sector credit grew significantly between 1988 and 1994, however this credit was allocated primarily to non-productive and consumptive areas. As a result household consumption, entertainment and catering, distribution and construction sub-sectors accounted for approximately forty-three percent of the credit allocated to the private sector.

Table 1
INCREASE IN PRIVATE SECTOR CREDIT BY INSTITUTIONS(G$ Mn.)

INSTIT.	1988	1989	1990	1991	1992	1993	1994
Commercial Banks	653.5 (98.7)	945.5 (80.3)	1590.0 (63.1)	1.6 (61.1)	59.9 (31.1)	1526.3 (17.6)	3592.6 (35.2)
Insurance Companies	22.8 (42.2)	131.0 (170.5)	137.6 (66.2)	2.5 (3.6)	192 (26.5)	50.9 (55.3)	441.4 (300.9)
Mortgage Instit.	30.3 (29.4)	1.5 (1.1)	7.2 (5.1)	202 (12.4)	129.5 (79.8)	505.6 (173.3)	348.6 (43.7)
Trust Companies	9.0 (47.0)	68.4 (31.7)	114.5 (40.3)	201.1 (50.5)	339.9 (56.7)	256.7 (28.3)	1544.9 (128.1)
Development Bank	65.4 (9.0)	62.7 (5.3)	262.0 (10.5)	872.7 (58.6)	1076.4 (75.6)	842.1 (33.6)	808.7 (24.2)

N.B Percentage increases are given in parenthesis
SOURCE: Statistical Bulletin, BOG, March 1995.

Moveover an examination of the portfolio of these institutions reveals a distinct preference for investing in virtually riskless government securities. During the same period only about ten to twenty percent of funds collected were lent. Of this amount, long-term loans consist of a mere eighteen percent.

This behavior is not peculiar to the commercial banks, since

figures from the other non-financial institutions reveal that similar credit and investment patterns prevailed, as shown by Table 2. The only exceptions to this pattern of behavior were the mortgage institutions and the development bank which because the nature of their operations were forced to grant long-term loans.

TABLE 2

NFI INVESTMENTS AS A PERCENTAGE OF TOTAL ASSETS G$Mn.(1994)

INSTITUTION(S)	TIME DEPOSITS	GOVT. SECURITIES	LONG-TERM LOANS	SHORT-TERM LOANS
Insurance	1.7	5.2	2.7	6.3
Companies	17.2	68.2	2.4	7.1
Pension Schemes	2.5	10.3	13.8	44.4
Trust Companies				
National	18.0	36.6	0.5	-
Insurance Scheme				

As a consequence of the portfolio behavior of the commercial banks it was felt that there was a need to develop a call exchange which would trade in equities and government securities in the first instance, but grow into a fully fledged stock exchange later on and enable investors to supplement or substitute equity for debt capital.

THE CALL EXCHANGE:

The call exchange was established in December of 1993 and its objectives were:-

(1) to exchange information relating to dealings and prices offered for purchases and sales of securities;

(2) to encourage widespread public investment in these securities;

(3) to facilitate an orderly and competitive market for transactions in such securities;

(4) to promote the development of a fully fledged stock exchange in Guyana.

Figures emanating from the exchange shows moderate activity from its establishment to date. The total volume of shares traded so far amounts to 6,197,040 valued at G$ 1.25 billion. Most of the shares trades were those of the major profit making public companies, however at times there was some activity relating to the shares of several less profitable, and even loss-making entities.

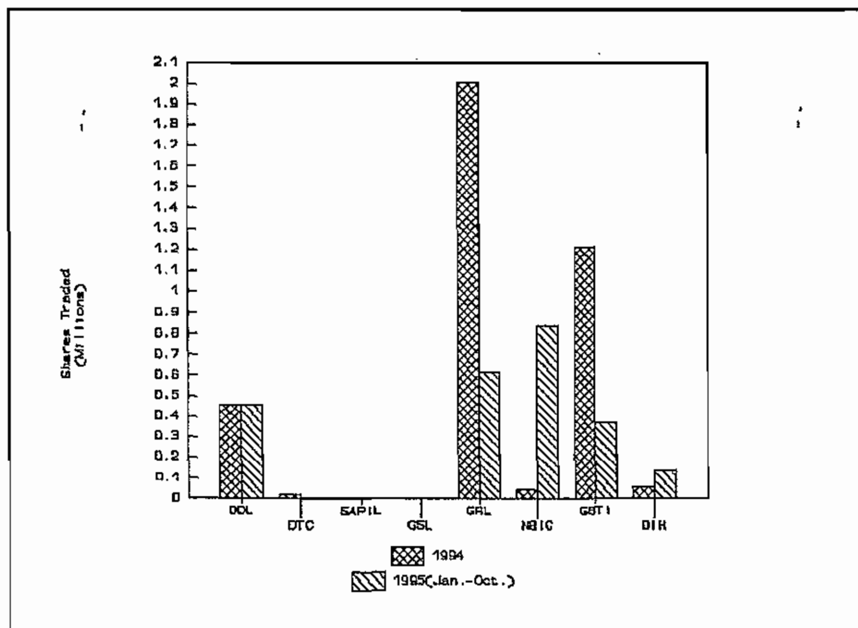

Figure 1 Volume of shares traded by company. (1994-1995)

This gives the impression that some investors to accept risk. It is noticeable also that with one exception, the demand for equities exceeded the supply on a monthly basis as shown by Figures 2 and 3. However, a striking feature is the wide gap between the amount offered for sale and the amount actually traded. One would have expected that given the large supply shortfall every share tendered would have been bought.

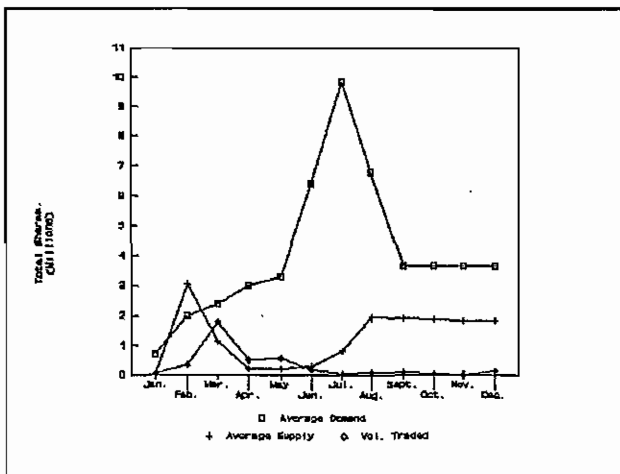

Figure 2

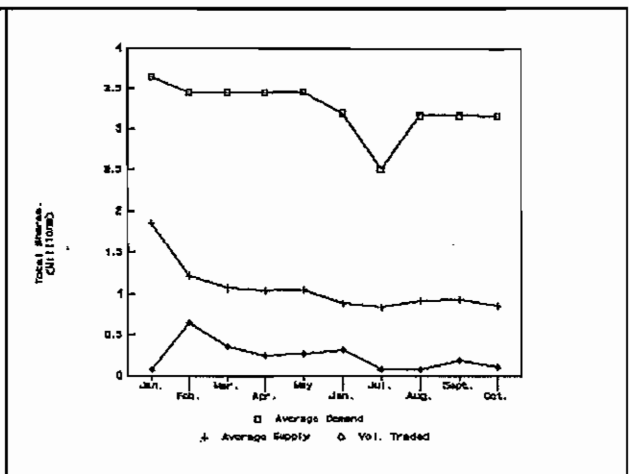

Figure 3

The fact that this has not happened suggests that the number of buyers were very few in number, and as a consequence the prices offered were rigid. This, at the very least is a sign of oligopolistic behavior which is further substantiated by the following:-

(1) all DDL shares were bought at a price of ten dollars each;

(2) all GBTI shares were bought at a price of thirty-eight

dollars each;

(3) all DIH shares were bought at a price of twelve dollars each;

(4) fifty-eight percent of NBIC shares were bought at fifty dollars each.

Moreover, what gives additional cause for alarm is the fact that there were no specific guidelines on "insider-trading", thus members were given ample opportunity to acquire the shares for themselves, rather than to facilitate trading among buyers and sellers.

Recent reports state that the exchange is not functioning as it should since many of its twelve members have lost interest. Two reasons were given for this loss of interest:-

(1) lack of government support - as it is felt that incentives were needed to persuade private companies to go public and hence stimulate activity. However no such incentives were not forthcoming; and,

(2) lack of participation - both by the public and the government itself. Some members lamented the fact that the sale of the government's Guyana Bank for Trade and Industry (GBTI) shares were not handled through the exchange.

SECTION 111

FACTORS AFFECTING THE DEVELOPMENT OF EQUITIES MARKETS IN GUYANA

The literature surveyed posited several conditions which affect the development of equity markets. Among the most frequently cited are:-

(1) the pattern of business ownership;

(2) the possibility of financing investments from retained earnings or bank credit;

(3) deficiencies in the demand for, or the supply of equities; and,

(4) the availability of close substitutes.

The present situation in Guyana is in conformity with most of these conditions as the following discussion will reveal.

(1) Pattern of Ownership:

In terms of the pattern of business ownership, Guyana's business sector consist of approximately three hundred and fifty-one registered entities.[1] If "bench marks" of G$ 200 Million in assets and existence of over ten years are used, then only eighty of these entities may be in a position to raise equity capital. The ownership patterns of these eighty firms are given below and illustrates that forty-three percent of these firms are under state and foreign ownership, while thirty-five percent are owned by private individuals. It is unlikely that any of the foreign

[1]. Total membership of GMA, CAGI and GCC.

TABLE 3
OWNERSHIP STRUCTURE OF THE BUSINESS SECTOR

TYPE OF OWNERSHIP	NUMBER OF FIRMS	%
State Owned*	18	22.5
State/Foreign	2	2.5
State/Local Shareholders	1	1.3
Public	14	17.5
Private	28	35.0
Foreign Owned	17	21.2

* Denotes state ownership in excess of ninety-five percent.

concerns will opt to go "public" as the evidence shows only one foreign owned company, the Demerara Tobacco Company ever went public willingly.

There may be some hope in terms of the state owned companies as many of them are currently to be divested. Nevertheless, it should be remembered that the present and past governments have divested a total of sixteen public enterprises, yet only two were offered to public shareholders. A similar pattern of behavior can be expected from the private owned companies as no private company has gone public over the last ten years.

(2) Easy Credit and Retained Earnings:

The argument that the failure of equities markets to develop is partly due to the relative ease with which firms access bank credit is not applicable to Guyana given the preference of the financial institutions for short-term lending. However it cannot be denied that private firms and companies have been able to finance necessary investment expenditure from retained earnings and

the savings of the owner(s). This has been possible because the level of new investment necessary has been marginal. Private investment as a percentage of GDP declined from 3.4% in 1983 to 2.9% in 1988 and though this figure increased to an average of 17% over the past six years much of the increase was due to new investments from foreign participation in the mining and forestry sectors.

These minimal investments were occasioned by the falling production during the 1980s which led to the existence of excess capacity in many industries. Moreover, if we examine the total output of some commodities it will be found that output is more or less constant which gives the impression that demand has to a large extent leveled off; hence the need for little investment, which in any case can be done out of retained earnings and savings.

(3) The Demand for and the Supply of Equities:

While it can be agreed that there is a limited supply of equities available, the call exchange statistics show that the demand for equities has been reasonably high. This gives the impression that even with a low per capita, there seems to be a willingness among members of the public to hold these instruments. The problem therefore seems to be one of increasing the supply of equities.

Expanding the supply of equities may however depend on the state sector, as all of the state owned enterprises with the

exception of sugars electricity and bauxite have been time-tabled for divestment in the not too distant future. The problem however lies with the private sector and judging from the past it would be unwise to anticipate a movement in the desired direction. That fact is that even if some of these entities were willing to go public it would be a waste of resources; and in addition possibly reduce profitability since the firms will now be faced with the burden of paying dividends to shareholders.

As Figure 3 shows only those entities that have been able to service and hold external markets managed to do well as illustrated by the increase in the value of their shares.

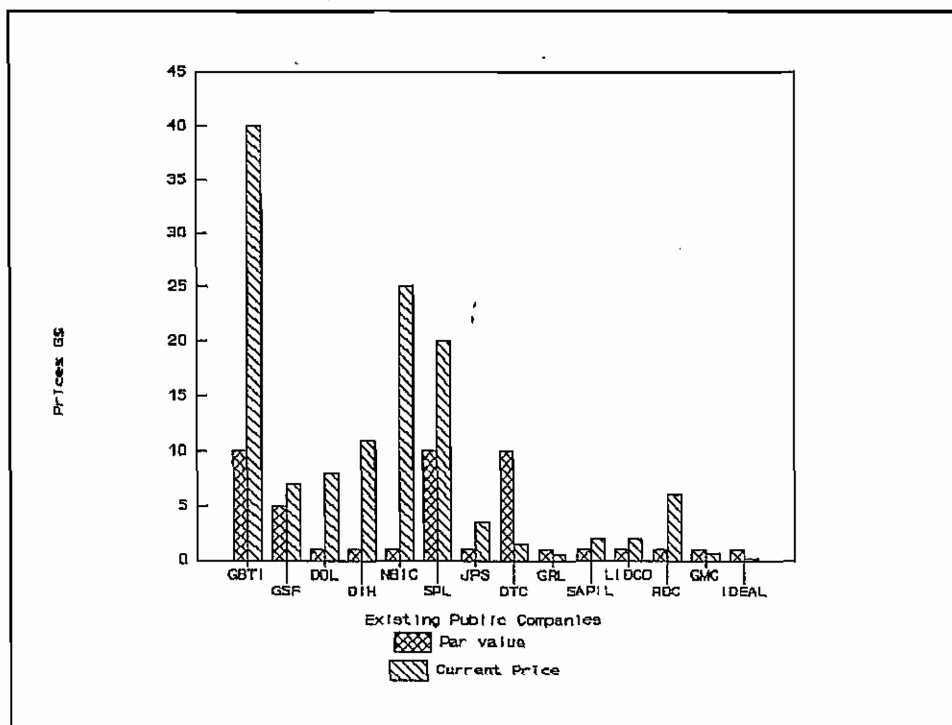

Figure 4

(4) Substitutability:

The existence of close substitutes for equities is also a real

one in Guyana, even now, when the rate of inflation is much lower and the exchange rate more-or-less steady. Investment in real estate offers even better returns, and in a shorter period than any other financial asset available. In addition the long standing practices capital flight and or investing in gold as a hedges against inflation still continue.

(5) Specific Factors:

However, in addition to these more widely accepted factors which affect the development of equities markets, there are also a few that are peculiar to Guyana.

(a) Reasons for Saving:

In a 1994 study of the financial services, seventy-one percent of the persons interviewed indicated that they saved primarily for unforeseen circumstances. This therefore means that liquidity is of the utmost importance and under the circumstances we can expect very little investment in equities, except when transitory income is available.

(b) Reasons for holding equities:

Moreover, with many ordinary Guyanese, even when they do buy equities it is not done for speculative purposes. Equities are bought primarily as a claim to part-ownership, and, to be eligible to receive gifts at every annual general meeting. As such

additional shares are hardly ever bought and those bought initially are hardly ever re-sold, a pattern which definitely affects the development of an active market for equities.

(c) Privatization:

Another issue which affects the development of an equities is the manner in which the privatization programme has been carried out. In the first instance the previous government viewed the privatization programme as a means of boosting the level of foreign reserves, consequently foreign investors were given preference. The present regime apparently has a preference for selling to local investors, but at a price which many cannot afford and at minimal transaction cost. Thus the emphasis is not on shareholder ownership. As noted earlier only two companies have been offered to the public so far.

The other major problems which are peculiar in Guyana's case are more or less related to private companies and the conditions under which they operate.

(a) The Relative Costs of Borrowing:

With the relative cost of equity and debt financing - given the wide disparity in costs, it is unlikely that firms will be encouraged to use equity financing. Over the period 1989 to December 1994 the following were evident:

Table 4
RELATIVE COSTS OF BORROWING

	1990	1991	1992	1993	1994
Commercial Banks Lending Rate(p.a)	32.44	35.22	29.76	18.24	20.80
Average Dividends paid by Public Companies (p.a) (Yield)	35.72	34.6	31.6	55.0	46.6

The figures in row 2 represent the average dividend paid by three of the most successful public companies and if this is used as an indication of the expected rate of return on equities, then with the downward trend in interest rates, firms will most likely utilize debt financing.

(b) Lack of Competition:

Private enterprise in Guyana is weak, and as a consequence excluding the commercial sector, there is very little competition among producers. Because of this, an increase in profitability is in many instances not linked to increases in production or market shares. Businesses, particularly in the manufacturing sector, have been able to maintain and even improve profitability by simply increasing prices. The possibility of being able to do this therefore removes the need to expand and hence make long term investments.

(c) Rights Issues and Bonus Shares:

In 1994, a local entrepreneur quietly unwittingly became the majority share holder of the third largest commercial bank. With

this in mind existing public companies in need of additional capital are using the "rights issues" and "bonus shares" method of acquiring additional capital, in order to protect themselves from a similar take over. While this may in the medium term serve their interest, it impacts negatively on the development of an active equities market as it rules out others desirous of holding long term financial assets of this type.

(4) Taxation:

The tax laws have recently been reviewed to allow for the removal of the withholding tax on dividends, as well as the capital gains tax on the sale of shares. Bonds are however still subjected to a withholding tax of fifteen percent plus further taxation as a part of income. Though this review offers incentive to those persons wishing to hold shares, it discriminates against bond holders. More over it provides no direct incentive to private companies wanting to go public, as interest payments on debt finance are still tax deductible while dividends expenses are not. All other things being equal, investors will still choose debt financing rather than equity financing.

SECTION IV

CONCLUSION

It is obvious that an active market for equities will not develop in the near future, unless there is substantial government

assistance. However the cost of such assistance may outweigh the benefits. For example there is a definite shortage of equities - which can to a large extent be reduced if the privatization strategy is reviewed. Nevertheless, the privatization programme is a source of much needed foreign exchange and selling to local shareholders does not bring in foreign exchange. Even though the proceeds from the sale can be converted it will have an affect the exchange rate.

Moreover it is doubtful if there will be an encouraging response from private companies if they are given some incentives. Private companies are constrained by prevailing domestic demand conditions and their inability to secure and hold foreign markets. As such what ever the incentive, there is virtually no good reason for them to go public.

With reference to the call exchange, it may be worth the while if the divestment of government ownership in state entitles can be done through this medium as it will obviously stimulate activity and aid the development of the exchange.

The commercial banks also can assist the development of an equities market if these instruments are accepted as security, even if for short-term loans only. The fact that cash deposits are accepted while equities are not, will encourage savers to hold cash rather than equities.

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