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CAPITAL MARKETS AND PRIVATIZATION

PREPARED BY:

THE MAC GROUP

SUITE 301

2828 PENNSYLVANIA AVENUE

WASHINGTON D.C.

PREPARED FOR:
PPC/PDPR
U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT

PURCHASE ORDER # PDC-0092-0-00-6117-00

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FOREWORD

This paper reviews capital markets development policy as it relates to AID privatization objectives and was funded by the Bureau for Program and Policy Coordination of the U.S. Agency for International Development. It represents the results of extensive research and many interviews with AID, World Bank, and IFC officers on privatization and capital markets, as well as MAC Group experience accumulated though participation in privatization processes in several countries in Central America and Asia.

This paper should not be taken as implying that progress in privatization efforts is totally dependent on the establishment of securities markets. While one might wish that all divestitures would result in publicly owned and traded shares, to set that as a general guiding principle would raise unrealistic expectations in many countries currently engaged in privatization activities with AID and other international and bilateral donor agencies. Capital markets provide an important vehicle for supporting and sustaining privatization activities, but, as experience has shown, they are not necessarily a fundamental prerequisite. Nonetheless, the presence of even a rudimentary capital market can play a strong role in nurturing privatization programs by providing a means for broad ownership of newly divested enterprises, as well as providing access to capital. Indeed, in many cases, the former is more important than the latter.

We at the MAC Group want to thank the Bureau for Program and Policy Coordination of the U.S. Agency for International Development for its support in funding this study. Any questions about the report can be addressed to Donald Shay of the MAC Group at (202) 42-6500.

EXECUTIVE SUMMARY

From a general perspective, active capital markets channel savings towards the most productive investments, congruent with the U.S. Agency for International Development's private sector initiatives. AID has long recognized the need to broaden capital markets and modify policies to provide more long-term finance (including risk capital for industry). To promote that goal, AID has been engaged in helping host countries overcome economic and policy shortcomings that have constrained economic growth.

Capital markets can also play an important role in supporting privatization activities. The lack of a developed and functioning capital market can be one of the key barriers to increased privatization. Since privatization cannot succeed without access to capital—and, in many countries, preferably domestic capital—viable capital markets can help foster AID's privatization goals by facilitating that access and the transfer of SOEs to the private sector. Where practicable, the use of a securities market will better support wide ownership of capital, vaster financial resources, and a more market driven economy.

Capital markets and privatization activities reinforce each other. While a divestiture project will benefit from the existence of a stock exchange for the public offering of SOE securities, the increased supply of new securities also helps the stock exchange develop and prosper.

Capital market development, as AID has found, is not a short term undertaking. A capital market program requires considerable commitment from both AID and the host country government, necessitating substantial planning, and technical and advisory resources, as well as several years of intense effort. Such a program inevitably has great impact on a country's economic policy, its institutions, and the regulatory environment.

This paper attempts to provide a framework for policy deliberations within AID on capital market development programs by taking into account the various factors that can affect a market's development and efficiency: political and economic conditions, capital market institutions and instruments, supply and demand of securities, and the regulatory and legal environments.

We also have reviewed the main obstacles to capital market development. While these vary depending on the country and time, all stem from the factors listed above. Political or economic policy instability certainly leads the list, followed by inappropriate tax and regulatory incentives, which constrain capital formation and hinder market success. Securities markets further depend on sufficient supply of and demand for securities, on the availability of reputable institutions to carry out trading, and on the quality of information disclosed to savers and borrowers. Nonetheless, market dynamics are contingent on the scale of a country's formal private sector as well as the experience of government officials who must implement the program--and dialogue with the private sector plays a major role.

The paper concludes with a discussion of AID's options for stimulating capital market development to support privatization; they range from broad policy options, such as stimulating policies to identify and encourage tax incentives that increase the supply of and demand for securities, to focused implementation programs, such as providing technical assistance to institutions and regulatory bodies. (See Chapter 7 for a more complete outline.) In essence, AID actions should be targeted at those impediments identified in a capital market development study, and should realistically consider what the mission can and should do in light of the host country environment.

The appropriateness of any one (or combination) of these options to any host country depends on that country's current capital market conditions, the forces that facilitate or hinder its development, and the attitude of the host government towards capital market issues. Although some of these options are "technical," the AID Mission will end up spending much effort making local political forces and bureaucracy more aware of the importance and opportunities that exist in a developed capital market. Regardless of the magnitude and timing of the effort assigned to capital market issues and of the favorable infrastructure already existing in the country, a successful capital market program will eventually be opposed by some of its stakeholders and will require support at the highest echelons of the host government (cabinet or even presidential level).

Given the broad scope of issues enunciated here and their possible consequences on both the private sector initiative and AID's privatization objective, a capital market development program is a major effort that may affect the Mission's overall strategy. In those countries where the absence of a capital market and funding alternatives creates a major impediment to private sector development or the privatization program, AID should consider requiring that a Mission's CDSS include examining the host country's capital market (as it relates to the private sector), as well as analyzing how that market can be used to encourage private sector growth.

INTRODUCTION

The purpose of this paper is to discuss the important role capital markets can play in privatization programs in developing countries and to explore ways in which AID's policies can support this process. Since capital is a key ingredient in any privatization program, the absence or presence of a functioning capital market can have a dramatic effect on a country's ability to privatize its state owned enterprises. Equally important as access to capital is the opportunity for broad ownership--a potentially powerful mechanism for gaining public (and therefore political) support for privatization.

Privatization

Privatization can be thought of in both a structural and policymaking sense. Structural privatization includes the full range of options a government may take to specifically (1) reduce government control or eliminate ownership of particular enterprises and (2) increase the role of private business and market forces. These options run the gamut from shifting a government operation to a statutory body operating under the direction of a semi-autonomous Board of Directors (but still owned by the government) to full divestiture or selling of a company's equity or assets.

Achieving these objectives--reducing government control on the market and increasing market forces--is an important part of a vigorous private sector: government regulatory policy can play a key role in fostering privatization by making the economy more private, for example, eliminating import subsidies, "demonopolizing" sectors, and reducing the number and scope of regulations.

One particular area of privatization policy (i.e., deregulation) allows private economic agents to respond unhampered to market forces as they produce goods and services.

State owned enterprises (variously known as SOEs, public companies, or parastatals) have grown both in number and in their relative share of the developing countries' economies. While some SOEs have been quite successful, the growth of inefficient public enterprises has become a drain on economic resources, and a large number of those enterprises would be more profitable if they were managed or owned by public investors. The deleterious effect of SOEs has been even more pronounced in some countries (e.g., Brazil, Bolivia, Bangladesh) where they were allowed to have direct access to international financial markets, absorbing foreign capital and making it more difficult for private firms to attract capital.

As a reaction to excessive and ineffective public sector growth, various countries in the 1980s have started privatization programs or are at least showing interest in them. Specific reasons for this trend vary substantially among different countries: an increasing recognition of the efficiency of the private sector and its management proficiency, as well as the need to raise government revenues (or reduce subsidies) are just a few of the factors pushing countries toward privatization. Reductions of activities and improvements in efficiency are planned for parastatals in countries such as Rwanda, Senegal, and Kenya, where governments have initiated reviews of their public sectors and are considering policies to improve the economic position of the formal private sector. Throughout the 1980s, various international institutions such as the IMF, the World Bank, and the Agency for International Development (AID) have encouraged this shift towards the private sector.

Impediments to Privatization - The Importance of a Capital Market

As they move to divest SOEs, developing countries face a number of significant obstacles. One of the key barriers is the lack of a functioning capital market. This is particularly critical in countries whose governments are trying to encourage widespread ownership of divested companies. Without a functioning market, countries are forced to sell state owned enterprises to private companies, wealthy families or groups, or foreign interests,* which they often find unacceptable. It is clear that if privatization programs are to reach their full potential, the development of capital markets must be encouraged, both to broaden the range of buyers and mobilize financial resources.

A well functioning capital market can contribute to the overall efficiency of the economy by improving the allocation of financial resources; by capturing the savings of individuals and institutions, it makes those funds available for a variety of long and short term investments. Since a substantial proportion of those savings are then absorbed by the private sector, the capital market creates growth opportunities and encourages local entrepreneurs, giving emerging companies access to sources of risk capital that would be otherwise unavailable to them. Conversely, the lack of a developed capital market acts as a constraint on private sector expansion.

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* Often, instead of outright divestiture, companies are leased because buyers cannot be found at the price the government requires or because available local capital is insufficient. This in part may be due to the lack of a capital market to mobilize the required financial resources. The most successful examples of leasing have occurred in certain services (hotels in Barbados, Grenada, and Jamaica, and transportation in South America), but the use of leases in the production of goods is complicated and has been very limited (Togo, Ghana, and the Philippines).

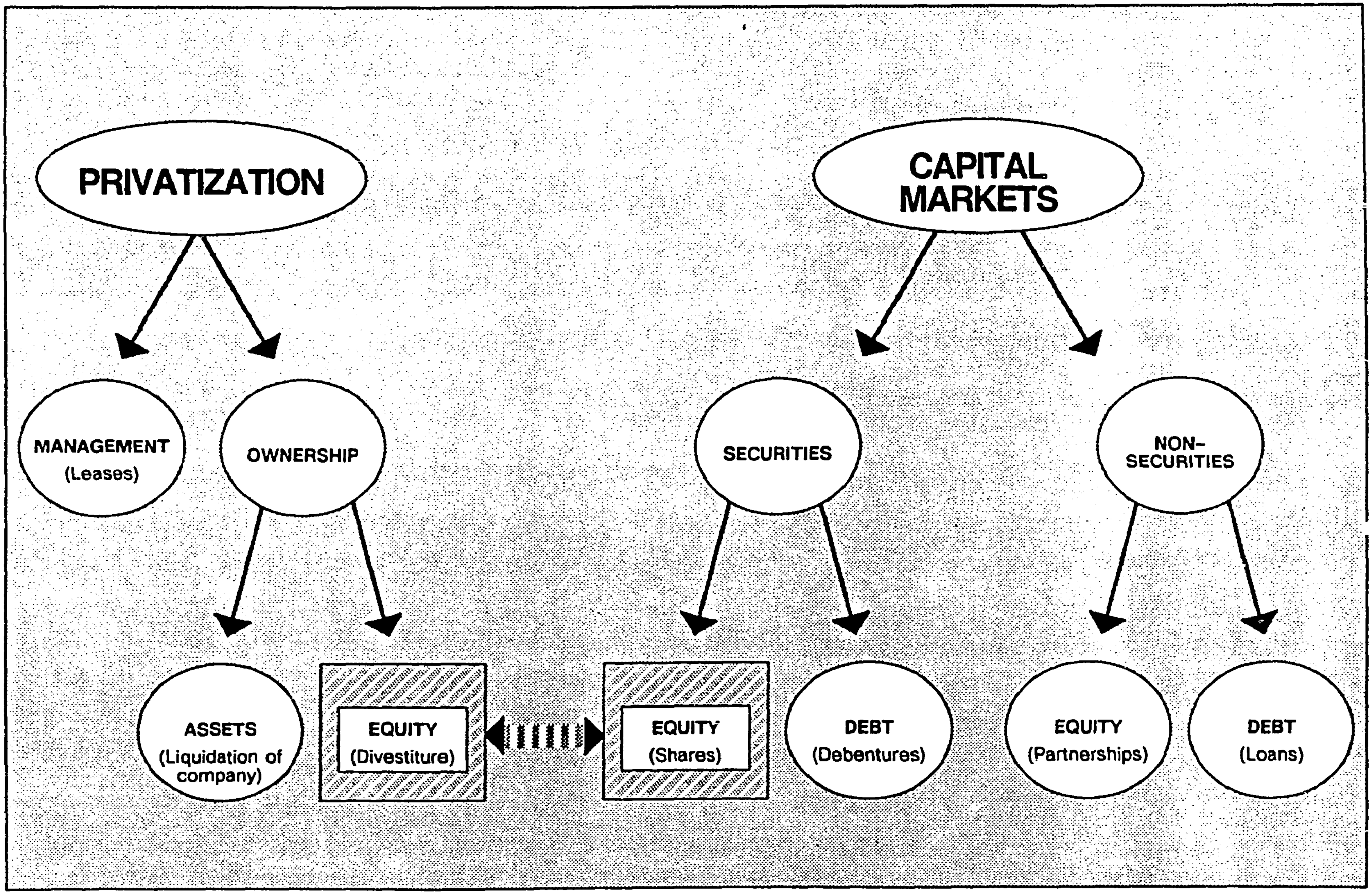
Unfortunately, those developing countries that could most benefit from the growth of the private sector are usually countries where capital markets either do not exist (in part because of the dominance of the state sector) or have been rendered inactive or ineffective—something that must be counteracted. In that regard, AID's ongoing efforts to support host country governments in capital market development are critical to the success of privatization. The development of an active capital market will contribute to private sector growth through increased domestic savings potential, improved economic allocation, and availability of risk capital.

The interaction of capital markets and privatization is mutually beneficial (as shown in Exhibit 1). Complete divestiture is AID's preferred approach to privatization of SOEs: it entails increasing broad private ownership and control of what were formerly nationally owned assets. A channel for the sale and purchase of equity shares—in short, a capital market—is needed.

The divestiture of an SOE will in turn have a positive impact on the capital market by providing shares for trading in that market. The United Kingdom illustrates how the capital market and the privatization programs reinforce each other. Denationalizing the state-owned British Telecom doubled the number of people who owned shares in the country.[1] At the same time, Margaret Thatcher's government was able to use the capital market and public placements to turn a dozen SOEs over to the private sector.

EXHIBIT 1

CAPITAL MARKETS AND PRIVATIZATION



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There are important non-economic benefits from the sale of a state owned enterprise to a broader number of owners. Such a transaction is more acceptable to the various political constituencies (including current company employees and labor unions) when it is viewed as a direct transfer to the public, instead of as a concentration of power in a smaller group of shareholders. The recent sale of shares in the National Commercial Bank in Jamaica to the general public has stimulated pro-privatization public sentiment and diminished opposition.

This advantage is particularly important in those countries where the motivation for privatization has roots in a desire for increased public ownership of the economic resources and where a public sale allows the populace to share in the fruits of privatization. As the International Finance Corporation has further pointed out:

> A securities market helps promote democratic capitalism. By distributing the ownership of securities more widely, a securities market assures that the ownership of the business is not confined to a small number of wealthy families or to big industrial-financial conglomerates.[2]

There are potential risks--both economic and political--for developing countries that do not have viable capital markets. The relationship between lack of active capital markets and narrow ownership can best be illustrated by the example of Chile, whose public sector had grown tremendously as a result of Allende's nationalizations in the early 1970s. When the post-Allende military government implemented its own privatization program, the severely depressed capital market was not yet able to absorb more volume, and potential buyer interest in the proffered SOE shares was low. Most companies had to be tendered to the principal financial groups despite the fact that shares could easily have been absorbed by the capital market had the economic circumstances been more favorable.[3] The economic distortions caused by the subsequent concentration of power point only to possible drawbacks of privatization accomplished soley through narrow transactions among a small "club" of investors rather than to problems within equity markets in general.

The existence of an active capital market does not, in itself, however, guarantee that broad ownership will automatically occur. It only highlights the fact that, under special conditions, when a government moves towards privatization without the benefit of a carefully thought out master plan, it can inadvertently cause greater concentration of ownership and wealth. The existence of an active capital market increases the odds of transferring stock ownership, and, if the transactions are subject to appropriate stock exchange regulations, reduces the odds for increased concentration.

Although it is theoretically possible for a government to make possible broad ownership of divested SOEs without selling shares but simply by issuing those shares to citizens or funds where they are represented, this solution is not always feasible in developing countries. In fact, even in cases where this has taken place and innovative approaches were used*, capital markets are still needed to determine the market value of the shares and provide a vehicle for their exchange. Moreover, the existence of trusts or funds is correlated to the existence of a securities market that allows for their flexible functioning. In light of the lack of other valid alternatives and given the benefits already discussed, we conclude that while creating or encouraging a capital market can be a major strategic undertaking, AID should continue to foster development of capital markets to help strengthen the private sector.

* * * * * *

This paper is divided into seven chapters: Chapter 1 is an introduction to capital markets, outlining the components of capital markets and their possible contribution to privatization. The threats and opportunities to capital market development posed by political and economic conditions are described in Chapter 2. Chapters 3, 4, and 5 deal with the components of the securities markets and include recommendations to help AID evaluate and modify unfavorable conditions. In Chapter 6, we review major impediments to capital markets, and in Chapter 7, we review market development conditions, considering various AID policies to stimulate capital markets and foster privatization.

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* The Canadian province of British Columbia tried a mailing approach in 1983 in a very controlled situation and was able to achieve its goal of broad privatization.[4]

EXHIBIT 2
COMPONENTS OF THE CAPITAL MARKET

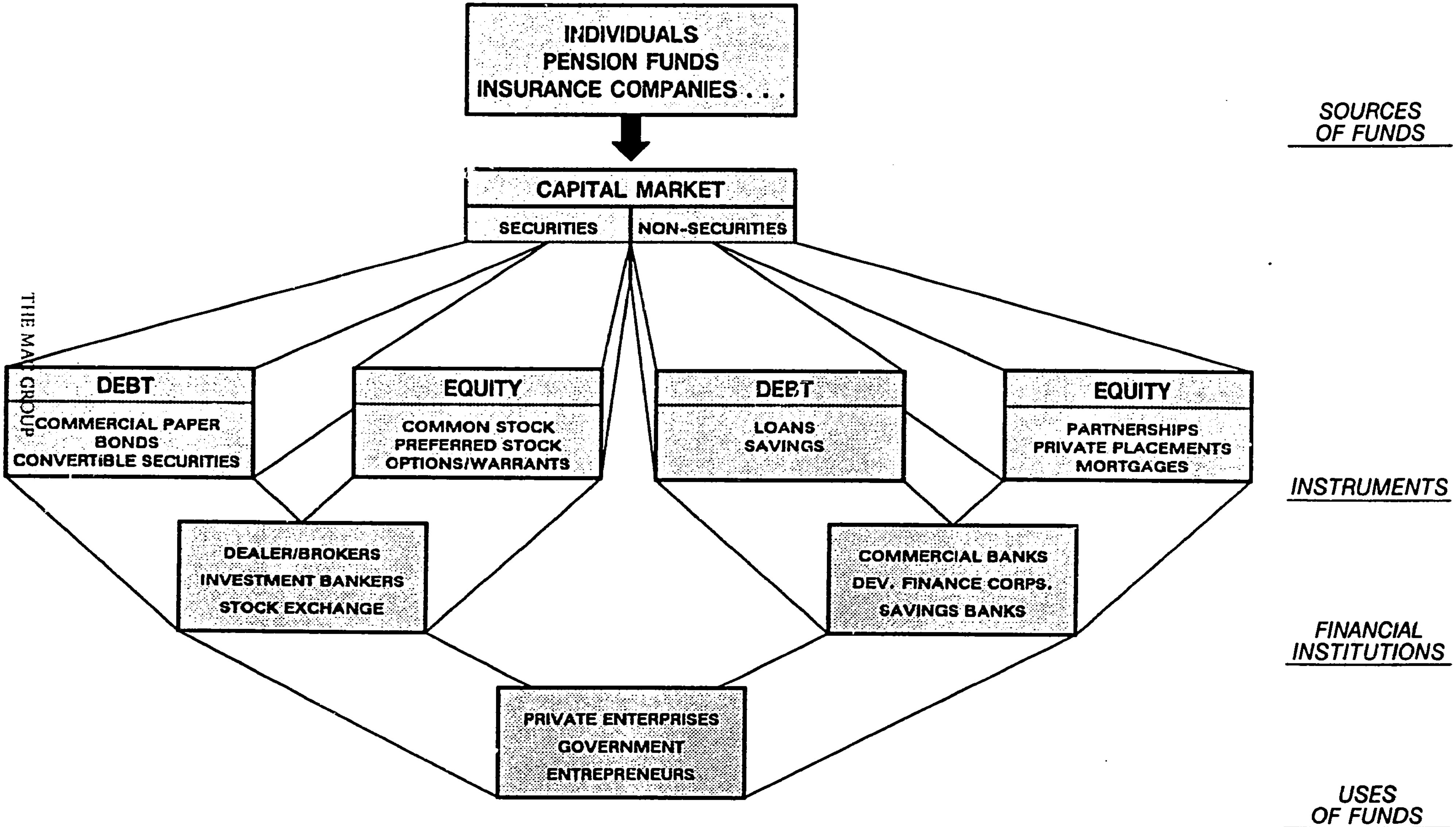

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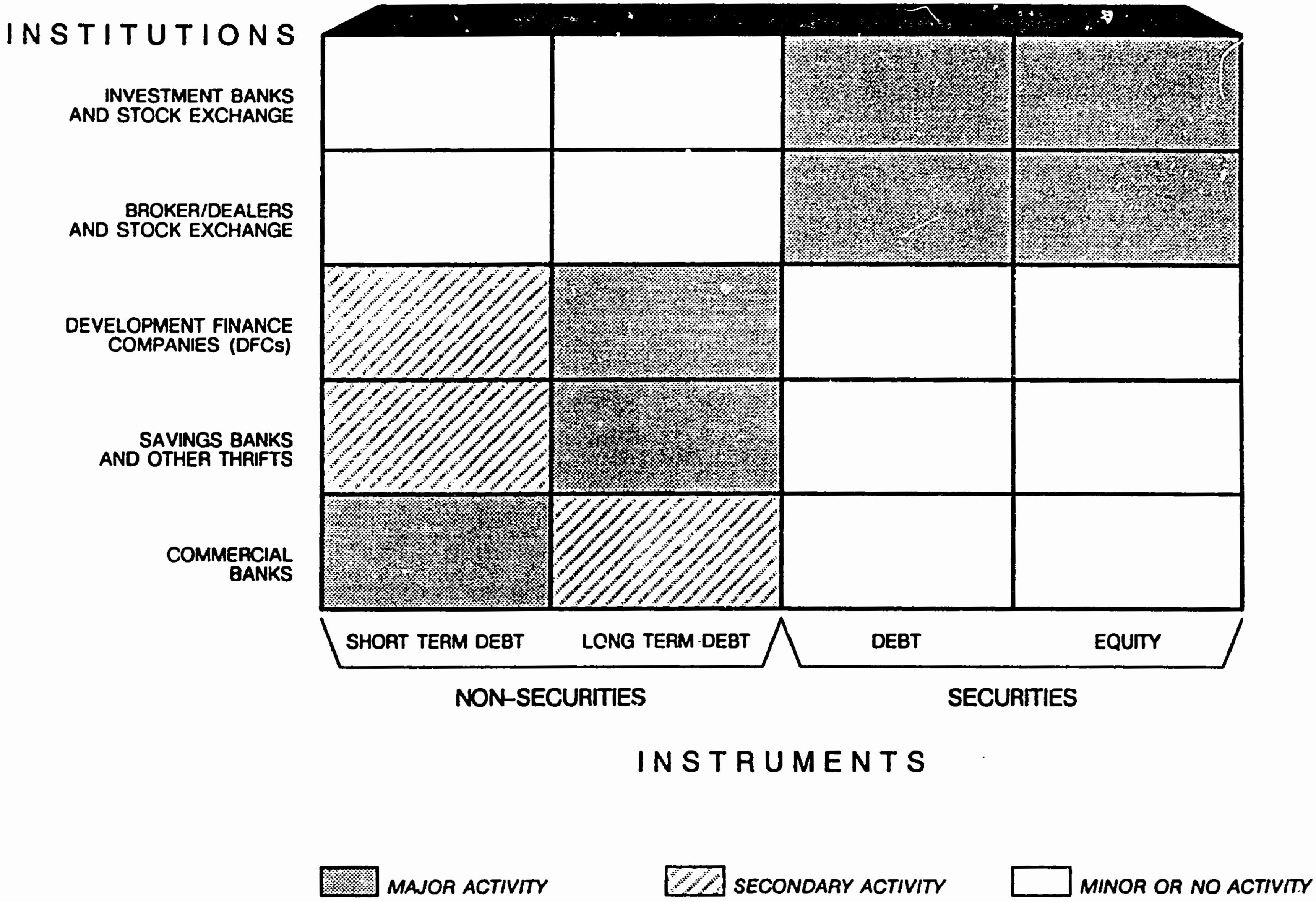
EXHIBIT 3

INSTRUMENTS AND INSTITUTIONS OF THE CAPITAL MARKET



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1. COMPONENTS OF CAPITAL MARKETS

To help understand the role of the capital markets in fostering private sector growth, in this chapter we will outline the key attributes of a capital market and analyze their importance for privatization.

A capital market brings together investors and users of funds and can be divided into securities and non-securities sectors. The securities sector can further be classified as either a debt (money market instruments, bond and debentures) or an equity sector (shares). Exhibit -2- presents a graphic picture of the interaction of sources and uses of funds through the capital market and the type of financial institutions* and instruments found in developing countries.

The range of financial instruments and institutions varies by a country's degree of economic development. Exhibit -3- shows the relationships that exist in a developed economy between these elements. The instruments are listed in the horizontal axis and include short term debt, long term debt, debt securities, and shares. The institutions are shown on the vertical axis and are grouped into commercial banks, savings banks and other thrifts, development finance companies (DFCs), brokers and dealers, and investment banks. Only the last two groups (brokers and dealers and investment bankers) need a clearinghouse for their transactions, although not necessarily a formal securities exchange.

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*In the context of this paper, the term "institutions" describes all that is needed for the markets to transact instruments, namely the stock exchange and the financial intermediaries.

The degree of sophistication of both the instruments and the institutions of the capital market increases as we move towards the upper right hand corner of the exhibit. As this exhibit shows, when a developing country's government wants to encourage a securities market, it may have to promote the creation of new institutions and financial instruments.

1.1 Formal And Informal Markets

In developed countries, the array of financial products fulfills the needs of individual investors seeking the best ratio of risk versus return. Savers and investors will direct their financial assets towards those investment opportunities--regulated or not--that will give them the largest return for a given risk. Although the alternatives for investors of developed countries' markets are fairly comprehensive and present various trade-off possibilities, this situation unfortunately does not exist in many developing countries with overregulated markets that are not responsive to private investor needs. With nominal interest rates often set by governments and under volatile inflation rates, real interest rates frequently are too low or are negative, resulting in the development of underground markets that operate in an environment of unwritten rules and unknown intermediaries.

These underground markets sometimes are the only avenue available either to a borrower who has no access to regulated interest rates or an investor who wants a greater return than what is offered by the official rates. Examples of such markets include:

- The "marginal" market of Argentina, which during 1982 accounted for a large percentage of the financial assets, and whose interest rates carried a substantial premium over the regulated official rates.

- The Korean "curb" market, managed by professional money lenders and investors, which emerged in reaction to overbearing financial regulations.[5]

Unorganized or unstructured markets can be an important source of capital. In fact, in many West African countries, where the total money supply is regulated by regional central banks, informal markets have provided the only viable—albeit restricted—funding alternatives to small and medium enterprises.

Other factors being equal, organized market solutions that allow the same type of transactions are preferable to their informal market alternatives. This bias in favor of organized and structured securities markets wherever possible should not, however, be construed as a dismissal of less formal means of mobilizing capital for privatization. Access to capital, be it controlled or uncontrolled, is an incontrovertable prerequisite for private sector stimulation.

Thus, Missions in some AID countries have no alternative but to recognize the role of informal markets in their privatization programs even though informal markets generally are more subject to volatile investor behavior, price manipulation, and expensive intermediation than are formal markets. Informal markets also can be undesirable for host governments because they make it difficult to effectively administer monetary and fiscal policies. Whenever possible, we will confine our discussion to organized or formal markets, exploring ways to "formalize" the informal sector.

1.2 <u>Non-Securities Segment</u>

In a less developed economy, the instruments and the institutions shown in Exhibit -3- are concentrated in the bottom left of the matrix and correspond to the non-securities segment.

Commercial banks, either public or private, lend short term funds to institutional and private borrowers, while savings banks primarily cater to residential or commercial mortgage funding needs. They are still the main source of capital in developing countries. Commercial banks occasionally make medium or long term loans, but in doing so, they face liquidity risks and maturity mismatches between their assets and liabilities.

The unwillingness of commercial banks to mobilize short term deposits for financing long term investments has affected businesses, especially in countries such as Senegal, where domestic banking resources constitute the sole source of capital. Banks are risk averse and will not make long term loans unless they have experience assessing the business risks and the borrowers seem unlikely to default. Unless the government agrees to guarantee the transactions, this aversion to taking risks makes banks less useful lenders for privatization.

In countries that do not have securities markets, development finance companies (DFCs or Development Banks) are perhaps the only existing long term source of capital. DFCs were very instrumental in project development during the 1960s and 1970s (examples can be found in most developing countries) and historically have been responsible for allocating long term funds to high priority projects that promised good economic return. Although their charters include the mobilization of private domestic economic resources to support long-term investment, in most cases DFCs' funds have been provided by the governments and central banks with little help from private savings.[6] Development banks hold a relatively small portion of a country's total financial assets, however, and according to an International Finance Corporation study, often are not well integrated with other institutions.[7] In the past, DFCs depended heavily on government funds and foreign sources, (commercial banks, bond markets, and the World Bank), but they now face a period of shrinking government budgets and inaccessible international markets, all of which is exacerbated by their own internal shortcomings (e.g., deficient staffing and outdated systems and analytic capabilities).

In those countries where there is no securities market at all, AID may still consider using the DFCs in the privatization process, if these institutions have sufficient liquidity to provide loans to buyers and facilitate those financial transactions. In such instances, DFCs can offer an existing channel for the state to distribute securities to individuals, act as lenders in leveraged buy-out transactions, or even guarantee outright company acquisitions, facilitating the privatization process. If their financial or human resources are insufficient or nonexistent, however, DFCs will demand substantial donor and host country financial support, and AID should instead consider developing and supporting private sector institutions (whose use is certainly desirable from the AID policy standpoint).

1.3 Securities Segment

The securities market includes both money market instruments and bond and equity instruments, either as new issues or in secondary markets.

Money market instruments include treasury notes, certificates of deposit, and commercial paper issued by large corporations; they reach maturity in a range from a week to less than one year. Because of this short life cycle, money market instruments are not appropriate financing vehicles for privatization.

Bonds and equity shares, the two long term securities, have very different characteristics. Bond instruments represent a fixed obligation by the enterprise owners to repay the principal according to an established schedule and at a certain rate of interest. Equity shares, on the contrary, represent ownership in the company, a claim on the assets and a participation in the earnings of the firm after outstanding debt has been paid.

1.3.1 Debt Securities

Basic long term debt securities include government bonds and corporate bonds or debentures. Government bonds constitute the largest share of the debt securities markets but are not relevant in privatization. The trading of country debt in return for corporate equity has emerged in the last couple of years (debt-equity swaps), providing an opportunity to use host government securities for privatization purposes.

To date there are only a few examples of active corporate bond markets in developing countries (e.g., Brazil, India, and South Korea). Straight corporate bond markets can at best play a minor role in financing divestiture since they do not entail the transfer of ownership to the investor. In developing countries their role is even less significant in the divestiture process than in industrial countries (where "junk bonds" are used to finance leveraged buy outs or the purchase of companies).

1.3.2 Equity Securities

The equity market is by far the most important segment of the securities market in developing countries, as well as the most relevant segment for privatization. Equity securities allow investors to choose between different ratios of risks and returns, making equity an attractive investment vehicle for a broad spectrum of investors.

Financial theorists and researchers have articulated a basic principle that has long been perceived by stock market participants: bigger returns require higher risks. Exhibit -4- is a graphic representation of the financial trade-off between risks and returns. Securities that have less-than-average risk offer smaller returns than an equity market portfolio, while riskier securities yield comparatively higher rates. A clear relationship between risks and returns exists only when the markets are efficient and investors are "rational," basing their decisions on publicly disclosed information.

1.3.3 Other Instruments

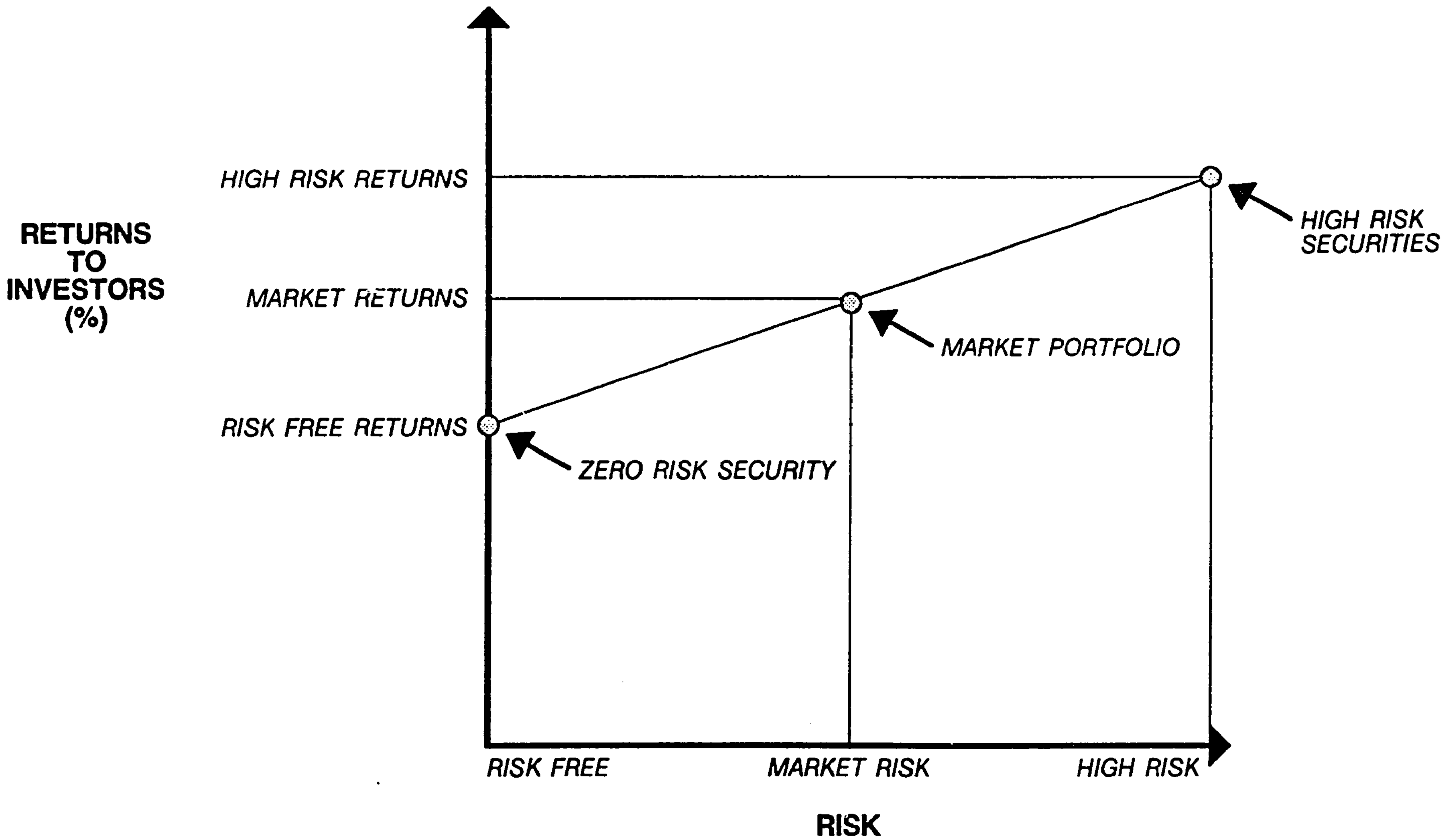
In recent years, industrialized countries have witnessed the introduction of a whole variety of debt, equity, and combined securities: future and option contracts, convertible bonds, preferred stock with or without conversion features, etc. Currently, these instruments are available only in the most developed countries, and while one can speculate about their possible application in developing countries, in our view, these instruments are suitable for only the most advanced capital markets, where information is readily available and sophisticated investors abound.

1.4 Financial Institutions

Institutions in many developing countries need to be strengthened and updated because the operations and volume of the capital market very often

EXHIBIT 4

RELATIONSHIP BETWEEN RISKS AND RETURNS IN THE SECURITIES MARKET



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have outgrown the institutional framework, especially in countries where the government owns key institutions. Institutional structures should be reviewed to determine if trading is provided at a reasonable cost and whether the borrowers and the investors are protected from excessive manipulation by financial intermediaries.

No examples are available of an organized market in which the sale of securities takes place directly between sellers and buyers. Capital market operations are performed by a wide range of different intermediaries in both developed and developing countries. Even countries with very shallow, inactive markets have some sort of forum and intermediation mechanism for transferring securities (e.g., some Caribbean countries have stock exchanges that open for only few a hours per week).

The securities market accomplishes similar tasks throughout the world: issuing securities in the primary market and trading them in the secondary market. The issue of securities includes all the activities involved in bringing equity to the market for the first time: writing and filing a prospectus, registering the security with regulatory bodies, underwriting the issue, listing with the securities exchange, advertising the issue, and managing the distribution of the securities. Secondary market activities include trading existing securities, clearing and settling accounts, and other "market making" activities.

The primary institutions of the securities market are the stock exchange and financial intermediaries.

1.4.1 Stock Exchanges

Stock exchanges establish prices through an auction mechanism. In simple exchanges, the prices are negotiated at established times during the day. In Nigeria and Turkey, for example, trading is conducted during a role call during which buyers and sellers bid and offer their quotes, and shares are sold at the highest quote possible. In bigger and more active exchanges, trading takes place almost continually in predetermined areas known as "pits." Bids and offers are publicly announced, enabling investors to obtain fairly up-to-date price quotations at any given time.

Almost all trading in developing nations is conducted in central exchanges because formal over-the-counter markets require sophisticated technology and communication support that are beyond the countries' current capabilities. Informal over-the-counter markets have proven to be very risky: the danger of an unregulated exchange mechanism is illustrated by the 1983 collapse of the Kuwaiti capital market, where continuous speculation and highly leveraged transactions financed by postdated checks caused the market to accelerate precipitously, ultimately collapsing into multibillion dollar chaos.[8]

The integrity of the exchange is guaranteed by the regulatory environment, and a very fine line separates exchange regulation strengths and weaknesses. On the one hand, investors depend on the protection offered by regulations to defend themselves against illicit manipulations by intermediaries and underwriters. On the other hand, especially in the early development of a securities market, such an environment constrains securities market growth. The optimum degree of regulation depends on certain cultural characteristics as well as the legal, regulatory, and contractual environments that exist in a given country.

1.4.2 Financial Intermediaries

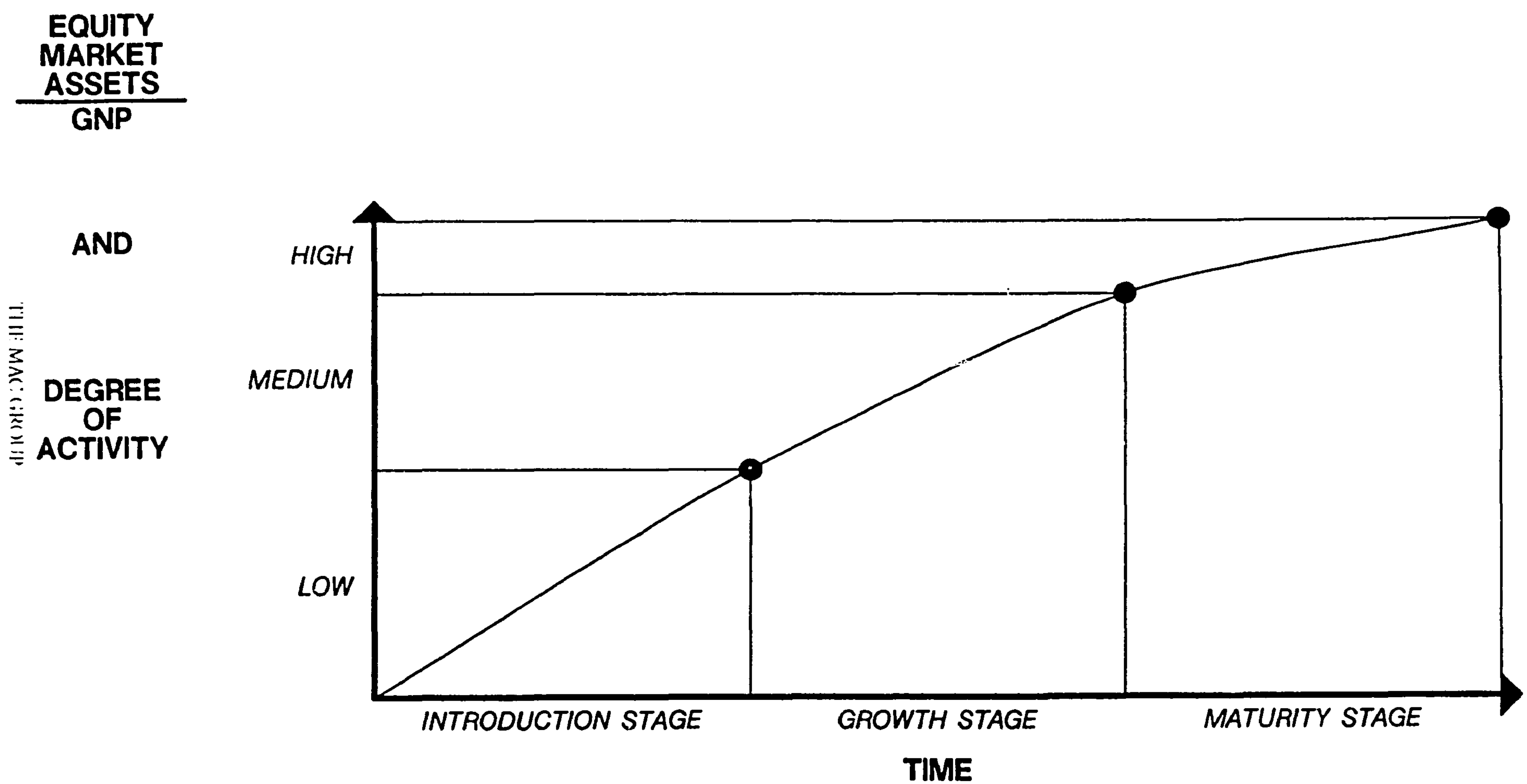
Financial intermediaries represent the buyers and sellers of securities in transactions in the stock exchange. Depending on their charter, the intermediaries may act as brokers or as principals in the transaction. A broker intervenes in a transaction only to represent one of the parties; he does not hold title to the shares. Conversely, a dealer acts as a principal in the transaction and actually owns the securities for a short period of time, gaining or losing from changes in the assets' value.

1.5 The Capital Market Life Cycle

Capital markets typically evolve through stages that can be described as a "capital market life cycle" (see Exhibit -5- for a graphic picture of the evolution of the securities market). The horizontal axis represents the time elapsed since the creation of an organized securities market, divided into the introductory, growth, and maturity stages. The vertical axis represents the proportion of the country's GNP invested in the equity market as well as the amount of market activity. Clearly, mature markets experience a higher volume of trading than markets in either the introductory or growing stages.

The introductory stage covers the creation of the securities market, during

EXHIBIT 5
CAPITAL MARKET LIFE CYCLE



which only a few companies offer shares to the public, and only a very small group of individuals and institutions are aware of the potential returns of the market. At the very beginning, very few transactions take place each day. In such a "thin" market, positions are usually short term; individual investors must be reassured that the price they are paying is the same as everyone else pays at that time. Clearly, disclosure plays a critical role.

An example of this introductory phase is the Istanbul stock market, which was created in December 1985. As described by Alan Friedman in Financial Times:

> The market is deemed to be active if there are 25 transactions a month...As regards corporate finance most companies are still stuck with bank loans as their main source of capital...the stock market is not much of a source of capital...Business is dormant because share trading is not a familiar tradition in Turkey...He (Chairman of the Capital Market Board) wants to see new companies coming to the market.[9]

This stage is followed by a growth period, which typically occurs after the government encourages an increased supply of securities, usually through tax revision of some sort. The emergence of a strong secondary market is also characteristic of this growth stage. In addition, investors become interested[10] in the intrinsic value of their holdings (earnings per share, dividend policies, price/earning ratios) and begin to expect—and require—better accounting standards and financial information.

If the growth stage evolves satisfactorily, the securities market moves into its maturity stage; this evolution is often somewhat uneven because the entrance of institutional investors and mutual funds increases the market's volatility. Ultimately, there is a move towards increased brokerage services, reduced transaction costs, and lower growth rates. The market reaches a stable operating condition (e.g., Hong Kong, Singapore, India), and trading patterns gradually become more consistent.

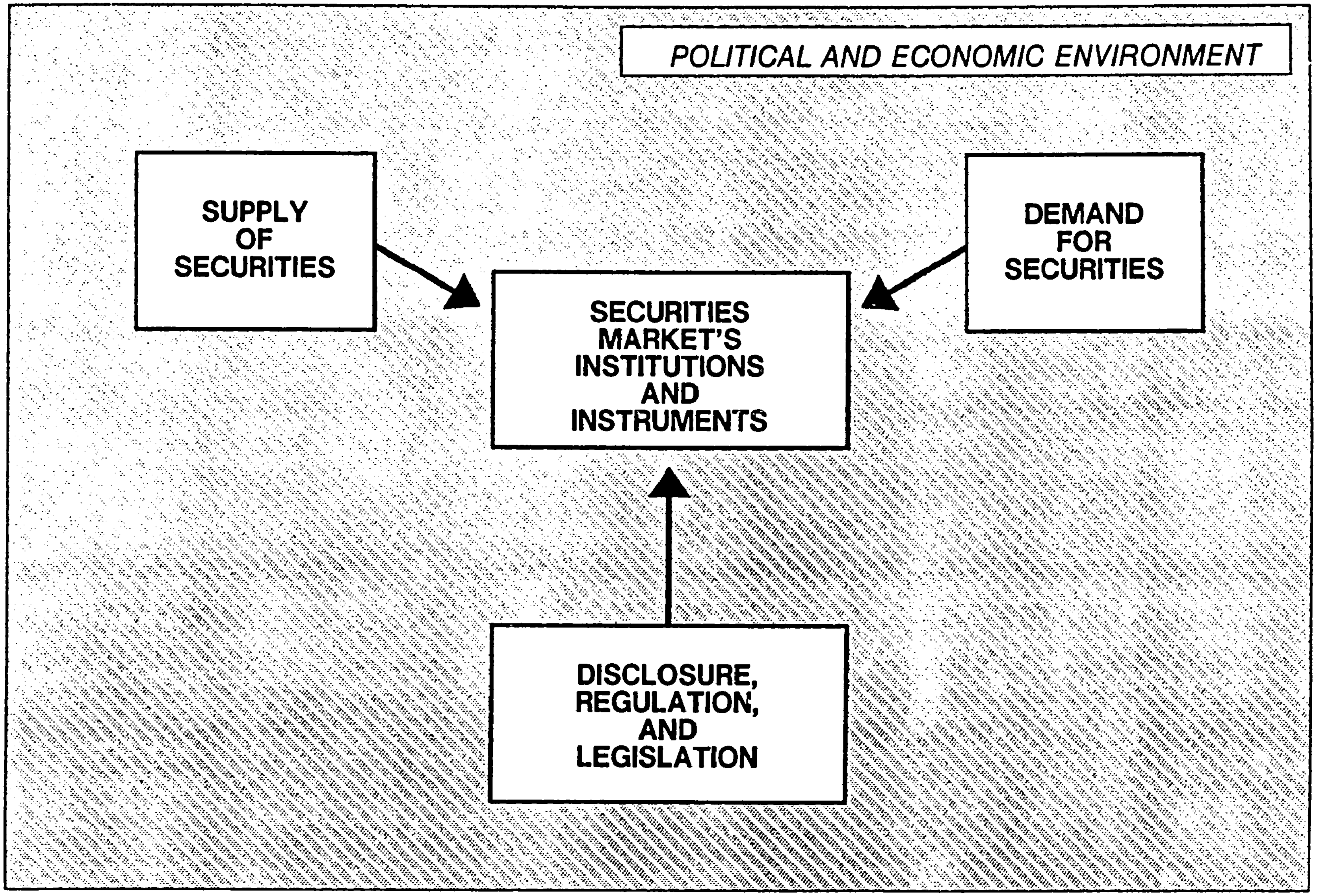
Unfortunately, it is also possible that a capital market might never reach the mature stage, becoming dormant after major economic shocks or because of the lack of positive government policies. The Colombian stock exchange is a classic example of a securities market that dates back half a century and still remains fairly shallow and sluggish despite its significant size. While it is conceivable that the market could be reactivated by a successful promotional program and active government support, the Colombian securities market "is what one might expect given the adverse social and economic conditions in recent decades and the lack of active government support."[11]

1.6 Framework for Analyzing Securities Markets

To help assess the role of a capital market in supporting privatization, we use an analytic framework that takes into account the various factors that affect a capital market's development and its efficient functioning (see Exhibit 6). Its central components include institutions and instruments (securities), their relationships to the supply and demand of securities, and the regulatory environment. Political and economic conditions, represented as the superimposed framework, have an important effect on the overall development and growth of the market.

EXHIBIT 6

FRAMEWORK FOR THE ANALYSIS OF SECURITIES MARKETS



2. CAPITAL MARKET ENVIRONMENT

Since investors' demands are extremely sensitive to political uncertainties and changes in the economic environment, when these factors are not conducive to market development, they usually outweigh any fiscal and tax policies designed to encourage its growth.

2.1 Political Conditions

The political environment plays an important role in the development of the capital markets because of the (1) effects of a country's institutional stability on investors' decisions and (2) local political opposition.

Political instability undoubtedly generates investor preference for highly liquid assets. A certain degree of institutional stability is necessary if investors are to feel confident enough to decide to hold economic assets instead of "real" assets such as precious metals. Capital market development is thus hindered by political instability as well as situations in which regulatory and contractual agreements are not honored, but are frequently changed and reinterpreted.

At the very least, a country should exhibit reasonable political and institutional stability and promote a sense of confidence about the future: a stable policy that is favorable to private enterprise development is necessary for the success of capital markets. On the other hand, a democratic government is not critical: Korea, Jordan, and Brazil actively developed their capital markets in the absence of democratic institutions.

The second political environment factor cited, local political opposition, often arises when such a highly visible effort as a capital market development program is launched by a government. Continuous public government sponsorship and commitment is a necessary concomitant of such a wide-ranging and visible program, especially given the fact that the results may be neither immediate nor obvious. Securities markets heavily depend on private initiative and ideas and require an environment that is conducive to rapid economic growth.

2.2 Economic Conditions and Policies

Experience has shown that rational investors will not commit their savings unless they believe they will find consistent returns commensurate with risk. If a country enters a period of austerity, the demand for and supply of funds and investments will most probably dry up and create a powerful economic impediment to capital market development. Since the economic conditions may outweigh the effects of any promotional scheme instituted by the capital market program, it is important to base that program on a reasonable forecast of the country's economic climate.

Formal economic policy also affects the demand for and supply of securities: since a country's credit policies determine interest rates, those policies have a powerful impact on the demand for and price of securities. On many occasions credit policy has stifled rather than encouraged possible capital market development, primarily due to a government's having set artificially low interest rates.

Some African countries (e.g., Nigeria and Cameroon) present a good picture of the effect of mandated low interest rates, further complicated by directed credit programs. It is clear that much of the "subsidized" credit was allocated to wealthy individuals, inducing investment in disproportionately capital-intensive facilities; as a result, total domestic credit growth in such countries has lagged behind other economic indicators. From the point of view of demand of securities and growth in the securities market, an economic policy that supports low interest rates induces a bias against equity and equity securities and instead encourages borrowing.

At the microeconomic level, excessive sector regulation (e.g., government sponsored monopolies, wage and price controls, differential duties and dividend taxes, and excessive sector regulation) reduces corporate earnings as well as corporations' ability to attract equity.

3. SUPPLY OF SECURITIES

The securities market cannot grow unless the number of shares available for trading also increases. Any incentive for enlarging the market without increasing its supply side will inevitably result in speculation, skyrocketing prices, and other undesirable repercussions. Based on the record of successful markets such as those in Korea and Jordan, it is estimated that 10 to 25 listed and actively traded companies support 80% of the trading during the first stages of a capital market.[12] No matter how many companies are listed, however, sustained activity of the securities market cannot be guaranteed. For example, the Nigerian, Venezuelan, Jordanian, and Singapore exchanges each listed from 75 to 100 securities in 1982 [13] (although the first two are considered quite underdeveloped given the size of the countries' overall financial assets), the second two are examples of a growing activity and presence of the securities market.

More securities create greater opportunities for savers to buy equity instruments and broaden the public ownership of enterprises. A desirable supply of securities will be generated by companies with proven track records, experienced management teams, and high share potential. As Exhibit -7- indicates, large private companies, multinational corporations, and state owned enterprises present the best conditions for increasing the supply of shares. An active, efficient securities market will attract all those companies. During the introductory stage of securities market development, however, activity is very slow, and the companies will not "go public" unless they are pushed to do so.

EXHIBIT 7

SUPPLY OF SHARES TO THE SECURITIES MARKET

			ATTRACTIVENESS						
POTENTIAL SUPPLIERS		**SECURITIES VOLUME POTENTIAL**		**TRACK RECORD**		**MANAGEMENT**		**CONCLUSION**
START-UPS	▶	LOW-MEDIUM	+	UNKNOWN	+	NEW (UNKOWN)	=	NOT IN SECURITIES MARKET INTRODUCTORY STAGE
SMALL PRIVATE COMPANIES	▶	LOW-MEDIUM	+	UNKNOWN	+	UNPROVEN	=	NOT IN SECURITIES MARKET INTRODUCTORY STAGE
LARGE PRIVATE COMPANIES	▶	MEDIUM-HIGH	+	PROVEN	+	EXPERIENCED	=	GOOD SUPPLY POTENTIAL (Limited by current owners' control)
STATE OWNED ENTERPRISES	▶	HIGH	+	WILL CHANGE IF DIVESTED	+	WILL PROBABLY CHANGE	=	GOOD SUPPLY POTENTIAL (Limited to certain SOEs only)
MULTINATIONAL CORPORATION SUBSIDIARIES	▶	MEDIUM-HIGH	+	PROVEN	+	EXPERIENCED	=	GOOD SUPPLY POTENTIAL (Limited by durable domestic participation)

Countries have used very different strategies to increase the number of private companies issuing securities in the stock market. Tax law reforms in particular have become very effective instruments for this purpose. Korea, for instance, very successfully induced companies to go public by imposing a special tax on the transfer of closely-held shares and threatening selected companies with increased "attention" of its tax authorities unless the companies went public. Other countries in the Far East, such as Thailand and Indonesia, also have used tax incentives to generate shares supply.

Under certain types of government, the supply of securities also can be simply and directly compelled by specific laws. For example, Jordan adopted a policy that required closely held companies to sell a certain portion of their equity to the public.[14] Nigeria and Indonesia mandated the issue of securities (although only for multinational corporations).

The current experience of the Istanbul stock market provides a good example of the difficulties faced by emerging markets to develop unless the supply for securities is increased by revisions in the regulatory and tax environment:

> [The Chairman of the Capital Markets Board] wants to see new companies coming to the market, but he is under no illusion that the number of traded shares is likely to increase beyond the 40 now existing in the market. To encourage new listings, tax incentives should be developed, he says... At present companies don't see any benefit in going public. If they do so they fall under the supervision of the Capital Markets Board and nobody likes supervision. The companies would then have to publish profits-and-losses accounts and balance sheets...When asked how long it will take for Turkey to develop healthy and active financial markets, he says, "In Turkey you should always look at the long term.[15]

Encouraging the sale of a certain volume of shares usually is not enough; these shares also need to be diffused among a broader group. The securities markets of developing countries tend to follow the "80-20" rule—20 percent of the companies provide 80 percent of the market activity. A substantial percentage of the companies are closely held (insiders own as much as 90 % of the shares), and their owners are not trading their shares in the market.

One very effective way to more widely distribute ownership is by closely defining listing requirements. For instance, if a company wants to benefit from a given tax advantage and/or avoid a penalty, it must sell a minimal percentage of shares to the public, and a specified number of investors each must own a certain minimum number of shares. Assuming that the companies selected have a large asset base and substantial equity, a relatively small percentage of shares in public hands will provide an important supply of securities. In the exchanges of most African and Asian developing countries the government requires that before a company can be listed on the exchange, at least 20 percent of the shares be held by the public.[16]

The subsidiaries of multinational companies (MNCs) also can contribute to the supply of securities. Their advantages are sustained by their management capabilities, profitable products, organized businesses, and reputation. Unfortunately, their contribution to the equity market cannot be much higher than the degree of control their headquarters office is willing to give up; imposing higher local equity percentages can result in disinvestment.
State owned enterprises obviously constitute an important potential supply of securities. As governments move to privatize, they view the sale of equity to the general public as desirable, and spreading ownership to a larger group

requires a mechanism--a capital market--that allows the exchange of shares. Additional supply of SOE securities can be achieved despite the lack of a privatization program. In some places, DFCs have been encouraged to sell their investments in public companies to private buyers;[17] the same mechanism can bring SOEs to the capital market in countries where the DFCs own equity in the public sector.

4. DEMAND FOR SECURITIES

The demand for securities is affected by investors' degree of confidence in the market, tax policy, the risk-adjusted attractiveness of alternative investments, and the overall availability of savings or "surplus" capital. Because of their limited numbers and greater financial sophistication, institutional investors' demand for securities can be more easily encouraged than that of the individual investor.

Institutional demand for securities in developing countries is concentrated in (1) companies that buy shares for investment or for control of the issuing entities, (2) banks that buy securities as a hedge against inflation, and (3) mutual and pension funds whose directors see equity securities as a source of income for their long term portfolios. Unfortunately, these very institutions where demand would be greatest are sometimes forbidden by law to invest in the securities market and have been targeted by many countries' securities market programs. In Morocco, for example, insurance companies must hold a minimum of 60% of their reserves in government securities, while Social Security, a major pension fund, deposits all its surpluses in a national savings account instead of investing even part of it in the stock market.[18] A similar situation occurred in Chile, where pension plan portfolios were restricted to money market and government securities. A subsequent amendment to the law, which allowed pension plans to own equity securities, improved the situation and significantly increased the demand for securities.[19]

The share of the capital market assets owned by institutional investors differs substantially throughout the countries considered. In Brazil, retirement mutual and pension plans have grown to a significant level, while Chile, Korea, and India also have sizable equity funds, although much smaller than Brazil's. Nevertheless, among developing markets, institutional investors still hold a relatively small portion of equity assets. To increase the demand and build confidence in the securities market and intermediaries, restrictions on institutional investors should be removed.

Individual investors still own the largest volume of securities in developing countries. Their exact number varies widely from country to country, but most active markets serve about 200,000 such shareholders. Individuals' buying and selling activity provides liquidity for the market, action in the secondary markets, and a source of equity capital for borrowers; therefore, despite the large proportion of securities held by individual investors in developing countries, their demand for securities must be further encouraged. If individuals' demand for securities is not encouraged, or if the people of a country fail to understand the market's role in investments, long term growth and activity of the securities market will be constrained.

5. DISCLOSURE AND THE REGULATORY FRAMEWORK

The main purpose of the equity market is to provide risk capital for the economy by allowing businesses to sell their shares in the market. Rational investors are usually willing to purchase securities if they are able to later trade them in an open market and derive an acceptable return to compensate for their risks. In order to make a reasonable market decision, however, investors must know the value of their holdings and need information about the prices and quantities of shares transacted on any given day. Public disclosure of financial information increases investor confidence in the system and ultimately encourages market activity and growth.

5.1 Disclosure

The end result of "full disclosure" is a set of quantitative data and facts that defines a firm's performance in economic terms. As was mentioned above, rational investors and securities analysts require adequate, accurate information to enable them to conduct a professional review of securities and assess their economic value. In advanced securities markets like those of the United States, United Kingdom, and Japan, securities firms have analyzed and reported about an increasing number of companies.

In these countries with mature markets, publicly-traded businesses are required to issue yearly and quarterly statements, provide management discussions of the operations, file prospectuses and proxy statements with regulatory bodies, and disclose to the public the members of and the compensation for the board of directors and senior management. Host countries should be encouraged to insist, whenever possible, that their businesses file audited balance sheets and income statements as a first step toward increasing the amount of publicly disclosed information about their securities market.

5.2 Accounting Standards

Accounting standards constitute the core of the information disclosed to the public. In order to be reliable—and be regarded as reliable—this information must be governed by accounting standards (in the United States known as the GAAP or Generally Accepted Accounting Principles) and auditing procedures (the GAAS or Generally Accepted Auditing Standards), which are usually approved by a national board to ensure consistency in the treatment of similar or congruent economic situations.

In developed countries, reviewing the accounting information to oversee the accuracy and proper application of accounting standards is the responsibility of an outside auditor, a totally independent professional without any affiliation to the company. In developing countries, however, financial standards are not as complete as in developed markets, and there is often no specific group of professionals who are mandated to create acceptable accounting standards. The auditing process is usually inadequate or performed by people affiliated with the company. Consequently, the disclosed information is not trusted, and investors must base their decisions on unreliable sources.

5.3 Regulation

The extent and the characteristics of government regulation of the securities market varies widely among countries. A number of markets have centralized the supervisory activity in a government agency that has total authority over the stock exchange. A comprehensive body of regulations and prohibitions covers the functioning of the primary and the secondary markets and institutions, and the securities commission is responsible for the enforcement of those regulations.

Other countries have allowed more autonomy for stock exchanges to enact their own specialized rules or regulations. This principle of self-regulation of the stock exchange may not be appropriate for developing countries given their government's desire for more surveillance. While the stock exchange should be given the responsibility to enact its own operating rules, procedures, and by-laws, those changes should be communicated to a central government agency to approve or reject them.

5.4 Legislation

A uniform body of law is generally viewed as a prerequisite if a mature securities market is to develop. We already have discussed many of the effects of tax laws on the functioning of the exchange, but it should be noted that legislation should involve not only the tax code but also the commercial code, which governs the time and conditions of transferring title and ownership.

Laws and regulations of LDCs often are not geared to dealing with issues such as securitization of assets, title to intangibles, and shared ownership. As a direct result, there are constraints on the issuance of new securities (in relevant issues such as quantity, timing, and price) and on the trading of those securities in a free marketplace. Inadequate rulings about the exact point at which title is transferred generate opportunities for unscrupulous price and dividend manipulations. Other regulatory impediments to free capital market functioning occur when the issuing companies have the power to veto or refuse the transfer of securities.

Effective legislation on the transfer of ownership, the margin requirements, and short sales also helps diminish the risks of market crashes such as the one suffered by the U.S. exchange in 1929, the Thai exchange in 1978, and the Kuwaiti exchange in 1983. In addition, for each specific country, laws must be carefully analyzed both in terms of the way the securities market actually operates and in terms of the cultural and contractual environment.

6. IMPEDIMENTS TO CAPITAL MARKETS

Impediments to the orderly development of a securities markets vary from country to country. In this chapter we will outline the main obstacles we have uncovered during our review of the capital market programs and issues.

<u>Lack of Political and Social Stability.</u> Political and social upheaval contributes to a decline of a securities market, and shifts in the ideology and power base of the government have a dramatic effect on the demand for securities. Certain Latin American countries (e.g., Chile, Argentina, Uruguay, and Colombia) can be cited as extreme cases where political factors have pushed the flow of savings away from the securities market.

<u>Political Opposition to a Securities Market Program.</u> To smoothly implement a securities market program, a top level government agency must suppport it both financially and with manpower. Since this kind of program diverts some resources and attention from existing programs, and since the benefits of the capital market program are not immediately apparent, it may consolidate local political opposition and threaten the securities market program itself. In many cases, ambitious players attempt to step into the program, all operating from their parochial perspectives. The result is political infighting, as each political interest group attempts to promote its own view of the best development strategy.

<u>Lack of a Free Market Ideology</u>. In order to develop a capital market program a country will benefit from: (a) a free market ideology, (b) an economic policy

not dominated by central planners, and (c) a private sector that is allowed a growing role in the economy. (Clearly, these factors also create a political climate that fosters privatization.) An open securities market cannot flourish in an environment of protected sectors, restrictive regulations, or state control. The securities market requires a free market environment that allows private enterprises to develop their own businesses and seek investment capital in the market.

Economic Policy Dominated by Central Planners or by Unsupported Free Market Mechanisms. Some barriers that limit demand for securities are caused by government actions. Economic policies that apply to other related sectors also can have a negative effect on the supply and demand for securities. In one Southeast Asian country, for example, the government's central planners sought to encourage savings by eliminating taxes on savings accounts; stock dividends, however, remained fully taxable, all of which quite unintentionally resulted in a severe decline in the demand for equity securities.

The equity market will be threatened if policies hostile to free market mechanisms dominate the economy. The capital required to finance government activities will then be raised through increased fiscal or monetary pressures and allocated to sectors that do not provide sufficient returns on the investment. These practices restrict the availability of investment capital for the securities market, causing severe problems for its growth and level of activity.

Fragmented, Redundant Institutional Regulation. Even in those countries that have securities commissions, the overall responsibility for regulating the institutions is often fragmented among different agencies of the Central Bank, Controller of the Currency, Ministries of Planning, Finance, Economics, Commerce, or Industry. Most of the individuals in these agencies lack the financial skills and systems for effective regulatory work, the roles of various agencies overlap, and no one organization is responsible for overseeing the entire regulatory environment and developing the capital market. The result is usually confusion, excessive controls, and/or conflicting regulations.

Inappropriate Tax/Regulatory Incentives. Tax incentives can be used to influence the development of the securities market. Since investors are aware of the after-tax returns of the various financial investments, tax implications play an important role in the way they allocate savings between debt, equity, or non-financial assets. Fiscal policies also influence the supply side by making new equity financing more or less attractive than retaining earnings or issuing more debt. Unfortunately, many governments continue to discriminate against shares (e.g., Senegal) and the equity market. According to the IFC:

> The fiscal policies of most countries create a bias in favor of debt financing because interest expense can be deducted in full from taxable income. Dividend payments, on the other hand, which may be viewed as a cost to the business to attract and retain capital, are rarely allowed as a deduction against taxable income. On the contrary, in many contries dividends are taxed twice, once as corporate income, and again as shareholder (personal) income.[20]

The securities market can also be hurt if policymakers set an introductory price for new shares. In Morocco, for example, a Technical Committee fixes the opening price below the real value to encourage buyers to subscribe. If the fixed price is too low, however, the supply will be threatened because of the economic loss to issuing companies.

Insufficient Supply of Securities. A functioning securities market depends on a continuous supply of securities. If ownership of the host country's enterprises is limited to local or foreign power groups and the government does not encourage the public offering of shares, volume in the primary market will be reduced, and secondary trading and a deep securities market will not develop. In Kenya, for example, most companies are privately owned family businesses or multinational subsidiary firms, and their resistance to going public has somewhat hindered the growth of the Nairobi Stock Exchange.[21] AID and other international donors should work with multinational corporations and large privately held firms to help them understand how the development of a capital market will increase their ability to raise equity funds and finance new investments.

The importance of an adequate supply of securities is demonstrated by Jordan, where the extraordinary development of a securities market is attributed to the government's having mandated the supply.

> The total value of outstanding marketable securities in Jordan accounts for 48% of the GNP. ... This ratio is remarkable given the size and stage of development of the country and the fact that a stock exchange was established only recently. The reason for this anomaly lies in Jordanian corporate law. By law, a new business seeking limited liability status must offer 25% (if a financial institution) or 50% (if an industrial or commercial company) of its capital stock to the public at the time of incorporation.[22]

Inadequate Demand for Securities. A reduction in the demand for securities diminishes the stock market's attractiveness as a place for companies to obtain appropriate financing at a reasonable cost. Restrictions on the demand can be indirect or direct: indirect restrictions result from tax laws that are unfavorable to the securities market, whereas direct restrictions are caused by legal prohibitions on institutional and individual investors. For example, ethnic and foreign groups are prohibited from investing in parastatals in the domestic stock market in certain countries (Indians in East Africa, Chinese in South East Asia). The "Moroccanization" law of 1973 prevents foreigners from investing in businesses ranging from food and drink production to livestock breeding.[23]

Absence of Financial Intermediaries. Financial institutions provide an infrastructure for the efficient trading of securities, but existing brokers may base trading on rumor and inside information, and indulge in share manipulation. If the host country does not have professional brokers and dealers who adhere to accepted trading standards, the public may not have much confidence in the market.

Commercial banks can constitute attractive intermediaries in the securities market; however, this alternative is restricted in those countries that have passed regulations similar to the U.S. Glass-Steagall Act of 1933, which prohibits commercial banks from entering the securities market.
The Glass-Steagall Act explicitly prohibits commerical banks from underwriting issues of, or purchasing for its own account, securities of any corporation.

It was enacted in the United States after the Depression to reduce commercial bank failure rates by keeping them away from volatile investments in the stock market. As a result, the United States financial system is considered "specialized," since it is segmented into commercial banks and investment banks, although the distinction is becoming less and less evident.

Similar regulations in developing countries restrict the entrance of commercial banks into the securities market. Although this may have been intended in certain countries (e.g., Korea, India), the consequence for other developing countries is that there may not be enough appropriate financial institutions to promote trading of securities.

Good financial institutions play a major role in promoting ownership by individual investors, providing investors with diversification and professional advice. Institutions in developing countries also play an important role in attracting individuals with enough savings potential to the securities market.

Insufficient or Non-existent Information. Because of the importance of financial information for decisionmaking, an unstable accounting environment poses a serious threat to a growing securities market. As can be seen in mature successful markets, specific guidelines for accounting and auditing procedures are critical.

Lack of Savings. Savings obviously depend on income and on an investor's concern for the future value of his domestic investments in the presence of inflation. The country's average level of savings is a very complex macroeconomic variable--one that may not support the continuous activity of a domestic capital market.

Lack of Scale. Small countries (e.g., some West African and Caribbean countries) do not have an economy with the scale to support a formal securities exchange. The fact that their SOEs control a large percentage of the economic output further diminishes the market's size in those countries, as well as the supply of securities. The economy of scale problem is further leveraged in countries with a large informal private sector. In Senegal, for example, for every one person working for a private firm there are three who work in the "marginal" private sector.[24]

Lack of Experience. In most cases a country's officials have little or no expertise in developing or managing a securities market. Thus, the government may decide not to develop a securities market because its officials lack confidence in their ability to implement it. Often the host government will take steps toward regulating the market rather than developing it; in fact, creating a strong regulatory body before there is any market to regulate simply impedes market development altogether.

Lack of Dialogue between Private and Public Sector. At the same time that the government may complain about the business sector's unwillingness to contribute to the economy, the private sector may have solid reasons to believe that it has been slighted by the government in the allocation of economic resources. Any current program that encourages more active dialogue between the government and the private sector should provide a better foundation for the securities market.

7. AID OPTIONS FOR STIMULATING CAPITAL MARKET DEVELOPMENT IN SUPPORT OF PRIVATIZATION

Governments in developing countries are becoming increasingly aware that the private sector can be a powerful generator of economic growth. A growing number of governments are planning to promote their private sectors and divest their state owned enterprises.

The host government's awareness of and commitment to developing the securities market also is an important factor to consider when fashioning a privatization/capital markets program. If the government is still unaware of the advantages of the securities market, AID can provide valuable insight by sponsoring a preliminary study of the local capital market (AID-PRE efforts are already aimed in this direction). If, on the other hand, the government is already familiar with the securities market and wants to encourage it through a development program, AID may assist the government by examining the full market or some particular development steps.

Most governments, however, face problems implementing privatization because their existing capital markets do not provide effective means of support for divestiture and risk-financing transactions. Capital markets in developing countries usually have strong non-securitized debt components whose major shortcoming is that they do not finance long-term needs. The securities markets, which could play an important role in fostering privat sector growth, are often nonexistent, immature, or outrightly moribund.

The successful development of an equity market depends on the government's ability to implement a program that encourages the supply and demand of securities while removing the obstacles to capital market growth. The market's stage of development and the maturity of its financial institutions should be studied to help determine which strategy to use — clearly, a different approach would be needed for a start-up market than for a market that already exists but has a weak institutional infrastructure.

Given these circumstances, AID can play a role as a source for technical assistance, providing an <u>in-depth</u> perspective of the entire financial market: the existing institutions and financing alternatives, the supply and demand of securities, the tax laws, and the disclosure and regulatory environments. AID can also support a securitiesmarket program by actively participating in the development program and by facilitating training of local staff in sophisticated financial centers worldwide. Given the complexity of the program, the development team should include local and foreign financial executives and experts with field experience in equity markets, government representatives, professional consultants, and personnel from investment houses with experience in developing countries.

A program's implementation can be plagued by market price crashes, speculative bubbles, bankruptcies of financial intermediaries, and important investor losses. AID can focus on those factors that influence local market development and should highlight specific obstacles that will require special attention. AID can support that effort in a variety of ways discussed below.

Quantify the Costs of Misallocating Capital Resources to the Government and the Economy. If AID were to conduct a study of the inefficiency of a host country's SOEs and point out for that country's government how misallocations could be avoided if companies were privately held and their shares traded in an active securities market, the host country's leaders might very well "see the light" about policy reforms. (The steel industry in the United States provides a classic example of the ruthless allocative efficiency of the stock market. If American steel companies had been owned by the state, they probably would have received even heavier price and tariff subsidies from the government, which would have perpetuated their inefficiency, but the stock market sent these companies a clear message, forced the total reorganization of the sector, leaving those companies that survived healthier as a result.) Failures in paper mills in Cameroon, steel mills in Brazil, and enormous projects in Zaire point at the inefficiencies of centrally planned decisions and management systems in allocating scarce economic resources.

By conducting such a study the agency would better understand the economic and political conditions of the host country, making it possible for AID to recommend capital market alternatives that would more closely match the host country's needs.

Identify and Encourage Tax Incentives that Increase the Demand for and Supply of Securities. A review of the tax structure may give a substantial boost to the capital market progam, especially considering that LDCs often fail to take into account capital market objectives. Determining if objectionable taxes are in fact providing substantial revenues may result in a recommendation to replace those taxes, thus generating a positive reaction in the capital markets.

The host country may be taxing income from equity securities more heavily than income from bank deposits or government securities, which constrains securities market growth. Fiscal incentives to reverse this situation will increase the demand for securities by encouraging investors to consider them competitive alternatives to bank deposits or government bonds. Incentives can range from relief from double taxation to more direct measures such as tax credits or deductions to investors for the purchase of securities. Such a scheme was successfully used in Brazil, where investments in parastatals (e.g., Embraer, a state owned airplane manufacturer) were allowed to be deducted from income tax liabilities.

The supply of securities can be increased by giving publicly held companies incentives or exemptions from tax penalties that are denied to closely held companies—actions that have been successfully implemented by several countries (Korea, Jordan). Given the profound implications of tax laws on the securities market, we recommend that AID work closely with tax authorities to evaluate the net effect of any tax code revisions, not only on revenues, but also on capital formation.

Identify and Encourage Other Sources of Demand for Securities. Additional demand for securities will be generated by removing existing restrictions on investments in equities by Employee Stock Ownership Plans (ESOPs, in which a firm's owners are encouraged to distribute stock shares to the employees), ESOP-type approaches, and other pension funds. (ESOPs are already mentioned in the current AID strategy as a useful divestiture tool.) The investment in equities of other firms, including SOEs, by the trustees of ESOPs and pension and mutual funds, are related ways in which the ownership of SOEs might be transferred to a broader group of people.

Influence Economic Conditions. Exhibit -8- summarizes the economic factors that foster growth in a securities market, classified according to whether or not they can be controlled or influenced by the host country government. While demand for action on all fronts that can be influenced is unrealistic, the Agency should attempt to work with host governments through dialogue, reform programs, or contingencies in loan or grant aid money to ensure that, whenever possible, economic conditions remain favorable to capital market development.

We have already discussed the impact of the expectations for long term economic growth and of investment opportunities on the demand for investment funds and on the capital market. The ability to earn fair rates of return and reasonable competition regulations would further leverage the marginal propensity for investment, while the fair exchange parity would allow for future fair rates of return. High nominal and real interest rates, and the unavailability of subsidized credit would encourage borrowers to resort to the capital market for their additional funding, while stable and fair monetary and fiscal policies would encourage savers to invest in the securities market instead of in the debt market or in material assets.

EXHIBIT 8

ECONOMIC CONDITIONS APPROPRIATE FOR SECURITIES MARKET DEVELOPMENT

- **Uncontrollable Factors**
  - Low inflation
  - Expectations of long term economic growth
  - Foreign exchange parity
  - Attractive investment opportunities
  - Interest rates reflecting real cost of capital
  - Ability to earn fair rates of return
- **Controllable Factors**
  - Rationed subsidized credit
  - Liquidity to finance transactions
  - Stable monetary policy
  - Reasonable competition
  - Fair fiscal policy

Missions' actions are somewhat facilitated by the fact that existing economic reform programs often have recognized the need for change in economic conditions similar to or the same as those described here. An integration of the objectives of the economic reform program and of the prerequisites of the capital market program would help accomplish many of these objectives.

Remove Barriers to Ethnic or Foreign Investors. AID should endorse (as a policy) the removal of prohibitions on ethnic and foreign investors, which should expand demand and increase the level of activity in the capital market. While it is understandable for governments to protect strategic industries from direct foreign investment to preserve the national identity and security, foreign portfolio investment offers important advantages to the securities market and the economy without causing internal political conflicts. As concluded by the IFC:

> Portfolio investors supplement rather than replace domestic shareholders as the foreign investor would probably prefer to buy new issues of stock in a proven company, than to buy it in the secondary market. On the other hand, foreign portfolio investment brings with it the capability of improving technical knowhow within the financial sector as a whole and thus provides an improved perspective for national planners as well as domestic investors to measure relative efficiency of different units in their economy.[25]

Reinforce AID Capital Market Support at Mission (Country) Level. AID efforts to stimulate capital markets also foster privatization--the two are mutually beneficial. AID should require that these two efforts be coordinated, ideally at the Mission level. (Special mention of this could be part of the CDSS.) We recommend that privatization studies include, at a minimum, an examination of the country's local capital market and how it can be used to encourage private sector growth. Where broad ownership is an objective, AID should encourage capital market growth by identifying specific impediments and helping to nurture market institutions.

<u>Provide Technical Assistance to Help Create a Stock Exchange and a Regulatory Body for Trading</u>.

- The stock exchange: In most countries the stock exchange lacks formal, modern operating procedures, which must be established to conduct trade in the secondary market and deal with the following issues: (a) type of trading, (b) physical handling of the traded shares, and (c) market information and indexes. (The need for trading premises must be added to those requirements if currently there is no organized market.)

  Since the stock exchange symbolizes the securities market, the authorities often rush to open it before its supporting infrastructure is in place. This puts the stock exchange's stability in jeopardy until its trading standards, membership requirements, and clearing mechanisms are defined and enforced by the regulators. Without proper trading facilities and procedures, financial intermediaries will find it very easy to manipulate the prices of securities and defraud bona fide investors. An effective securities market program minimizes these risks by applying trading rules that have proved to be successful in other countries.

  Exhibit -9- summarizes the variety of institutional and trading features that exist in different countries, grouped in three columns. Column one

EXHIBIT 9

INSTITUTIONAL AND TRADING CHARACTERISTICS

UNDESIRABLE	REQUIRED	DESIRABLE
		STOCK EXCHANGE
— Unfair market activities allowed (insider trading, manipulation, etc.) *— Price regulation*	*— Good communications network* *— Clear methods of settlement* *— Listing requirements*	*— Data processing capabilities* *— Central securities depository* *— Market indexes* *— Market makers* *— Continuous trading*
		FINANCIAL INTERMEDIARIES
— Unclear commissions structure	*— Intermediation at reasonable cost* *— Minimum capital requirements* *— Management and professional qualifications* *— Membership of securities exchange*	*— Competition among firms* *— Investment bankers*
		TRADING PATTERNS
— Short Selling *— Unregulated margin trading* *— Delayed delivery* *— Unclear trading rules*	*— Organized market* *— Transfer procedures* *— Clearing procedures* *— Settlement procedures*	*— Procedures for the trading of large volume of shares* *— Cash or "ready" basis* *— Everyday trading*

lists "undesirable" characteristics for the intermediaries, the stock exchange, and the approved trading patterns. The second column shows the "required" traits, while the final list expands these requirements to those characteristics that would improve the service performed by the institutions. AID should discourage the "undesirable" characteristics while requiring that the "required" conditions are implemented or provided for by the capital market program. The Mission can have both an overall policy role, by requesting that the general conditions be considered by government actions, and a specific role, by endorsing particular projects that foster "required" characteristics.

- Regulatory matters: To ensure the orderly trading of securities, the market must be constantly supervised to prevent securities manipulation, insider trading, and fraud. On the other hand, excessive regulation constricts market development and limits trading to a few brokers and dealers. There is no simple answer to this dilemma, and the specific requirements must be examined to determine if they are necessary or put excessive restraints on market development. The best solution for the regulatory issue would be to have overall supervisory authority reside in a single government agency while daily self-regulation takes place at the stock exchange level. AID can sponsor a detailed study of the various alternatives for market regulation. It can draw from the experience of financial markets experts and stock exchanges case histories to recommend a scenario that would allow enough freedom for the institutions while ensuring sufficient protection for individual investors.

The regulatory environment should not be restricted solely to the stock exchange; trading intermediaries are an integral part of the process and must also be monitored. The exact degree of control needed depends on the commercial practices within the country and the self-regulation that dealer and broker associations impose on their members.

Given that a growing securities market will put more demands and pressure on intermediaries and that exchange authorities are eager to develop a high transaction volume and may overlook illegal practices (e.g., insider information and preferential trading), the cautious development of regulatory standards is critical to a market development program.

- Securities laws: If the existing Commercial Code does not legislate the timing and manner of transferring title or securities, those practices should be stipulated very clearly in a brief securities law code. (In many cases, the host country must remove pre-existing legal obstacles to the capital market development.) The regulatory framework required for securities market development should also be reviewed and updated as part of the capital market development program, simplifying the regulatory responsibilities of government agencies and coordinating them through one rule-making organization. Similarly to the regulatory matters issue, we see here a possible Mission's role in sponsoring a technical study of the securities laws environment and providing for subsequent training and assistance in the field.

Create an Awareness in Host Governments of the Complexities of Market Development and the Proper Role of Financial Intermediaries. Expert opinions differ about the appropriate structure for a securities market. Proponents of universal banks (or "multibanks") argue that both banks and securities market activities require extensive distribution networks and financial skills that do not need to be duplicated. Opponents of universal banks, among them the IFC's Capital Markets Department, believe that:

> ...securities markets tend to be more efficient, more competitive and more able to meet the financing needs of business if the financial system is specialized.[26]

Both multibanks and specialized institutions have strengths and weaknesses. From the studies that have been published, it is not clear that the multibanks enjoy lower intermediation costs or that specialized intermediaries result in strong securities markets.

In a start-up or dormant securities market, the reputation and technical capabilities of the broker/dealers --if there are brokers/dealers-- are unknown (Exhibit -10- reviews some of the institutions available in a country that has a typical capital market start-up situation.) On the other hand, commercial banks are the largest institutions in the financial markets of the developing country--and probably the only ones with trained personnel. In Bangladesh, where a large privatization program has taken place, commercial banks facilitated the program by providing debt capital that was later converted into equity securities.

EXHIBIT 10

CAPITAL MARKET START-UP: INSTITUTIONAL STRENGTHS

	FINANCIAL SKILLS	CLIENT BASE	DISTRIBUTION NETWORK	CAPITAL	CONTACTS	REPUTATION	ENTREPRE-NEURSHIP
CENTRAL BANKS	✓			✓		✓	
COMMERCIAL BANKS	✓	✓	✓	✓	✓	✓	
DEVELOPMENT FINANCE CORPORATIONS	✓			✓		✓	
DEALERS/BROKERS (IF THEY EXIST)	✓	?		?	?	?	✓

We believe that the best solution for a start-up market lies in a "mixed" system, a combination of both universal banks and specialized intermediaries. Regulations should allow bank-holding corporations to underwrite and own securities, but the securities trading and the banking activities should be conducted by separate legal entities under different management.

We believe that a mixed system is in a better position to encourage safe development of the securities markets while allowing for an aggressive entrepreneurial culture that will further encourage privatization. The best example of a mixed system involved in a successful privatization program can be found in Brazil; since the early 1980s over a dozen SOEs have been sold. As defined by the IFC:

> It would appear that Brazil has numerous kind of institutions, all of which are specialized to some degree by law or regulation. However, banking conglomerates tend to own brokerage houses and distributors as well as investment banks,..... The links between these affiliated institutions are quite strong..... often resemble multibanks....each specialized activity in the banking conglomerate has its own structure and management, which may make these institutions act as specialized intermediaries....[27]

Caution must be taken to ensure that only economically responsible institutions are allowed to become members of the exchange; it is critical that early investors view those firms with confidence.

Since increased competition lowers the cost of financial intermediation and drives more funds into the marketplace, new financial intermediaries (e.g., investment bankers and discount brokers) should be encouraged to enter the market as long as they comply with regulatory requirements. If these institutions appear to be needed given the limited competition of the present financial intermediaries or their inability to further stimulate the securities market, the Mission could endorse or sponsor a study of current financial institutions. As a result of this study, the Mission should be in a position to recommend changes that are needed to encourage entrepreneurial financial intermediaries, who could in turn infuse the financial marketplace with more activity.

Push for Accounting Standards and Full Disclosure Rules. Financial reporting can be improved when the country adopts accounting standards and independently audited statements as the norm. Disclosure is another field where there are no standard solutions and where the final recommendation involves a trade-off between issuers' costs and investors' benefits. In most developing countries, however, the quality and timing of the financial information must be substantially improved; this is clearly an area where AID can offer support.

Emerging markets usually present little or no information about the economic performance of a firm; often the only available information is for tax purposes. While there is no doubt that the quality and quantity of disclosed information in developing countries must be improved, the cost of disclosure standards needed for sophisticated markets can be prohibitive, resulting in unnecessary business costs and confusion on the part of investors. Local authorities will have to make country specific decisions regarding required audit and disclosure standards. Ideally, these standards should enable an outsider to arrive at similar investment decisions as an insider.

Regulators will have to decide, according to the specific characteristics of the investing population in the country, what level of disclosure is necessary to ensure that sellers and buyers have more or less equal access to relevant information. By opening equity markets to foreign portfolio investors, the quality and amount of local information will probably improve to conform to the requirements of more sophisticated portfolio managers.

Encourage Governments to Plan Privatization Efforts so that the Supply Matches the Capacity of the Market. The government can play a powerful role in the supply of securities through divesting the shares it owns in state controlled enterprises. A divestment program is mutually beneficial for both the securities market and the privatization effort, but its implementation may be threatened by the following roadblocks:

1. A government may be reluctant to sell the profitable SOEs that do not require attention or funds but find few buyers willing to bid for the more troublesome or less lucrative SOEs. The solution lies in initially privatizing a small portion of the top-notch SOEs and only then bringing the second tier to the market.

2. Government officials usually have a short term perspective, and if under pressure, have, on at least one occasion (i.e., Chile) tried to unload all the companies in a very short time; the market on the other hand can only absorb a given number of new shares at a time. This problem can be minimized by an action plan that specifies a gradual release of the equities to the market.

3. The book value of the SOEs may be much higher than the market value. This is a typical problem when the government has put large investments in development programs that failed because of reduced market size or adopting the wrong technology. Unfortunately, the companies may have to be devalued in order to attract investors, and government officials may be unwilling to admit a depreciation of the public assets.

4. The great number of SOEs (over 500 in Brazil alone), their interrelationships (some buy from or sell to other SOEs at non-market prices), and the lack of reliable information confuses officials and complicates government evaluation of SOEs. The government's list of SOEs to divest should be based on agreed upon privatization criteria. Some countries have helped the process by creating boards to conduct the privatization program (e.g., the Brazilian Ministry of De-bureaucratization — Ministerio de Desburocratizacao).

5. Assuming that political and economic hurdles are overcome, all SOEs must be prepared for sale, a process which in and of itself is fraught with pitfalls. It usually involves closing down operations that are unprofitable

or cannot be absorbed by the public, decentralizing certain functions, and defining employees' pension plan liabilities. In theory the best solution is to recognize these winding-down costs and take them into account when the sale price is formulated, although this can slow down the divestiture program and entangle it in political machinations that delay the process indefinitely.

Because of the complex issues mentioned above and the general scarce supply of new shares, when the SOEs are finally brought to the market, they are often in considerable demand and experience oversubscription. Individual investors are very interested in the divested SOEs at the time privatization shares are first offered. In Bangladesh, for instance, the public subscribed from 25% to 200% over the offered number of shares.[28]

In Kenya, we believe that an initial public offering at a fair price would generate immediate acceptance, given that since 1977, only one issue of corporate equity has been offered.

<u>Provide Training for Public and Private Sector</u>.

- o Indoctrination trips: AID can benefit from its multiple residence status by combining guided visits of host country public sector officials and private sector representatives to active markets in the United States and other countries. These trips can bring the securities market potential to the attention of the host country policymakers and help develop a focused view of the program.

- Training: While outside consultants and financial experts can provide expertise and guidance in the process, local personnel will be needed for the project team and for staffing requirements during the implementation stages. In developing countries there is usually a shortage of people who understand a securities market; AID can coordinate and conduct a training program for both public and private sector representatives and eventually sponsor some specialists in training programs at securities firms or regulatory agencies of more developed stock exchanges.

<u>Seek Ways to Use, Support, and Eventually Organize Informal Markets as a Stepping Stone to Capital Market Development</u>.

The economic policymakers of developing countries tend to prohibit the unorganized market, which they consider to be an emblem of their failed policies. In doing so, they disregard the fact that the curb economy is a free market reaction to the over-planned economy and will survive despite prohibitions, although at a higher cost to the participants. Any realistic plan to support a securities market must involve the unorganized market and an in-depth analysis of why it exists. The end result should be its replacement by a "formal" or organized market.

In some instances, this may be a fairly easy task: in one Middle Eastern country, for instance, a simple regulation requiring the publication of the prices at which securities were purchased or sold (disclosure) was instrumental in organizing the market. Once the prices were disclosed to buyers and sellers of shares, dealers' windfall gains ended, and trading volume grew substantially.[29]

In yet other instances, informal markets developed as a consequence of over-regulation of the economy are not likely to be affected in the short run. AID and the host government should negotiate specific reform packages to ensure that the country will progressively eliminate the policies, regulations, and procedures that restrict the access of savers and borrowers to a more formal capital market.

Recommend Gradual Approaches in Countries where the Public does not Understand Marketable Securities.

Since they do not entail change of ownership, debt securities can be expected to play only a marginal role in privatization efforts. While debt has been suggested by some (in its high-yield low grade variety) as a source of transitory financing for leveraged buy-outs, these type of transactions are likely to be more the exception than the rule in developing countries and should not constitute the main componenent of AID strategy in capital market development for privatization purposes.

The use of debt securities may, however, contribute indirectly to AID efforts in fostering private sector development by providing alternative funding solutions in those countries where an unsophisticated populace does not readily accept equity securities. In those instances, debt securities could be used in an interim phase, helping ease the transition from ownership of tangible and controllable assets to ownership of intangible assets managed by other individuals. A gradual capital market development program could thus be designed to help move investors and enterprises from bank demand deposits to high grade commercial paper, on to the bond market, and finally to stock shares.

In Small Countries, Help Create and Support a Formalized Non-auction Market to Provide a Vehicle for Equity Exchange. Despite the mechanisms that we have identified so far, some countries have such small economies that in the short run, setting up a formal stock exchange is not possible. In these situations, an initial supply of securities encouraged through a privatization program would "spontaneously" generate an informal market to deal with the secondary trading of securities. To provide for a formalized institutional environment, AID should consider recommending a process similar to that used by the Nairobi Stock Exchange, which has no physical trading floor, but where the brokers set a daily securities roll-call to match demands and supplies and set transaction prices.

Another related possibility for AID to investigate is to set a "securities window" in authorized commercial banks, similar to the foreign exchange window that already exists in some financial institutions, in which buyers and sellers tender their securities at a disclosed price and known commission charges.

Give Priority to Change in Policies that Affect Capital Markets in Determining Loan and Grant Conditionalities. Clearly, AID can affect host country policy by encouraging government policies that foster capital market development; however, Missions must realistically assess their probable degree of influence, given the availability of resources and the magnitude of needed policy change.

In instances where a Mission does not count on strong government support and is unable to affect the country's capital markets policy, it might consider interrupting its market development plans until the host government demonstrates that it is serious about capital markets policy reform. Even if a country is ready for a stock market, the initiatives for engaging in further development must always come from those local policymakers who have favorable attitudes towards gradual privatization of the economy.

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