PD-AAZ-783

AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON, D.C. 20523

June 3, 1988

ACTION MEMORANDUM FOR THE ASSISTANT ADMINISTRATOR, PRE

FROM: PRE/PD, Russell Anderson Russell Ander

SUBJECT: Financial Sector Development Project (940-0014)

Problem: You are requested (1) to authorize a five year, $12.363 million project whose goal is to increase developing countries' abilities to promote efficient mobilization and allocation of financial capital and (2) to execute the attached PIO/T requesting that the Contracting Office obligate $563,468 of Fiscal Year 1988 funds through open-competitive bidding.

Discussion: In 1985 PRE began implementation of its first comprehensive project to provide finanical sector technical assistance to developing countries. That project provided assistance to 25 countries on a wide array of problems affecting financial sectors. The project proved to be an effective mechanism to respond quickly to technical assistance needs and to market the integration of financial sector assistance into the A.I.D. portfolio. That project comes to a close on September 30, 1988 and we propose to continue efforts by PRE in the financial sector, but with a more focused approach.

The design of the proposed project is based on a combination of factors. First, the experience under the first project, as evaluated, provides us with useful information on the levels and types of demand for assistance. The evaluation pointed out areas for improvement, such as better marketing to USAIDs, a more cohesive project strategy and improved coordination with other donors and the Revolving Loan Fund. Second, a series of joint and individual meetings were held with PPC, S&T and the Regional Bureaus to outline the scope of a project that would be useful to the Agency. The result is a program that has the following main components. The Project Paper provides a fuller description.

-- Strategic planning and implementation: Will develop and utilize a strategic planning model to enable U.S.A.I.D.s to quickly and efficiently incorporate financial sector development into their overall portfolios. Missions could buy into short or long-term assistance on a country specific basis. We will market this to a select group of countries desiring a long-term capacity to respond to needs in the financial sector.

- Technical Assistance: Will provide standard response mechanism for missions outside the framework of a long-term relationship. Generally this will be fully funded by missions, but we may opt to co-finance certain activities that are of interest to PRE.

--- Research and Development: Will explore the application of different financial instruments or mechanism either generally, or specifically to sectors such as agriculture, health, exporting, etc., and to explore the macroeconomic impacts of policy change.

-- Information: Will serve to promote further integration of financial sector program into A.I.D., serve as an information center for the Bureau (and possibly the Agency) on the state of the art of developing country financed sector development, and take what we've learned and put it into usable form for development professionals. Conferences, seminars, newsletters and other papers are contemplated.

Total funding of the project is estimated at approximately $12.4 million. PRE will fund approximately $4.2 million, with the Missions funding the balance of $8.2 million through buy-ins to the technical assistance contract. The first year of obligation is FY 1988, with PRE funding $563,468. The final year of obligation will be FY 1992. Your authorization will include $4.223 million of PRE funds over a five year period, and approval of $8.14 million of buy-ins authorized by missions.

A Congressional Notification will be submitted prior to obligation of funds, which is expected to be in September.

The project will have no impact on the environment and is exempt from those regulations.

Recommendation: That you (1) sign the attached Project Authorization for a five year $12.363 million project with PRE funding of $4,223 million and mission buy-ins of $8.140 million and (2) execute the attached PIO/T requesting that the Contracting Officer obligate $563,468 of FY 88 Section 106 and 103 in a competitively bid contract.
funds.

Attachment: a/s

Clearances:
PRE/PD:JDry
PRE/PDP:MUnger
PRE/I:JHardy
GC/PRE:MKitay
DAA/PRE:CRussell

Drafter:PRE/PD:RAnderson:cmw:6/1/88:00560

AGENCY FOR INTERNATIONAL DEVELOPMENT

PROJECT DATA SHEET

1. TRANSACTION CODE: A (A = Add, C = Change, D = Delete)

Amendment Number

DOCUMENT CODE: 3

2. COUNTRY/ENTITY: Worldwide

3. PROJECT NUMBER: 940-0014

4. BUREAU/OFFICE: PRE/FD

5. PROJECT TITLE (maximum 40 characters): Financial Sector Development Project

6. PROJECT ASSISTANCE COMPLETION DATE (PACD): MM 09 DD 30 YY 93

7. ESTIMATED DATE OF OBLIGATION (Under 'B.' below, enter 1, 2, 3, or 4)

A. Initial FY 88 B. Quarter C. Final FY 92

8. COSTS ($000 OR EQUIVALENT $1 =)

A. FUNDING SOURCE	FIRST FY 88 B. FX	C. L/C	D. Total	LIFE OF PROJECT E. FX	F. L/C	G. Total
AID Appropriated Total						
(Grant) PRE Sourcing	(563)	( )	(563)	(4223)	( )	(4223)
(Loan)	( )	( )	( )	( )	( )	( )
Other U.S. 1. USAID Sourcing	1000		1000	8140		8,140
2. (Grant)						
Host Country						
Other Donor(s)						
TOTALS						12,363

9. SCHEDULE OF AID FUNDING ($000)

A. APPROPRIATION	B. PRIMARY PURPOSE CODE	C. PRIMARY TECH. CODE 1. Grant	2. Loan	D. OBLIGATIONS TO DATE 1. Grant	2. Loan	E. AMOUNT APPROVED THIS ACTION 1. Grant	2. Loan	F. LIFE OF PROJECT 1. Grant	2. Loan
(1)									
(2)									
(3)									
(4)									
TOTALS									

10. SECONDARY TECHNICAL CODES (maximum 6 codes of 3 positions each)

11. SECONDARY PURPOSE CODE

12. SPECIAL CONCERNS CODES (maximum 7 codes of 4 positions each)

A. Code

B. Amount

13. PROJECT PURPOSE (maximum 480 characters)

The purpose of the project is to assist developing countries in their efforts to develop and improve domestic capital markets as well as augment the flow of international and domestic financial resources to the private sector.

14. SCHEDULED EVALUATIONS

Interim MM 11 YY 90 MM 12 YY 90 Final MM 11 YY 92

15. SOURCE/ORIGIN OF GOODS AND SERVICES

[x] 000 [x] 941 [x] Local [ ] Other (Specify)

16. AMENDMENTS/NATURE OF CHANGE PROPOSED (This is page 1 of a ____ page PP Amendment.)

17. APPROVED BY

Signature

Title: AA/PRE, Neal Peden

Date Signed MM DD YY

18. DATE DOCUMENT RECEIVED IN AID/W, OR FOR AID/W DOCUMENTS, DATE OF DISTRIBUTION

MM DD YY

AID 1330-4 (8-79)

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DRAFT PROJECT AUTHORIZATION

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AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON D C 20523

ASSISTANT
ADMINISTRATOR

PROJECT AUTHORIZATION

Name of Country: Worldwide

Project Title: Financial Markets Development Project

Project Number: 940-0014

1. Pursuant to Sections 103 and 106 of the Foreign Assistance Act of 1961, as amended, I hereby authorize the Financial Sector Development Project involving planned obligations of not to exceed Four Million Two Hundred Twenty-Three Thousand U.S. Dollars ($4,223,000) in grant funds over a five-year period from the date of authorization, subject to the availability of funds in accordance with AID/OYB allotment process. I also approve the use of up to Eight Million One Hundred Forty thousand U.S. Dollars ($8,140,000) of incremental funding by USAID missions and other Bureaus. The Project Assistance Completion Date is September 30, 1993.

2. The project consists of technical assistance to developing countries directed at developing effectively operating financial systems which will provide the credit and capital for economic expansion.

Neal Peden
Assistant Administrator
Bureau for Private Enterprise

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Chapter III

PROJECT RATIONALE AND DESCRIPTION

3.1 Background

3.1.1 The world Economy

The latest reports from the World Bank, IMF and OECD point to a critical shortage of private capital flowing to developing nations, mainly because private bank lending has been curtailed. External official lending has filled some of the gap, but not to the extent of maintaining an adequate level of economic prosperity. Domestic savings are not large enough to satisfy domestic investment.

To aggravate the situation, the GDP of most developing countries has decreased due to unfavorable terms of trade caused by a worldwide decline in commodity prices. Those countries which are burdened by external debt have seen a greater portion of their export income eroded by debt commitments. In an environment of high inflation and uncertainty, domestic savings disappear into capital flight.

If this cycle of economic decline is to be broken, developing countries must adopt mechanisms to repatriate domestic savings and attract foreign investment. The most promising

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mechanism is the integration of financial activities into strong financial markets that deserve the confidence of investors and provide adequate funding for a sustained level of economic development.

3.1.2 Domestic Economies

An additional burden on domestic economies is the fact that they are heavily dominated by central planning and government parastatals.

The inefficiencies inherent in centrally planned economies became apparent as productivity fell and standards of living declined in many LDC's. Nevertheless, governments continued to borrow from international banks who were anxious to invest the surplus liquidity of oil-producing countries. Finally, in the early 1980's it became evident that these heavily indebted countries could not service their large foreign debt obligations.

As a consequence, private lenders reduced dramatically the flow of bank credit . The OECD estimates that total net disbursements to LDC's are about one-half what they were in 1981. The largest contraction occurred in commercial bank lending which fell from $50.2 billion in 1981 to $4.1 billion in 1986. These figures must interpreted with caution, however. In 1986 the US dollar depreciated dramatically and exerted a major impact on the measured value of financial flows. Nonetheless, there is no question that the decline was dramatic.

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The IMF reports that the outlook for lending to developing countries that have experienced payments difficulties deteriorated further during 1987. This means that spontaneous bank lending will not be available to those countries. There are three main reasons for this lack of credit: 1) uncertain interest rates in industrial countries, 2) unfavorable economic trends in many developing countries, and 3) reluctance on the part of commercial banks to perpetuate their exposure to debtor countries.

Many LDC's have begun to realize that government economic interventions are far less effective to encourage economic activity than private sector initiatives. Evidence of this new trend is the increased privatization and divestitures of government parastatals.

Although there are signs of increased reliance on private sector initiative, there remain oppressive regulations and unfavorable taxation in the financial structure of most developing countries. Most importantly, these barriers do not allow the private sector to access the volume of funds they need at a resonable cost. A.I.D has recognized the magnitude of this problem and has initiated a number of programs to find solutions.

However, it is difficult for any one entity to attempt to solve this situation alone. Certainly A.I.D. cannot offer a panacea. This must be a joint effort of the international community. And A.I.D. now has an opportunity to assume a position of leadership and aggressively pursue solutions in collaboration with other institutions.

3.1.3 Some Characteristics of A.I.D. countries.

Most A.I.D. countries are the least developed of the developing countries: therefore, their financial systems generally are unsophisticated and dominated by the banking industry, which in turn extends loans heavily subsidized by governments, and receives deposits artificially enhanced by tax exemptions and other benefits. The result is financial stagnation, that is, a system entrenched in a mass of laws and regulations that can not be dissolved by legislation alone. Policy reforms must be accompanied by a strong private business sector and the necessary financial institutions to support it.

Consequently, although a dialogue with host governments is a useful practice to encourage policy reform, these reforms will not last unless they are sustained by true economic development.

The starting point of economic development is the financial health of private industry, which is reflected on the quality of earnings and solvency of the firms in the industry. In essence then, the assistance needed most in the short term is in the area of strengthening the capital structure of domestic industries. Since their most immediate needs

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are in the area of working capital, short term financial intermediation - including instruments, mechanisms, and institutions - is an area that deserves close attention. Firms need to find alternatives to access operating capital as well as longer term capital to finance business expansion.

Generally, all financial intermediation occurs in the banking system. Non-bank financial institutions are weak or nonexistent. There is a need to build institutions tnat will be responsive to all business activities in the economy. However, the creation of new institutions or the reform of old ones, sometimes is not compatible with the level of financial sophistication that exists in the country.

In summary, the majority of A.I.D. countries face obstacles to economic growth brought about by regulatory imbalances that stifle efficient intermediation and a private sector which has limited, or no access to adequate sources of short and long capital to sustain a desirable level of productivity.

This new project, now named Financial Sector Development Project (FSDP), is designed to help remedy these problems and to incorporate the experience gained in the project that preceded it.

3.2 Rationale: A.I.D. Experiences

3.2.1 Relevant Experience with Similar Projects

As indicated previously, the FSDP is a follow-on to an existing project. The experience of the previous project and the results of a recent evaluation have been relied upon to a considerable extent in the design of FSDP.

The experience of PRE in carrying out two other projects, Privatization and Private Enterprise Development Support, is also highly relevant to the FSDP. Both of these projects have demonstrated the barriers that are created to economic growth by poorly functioning financial markets.

The objectives of divestiture of state-owned enterprises and transfer of ownership to a large segment of the population is facilitated by the use of domestic capital markets. unacceptable. Therefore, the continued success of privatization efforts are enhanced by the existance of capital markets as a source of local financing.

Experience in carrying out the Private Enterprise Development Support Project (PEDS) has also confirmed the importance of capital markets in the growth of the private enterprise in the LDCs. The policy reform agendas and private sector strategies developed by the USAIDs with the assistance provided under that project have played an important role in creating the appropriate incentives for development of market-driven economies. However, the success of these efforts depends almost entirely on the availability of long-term debt and equity capital, and cannot be achieved through the traditional approach of relying on bank credit alone.

Finally, while A.I.D. has delivered substantial amounts of credit through IFI's with a degree of success, there are limitations to that approach. It is extremely difficult for start-up businesses to generate the cash flows necessary to meet debt servicing requirements in the early years of the business. This is true in the U.S. as it is in the developing world. The continued growth of the number of enterprises in the industrialized countries is due in very large part to the availability of long-term financing that is made possible by the existence of capital markets. The PRE experience to date has demonstrated that the FSDP can contribute significantly to the development of these essential markets in A.I.D. assisted countries.

In general, the experience of A.I.D. in trying to promote the development of indigenous private enterprise through credit programs has demonstrated the limitations of that approach, and confirmed the importance of accessing funds through securities markets.

The IFC's Capital Market Development has been active in syndicating mutual funds comprised of LDC securities. The UNDP has also recently begun to devote considerable effort to developing securities markets, for example in Tunisia. A.I.D.'s contribution, by contrast, has been in the policy dialogue area, to be sure, but also at the more technical level.

A.I.D.'s role in developing capital markets has been through policy reform, credit programs and technical assistance. The FSDP will focus on the four activity components of the project outlined in the next section. The strategic planning component, in particular, will identify areas of opportunity for other A.I.D. financial market projects, such as the PRE Revolving Fund, PL 480 lending programs, small and micro-lending projects, etc. The project will seek to coordinate its activities with other A.I.D. Bureaus and donor agencies.

3.2.2 Current A.I.D. Programs and Relationship to Country Strategies

A.I.D. has recognized the problem of accessibility of credit in developing countries and has initiated a number of programs to help resolve the problem.

3.2.2.1 The S&T Bureau

The S&T Bureau has several on-going projects in this area. The Aries project seeks to strengthen the institutional capabilities of PVO's lending to small enterprises. SC Experimental Approaches to Rural Savings Project has concentrated on policy reform, institutional strengthening and deposit mobilization. The S&T project works with Central Banks and agricultural credit intermediaries. A follow-on 10 year, $5.75 million Financial Resources Management Project will expand that project's scope of work to include regulatory reform to promote linkages with the informal financial market. SC Employment and Enterprise Policy Analysis Project tries to enhance industrial efficiency with special concern for eliminating policy biases against small enterprises.

3.2.2.2 The LAC Bureau

The LAC Bureau has addressed the capital problem in a number of ways, including the establishment of Development Finance Companies and "financieras" in Latin America. To some extent these institutions specialized in providing credit to the export sector, farming sector, or other sector depending on the country's specific strategies. LAC has also been a leader in innovative microlending and in the amount of money made available to small and microenterprises through PVO's such as Accion. LAC also actively seeks to engage host governments in monetary and fiscal policy reform, in large measure through its ESF conditionality. LAC missions have also provided assistance in exploring opportunities to develop securities markets in several countries.

3.2.2.3 The ANE Bureau

The ANE Bureau has an active program of financial markets development at the USAID level. Indonesia is proposing a large $15 million, five-year capital markets development program. In fact, there are financial sector projects in almost all ANE USAIDs, particularly in Thailand, Jordan and Tunisia.

3.2.2.4 The AFR Bureau

The AFR Bureau Missions have sponsored a number of small and micro-business lending programs in many countries; broad financial market development has been approached in only a few countries with adequate policy environments like Kenya and Botswana. Senegal will soon begin a major banking reform effort. Also the Bureau will soon begin a project to examine credit flows in informal markets and find ways to improve them and possibly link them. In the past, the African USAIDs had less options to explore because the financial sector in these countries are extremely underdeveloped. In the future greater emphasis will be given to financial policy reforms, linkage of rural and urban markets and adaptation of capital mobilization techniques.

3.2.2.5 The PRE Bureau

The PRE Bureau has designed several programs to assist LDC's in mobilizing and channeling credit. The PRE Bureau's Revolving Fund, currently funded at $60 million, provides credit and guarantees directly to financial institutions. Loans and guarantees to IFI's are often made by the Revolving Fund in order to encourage lending to small and micro businesses. The Fund continually seeks creative financing mechanisms to leverage its limited resources in a way that helps alleviate credit shortages.

In an attempt to assist LDC's in their own efforts to implement domestic financial markets which would capture and channel savings into the productive sectors of the economy, PRE designed a Financial Markets Development Project in 1985. As described below, the project was designed as a central resource for technical assistance to USAIDs in their work with host governments in financial sector development.

3.2.3 The Predecessor Project

In compliance with the mandate given to PRE to fully integrate A.I.D's private enterprise initiatives into foreign assistance programs and projects, the PRE Financial Markets Project was initiated in 1985 for a three-year term to help develop financial markets and promote private sector institutions.

Although the project succeeded in creating interest in financial sector development, a greater effort will be required in the future to promote the benefits of the project and enlist the active participation of USAIDs. In several USAIDs it was found that the financial markets project was not an integrated strategy in their CDSS's. Furthermore, not all USAIDs and host governments were fully knowledgeable either about the magnitude of the intermediation problems existing in their countries or the financial mechanisms that could be applied to alleviate them.

Another lesson learned from the first project is that the private sector is trapped in a constrained financial environment which obviously is not conducive to market-driven economic development. The majority of private companies in A.I.D. countries do not have strong financial profiles or satisfactory growth rate because of inaccessibility to sources of funds. In some instances the paradox is that local firms cannot access capital through the highly regulated financial system, therefore they can not grow and become viable investments to attract private investors - domestic or foreign. Yet, there is strong indication that private portfolio funds would flow to local firms only if they offered a more attractive investment.

All these experiences lent focus to the design of the new project in the areas of strategic planning, technical assistance, research and development, and dissemination of information.

2.3 Description: The New Project

Like the previous project, FSDP will continue to provide specific technical assistance as requested by USAIDs in designing or implementing projects to promote the growth of financial markets.

However, the FSDP is substantially different from its predecessor. The new project focuses on the following areas:

1. Strategic planning and implementation, for the purpose of giving better quality and depth of assistance to developing countries by conducting preliminary assessments and recommending the most suitable form of assistance within the context of specific countries and programs conducted by other donor agencies.
2. Technical assistance, both short and long term to comply with requests from USAIDs.
3. Research and development, to make use of the expertise of researchers and leaders in development finance who will use the experience gained to to date to promote knowledge and to identify alternative solutions to current problems facing developing countries.
4. Dissemination of information and research findings for the purpose of sharing experiences and forging closer collaboration with other sectors within A.I.D. and with other international organizations working in the field of private sector development.

The motivation behind this expanded project is a desire to use the experience of the last three years and launch a new project that will strive for excellence in its field.

3.3.1 Goal and Objective

The overall goal is to increase LDC's capacity for market-based economic growth.

The objective of this project is to provide assistance through USAIDs to developing countries to promote more efficient capital mobilization and allocation of resources.

This will be accomplished by developing and implementing financial strategies that will improve the financial position of the private sector. These strategies will include assistance to bring about policy reform, and to create instruments, mechanisms and institutions that will facilitate financial intermediation in the economy.

This project will be implemented through direct technical assistance - both short and long term. In addition, it will include a research and development element to analyze and synthesize the experiences gained, and generate new insights into the financial needs and potential of the private sector in developing countries.

Finally, the findings from these activities will be published and presented in workshops and conferences for the purpose of disseminating as widely as possibly the principle of market-driven economic systems.

In short, the new FSDP will assist LDC's to achieve broad-based market-driven growth, by working with USAIDs in establishing a policy reform agenda, strengthening the financial postion of the domestic private sector, and encouraging the eventual formation of structured securities markets and other institutions that will channel financial resources to private industries. A complete breakdown of goals, purposes, inputs and output is included in the Log Frame.

3.3.2 Expected Achievements

The overall expected achievement will an improvement in financial intermediation in the countries assisted resulting from policy reform, adoption of new financial techniques and the establishment of institutions that will continue to promote economic growth long after A.I.D. assistance has ceased.

However, the magnitude of the improvement will vary from country to country, depending on their receptivity and commitment to change. Besides, not all A.I.D. countries have the level of financial sophistication that will permit them to adopt innovation with the speed desired. In several countries the evolution will be long and tedious, but FSDP will persevere in assisting USAIDs to develop policy reforms to gradually mobilize increased domestic investment and attract external capital flows. Simultaneously, FSDP will assist private industries and the financial sector to create mechanisms and instruments to handle capital shortages and financial risk. A discussion on global markets, instruments and mechanisms follows this section.

Another expected achievement is a greater collaboration with other donors. The donor community, in eneral, has realized the importance of developing capital markets and significant programs have been undertaken in this area. The World Bank has designed numerous policy-based financial sector loans whose draw-downs are conditional on policy reforms favoring capital market development. Other donor agencies are expected to include conditionalities in support of A.I.D.'s efforts in behalf of policy reform.

3.3.2.1 Global markets, instruments and mechanisms.

Globalization of financial markets: The consensus in the international financial community is that the most important development taking place at the closing of the twentieth century is the integration of financial markets into a global economic community.

Technology in communications and production is spreading quickly and causing national economies to become meshed into a common system of commerce and finance. As this trend toward globalization accelerates, differences in individual national policies become less distinct.

Furthermore, this globalization trend is encouraged by monetary authorities in industrialized countries who realize that a higher degree of economic cooperation among nations is essential to withstand the pressures and shocks in the international monetary system.

Instruments and Mechanisms: The international financial system has been revolutionized in the last decades by a proliferation of instruments and mechanisms that were created in response to the interaction of a variety of developments.

A major development was the trend toward globalization of financial markets, as mentioned earlier.

Another development was the collapse of the Bretton Woods System in early 1970's. Since then the monetary systems of all nations - both industrialized and developing countries - have been shocked by major imbalances in their balance of payments, volatile interest and exchange rates, and unprecedented inflation rates, particularly in developing countries.

These developments coupled with the mounting LDC debt and banking deregulation in industrialized countries, prompted the international financial community to create a variety of financial mechanisms and instruments.

The list of new financial instruments is too long to mention. Two examples are floating rate notes created to cope with interest rate fluctuations, and note issuance facilities - a form of commercial-bank underwriting commitment - to allow borrowers to issue short term paper, with the assurance that the commercial bank purchases any unsold portion or provides standby credit. The purpose of either one of these instruments is to share the risk of inflation, interest, and foreign exchange between borrower and lender, as well as to provide funds at lower cost and with greater flexibility.

Two of the most important mechanisms developed to preserve solvency and liquidity at times of economic volatility are securitization and immunization.

The international banking industry has turned to securitization to convert balance sheet liabilities into marketable securities - a lesson learned from the disastrous outcome of syndicated loans to developing countries. Immunization from interest rate and foreign exchange volatility has been accomplished by focusing on asset liability management through duration rather than maturity and managing interest rate exposure with combinations of variable and fixed rate instruments hedged with financial futures.

Other developments include a variety of techniques to control exposure to interest rate and foreign exchange volatil-

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ity through hedging operations in the forward, futures, and options markets.

Lately another investment technique has been revived and applied to international money management by private corporations: efficient portfolio management. Based not on naive diversification, but rather on diversification through investment in optimal combinations of assets, portfolio management is becoming widely used. Years ago, this innovation born from Financial Theory launched the mutual fund industry in the US. Now the use of the technique is more widespread because of greater accessibility to computer technology and the higher level of education of investment managers.

This portfolio management technique has direct relevance to the emerging capital markets of developing countries. In the process of determining the optimal level of investment in each asset in a portfolio, this technique lowers the risk of the total portfolio, not necessarily by selecting assets with the lowest risk, but rather assets whose returns move in different directions in successive periods of time. This low correlation between assets in a portfolio is what lowers the risk of the portfolio. Since most assets in industrialized countries move in unison, they offer little opportunity for diversification. In contrast, it has been found that assets from developing countries offer excellent opportunity for diversification, both by lowering portfolio risk and increasing returns. Evidence of this investment trend is the success of national funds of newly industrialized and some advanced developing countries. Two Korean funds traded in New York and London have been very successful. A Thai fund is performing well. International portfolio investments by pension funds is increasing. IFC is actively involved in underwriting several of these funds. The Central American Capital Markets study conducted under the PRE Financial Markets Project is an example of this investment technique.

Financial Institutions: Instruments and mechanisms are created and implemented by financial intermediaries. Although it is desirable to create and strengthen domestic institutions who will insure long term continuity in the system. The mechanisms described above may take place in financial markets abroad handled by local branches of foreign financial institutions.

One example is American Depositary Receipts, the equivalent of foreign securities not registered in the US but traded, for instance, in the New York Stock Exchange.

Likewise, the forward, futures and options markets in large international financial centers may be used to execute hedging operations.

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In summary, every financial difficulty has given rise to an opportunity to create a new instrument or mechanism. Many of these could be adapted to assist developing countries in their quest for economic growth and stability.

The challenge: Under these circumstances, developing nations can not ignore the global environment and continue to operate in isolation. On the contrary, their economic prosperity depends on their degree of integration into the global community, and their ability to adopt viable instruments and mechanisms, and create institutions that will support their economic growth.

Yet, this is a complex proposition which poses two questions:

1) How can developing countries be helped to enter the global mainstream by competing successfully in financial markets by offering investments that are more attractive than those available elsewhere in the world?

2) Once they have entered the mainstream, how can they protect themselves against erratic swings in international financial markets? The theory of open financial markets was contradicted when financial markets which are closed to foreign investment (Korea, for example) remained impervious to the October 1987 crash.

What this means is that the complexity of issues and the abundance of alternative solutions represent a challenge to donor and multilateral institutions who wish to intervene in the restructuring of the financial systems of developing countries.

A prudent way to proceed is, first, to carefully assess and respect the financial system that exists in each country, and recognize its merits and pitfalls within the country itself. Secondly, recommend a system that is viable in the context of the country's level of financial development and in the context of the global financial environment. Thirdly, insure that the impact that the recommended actions will have on the country are thoroughly understood before implementation.

The challenge to donor institutions is great, but so is the opportunity to give meaningful assistance to foster economic growth in developing countries.

IMPLEMENTATION PLAN

Primary implementation responsibility shall rest with a single contractor. This prime contractor shall be selected in accordance with competitive AID direct contracting procedures as spelled out in the FAR. The scope of the work shall be prepared by the PRE/PD office and shall require the prime contractor to directly perform work on three of the four project elements; diagnostic evaluations, technical assistance and the dissemination component. Work shall be done directly by the contractor's staff or through the use of consultants approved by PRE/PD.

The Rand D component shall be performed by a subcontractor. Each bidder on the prime contract shall be required to name the subcontractor they will utilize as part of their proposal. Bidders shall be evaluated in part on the strength of the subcontractor which they propose.

Missions requiring diagnostic evaluations and/or technical assistance will be required to partially or fully fund a buy-in to the contract. It is anticipated that PRE will not fund more than 50% of any buy-in. Interested missions will send a PIO/T to the PRE/PD office which will forward it to the contracts office for action. The prime contractor shall break out each bill presented for payment with respect to core vs. buy-in funds.

IMPLEMENTATION SCHEDULE

Date	ACTION
6/88	Project paper reviewed and authorization signed
6/88	SOW for prime contract prepared by PRE/PD
8/88	Proposals from contractors received
11/88	Contractor selected
11/90	Interim evaluation
11/92	Final project evaluation
6/93	PACD

MONITORING PLAN

Primary responsibility for monitoring the project shall rest with the project officer within PRE/PD to whom the project has been assigned. The project officer shall draw on a variety of sources of information to keep current on all aspects of implementation.

A primary source of data on project implementation shall be the prime contractor whose reporting requirements shall be spelled out in detail in the contract. This shall include at a minimum a monthly progress report and a quarterly financial report in form and substance acceptable to the project officer. The project officer shall also exercise oversight by review and administrative approval of vouchers submitted for payment by the contractor and review of specific research works and reports done by the contractor.

The project officer shall also use AID financial reports, such as FACS, and project records, PIO/T, cable correspondence, and contract files, to monitor performance. The midterm and final project evaluations will provide additional data. Finally the project officer will gather information by visiting missions which have participated in the project through buy-ins and by attending workshops and conferences put on by the contractor.

ANNEX A

LOGICAL FRAMEWORK

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APPENDIX A

PROJECT DESIGN SUMMARY

LOGICAL FRAMEWORK

Project Title & Number: Financial Sector Development Project

NARRATIVE SUMMARY	OBJECTIVELY VERIFIABLE INDICATORS	MEANS OF VERIFICATION	IMPORTANT ASSUMPTIONS
Program or Sector Goal:	Measures of Goal Achievement:		Assumptions for achieving goal
To increase LDC's capacity for market-based economic growth by: a) Promoting efficient capital mobilization and allocation to productive resources. b) Encouraging policy reform in LDC's. c) Recommending the use of financial mechanisms and instruments designed to meet short-term and long-term capital needs of the private sector in LDC's d) Assist in the development of LDC financial institutions designed to facilitate the flow of capital in the economy.	-Improved performance of macroeconomic indexes related to financial intermediaries -Adoption of new financial mechanism and instruments in LDC's serviced.	+Macroeconomic data from IFC/IMF +Project reports and records	Continued political will and interest in LDCS to pursue market-based economic growth LDC's interest in developing the private sector

Project Title & Number: Financial Sector Development Project

NARRATIVE SUMMARY	OBJECTIVELY VERIFIABLE INDICATORS	MEANS OF VERIFICATION	IMPORTANT ASSUMPTIONS
Project Purposes:	Conditions indicating purpose has been achieved: End of project status.		
To assist USAIDs to develop and implement private sector financial strategies.	A. 10-20 reports that contain strategy plans and recommendations for inclusion in CDSS's.	Project records	USAIDs have interest and resources to collaborate with PRE in support of financial sector activities
To allow AID to contribute to the advancement of international financial development by: a)Synthesizing and analyzing previous experiences. b)Researching new solutions. c)Disseminating information and training.	B. 10-20 occasional papers C. 10-20 meetings/conferences D. Periodic publications		
Outputs:	Magnitude of Outputs:		Assumptions for achieving outputs:
Private sector financial strategies and recommendations for use in USAID CDSS's.	New USAID projects developed as a result of financial sector strategies and recommendations	Project records and feedback communications from USAIDs	Recommendations prioritized and actionable by USAIDs.
Mechanism to assess country needs and respond to USAID requests for technical assistance in the implementation of financial strategies.	Periodic visits to selected countries by a strategic core group of experts including the Project Officer		

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NARRATIVE SUMMARY	OBJECTIVELY VERIFIABLE INDICATORS	MEANS OF VERIFICATION	IMPORTANT ASSUMPTIONS
Outputs (cont.):	Magnitude of Outputs (cont.):		
Original applied research in the field of international development finance.	10-20 occasional papers	Publications generated	Referred papers are selected for publication
Workshops, conferences, publications and occasional papers on financial development topics relevant to AID and LDC's.	10-20 meetings	Reports and proceedings	Attendance of beneficiaries
Inputs:	Magnitude of Inputs:	Project records	Assumptions for providing inputs:
Technical assistance over over the LOPX.			Demand for services by USAIDs and LDC's
_________person-hours: Assessments, technical assistance, research, and dissemination	Budget		Approval of project by AID and buy-ins by USAIDs.
			USAIDs find the project useful to support their endeavor to assist the private financial sector.

ANNEX B

PROJECT IMPLEMENTATION ORDER