PN-ABC-737

Policy and Institutional Considerations in Equity Market Development

Final Report

U.S. Agency for International Development

Prepared for: *Bureau for Program and Policy Coordination, Office of Policy Development and Program Review*

Contract No: *PDC-0092-C-00-7167-00*

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Prepared for:	*Bureau for Program and Policy Coordination, Office of Policy Development and Program Review*
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April 1989

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PREFACE

The treatment of the subject discussed in this report was suggested by Terrence C. Reilly, an internationally-recognized specialist on securities market development. Mr. Reilly provided an outline which provided the basis for an initial draft of the report. Although revised substantially from the initial draft, previous reports by Mr. Reilly were an important source of information as indicated in the footnotes. The report, however, was written by Flora M. Painter and Robert J. Rourke of Arthur Young's International Management Consulting Group, and they alone are responsible for errors of omission and commission included therein.

In writing the report, the authors benefited greatly from the work and practical experience in equity market development of several experts in the field in addition to Mr. Reilly, especially George M. Ferris, Jr., Chairman of the Board and Chief Executive Officer of Ferris, Baker, Watts, Inc., one of the largest investment firms in the Washington, D.C. metropolitan area, and Robert M. Bishop, retired Senior Vice President of the New York Stock Exchange. Both Mr. Ferris and Mr. Bishop reviewed the report and provided valuable comments for which the authors wish to thank them.

The authors also benefited greatly from the comments and recommendations provided by Neal Zank, Senior Policy Advisor, Office of Policy Development and Program Review, Bureau for Program and Policy Coordination, who commissioned this study.

EXECUTIVE SUMMARY

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I. INTRODUCTION

The purpose of this study is to provide the Agency for International Development (A.I.D.) with a conceptual framework for evaluating capital and equity market development activities in host countries to determine if, and how, A.I.D. should assist these activities within the broader context of financial market development. Because not all countries exhibit the same types of problems and the significance of these issues may differ among different countries, a major objective of the study is to identify the broad range of issues that A.I.D. should consider in seeking solutions to the problems that confront countries in their attempts to increase the availability of capital through the equity market.

II. NEED FOR CAPITAL AND EQUITY MARKETS

The 1980s have seen a significant increase in interest among developing countries (LDCs) in the role of the private sector in economic development. Much of this interest can be attributed to changes in the global economy in the last decade which have resulted in reductions in the funds available for public sector development activities. Faced with national budgetary constraints and reductions in the flow of foreign private and officials loans, policymakers in a growing number of developing countries are turning to the private sector to maintain development momentum and the improvements in the standard of living achieved through the public sector-oriented policies of the past.

The inadequacy of capital markets in many developing countries is a major deterrent to the growth of indigenous private enterprises and a key obstacle to rapid economic development. Capital markets play a critical role in economic development by encouraging domestic savings and mobilizing these savings for investment in productive activities. Well functioning and dynamic capital markets are essential to finance the capital investment needs of business and facilitate expansion of private enterprise.

The securities component of capital markets is significant in that it provides long-term equity and loan funds through the use of negotiable instruments that can be freely traded by individuals as well as institutions. This component of the market can be highly effective in mobilizing domestic capital, because the securities representing the investment can be sold to meet cash needs or other investment objectives. Moreover, from the point of view of an entrepreneur, equity capital serves as the basis of support for bank and other borrowing, and allows the enterprise to grow and weather changes in the economic environment. In contrast to debt finance, which carries contractual obligations to make fixed payments without regard to the profitability of the enterprise or the potential benefits of other applications of the funds, equity capital provides permanent finance to a business, with no contractual payments.

III. KEY CONSIDERATIONS IN CAPITAL AND EQUITY MARKET DEVELOPMENT

Development of a country's capital and equity markets is part of a broader effort of macroeconomic policy and private sector business growth. Economic policies that discourage formation or expansion of private enterprises also impede development of capital and equity markets because they impact negatively the demand for long-term finance. Economic policy, private sector growth, and capital mobilization, therefore, are interrelated conditions that must be examined in any comprehensive study of capital and equity market development.

A. Importance of the Policy Environment

Vigorous equity markets can exist and develop only in supportive political, legal, and economic environments. Excessive government involvement in the economy may doom the prospects for equity market growth if it inhibits formation and growth of private sector firms. In addition, government policies--fiscal, monetary, and regulatory--can impede the development of equity markets if they distort interest rates and prices, or if they encourage inflation and price instability, or if in pursuing short-range fiscal objectives they create disincentives to investment in private enterprise.

Conditions of political instability and social turmoil, or inadequate and restrictive laws and regulations, also increase the risk of investment and raise expectations of the return on investments. Under these circumstances, publicly owned companies will find it necessary to distribute most profits, and even incur losses, in order to meet shareholders' dividend expectations. Privately held companies have no incentive to go public under these conditions, and generally divert their profits to investments in overseas markets, or in unproductive activities such as real estate development.

B. Factors and Conditions Inhibiting Capital and Equity Market Development

Securities market activities in developing countries tend to consist principally of trading of the limited number of issues available in the market by a small number of investors. Growth of the market requires continual introduction by issuers of the new debt and equity of companies seeking long-term financing. It is this important function that serves to attract domestic savings and provide for a wider distribution of ownership, and that leads to an increase in the number of enterprises and to growth of the private sector. For reasons that are described in the report, the number of new issues offered annually in most developing countries is small relative to the opportunities that exist.

This will have to change, however, as LDC governments turn increasingly to the private sector to achieve economic development objectives that the public sector no longer can afford to finance.

Explanations for the undeveloped nature of capital markets in developing countries can be grouped into four major categories:

1. Developmental and Regulatory Considerations

In most developing countries, regulatory and developmental policies and procedures affecting the securities market require substantial improvement. Common problems include:

- Lack of a unified government office for the supervision and development of the market
- Scarcity of adequate skills
- Lack of authority to enforce regulations
- Inconsistent and outdated regulations

2. Institutional Considerations

In many developing countries, securities intermediaries--brokers, dealers, market makers, and investment and merchant bankers--are inadequate. Some common problems include:

- Inadequate capitalization
- Inadequate training
- Absence of market makers
- Excessive or inappropriate regulation

Another consideration relates to the availability and effectiveness of secondary trading facilities. In many developing countries facilities for trading securities must be established for the first time. In some cases an organized market exists, but the facilities are obsolete or lack dynamism. In still other countries, existing facilities are not subject to adequate standards or safeguards, and operate like a private club.

3. Factors Limiting the Supply of Securities

There are specific reasons why companies in many developing countries are reluctant to "go public". These include:

- Government interference in the pricing of equity issues

- Tax policies that make the cost of raising equity funds more expensive than debt finance
- Inadequate or restrictive laws and regulations that inhibit formation and expansion of business
- Reluctance to share control due to inadequate protection of property rights and contracts

4. Factors Limiting the Demand for Securities

Insufficient demand for securities is a common deterrent to growth of equity markets in developing countries. The most typical impediments to the growth of demand for securities are:

- Tax policies that favor deposit of savings in banks or investment in government savings programs, and discourage investment in corporate securities
- Restrictions on institutional investors, such as pension funds and insurance companies, that limit investment in corporate securities
- Lack of investor confidence due to inadequate accounting and auditing standards and limited availability of financial information about companies
- Restrictions on foreign portfolio investment

IV. A.I.D POLICY AND ACTION OPTIONS FOR CAPITAL AND EQUITY MARKET DEVELOPMENT

In light of the current policies and capacities of A.I.D. with regards to financial market development, the Agency should consider the following recommendations when selecting strategies and approaches for development of capital and equity markets in developing countries.

A. Policy Considerations in Supporting Equity Market Development

While all LDCs would benefit from development of their capital and equity markets and a shift in responsibility for economic growth from the public sector to the private sector, the limited A.I.D. resources available for this activity necessitate an emphasis on countries that are likely to benefit the most. In selecting these countries, A.I.D. should consider the following requisite conditions before undertaking development efforts in any particular country:

1. Policy Environment

The challenge confronting A.I.D. in seeking to bring about greater mobilization of capital through the securities market lies in targeting those countries with the most favorable policy environment and/or the greatest potential for policy and institutional reform. No amount of traditional project assistance is likely to increase the number of companies going public, or the number of investors willing to buy corporate shares in the market if tax or other policies discourage these activities, or if political conditions are highly unstable and turmoil is widespread.

Among the targeted countries, the task of the Missions is to design projects that adequately address policy reform requirements, as well as the more traditional components of technical and commodity assistance. Policy dialogue is clearly indicated as a means for achieving policy reform, and Missions should include it as a distinct component of their programs and projects in targeted countries.

2. Accessibility to Senior Officials

Policy dialogue, if it is to bring about the reforms that are prerequisites to achieving capital market development, must address the range of economic, legal, and regulatory impediments to private sector-led, sustainable economic growth. Progress toward achieving the necessary reforms can only be expected to be slow and to require a sustained level of dialogue with LDC government officials. The USAID, in undertaking efforts to promote development of the capital market, must be assured of ready access to LDC senior policy makers to discuss the effects of policy reform and the restructuring assistance that might be required to complement these reforms. In the absence of obtaining such access to senior officials of the host government, the Mission runs the risk of devoting resources to an effort that is likely to be seriously hampered by existing policy deficiencies even among the targeted countries.

B. Resources Available to A.I.D.

All of the resources currently available to A.I.D. are appropriate for assistance in developing capital and equity markets. Little can be achieved by providing assistance in a piecemeal fashion, and the USAID should be prepared to make a commitment to a comprehensive program if it determines that an opportunity exists to promote development of capital and equity markets.

1. Financial Assistance

Design and implementation of the activities directed at promoting development of capital markets will most often be accomplished through projects which provide both financial and technical assistance. Financial assistance, especially in the form of program assistance, provides USAIDs with important opportunities for engaging in policy dialogue with LDC government officials and for obtaining government agreement on the set of policy and regulatory reforms required for capital market development.

Because the level of funding provided under Economic Support Fund (ESF) programs is generally greater than that of other forms of assistance provided by A.I.D., they are the most effective and most commonly used mechanism for establishing conditionality in negotiations with LDC governments. ESF program assistance, however, should not be regarded as the only source of assistance that permits the use of conditionality. Although rarely applied, conditionalities should be set in negotiating project designs and agreements with LDC governments when the project enjoys a high priority with the government. While the ultimate objective of conditionality is reform of the policies and regulations that inhibit capital market development at the macroeconomic level, project conditionalities in support of policy reforms at the microeconomic level can have an important demonstration effect.

2. Technical Assistance

In the early stages of providing assistance in the development of capital markets, there is likely to be considerable need for technical assistance. This assistance might be provided by A.I.D. personnel or through institutional contractors and individual consultants.

The types of technical assistance activities include the following:

- Assistance in assessing capital markets and identifying required reforms

It is important to conduct a comprehensive assessment of the status of the existing capital markets in an LDC prior to initiating the policy dialogue process. The purpose of the assessment is to identify those conditions that are hampering development of the indigenous markets, and the actions that are necessary to improve the climate for capital market and private enterprise development. This assessment would provide the agenda for the policy dialogue to follow.

- Assistance in implementing policy and regulatory reforms

Adequate attention should be devoted to addressing the structural relocations that might result initially from enactment of policy reforms. This is also an instance in which a comprehensive assessment of conditions affecting capital market development can be useful in identifying the consequences of policy and regulatory revisions.

- Assistance in project implementation

Technical assistance in support of capital market development projects most likely will include both long-term and short-term assistance.

- Seminars and training

Properly designed seminars and training programs can be very useful tools for assisting in the development of capital markets. As a minimum, capital market development projects should include a training component that will permit appropriate LDC officials to visit and observe financial market operations in countries that are comparable to their own country, but are further along in the development of their markets.

C. Importance of Targeting Equity Market Development Assistance

Given the diversity of political, economic and social conditions in the A.I.D.-assisted countries, there is no one approach to capital market development that is suitable for all countries. Experience to date suggests that the only two conditions that can be expected to be common to all countries are that 1) the barriers to capital market development will not be amenable to "quick fixes", and 2) effective policy dialogue is critical to achieving any progress toward development of the capital markets in an LDC. Other than these two common characteristics, the variation in conditions within each country necessitate the development of an approach tailored specifically to the individual country.

Clearly, not every country assisted by A.I.D. will benefit or be at a stage of development that is appropriate for expansion of its equity markets. Nevertheless, it is possible to describe types of countries based upon their receptivity to capital and equity market development, and types of approaches that are appropriate to generalized situations. The following categories are provided to reinforce the importance of targeting countries with the most favorable policy environment and/or the greatest potential for policy reform in support of capital and equity market development.

- Non-Starters

These are countries that are experiencing severe political or economic instability, or that are characterized by extreme degrees of government intervention in or operation of markets. Countries with economies that are based almost exclusively on agriculture are not viable candidates for equity market development.

- Potential Candidates

These are middle income countries that might be pursuing export-led growth strategies, or that possess human and natural resources that favor the development of local processing and manufacturing industries. In all likelihood these countries have not devoted much attention to promoting capital market growth, although they might be encouraging private enterprise. The latter is expected to be accomplished primarily by attracting foreign investment.

- Strong Prospects

There are probably no more than 5-6 countries that fall in this category. These countries are characterized by relative political and economic stability, at least marginal self-sufficiency, an embryonic capital market and probably a well-functioning informal sector, and a thin, but growing business base. The most important characteristic, however, is a visible willingness on the part of the government to make the difficult changes that will be necessary to accelerate growth of the capital and equity markets. Assistance provided by A.I.D. can be invaluable to these countries in establishing the infrastructure necessary for well functioning equity markets.

D. Types of Responses to Equity Market Development Constraints

The response to impediments to capital and equity market development will vary in accordance with the special circumstances prevailing in each country. Nonetheless, responses typically will include the following:

1. Potential Approaches to Strengthen the Institutional Framework

Adequate development of securities intermediaries will require the following actions:

- Provide training to create a professional core of securities intermediaries
- Ensure legitimate profit-making by removing ceilings on underwriting commissions, brokerage fees, and the like
- Privatize underwriting activities
- Ensure adequate finance for underwriting, market making and investment activities
- Establish intermediary institutions or branches outside the main urban centers to expand interest in share-ownership

2. Potential Approaches to Increase the Supply of Securities

Actions to increase the supply of securities generally take the following form:

- Review and revise laws and regulations that impede the development and efficient operation of securities markets
- Eliminate government involvement in establishing the price of shares
- Eliminate tax biases against securities and in favor of bank deposits and non-negotiable debt finance
- Privatize profitable parastatals by offering shares in selected companies to the public
- Promote development of new financial instruments
- Provide tax incentives to encourage companies to "go public"

3. Potential Approaches to Increase the Demand for Securities

Efforts to increase the demand for securities should give attention to the following conditions:

- Adopt tax policies that place dividend and interest income on an equal footing (comparative yield)
- Adopt measures to increase investor confidence such as enhancing the disclosure of material information by companies, correcting weaknesses of the regulatory and supervisory climate, and establishing professional requirements for securities brokers
- Promote foreign portfolio investment
- Provide tax incentives that make equities more attractive than other forms of savings
- Increase the role of institutional investors by removing restrictions on investment in corporate securities

INTRODUCTION

A. Purpose of the Report

This report examines the role that equity markets play in the economic development of a country, and discusses the implications for A.I.D. policies on assistance to the development of equity markets.

The purpose of the study is to provide A.I.D. with a conceptual framework for evaluating capital and equity market development activities in host countries to determine if, and how, A.I.D. should assist these activities within the broader context of financial market development. The objective is to identify the broad range of issues that A.I.D. should consider in seeking solutions to the problems that confront countries in their attempts to increase the availability of capital to promote growth of broad based market-led economies.

B. Organization of the Report

This report is organized into four chapters. Chapter I presents a brief discussion of the importance of equity markets to the growth of the private sector in industrialized and developing countries, and describes the various segments comprising the financial markets of industrialized countries.

A brief history of the various activities undertaken by A.I.D. and other international donors to promote the development of financial markets in LDCs is provided as background in Chapter II.

Chapter III presents a discussion of the conditions that tend to deter growth of the private sector and development of equity markets in developing countries. The effects of particular macroeconomic policies, political conditions, and the legal and regulatory environment on the growth of the private sector and development of financial markets are described using examples from various countries.

Chapter IV considers the approaches that A.I.D. might take in seeking to promote development of equity markets among assisted countries, and examines the appropriateness of A.I.D. policies and resources for providing assistance to promote market development.

CHAPTER I:
The Role of Equity Markets in Economic Development

Chapter I
THE ROLE OF EQUITY MARKETS IN ECONOMIC DEVELOPMENT

A. Purpose of Capital and Equity Markets

Financial markets play a crucial role in the development of a country by encouraging domestic savings and mobilizing these savings for investment in productive activities. Well functioning and dynamic markets are essential to providing the financing of the capital investment needs of private enterprise and to encourage growth of the private sector. While all countries have financial markets, the markets in many of the developing countries are in an immature stage of development. Most, for example, are dominated by the banking sector and provide only short-term, highly collateralized loans. Government tax and interest rate policies frequently favor savings over corporate investments as a curb on capital flight, or in some countries, to prevent concentration of wealth in non-indigenous groups.

Public sector financing and operation of many activities that are left to the private sector in industrialized countries has also served to inhibit development of financial markets in many developing countries. Governments in developing countries typically meet a substantial portion of their financing requirements by setting excessively high reserve requirements and by requiring banks to purchase low interest-bearing bonds from savers' deposits. These practices significantly reduce the level of funds that banks have available to lend to the private sector, particularly in countries with low savings rates. Government operation of activities that are more commonly under private sector management in developed countries also subverts the demand for capital financing that has spurred the growth of financial markets in other countries.

Perversely, the financial systems in many developing countries are highly liquid, particularly in countries in which the government-controlled interest rate has been set higher than prevailing inflation. However, excessively high reserve requirements, artificially low loan-to-asset ratios, or excessive reliance on bank reserves and deposits for government financing, remove any incentive to the banks to make more or higher risk loans. Often there is considerable liquidity outside of the formal financial system. Mobilization of this capital is impeded by tax disincentives to holding corporate debt or equity investments, with the result that a disproportionate, and often significant amount of domestic capital is invested in real estate and other non-productive assets, or in foreign markets.

These conditions can lead, particularly in countries in which government employment accounts for a significant portion of total employment, to an economy that functions virtually as a closed system. Domestic savings deposited in state-owned banks and pension funds often provide a dominant source of public financing and, along with the revenue generated from government controlled exports or by state-owned enterprises can account for 70%-80% of GDP. The economic inefficiency in this condition is that government-owned enterprises are often less productive than similar private enterprises motivated by maximum return. Restrictions on foreign investment worsen the situation by limiting the introduction of new capital.

Banks have little interest under these conditions in extending term credit. As a result, the only source of term financing to private businesses is the informal sector which can become quite large through the illegal or unreported activities that are encouraged by government efforts to control the economy. Companies in Korea, for example, still finance major capital expansion efforts through loans and other investments provided by the informal sector, although the practice is dying out as the result of liberalization of the market by the government.

Traditionally, A.I.D. has addressed the problem of an inadequate supply of capital for private sector activities by providing loans to LDC governments for on-lending to entrepreneurs through various intermediary organizations, and more recently, by guaranteeing a portion of the loan portfolio of banks willing to make loans to small businesses.

The experience of A.I.D. in supporting debt financing points up the difficulty that many start-up and under-capitalized firms have in relying on borrowing to meet their working and fixed capital requirements. Frequently, the revenue stream and cash flow of these firms in the early phases of operation will not support regularly scheduled loan repayments. This condition is not unique to enterprises in LDCs, and has in fact given rise to a wide variety of financing methods in developed countries that are not often found in developing countries, or that exist in only very primitive forms. However, by A.I.D. stressing reliance on borrowing to meet the needs of businesses for capital through loans and guarantees to LDC financial institutions, many of these institutions find themselves in financial difficulty and holding loan portfolios that cannot be liquidated.

B. Structure of Financial Markets

Before examining the conditions in LDCs that tend to deter the creation of adequate sources of capital for business formation and expansion, and that are the major focus of this report, it is useful to examine the characteristics of financial markets in industrialized countries. The components of the financial markets of developed countries can be roughly grouped into two categories:

- Money markets
- Capital markets

Capital markets can be further divided into two segments -- non-securities and securities markets -- to differentiate between non-negotiable loan funds and negotiable equity and loan funds. While this report is concerned principally with the equity component of capital markets, it is useful to examine briefly the functioning of all these markets in the developing country context.

1. Money Markets

Money markets are a source of short-term financing. They have developed in response to the needs of governments, financial institutions, and businesses for ready access to a supply of cash to meet immediate needs and to a place to put excess cash temporarily. One of the best examples of the use of money markets is provided by the cash management services that most banks in the developed countries offer to their clients. Banks invest corporate client cash balances in short-term securities such as Treasury bills for tenure that matches the client's cash flow requirements, and extend short-term loans and reverse repurchase agreements to meet periodic peak cash needs such as payroll expense. The yield on money market investments also serves an important function in providing a reference point, or index, for evaluating the return on investments in capital markets.

The financial instruments used in money markets include government securities, commercial paper, certificates of deposit, repurchase agreements, and bankers acceptances. Traditionally, banks were the only formal institutions participating in money markets, but there has been a significant increase within the last 10 years in the number of mutual funds and dealers that invest and trade in the money market. For the most part, money markets are non-existent or are of inconsequential proportions in LDCs. Few governments rely on short-term securities to meet financing needs, or when they do, trading in the securities is not permitted.

Banks in developing countries do not usually engage in "balance sheet" lending to meet the cash flow requirements of businesses, but frequently a thriving informal or "curb" market operates to provide a ready, albeit expensive, source of short-term financing.

2. Capital Markets

Capital markets exist to provide long-term financing for start-up and expanding enterprises. Financing is obtained in the capital markets either by issuing debt instruments, typically bonds, or by selling equity in the enterprise through the sale of shares. Long-term financing raised through the sale of bonds or shares through either a private placement or a public offering is frequently referred to as "risk capital", in that the providers of funds are at risk that the enterprise will earn sufficient profit to pay dividends to its shareholders, or to pay the interest and principal on its debt.

a. Non-Securities

The sources of financing in the capital market fall into two categories -- non-securities and securities-- depending upon whether or not the financial instrument used to document the financing arrangement is transferable, i.e., negotiable. One way to maintain the distinction is by viewing the non-securities component of a capital market as a "closed shop". The sources of funds in the non-securities component of the market are usually financial institutions or related organizations such as banks, leasing companies, pension funds and insurance companies. Businesses seeking funds negotiate directly with these providers of funds. While the institution may sell off a portion of its investment to other financial institutions, the investment is not represented by a negotiable instrument that is readily available for purchase by individual investors or investor groups.

Typical forms of non-securities financing include: term loans, leases, sale and lease backs, and mortgages. To the extent that long-term financing is available in a developing country, it almost always is provided through term loans and mortgages, although sale and leaseback arrangements are also becoming important in meeting the capital equipment needs of businesses in developing countries. As one example, 84 leasing companies were established in Indonesia within months of a revision to the regulations permitting leasing operations. While sale and leaseback arrangements can be a useful alternative to raising funds for capital equipment purchases through bond issues or sale of equity, this financing technique is generally only available to well established firms that offer low risk of default to the leaser.

In developed countries many types of non-securities financing are being packaged and converted to securities (securitization).

b. Securities

The securities component of capital markets provides long-term equity and loan funds through the use of negotiable instruments that can be freely traded by individuals as well as institutions. This component of the market can be highly effective in mobilizing domestic capital, because the securities representing the investment can be sold to meet cash needs or other investment objectives. The liquidity of the provider of funds in the securities component contrasts sharply with the situation of the institutions providing non-security financing, in that the latter institutions generally hold their investment until the final payment has been made.

The liquidity of an investment in securities is not limited to shares or stocks, but holds for all investments represented by a negotiable instrument including bonds and debentures.

The securities component of capital markets in developing countries is generally small, and seldom fulfills its role of providing a market for the sale of bonds or shares by the initial purchaser of these securities. (Underwriters and dealers usually do not exist at this early stage.) The reasons why this is so, and the actions necessary to encourage development of the securities component are the principal subjects of this report. Before turning to that discussion, however, it is important to review the two important functions of the securities component of capital markets--issuance and secondary trading of securities.

C. Securities Market Functions

The securities segment of capital markets consists of a primary market and a secondary market. Both markets are essential in attracting savings to investment in productive activities.

Companies obtain financing for acquisition of the plant and equipment needed for production by issuing securities (shares and stock, bonds, or equity equivalents) in the primary market. In developed countries, these securities are generally not sold directly to the public by issuers, but instead are distributed by brokers or purchased by underwriters for subsequent resale to institutional and individual investors. Financial intermediaries in this primary market include: merchant, investment, and commercial bankers, and brokers and licensed dealers.

The financial intermediaries fulfill an important role in establishing an effective market price for the securities being issued by the company. In more developed countries they often also purchase the entire issue, and in "underwriting" the sale assure the issuing company of obtaining the total proceeds estimated for the issue.

Once the securities of the issuing company are sold, it has no further involvement in the disposition of its issues although maintaining much influence through its actions and information. Trading of securities is carried out in the secondary market by brokers and dealers acting on behalf of individual and institutional investors. It is this market that provides the liquidity that is so important, not only to the individual investor, but also to the financial intermediaries involved in the initial purchase of new issues in the primary market. In other words, unless underwriters are assured of a market for resale of the bonds or shares that they purchased from issuing companies they will be unwilling to purchase any issues.

Securities market activities in developing countries tend to consist principally of trading of the limited number of issues available in the market by a small number of investors. Growth of the market requires continual introduction by issuers of the new debt and equity of companies seeking long-term financing. It is this important function that serves to attract domestic savings and provide for a wider distribution of ownership, and that leads to an increase in the number of enterprises and to growth of the private sector. For reasons that will be described more fully in subsequent sections of this report, the number of new issues offered annually in most developing countries is small relative to the opportunities that exist. This will have to change, however, as LDC governments turn increasingly to the private sector to achieve economic development objectives that the public sector no longer can afford to finance.

D. Need for Capital and Equity Market Development

The 1980s have seen a significant increase in interest among A.I.D.-assisted and other developing countries in the role of the private sector in economic development and in privatization of state-owned enterprises. Much of this interest can be attributed to reductions in the funds available for development activities as a result of falling oil revenues, the cost of servicing debts in appreciating currencies, and declining demand for traditional exports.

Changes in the global economy in the last decade have forced LDC governments to recognize the importance of mobilizing domestic savings to increase the size and vitality of the private sector in the economy. Policymakers are becoming increasingly aware that the capacity of the public sector to produce and distribute needed goods and services is limited and is shrinking as a result of national budgetary constraints, declines in the flow of foreign commercial loans due to the debt crisis, and budgetary uncertainties surrounding external donor funds. The result is that a growing number of LDCs are turning to the private sector to maintain development momentum and the improvements in the standard of living achieved through the public sector-oriented policies of the past.

The inadequacy of capital markets in many developing countries, however, is a major deterrent to the growth of indigenous private enterprises. As discussed earlier, capital markets play a pivotal role in economic development, serving to mobilize domestic resources and allocate them efficiently to the most productive investments. They provide the long-term financing necessary for the creation and expansion of private enterprises. The development of more efficient capital markets has become even more important in recent years since global economic conditions have limited the flow of foreign private and international donor funds to LDCs. Thus, developing countries must rely more than ever before on their own capital markets to achieve private sector growth.

Private sector initiatives are intimately linked with capital market development efforts. Private enterprises cannot grow significantly without adequate capital markets, and capital markets can only grow and contribute to the development process when there is an active private sector.

The equity segment of the capital market is fundamental to business expansion and economic growth. It serves as the basis of support for bank and other borrowing, and allows the enterprise to grow and weather changes in the economic environment. The importance of equity capital is that it provides permanent finance with no contractual payments. On the other hand, reliance on debt capital carries contractual obligations to make fixed payments without regard to the profitability of the enterprise or the potential benefits of other applications of the funds. The dangers to both governments and private enterprises of heavy dependence on debt are highlighted by the current international debt crisis. Adequate securities markets and greater reliance on equity finance would have reduced significantly these problems by making the borrowers less vulnerable to high real interest rates. In Brazil, for example, the oil price increases in the 1970s, the rise in international interest rates, and their internal and external consequences, put Brazilian companies in a serious dilemma. The cost to debtor companies of repaying foreign currency loans virtually doubled due to the rise in interest rates during the period. At the same time, the companies could not raise new resources abroad because their external accounts had been exhausted. The situation was further complicated by the fact that the Government, faced with accelerating inflation and mounting public debt, abolished credit subsidies and competed with the private sector for capital, usually offering higher interest rates to affect liquidity and obtain financing for itself.

In summary, the problems associated with over-reliance on debt finance have become painfully evident to governments and businesses. For governments, excessive reliance on debt finance to fund capital-intensive projects with low returns has led to debt servicing problems. For private companies, high debt to equity ratios have led to unbalanced capital structures and financial vulnerability during periods of economic downturn in the international and domestic economies. These problems have served to encourage governments to put more emphasis on development of their domestic capital markets. There is also a growing recognition among LDC governments that expanding the role of the private sector in economic development is a prerequisite for sustained economic growth, and that equity markets play a crucial role in financing the growth in private investment.

CHAPTER II:
Recent History of Capital and Equity Market Development Efforts

Chapter II
RECENT HISTORY OF CAPITAL AND EQUITY MARKET DEVELOPMENT EFFORTS

This section summarizes the policies of A.I.D. in the last two decades regarding assistance for financial market development and provides a brief overview of recent A.I.D. and other donor activities related to capital and equity market development.

A. Shift in Emphasis to Private Enterprise Development and Capital Mobilization

In 1961, when the US Agency for International Development was established, developing nations world-wide were focusing their developmental efforts on import-substitution strategies that promised a "take-off" into rapid economic growth. This strategy required LDC governments to play a key role in the management of the economy. As a result, state development banks and government-owned enterprises were established in many countries during this period, and into the seventies, to provide the financing and the initiative which a strategy of import-substitution industrialization commanded.

In many countries, most notably in Latin America, state-owned development agencies supported massive infrastructure development projects to pave the road for industrialization. During this period, A.I.D., like other international development agencies, tended to emphasize loan financed assistance for such infrastructure projects, as well as humanitarian assistance. By the early 1970's, however, the explosive growth of urban populations in the major cities of developing countries, and the decline in agricultural production, made clear some of the implications of a dualistic economic development strategy based on protectionist policies and extensive foreign borrowing.

Throughout this period, but especially during the mid-1970's, a "basic human needs" approach to development became a central component of A.I.D. assistance programs. A.I.D.'s main focus thus shifted from support for large infrastructure projects, such as hydropower and fertilizer plants, to assistance for relatively small scale social development projects.

Meeting the basic needs of the Third World populations is still an important objective of A.I.D. development programs. The question of how to meet these basic needs, however, has evolved from a more narrow interpretation requiring heavy reliance on government transfer of resources to a broader understanding of the complex interrelationship between job creation and capital mobilization, and private enterprise development and economic growth.

Beginning in 1981, A.I.D. has made a systematic commitment to private enterprise as the central vehicle for renewed economic growth in developing countries. By stimulating private sector growth and employment, the Agency is assisting LDCs in developing their own capabilities to meet basic human needs. In addition, as a corollary to private enterprise development support, A.I.D. has adopted new policies that concentrate on policy reform and liberalization of markets. These policies stress the importance of providing assistance to and through private sector institutions. To date, the emphasis, at both the AID/W and the USAID mission level, has been on encouraging the divestiture of state-owned enterprises (SOEs) or on assisting in the development of specific subsectors of the private sector, e.g. export facilities, processing facilities.

In assisting these activities A.I.D. has moved away from its traditional approach of providing loan funds for these activities out of recognition that it might be substituting for local capital, or retarding the development of the markets that should be the sources of financing. As stated in its policy paper on financial market development, "A.I.D. should promote a system of financial markets that is integrated and relatively undistorted, one that relies heavily on competitive financial institutions, and on policies to facilitate competition. This system should be capable of effectively mobilizing private savings, allocating that savings to investments yielding maximum returns, and maximizing the participation of the general populace.... A.I.D. can be a catalyst for financial liberalization in developing countries through both the policy dialogue process and project assistance."

Similarly, the World Bank, the International Finance Corporation (IFC), and regional development banks have also embarked on major private sector initiatives in recent years that complement their financial sector development programs.

The shift in emphasis to developing market-led economies was marked by the establishment of the Bureau for Private Enterprise (PRE) in 1981. Subsequently, PRE and the regional bureaus have organized projects that are designed to assist A.I.D. missions in developing comprehensive financial market and private enterprise promotion strategies. The Financial Sector Development Project (FSDP) managed by PRE, and a related research project managed by the Bureau for Science and Technology (S&T) are the principal AID/W projects currently devoted to development of LDC financial markets.

B. A.I.D. Financial Market Development Assistance

A.I.D. development program objectives beginning in the late 60's and into the early 80's have tended to stress progress in the traditional sectors of agriculture, education and health. To support these and other activities, A.I.D. has used a number of instruments, including loans, investment guaranties, investment centers, co-financing arrangements, and so forth. To mobilize resources for these activities, A.I.D. has also provided considerable support to intermediate credit institutions (ICIs) in developing countries, particularly in the 1960's. The principal objectives of this type of support include:

- strengthening banking/lending capabilities;
- extending medium and long-term credit and providing equity financing;
- directing investment to high priority areas such as agribusiness;
- making credit accessible to a broader segment of the business population; and
- promoting self-sustaining intermediary institutions.

In the 1960's, when A.I.D. support of ICIs was at its peak, it provided 61 dollar loans to 45 ICIs in 34 countries. Two thirds of these loans, however, were provided to public institutions for purposes other than seed capital. It was not until 1969 that A.I.D. support of ICIs shifted from financing provided primarily to public institutions to financing for seed capital in private credit institutions.

Nonetheless, there are a number of early examples of A.I.D. assistance to private ICIs designed to support the needs of private enterprises in developing countries. In the early 1960's, for example, A.I.D. supported the Industrial Credit and Investment Corporation of India, Ltd., and made available foreign exchange for re-lending to private firms. The project provided sub-loans to private companies planning to employ U.S. inputs in their projects and also served as a source of information for these companies. Information was then used in policy dialogue between the A.I.D. mission and the Government of India regarding investments, and fiscal and regulatory policies affecting private sector development.

In 1963, A.I.D. also supported the creation of the Costa Rican Industrial Financing Corporation (COFISA), a private development finance company, to facilitate capital for the country's private industrial sector. (The banking system had been nationalized in 1949.) Years later, A.I.D. supported the development of the Private Investment Corporation (PIC), a merchant bank to provide badly needed investment capital. There is some disagreement, however, as to whether PIC has really functioned as a merchant bank, and the corporation reportedly has experienced considerable management problems.

In the early 1960's, A.I.D. joined the World Bank and private Philippine interests in the formation of the Private Development Corporation of the Philippines (PDCP) with the objective of facilitating foreign and domestic capital and long-term financial assistance (loan, equity, guarantee, and underwriting) to private enterprises in the country. A.I.D. provided a "soft loan" to PDCP as a way to attract "hard" loans, and provide a subsidy and more leverage to attract private investors to a public offering of the corporation's stock. The highly concessional nature of the A.I.D. loan, however, contrasts sharply with its current policy on financial market development, which emphasizes competitive, market-determined rates of interest.

A.I.D.'s history of support for capital and equity market development activities also dates back as early as 1962 in South Korea. At that time, A.I.D. engaged a consultant to study the conditions of the Korean Stock Exchange and the investment climate in the country. During that period, there was considerable speculation on the Exchange and ample evidence of manipulation of share prices. The study provided a series of recommendations for re-organization, supervision, and regulation of the Exchange.

A.I.D.'s early efforts to support capital markets also include support of the Capital Markets Development Fund (FUMCAP) in Brazil in the mid-1970's. The Fund was established within the Central Bank to provide long-term financing to Brazil's private capital market. FUMCAP was initially capitalized at $50 million, $12.5 million each from A.I.D. and the World Bank, and $25 million from the Government of Brazil. Funds were channelled through the National Development Bank and the Federal Savings Bank to provide credit to investment banks and reduce their risks in underwriting long-term corporate debt and equity securities. FUMCAP also provided credit through the banks to support the price of the shares underwritten as an incentive for companies to go public. In addition, FUMCAP supported the development of a secondary market in corporate bonds by allowing traders in such bonds to draw on credit provided by FUMCAP to the investment banks.

The project also supported the Rio de Janeiro and Sao Paulo Stock Exchanges with operational problems, created a system to accredit independent auditors, and helped the Central Bank with regulation of brokers and other securities related issues.

In the mid-1970's A.I.D. also supported a project to increase the economic growth rate of Pakistan by accelerating the implementation of selective capital projects. The project provided financial assistance to the Government of Pakistan in financing the foreign exchange costs of technical assistance in the design and implementation of a broad range of capital development projects during a 3-year period. An evaluation of the project in 1978 noted a series of problems including delays in implementation, difficulties in understanding A.I.D. regulations, and lack of coordination between study sponsors and other related agencies.

Thus, it can be said that A.I.D. has a long history of involvement in financial market development activities through its support of ICIs and its many credit and loan guaranty programs. It is only recently, however, that A.I.D. has developed a systematic and comprehensive approach to financial market development, and that this has been stated as an explicit objective of its development programs and a principal component of its private sector initiative. In addition, A.I.D.'s experience in the complex field of capital and equity market development assistance has been much more limited, although this study is an indication of A.I.D.'s increasing interest in playing a pivotal role in capital mobilization activities through the securities market.

The Financial Markets Development Project (FMDP) managed by the Bureau for Private Enterprise and its successor, the Financial Sector Development Project (FSDP), are the best examples of A.I.D.'s current objective to make financial market development a crucial component of its private initiative and a systematic strategy for economic development in LDCs. Through FMDP, A.I.D. provided technical assistance to more than 25 countries in a 3-year period. Assistance ranged from the assignment of specialists to meet highly specific requirements in support of on-going activities to conducting comprehensive reviews of the impediments to expansion of existing financial markets. Assistance provided under FMDP took many forms, including:

- providing experts to LDCs to help resolve policy issues related to development of capital markets;
- performing various analyses required to support specific actions or policy revisions;
- providing training to bankers, potential investors, and other key groups; and
- providing advice and personnel to assist in establishing components of the financial systems (e.g. debt instruments, regulatory agencies, etc.) that are key to the expansion of the capital market.

Under FSDP, assistance will focus on the development of financial sector strategies, technical assistance in the design and implementation of projects, and dissemination of financial market information to A.I.D. missions, private sector groups, and host governments worldwide. A fourth component of FSDP will support applied research on financial sector development.

A.I.D. efforts to encourage and improve equity market development specifically have been much more limited. A brief description of some of the activities, conducted under the Financial Markets Development Project, which are related to equity market development follows:

- Thailand

A.I.D. provided assistance to the Securities Exchange of Thailand (SET) by reviewing the efficiency of SET operations and the need for market makers to improve the liquidity of the market.

- Kenya

A.I.D. is assisting the Government of Kenya to finalize its plans for creating a Capital Market Development Authority (CMDA). Assistance includes identification of the key issues to be addressed by the CMDA, such as existing disincentives to companies going public, and recommendations regarding the structure and composition of the CMDA.

- Panama

A.I.D. conducted a study of the feasibility of establishing a local stock market.

- Indonesia

A.I.D. is providing long-term and intermittent technical assistance to aid the Government of Indonesia in the development of the capital market. Through this project, A.I.D. has provided the Government of Indonesia with an incentive to develop an action plan using the recommendations of four previous reports. Assistance has included a review of the role of Danareksa, the national investment and unit trust fund. A.I.D. has also provided technical assistance to the Ministry of Finance and the Capital Market Development Authority (BAPEPAM) by reviewing regulations proposed for an over-the-counter (OTC) market. The OTC is seen by the Indonesian Government as a possible way to expand the securities market and boost secondary trading activity. Unlike the existing stock exchange, the new OTC market will be open to foreign participants and will have less rigorous listing requirements. A.I.D. is providing assistance in formulating the specific regulations for this market.

- Jordan

A.I.D. provided technical assistance to the Amman Financial Market (AFM) by assessing the feasibility of establishing a mutual fund industry and detailing specific recommendations on the types of regulatory controls needed.

C. IFC Activities

The International Finance Corporation established the Capital Markets Department in 1971 in recognition of the importance of financial markets to economic development. In general, IFC activities focus on countries that are more advanced economically than the countries assisted by A.I.D., although there is some overlap among the more developed countries in the A.I.D. portfolio. Assistance provided by the IFC for financial market development takes two main forms:

1. Policy Advice/Technical Assistance

The IFC provides member countries with advice and technical assistance designed to improve the environment and operation of their financial markets. Such assistance involves 4 major types of activities:

- Preparing general policy papers

The Capital Markets Department has prepared a number of general studies examining a variety of financial market development issues, including fiscal incentive programs for increasing equity investment, implications of different financial institutional structures on securities market development, and the potential for foreign portfolio investments in LDC stock markets, among others.

- Conducting country financial sector surveys

At the request of member countries, the IFC undertakes comprehensive reviews of the entire financial system of a country, often in collaboration with the World Bank. It also conducts in-depth analyses of specialized areas such as securities market operations.

- Providing policy advice on regulatory, fiscal and institutional frameworks

The Capital Markets Department has provided assistance in a number of areas such as fiscal policies to promote long-term savings, including the purchase of stocks; financial leasing regulations; the role and organization of securities commissions; securities market mechanisms, particularly stock exchanges; financial market information requirements in general and securities market disclosure in particular; and regulations for bond and stock issues.

- Providing assistance for implementation of programs/recommendations

In the area of securities market development, the Capital Markets Department has provided assistance for securities commission and stock exchange organization and procedures, and for primary market underwriting and placement procedures.

2. Investment Activities

As an investor, the IFC provides equity and loan funds and needed financial technology to assist in the creation of new, and in the expansion of existing, financial institutions. Through participations in IFC loans, syndications and other co-financing mechanisms, the IFC also helps to mobilize other domestic and foreign sources of finance. In the area of securities market operations, the Capital Markets Department has helped to establish money market firms, brokerage/investment/merchant banks, securities financing firms or mechanisms, and mutual fund/unit trust management companies. In an effort to mobilize foreign resources for private sector investment in LDCs, the IFC also assists private enterprises to enter international capital markets by acting as an underwriter in bond and equity issues.

As of June 30, 1987, the IFC had over 250 equity investments in 68 developing countries, for a total equivalent of over US$400 million. About 70 of these investments are in financial institutions, including commercial banks, investment banks, development finance companies, venture capital companies, and fund management companies. The IFC has also performed as an underwriter of some 40 domestic private securities issues in LDCs.

Since 1984, the IFC has acted as lead manager or co-lead manager of several investment funds--the Korea Fund, the Thailand Fund, and the Malaysia Fund--whose purpose is to invest in the publicly listed companies of LDCs. The Korea Fund, which is listed on the NYSE, was first launched in 1984, but its success led to another issue in May 1986. The public offering of the US$30 million Thailand Fund was made in December 1986, and that of the US$84 million Malaysia Fund in May 1987. These special funds attract foreign portfolio investment in domestic private company securities in LDCs.

In 1986, the IFC also launched the $130 million "Emerging Markets Growth Fund" as a private placement with 11 institutional investors from 7 countries. The fund, with investments in 9 countries in Asia, Latin America, and the Middle East, offers risk capital for domestic business without contributing to increased debt levels. As a complementary activity, the Capital Markets Department has been "tracking" equity markets in twenty of the more advanced LDCs through the "Emerging Markets Database".

D. Other Donor Activities

Like A.I.D., other international donors also have begun to increase the emphasis in their development strategies on development of financial markets and market-led economies. The Asian Development Bank recently conducted an assessment of the financial markets in Indonesia to determine the role that the Bank will take in assisting development of the market. In 1984-85, the ADB also conducted a critical study on capital market development in Korea, Pakistan, the Philippines, Sri Lanka, Thailand, and Indonesia. The principal objectives of the study were to assess the conditions of the capital markets in these countries, to identify relevant strategies for development of the capital markets, and to establish an action plan for ADB capital market development assistance.

While the World Bank continues to emphasize credit programs and infrastructure development, it has included components in recent loan programs for Bolivia and Indonesia that address capital market conditions.

As a further example of the growing awareness of the importance of financial markets, the United Nations Development Program (UNDP) recently established a Capital Markets Department to provide technical assistance in this area.

Although it is too early to document the experience of these donors, it is clear from their actions that they attach considerable importance to capital market growth in economic assistance efforts.

CHAPTER III:
Key Considerations in Capital and Equity Market Development

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Chapter III
KEY CONSIDERATIONS IN CAPITAL AND EQUITY MARKET DEVELOPMENT

Development of a country's capital and equity markets is part of a broader effort of macroeconomic policy and private sector-led, sustainable economic growth. Economic policies that discourage formation or expansion of private enterprises also impede development of capital and equity markets because they impact negatively the demand for long-term finance. Economic policy, private sector growth, and capital mobilization, therefore, are interrelated conditions that must be examined in any comprehensive study of capital and equity market development. This chapter addresses the impact of each of these conditions as follows:

Section A discusses the interrelationship between private enterprise development and equity market growth, and the significance of evaluating the political, economic, and regulatory environment as requisite conditions for capital market development. In addition, this section considers the implications of alternative economic development approaches on the role of government in the economy and on the government's choice of macroeconomic policies. As a supplement to section A, a more theoretical discussion of general types of economic development approaches is provided in Appendix A. That discussion emphasizes the role of government under different approaches and the implications of these approaches for overall economic development and private sector growth.

Section B describes specific types of issues and market conditions that affect the development of securities markets, and the barriers that inhibit efforts to mobilize capital through that market. The discussion is structured around four fundamental considerations: (1) developmental and regulatory considerations; (2) institutional factors affecting equity market growth; (3) factors limiting the supply of securities; and (4) factors limiting the demand for securities.

A. Requisite Considerations for Capital and Equity Market Development

Vigorous equity markets can exist and develop only in supportive political, legal, and economic environments. Excessive government involvement in the economy may doom the prospects for equity market growth if it inhibits formation and growth of private sector firms. In addition, government policies--fiscal, monetary, and regulatory--can impede the development of equity markets if they distort interest rates and prices, or if they encourage inflation and price instability, or if in pursuing short-range fiscal objectives they create disincentives to investment in private enterprise. Empirical studies have shown that the choice of economic policies can have an important effect on productivity and economic performance, which in turn has implications for private sector growth and equity market development. (See Appendix A for a fuller discussion.) This does not mean that other factors, including political and social conditions, and regulatory factors, do not influence the outcome.[1] Economic development in general, and equity markets in particular, are much affected by legal and political, as well as economic factors and conditions. While reliance on equity markets is a strategy applicable only to market-economies, free markets are not sufficient conditions for successful implementation of equity market development programs in the presence of political instability and social turmoil, or inappropriate regulation and inadequate supervision of financial intermediaries.[2]

1. Impact of Selected Macroeconomic Policies and Government Regulations on Business Activities and Equity Market Growth

An environment that supports profitability, growth, and expansion of private enterprise is a necessary condition for success of equity market development efforts. Equity markets serve the dual purposes of encouraging savings and providing a channel for directing these savings into investments that finance the capital needs of various enterprises. Increased capital permits businesses to expand and create additional jobs and income. A favorable climate for business formation and expansion will promote the development of a securities market as businesses seek ways to obtain long-term financing of capital requirements through family resources, internal profit financing, and traditional and other borrowing. Conversely, a securities market will not develop and grow in an environment in which political turmoil, tax policies, regulations, or laws governing company operations discourage formation of new companies or expansion of existing enterprises.

The growth of the private sector and the willingness and ability of private entrepreneurs to invest in new operations and expansion of existing enterprises is determined by perceptions and analyses of the potential profitability of an investment. The degree of political and economic stability in a country is one key factor in any assessment of this potential. Instability increases the perceived risk associated with investments in a

1 Bela Balassa and Associates, *Development Strategies in Semi-Industrial Economies* (Baltimore and London: Johns Hopkins University Press, 1982), p. 59.

2 See U Tan Wai and Hugh T. Patrick, "Stock and Bond Issues and Capital Markets in Less Developed Countries", *International Monetary Fund Staff Papers* (July, 1973), p. 281 and Maxwell Fry, *Money, Interest, and Banking in Economic Development* (Baltimore and London: The Johns Hopkins University Press, 1988), pp. 419-441.

country. Under these circumstances, a domestic investor may prefer to transfer resources abroad rather than invest in a venture with a highly uncertain return. Private sector business activities in the domestic economy generally tend to decline because of unstable political and economic conditions, with the result that demand for equity and other forms of long-term financing is very limited and opportunities for development of equity markets are curtailed.

A case in point is Guatemala, where regional political conflicts and a deteriorating economic climate have contributed to sharp declines in private investment and substantial capital flight since 1980. There, the securities exchange has not been able to get off the ground, despite private efforts to support its development. Lingering uncertainties about the future political stability of the region, among other factors, continue to affect perceptions of the risk of private investment and the level of investment activity.

Tax policies constitute another important influence on private enterprise development and equity market growth because taxes affect the cost of operating a business and incentives for expansion and diversification. Tax policies also affect a firm's choice of financing and influence the pattern of investment, with consequent effects on overall economic efficiency.[3]

Interest rate policies also have substantial impact on private sector business growth by influencing the availability of credit (financial savings is deterred by the imposition of below-equilibrium interest rates) and the efficiency of investment. Markets in which interest rates are freely determined by the interaction of supply and demand exist in very few developing countries. Most governments impose interest rate controls, such as ceilings on lending and deposit rates, and pursue selective credit policies designed to channel credit to priority sectors, groups, or regions at subsidized rates.

When interest rates are low relative to the prevailing level of inflation, firms will find it profitable to use internal resources as well as credit facilities to build up their inventories and to invest in other inflation hedges such as real estate. Because negative real interest rates discourage saving, this transfer of resources into inflation hedges will tend to "crowd out" financing of productive investment in plant and equipment because investible resources will become more scarce. In addition, when interest rates are kept

3 Keith Marsden, *Links Between Taxes and Economic Growth*, World Bank Staff Working Papers No. 605, 1983.

low or negative, and demand for credit outstrips supply, credit is generally rationed in favor of parastatal enterprises and well-established, large-scale firms with close connections to the banks.[4]

In countries with well-functioning securities markets, such limits on the availability of bank credit would tend to increase the supply of securities as firms looked for alternative sources of financing. In the absence of a well-functioning securities market, which is typically the situation found in developing countries with repressive financial systems, the imposition of interest rate controls will result in a decline in investment and growth because the creation and expansion of business will be limited by the lack of finance.

The relationship between credit policies and securities can be illustrated further by considering the impact of interest rate ceilings on bank deposits. In countries with well-functioning securities markets, such limits would increase the demand for securities for a given level of risk, as the perceived reward of investing in securities would be higher than the expected reward for bank deposits. Moreover, in the presence of high levels of inflation, investment in securities, stocks for example, would be desirable as a hedge against inflation. In most LDCs, however, for reasons that will be described later in the report, the risk/reward of investing in non-government securities is typically higher than the risk/reward of investing in commercial bank deposits. Particularly in the presence of high levels of inflation, the effect of interest rate ceilings on deposits is to decrease savings and encourage investment in consumer goods, real estate and other non-productive inflation hedges. In short, the ultimate result of interest rate controls in countries with poorly-functioning markets is to decrease financial savings and investment in productive assets, with no commensurate increase in growth of the securities market.

In many developing countries, the legal and regulatory environment is inadequate or unduly restrictive of private sector activities and obstructs development of an equity market. Regulations often attempt to influence the pattern of private investment in line with government priorities. In addition, extensive licensing procedures are required often for set-up or expansion of private firms, and regulatory and bureaucratic inefficiency may increase the cost of doing business. The importance of legal and regulatory impediments to the growth of private sector economic activities has been underscored in the recent book by Hernando de Soto of the Instituto Libertad y

4 Fry, *Money, Interest, and Banking*, p. 374, and *World Bank Development Report 1987*, pp. 118-119, and International Monetary Fund, *Interest Rate Policies in Developing Countries*, Occasional Paper No. 22 (Washington, D.C.: IMF, 1983), pp. 10-11.

Democracia in Peru. De Soto has demonstrated that in Peru the high costs of compliance with government laws and regulations raise the price of entry and financing of new firms to such a degree that they force a sizable segment of the economically active population into the informal sector of the economy.[5]

In short, to promote growth of the private sector and development of equity markets, the environment--political, economic, legal, and otherwise--must offer business the opportunity to make an adequate return on its investment. Political or economic instability, or inadequate and restrictive laws and regulations, increase the risk of investment and raise expectations of the return on investments. Publicly owned companies in this situation will find it necessary to distribute most profits, and even incur losses, in order to meet shareholders' dividend expectations. Privately held companies have no incentive to go public under these conditions, and generally divert their profits to investments in overseas markets, or in unproductive activities such as real estate development.

2. Extent of Government Participation in the Economy

Most developing country governments take the lead in directing economic development activities in their countries. Excessive government involvement in the economy, however, can stifle the formation of private enterprises. In particular, government control of certain lines of business has blocked competition and limited private sector activities. In some countries, for example, state-owned banks have privileges not extended to private financial institutions. These advantages limit the ability of private sector banks to compete and to become players of any consequence in the financial markets of the country. The favored position enjoyed by state banks reduces their incentives to operate efficiently, with the result that businessmen find the banks unresponsive to their financing requirements.

In the absence of significant tax revenues from a large corporate base, most LDC governments rely heavily on public sector borrowing to meet the cost of services and development activities. In some countries, the government has preferential access to credit through state-owned financial institutions. Access to "cheap" sources of credit might be assured through government imposed interest rate ceilings and other credit controls, or by requiring institutional investors, e.g. pension funds and insurance companies, to invest a certain percentage of their funds in governments bonds or other financial instruments. Tax policies may favor investment in government bonds rather than private securities by exempting the former but not the latter from equity or wealth taxes. Privileged access to credit on the part of government agencies inhibits private

5 Hernando de Soto, *The Other Path: The Invisible Revolution in the Third World*, (New York: Harper & Row, 1989).

sector activities. If credit conditions are relatively tight, public sector borrowing will crowd out private sector borrowing. In addition, access to cheaper sources of funds on the part of public enterprises places private enterprises at a competitive disadvantage.

Precipitous declines in oil revenues and massive debt servicing requirements have caused an increasing number of developing countries to turn to the private sector to accomplish economic development objectives that were previously financed from government budgets. However, it is unrealistic to expect that local or foreign investment in the domestic economy will mushroom simply as a result of government pronouncements or promises of policy revisions. Government controls and intervention in private sector activities have been too long-standing and pervasive to expect other than cautious enthusiasm from the business community in many countries. Expansion of the private sector in many developing countries will require a difficult political commitment by the government to specific actions, including dialogue with the private sector, that will reduce, and eventually remove, obstacles to investment in private sector operations and attainment of reasonable levels of profitability.

3. Implications of Alternative Approaches to Economic Development

Assessment of a country's economic development approach or philosophy provides considerable insight into the role of the government in the economy and the selection of macroeconomic policies. For that reason, it is important to start the evaluation of prospects for equity market development in a particular country with an understanding of the approach that has been selected to achieve economic development. Some countries, in the absence of any change in their development strategy, will not be candidates for equity market development. Others will be potential candidates on the basis of obvious shifts in their approach to development. Still others will be clear candidates, but will require assistance to move from the point of having created favorable conditions to achieving progress toward development of their equity market.

Empirical studies have shown that changes in economic development approach can have important effects on the economic performance of individual countries in the absence of significant modifications in the political, social, and legal environment. These studies have found that countries which have pursued outward-oriented (export promotion) approaches to economic development--as opposed to inward-oriented import substitution (IS) strategies--have experienced faster rates of economic growth.[6]

6 Hollis Chenery, Sherman Robinson, and Moshe Syrquin, *Industrialization and Growth: A Comparative Study* (Oxford University Press, 1986), p. 358 and The World Bank, *World Development Report 1987* (Oxford University Press, 1987), p.8.

These results reflect the benefits derived under an export promotion strategy which stresses resource allocation according to comparative advantage.[7]

The choice between an inward- or an outward-oriented approach to economic development has varying implications on the role of government in the economy and on the selection of policy instruments--e.g. import controls versus free trade policies, support of overvalued exchange rates versus exchange rate adjustment--to promote economic growth. While inward-oriented IS strategies call for extensive involvement by the government in the economy, outward-oriented strategies rely to a greater extent on market forces. This does not mean that the government has not played an important role in the successful experience of export promoters such as South Korea, Taiwan, and Singapore. Indeed, as is discussed in Appendix A, what seems to distinguish the Asian development experience is the effective interaction between the government and private sectors in formulating development strategy and in pursuing common economic goals more than the predominance of free market forces. A study by Maxwell Fry has shown that between 1960 and 1983 the "Gang of Four" governments, with the exception of Hong Kong, used selective credit policies to influence allocation of investible funds, and all four intervened in one way or another with the interest rate setting process, despite the frequent references to the accomplishments of financial reform in Taiwan and South Korea. According to Fry, "[s]ustained rapid growth was achieved despite, rather than because of, these [financial] policies."[8]

4. Monetary Control and Stability

Stable macroeconomic policies, aimed at reducing inflation and preventing currency overvaluation, are crucial for a successful transition to export promotion strategies and financial liberalization. This requires monetary control and fiscal discipline, as well as consistent monetary and exchange rate policies. The experiences of the "Gang of Four" countries, in comparison to those of the Southern Cone countries and Turkey, show that the outcome of financial liberalization and reform programs is greatly affected by the presence or absence of price stability, fiscal discipline and policy credibility, and adequate regulation and supervision of financial institutions.[9]

Unlike most developing countries, however, the "Gang of Four" have adopted consistent monetary and exchange rate policies, avoiding overvaluation of their domestic currencies by ensuring that the real effective exchange rate never appreciates solely as a result of domestic inflation caused by accelerated monetary expansion. Moreover,

7 Balassa and Associates, *Development Strategies,* p. 59.
8 Fry, *Money, Interest, and Banking*, p. 350.
9 *Ibid.*, pp. 425-444.

as Fry has noted, "financial repression" was far less pronounced in these countries than in countries such as Chile, Argentina, and Turkey, that have suffered from very high levels of inflation. In addition, government finance was well-managed among the "Gang of Four": none of the countries experienced pressure for monetary expansion to finance large and persistent government deficits. This has given the governments a high degree of credibility that many LDC governments lack.[10]

B. Factors and Conditions Inhibiting Capital and Equity Market Development

Although the level of sophistication of equity markets among developing nations varies considerably, the growth of these markets in most LDCs is retarded by the common constraints to private enterprise development cited in the previous section. As a result, the number, volume and variety of stocks traded, and even the number of investors in LDC equity markets is characteristically small. Generally, the equity raised through new public issues is insignificant relative to GNP or to the value of funds channeled to the private sector through the non-securities market and other sources. The types of securities available are usually limited and the secondary market, when it exists, is sometimes dominated by government debt securities. In addition, the volume of transactions in the secondary market (turnover activity) is generally very low, and financial intermediary institutions are inadequate. Finally, investor confidence in the operations of the securities market and in the issuing firms is generally low. At the same time, investors more often than not exhibit a preference for quick, guaranteed returns rather than long-term capital gains. They evaluate equities only on dividend return, neglecting earnings.

This section examines a number of these issues and describes specific factors and conditions that limit development and growth of equity markets. Because not all countries exhibit the same types of problems and the significance of these issues may differ among LDCs, this section provides an overview of the types of issues/problems encountered in equity market development efforts. The discussion is based largely on practical experience in equity market development in a number of developing and developed countries. The section is organized around three critical issues in equity market development: (1) developmental and regulatory considerations; (2) institutional considerations; (3) factors limiting the supply of securities; and (4) factors limiting the demand for securities.

10 *Ibid.*, pp. 347-375.

1. Developmental and Regulatory Considerations

In most developing countries, regulatory and developmental policies and procedures affecting the securities market require substantial improvement. Some of the more common problems include:[11]

- Lack of a unified government office for the supervision and development of the market

In many developing countries, no single government agency is charged with coordinating capital market development activities. Generally, responsibility for supervision and development of the capital market is segmented among different government agencies--the Ministry of Finance, the Securities Commission, the Central Bank, etc.--whose roles may overlap or conflict. The outcome often is extensive, duplicative, and sometimes inconsistent regulations.

Lack of a unified government office for the supervision and development of the capital market was a major problem at the time of the 1979 crisis in Thailand, for example. At the time, regulatory and developmental responsibilities were fragmented among various government agencies. According to Manas Leeviraphan, Director-General of the Fiscal Policy Office of the Ministry of Finance of Thailand, this fragmentation impeded efficient policy formulation with the consequence that no single agency was able to take immediate action to resolve the crisis in the Securities Exchange of Thailand. The crisis had a detrimental impact on investor confidence for years to come.[12]

On the other hand, a crisis in Singapore in 1986 was quickly resolved by their Monetary Authority's capital market section and the Stock Exchange. The Exchange was closed and reopened after two days.

- Scarcity of adequate skills

Often, regulatory officials do not have the requisite skills to conduct regulatory work or to promote development of the securities market. In addition, the unnecessary duplication that results from having a number of government agencies involved in securities market regulation and development often contributes to the shortage of skilled personnel.

11 Terrence Reilly, in *Capital Market Development in the Asia-Pacific Region*, Summary of the Proceedings and Papers Presented at an ADB Symposium held on January 14-16 in Manila, Philippines, p. 184-185. (Hereinafter referred to as "ADB Symposium".

12 Leeviraphan, in "ADB Symposium", p. 151.

- Insufficient understanding of the markets

In many countries, existing regulatory bodies are run by officials and civil servants who have knowledge of regulation, but lack knowledge of how a market works, and what will make it grow. Generally, there are few if any practitioners with a real understanding of how securities markets operate.

- Lack of authority to enforce regulations

Existing bodies often do not have enough authority or qualified manpower to enforce rules or to promote regulations to develop the market.

- Inconsistent and outdated regulations

Frequently, regulations are introduced in response to specific problems and on an *ad hoc* basis. As a result, regulations are often inconsistent and may even be unenforceable.

In fact, some regulations are based on outdated legislation and may be at cross-purpose with goals to develop a securities market.

a. Development/Regulation

A common problem in securities market development is that too much emphasis is placed on regulation and little if any on market development. All too frequently, the focus of government agencies is heavily weighted towards regulation rather than development of the market. However, an appropriate balance between regulation and development of the market is important. As Sir Kenneth Berril, Chairman of the Securities and Investments Board of the United Kingdom has pointed out, "It is essential not to divorce the objective of developing capital markets from the objective of regulating them: markets which develop without a suitable regulatory framework will not, in the long run, operate as successfully as those which are effectively regulated. Securities commissions, and similar organizations, thus have a dual responsibility, neither of which should predominate at the expense of the other."[13]

Experience shows that countries like Brazil and Korea, which have taken a developmental approach to capital market growth while at the same time attending to regulation, have been more successful in their efforts to develop the market. In Brazil, for

13 Berril, in "ADB Symposium", p. 160.

example, associations comprised of merchant bankers, brokers, and institutional investors have been particularly effective in making practical recommendations on how to develop the securities market.[14]

b. Self-Regulation/Oversight Regulation

The primary purpose of regulation is to support fair and orderly markets and to protect investors in order to maintain and increase investor confidence. The issue of self-regulation has to do with the extent to which a privately operated trading facility should establish its own rules and regulations and the extent to which government agencies should act as regulators of market participants. Different countries have taken different approaches, ranging from extensive private self-regulation to extensive government regulation. The correct response will depend on local conditions.

In some developing countries, trading facilities are operated by government agencies and regulations are set by them. Other countries have adopted the British approach which allows the stock exchange to function primarily on the basis of private self-regulation. Still others have followed the U.S. approach in which trading facilities are allowed to operate as self-regulatory agencies subject to oversight regulation by a government ministry or securities commission.[15] The challenge is to attain a delicate balance between a system that assures adequate protection of investors and one that does not deter market growth. Inefficient or inappropriate regulation can lead to speculation, heavy damages to investors, and loss of investor confidence. On the other hand, over-regulation can stifle private initiatives and discourage companies from going public.

c. Equity Market Depth and the Structure of Financial Institutions

A topical discussion in securities market development centers on the implications of different institutional structures on the effectiveness of securities market development. More specifically, the question is which type of financial structure--universal banking (also known as multi-banking) or specialized securities market institutions--has a

14 Terrence C. Reilly, "Initial Discussion Memorandum on Policy for Capital Market Development in Indonesia," Draft Report Prepared for Arthur Young under contract with the Agency for International Development. (July 7, 1986) p. 11. (Hereinafter referred to as "Indonesia Memorandum.")

15 Reilly, in "ADB Symposium", pp. 182-183.

greater positive impact on the development of securities markets. The International Finance Corporation(IFC) has been at the center of this discussion. For this purpose, the IFC has conducted numerous case studies in developed and developing countries which have sought to relate the depth of the securities market (measured as the ratio of securities outstanding to GNP) in a particular country to the structure of financial institutions. The discussion presented below is based on these findings. [16]

Arguments in favor of universal banking systems focus on the economies of scale which should result from merging banking and securities market activities into a single institution. Even if economies of scale were insignificant, supporters of universal banking argue that if specialized institutions are as efficient as the former, universal institutions will evolve naturally into specialized systems in the absence of laws and regulations to enforce this specialization.

On the other hand, proponents of specialized systems argue that laws, such as the Glass-Steagall Act in the United States, are necessary to curb abuses which might arise from conflicts of interest and undue concentration of power if banks are allowed to engage in securities market operations. Abuses could lead to a loss of confidence on the part of savers to the detriment of securities market development. Another argument in favor of specialized systems focuses on financial innovation and entrepreneurship. The argument is that specialization facilitates the entry of entrepreneurs into securities markets because less capital is required to start these operations, and encourages development of new financial instruments and techniques. Universal banking, on the other hand, requires considerable start-up capital and banks may resist development of securities markets in favor of traditional bank finance if monopolistic structures emerged.

A survey of developed countries, including Germany, the United States, Canada, Japan, and the Netherlands, conducted by the IFC found that there is little evidence to support the argument that universal banking systems result in significant economies of scale leading to greater efficiency and securities market depth. With regard to developing countries, the conclusions of the IFC are overshadowed by difficulties in segregating universal banks and specialized institutions in particular countries, and by other factors such as the stage of economic development and periods of high levels of political and economic turmoil. Nevertheless, the IFC finds no evidence in the developing country studies to support arguments in favor of univetsal banking structures. In fact, in the case of developing countries with prominent securities markets, such as Korea, the

16 David Gill, "Some Thoughts on the Implications of Different Financial Institutional Structures on Securities Market Development." Paper presented at the Conference on Las Instituciones Financieras en el Mercado de Capitales en Chile (Chile, 1979).

Philippines, Jordan, and India, development of the market has taken place in an environment of distinct specialization of financial institutions.

Some exception was found in the case of Mexico and Brazil, both countries with successful securities markets and multi-function banking conglomerates. Nevertheless, closer scrutiny of the Brazilian and Mexican cases reveals that in Brazil the various activities of the banking conglomerates are managed by separate legal entities which function much like specialized institutions, while in Mexico, independent brokers/dealers and the government have provided most of the stimulus to securities finance whereas the banking conglomerates have played only a minor role. The single most important conclusion of the IFC, however, is that other factors, such as fiscal policies, laws and regulations, and the level of economic development, are more important determinants of the level of securities market depth.

2. Institutional Considerations

The following provides an overview of the key considerations which require attention in any equity market development efforts:

a. Financial Intermediaries

The principal financial and securities intermediaries in equity markets are brokers, dealers, market makers, and investment and merchant bankers. In the primary market, the role of merchant and investment banking firms is to encourage companies to raise finance through public offerings of securities. In the secondary market, brokers act as intermediaries between buyers and sellers in exchange for a fee. Market makers are dealers who buy and sell securities for their own account, to make a market for customers. Their role is very important to the liquidity of the secondary market. In addition, financial intermediaries can play an important role in the growth of the capital market through education of potential investors and programs to promote ownership of securities.

In many developing countries securities intermediaries are inadequate. Often, LDCs have few if any viable investment or merchant banking firms. The financial sector is generally dominated by commercial banks that play a relatively small role in the capital market, since their lending activities are primarily short-term oriented. In addition, in countries with a Glass-Steagall type of banking system, commercial banks are not allowed to engage in underwriting activities. Other common problems include:[17]

17 Reilly, in "ADB Symposium," pp. 178-179.

- Inadequate capitalization

In many LDCs, brokers are under-financed individuals, rather than properly capitalized firms with branch offices to serve customers and generate business throughout the country.

- Inadequate training

Often, brokers have little if any training in financial analysis. As a result, they cannot provide investors with sound financial advice and generally act solely as "introducers" between clients, and take no responsibility for securities transactions.

- Absence of market makers

In some countries, there are no market makers who will buy and sell securities for their own account and in so doing provide liquidity for the secondary market.

- Excessive or inappropriate regulations

In some countries stock exchange regulations or laws may prohibit brokers from engaging in related activities (such as underwriting). In Indonesia, for example, brokers are not allowed to act as dealers or market makers, only as agents for clients.[18] Because of the low level of market activity that prevails in many LDCs, this policy in effect limits profitability and, therefore, the number of brokers. In addition, there may be limitations on selling prices and underwriting commissions and fees, which may encourage abuses such as "free-riding" and insider-trading. "Free-riding" was a common practice in Brazil, for example, in the early 1970s. In fact, it was the largest source of profit from underwriting activities.

The deliberate underpricing of issues and market manipulation that occurs with "free-riding" leads both to a substantial reduction in the amount of proceeds from the offering available to the issuing company and significant losses to public investors. Sooner or later, such practices undermine public confidence.

- Lack of awareness of comparable institutions in other countries

Often there is little information about the role of financial and securities intermediaries in other countries. As a result, the importance of these intermediaries is down-played or regulations are adopted that impede the healthy development of such institutions[19].

18 Reilly, "Indonesia Memorandum," pp. 31-32.
19 George M. Ferris, Jr., "FUMCAP - Securities Aspects: Brazil," 1971, p. 4.

b. Trading Facilities

The purpose of the secondary market is to facilitate trading in already issued securities.[20] Its role is critical to a properly functioning securities market for two major reasons:

- Liquidity

The secondary market provides liquidity, so that holders of securities can sell their securities when they desire;

- Pricing

The secondary market provides a price-determining mechanism, whereby market participants interact to bring together buying and selling interests both for fair secondary market prices and for use in setting prices on new issues of securities in the primary market.

From the point of view of equity market development, these functions are essential because they facilitate mobilization of and access to equity capital for growth and expansion of private business. In the absence of properly functioning secondary trading facilities, there is insufficient liquidity to attract investors, securities can be priced incorrectly, prices can be manipulated, and securities intermediaries can take advantage of inside information and opportunities denied to ordinary investors.

In many developing countries facilities for trading securities must be established for the first time. In some cases an organized market exists, but the facilities are obsolete or lack dynamism. In still other countries, existing market facilities are not subject to adequate standards or safeguards and operate like a private club.

Efforts to correct deficiencies in or establish secondary market trading facilities must deal with the following issues, among others:

(i) Type of Market

A country or company must decide whether the trading mechanism for particular securities should be an auction stock exchange, where all current buy and sell orders represented by brokers are centralized in one physical place or computer system and exposed to each other and market maker interest to produce the best possible price for each order transacted. Or where there is insufficient infrastructure or trading volume,

20 The following discussion on trading facilities is based on Reilly, in "ADB Symposium", pp. 180-185.

purely brokered transactions between customers or an over-the-counter trading market may be the only alternatives.

In Kenya, for example, stockbrokers neither conduct an auction nor buy and sell for their own account. They are simply intermediaries for negotiations between buying and selling customers, occasionally represented by other brokers.

Over-the-counter markets are those in which individual security dealers make their own markets buying securities for or selling securities from their own inventories. At primitive stages of development, over-the-counter markets can result in different prices for the same security at the same time by different brokers. With regulation and fast communication between many dealers by telephone or computer, however, over-the-counter markets can compete with auction markets in pricing efficiency and liquidity.

Both types of markets exist simultaneously in the highly developed securities markets, some physical trading floors, some computer networks, some telephone networks. The United States has both the largest auction and over-the-counter markets: the auction market on the computer assisted trading floor of the New York Stock Exchange, and the over-the-counter market through the automated quotation and trading systems of the National Association of Securities Dealers (NASDAQ).

Typically, an over-the-counter market may be developed to supplement trading on the traditional stock exchange and to attract companies that can not meet the stringent requirements of the stock exchange. In the United States, for example, the over-the-counter market developed because many of the smaller companies could not meet the stringent listing requirements and listing costs of the major exchanges. In other environments, smaller companies not suitable for stock exchange listing and auction trading may be traded as unlisted securities on the Exchange as a second tier. This has been recommended for Kenya, for example.

In some countries, an over-the-counter market is effective in establishing an investor base and a secondary market for a company. According to Mr. Kanju Sugimoto, General Manager of the Nomura Securities Company Limited in Japan, "new issues opportunities and secondary market trading are in a chicken-and-egg relationship." If it is difficult to obtain financing in the equity market because the secondary market is very weak, few companies will want to list their shares. But, with few listed companies, activity in the secondary market cannot pick up. Sugimoto suggests that an over-the-counter market can be used to solve this dilemma. Listing requirements in the over-the-counter market would be less stringent and companies might not be able to obtain the same tax privileges accorded listed firms. However, when the trading volume of such shares became large enough, companies might then move to the stock exchange and comply with its listing requirements.[21]

Recently, the government of Indonesia decided to establish an over-the-counter market in order to supplement trading on the Jakarta Stock Exchange, which has failed to attract new listings since 1984 and has suffered from a very low level of trading activity. The new market will be open to foreign participants and will have less stringent listing requirements than those of the Jakarta Exchange.[22]

(ii) Market Structure

A country also needs to decide whether trading will be required to occur only on the officially recognized trading facility, or whether trading will also be allowed outside the facility, on the "curb". If trading will only be allowed on the official facility, the question then becomes how to enforce this rule.

(iii) Efficiency

An important consideration is how to make trading facilities more efficient, productive and useful for securities professionals and investors. A number of issues need to be considered in this regard, including:

- compilation and distribution of information about transactions in the market such as volume, and opening, closing, high and low prices ("market information");
- compilation, distribution, and analysis of information from issuers of securities traded in the market relevant to buyers and sellers in determining market prices ("corporate information and analysis");
- recognition and deterrence of fraud and manipulation;
- development of improved procedures for trading;
- refinements in clearance and settlement of securities transactions; and
- marketing and promotion to extend securities ownership among the general population.

21 Sugimoto, in "ADB Symposium", p. 55.
22 Intrados Group, *Swaps*, 2, 2 (February 1988), p. 11.

(iv) Government or Private

Another issue is to determine whether the trading facility should be private, with no government involvement, or whether the government should play the primary role in establishing, financing, monitoring, or even operating the facility.

Historically, stock exchanges in most countries were established as private bodies by members wishing to exercise monopoly control over securities trading. As markets grew, the stock exchanges imposed listing requirements, and concerned governments relied on these to protect investors. In addition, many countries, particularly European, imposed restrictions on institutional investors, prohibiting them from investing in unlisted securities. Since the birth of the concept of securities regulation, however, other means of protecting investors have emerged, such as securities laws, disclosure requirements, standard accounting and auditing procedures, among others.

Currently, the stock exchange in most countries still operates as a private body with formal requirements for listing and membership. A securities commission is generally charged with oversight responsibilities. This is not always the case, however. In Indonesia, for example, a government agency, BAPEPAM manages the stock exchange. One important disadvantage to this is that it is difficult for BAPEPAM, as a government agency, to take a profit-making, private sector point of view in operating an exchange. Therefore, in the case of Indonesia, it has been recommended that the BAPEPAM should adopt a more traditional oversight role and allow the private sector to manage the stock exchange.[23]

An intermediate condition existed in Jamaica from 1980 to 1988. The government subsidized the private stock exchange by furnishing a trading room and offices in the Bank of Jamaica and a bank officer and six staff members to administer the Exchange.

(v) Cost

Initial trading facilities in LDCs need not be costly. It is not important to establish elaborate securities exchanges; simple trading facilities can be established that allow flexibility for growth. In Kenya, for example, it was recommended that the brokerage system be converted to an auction market by purchasing a blackboard and renting one member's conference room for an hour each day. In Alexandria, Egypt, the auction trading facility is also a blackboard in a rented room.

23 Reilly, "Indonesia Memorandum," pp. 10-11.

3. Factors Limiting the Supply of Securities

One explanation for the undeveloped nature of capital markets in developing countries is that the supply of securities is very limited. While the lack of a market is also related to the demand for securities, there are some specific reasons why companies are reluctant to "go public". These include the following:

a. Pricing Interference

Government intervention in the pricing of equity issues is one of the major impediments to companies going public. The price at which a company can sell its shares is a very important consideration as it determines whether the cost of capital raised through the equity market is economically attractive or not. In some LDCs, the government might fix the price at which companies and controlling shareholders can sell their shares based on the notion of "par value". In other cases, the LDC government might establish an issue price on the basis of book value, without adequately taking into account current or future earnings potential. In developed markets the price of a share is established in negotiations between the underwriter and the issuing company, and relies heavily on the underwriter's assessment of what the market would be willing to pay given the earnings record and other characteristics of the company.

Government involvement in the pricing of public issues occurs in most developing countries. One typical example is Kenya, where the government, through the Capital Issues Committee, plays a major role in the pricing of issues in an effort to "protect" the unsophisticated buying public.[24] Unfortunately, this places the government in an undesirable position of appearing to be "recommending" an issue at a particular price. In addition, if the issue is underpriced, it may encourage "free riding" by the financial intermediaries. "Free riding" is a practice whereby the middleman or underwriter of an issue, knowing that the issue is underpriced, buys most of the shares for his own account and issues only a few shares to the public. The middleman then sells his holdings when demand pushes prices up. This provides a substantial profit for the underwriter, but penalizes the public who paid the higher price and the company which received a lower price for its shares.

Another example is Malaysia where companies are only allowed to issue shares at prices ranging from four to eight times their pre-tax earnings. According to Dato Malek Merican, Managing Director of the Arab-Malaysian Merchant Bank Berhad, shares

24 George Ferris, Jr., "Kenya: An Action Plan for Capital Market Development and Capital Mobilization," Report Prepared for Arthur Young under contract with the Agency for International Development (April, 1987), p. 9.

are systematically underpriced, increasing the cost of going public and encouraging considerable oversubscription of shares. As a result, an elaborate balloting system is required to select the successful applicants, "many of whom will sell their shares at considerable capital gains within a few weeks of the public listing."[25]

Indonesia presents still another example of government interference with market pricing. There, the national investment and unit trust fund, Danareksa, is said to "encourage" companies issuing public shares on the Jakarta Stock Exchange to set low prices.[26] As a result of these and other practices, only 24 companies have listed shares on the Jakarta Stock Exchange since 1977 and there has been no new stock issue on the exchange since 1984.

b. Tax Biases/Disincentives

The supply of securities is also diminished if tax policies make the cost of raising equity funds more expensive than debt finance. Interest on debt, for example, is generally tax-deductible to a corporation, while dividends on shares must be paid out of after tax profits. In addition, stamp duties and other transaction costs are frequently high and discourage the transfer and trading of securities. Excessively high taxes on the capital gains arising from the sale of shares also impede secondary market activity as controlling shareholders prefer to retain their shares and take out profits in dividends or illegal payments.

Tax biases against investment in securities and in favor of deposits in banks also force companies to rely on borrowing from domestic banks or other sources rather than issuing bonds or selling equity interests. When interest received from bank term deposits is tax free, and dividend income is taxable, which is frequently the case in developing countries, banks can obtain funds from depositors at lower rates than companies can obtain such funds through the issuance of securities. The situation is further complicated when one considers that in many developing countries, particularly in those with new or relatively inactive markets, investors are more interested in receiving dividends than in the capital gain from share appreciation. As a result, in order to be competitive with the banks, publicly-listed companies must offer dividend rates that are equivalent to the after-tax interest rates paid by the banks. In these instances it is less costly for firms to borrow from banks than it is to issue equity or debt securities in the market. According to the Asian Development Bank (ADB), for example, the 1983 dividend pay-out ratio (total annual cash dividends plus any pay-

25 Dato Malek Merican, in "ADB Symposium," p. 136.
26 Reilly, "Indonesia Memorandum," p. 136.

ments on preferred stock divided by annual company earnings) for 19 listed companies in Indonesia ranged from less than 60 per cent to 120 per cent. According to the ADB, some publicly-listed companies paid more in dividends than they gained in profits, a situation that diminished the capital base of the companies.[27]

In many countries tax laws are poorly administered and tax requirements are not enforced rigorously or uniformly. As a result, companies may be reluctant to go public because they are afraid that financial disclosure, required for public offerings, will lead to increased tax assessments by the fiscal authorities.

c. Inadequate or Restrictive Laws and Regulations

Company law is central to the establishment and operation of companies, and the issuance of securities. For this reason, it is generally regarded as the most important law with regard to securities market development. The Asian Development Bank, among others, has found that in many developing countries company laws are usually very rigid and require substantial reform.[28]

Some of the most common problems for securities market development posed by company laws in developing countries include the following:[29]

- Impediments on the potential for securities market development, including restrictions on incorporation without specific approvals and on the issuance of securities, limitation of the public offering price to "par value", restrictions on new share issues to rights offerings, allowance of partially-paid shares and founders shares, restrictions on the issuance of corporate bonds and debentures, cumbersome share transfer requirements, and impediments on the issuance of more innovative instruments such as convertible bonds, warrants, and options.
- Lack of clear definition of the legal position of certain types of activities such as investment and merchant banking activities, leasing, and venture capital.
- Lack of adequate provisions for proper market functioning such as disclosure of material information about companies.

27 Asian Development Bank, *Capital Market Development in Selected Developing Member Countries of the Asian Development Bank* (1985), p. 45.
28 ADB, *Capital Market Development*, pp. 68-69, and Reilly, in "ADB Symposium", pp. 186-187.
29 Reilly, in "ADB Symposium", pp. 186-187 and ADB, *Capital Market Development*, p. 69.

- Inappropriate protection for securities holders. This refers to majority control of all actions without due protection of the rights of minority holders.
- Lack of appropriate enforcement powers and sanctions.

Laws and regulations that stifle the formation and expansion of private sector companies also effect the number of potential issuers of public shares and, therefore, the supply of securities. In many developing countries, extensive approvals for set-up or expansion of private firms are required and the registration process for a public offering of shares is often cumbersome and time-consuming, and can discourage companies from going public.

A common problem also arises because laws and regulations are inadequately enforced and there is wide discretion in the actual application of such laws. Tax rates, for example, might differ from those set by law. In addition, unauthorized and *ad hoc* concessions, and noncompliance with government laws and regulations, can be widespread. For the private sector, inadequate or inconsistent enforcement of laws and regulations creates considerable uncertainty, and uncertainty increases the risks of doing business. In these instances the "rules of the game" become obscured as decisions tend to be made on a case-by-case basis. Opportunities for corruption increase, and enforcement of rules might be subject to pressure from special interest groups. Moreover, conscientious and uniform application of tax laws is an important consideration in the decision of private companies examining the advantages of going public.

Another problem arises because prevailing laws and regulations are based on legal systems, such as the Napoleonic Code, developed in other countries in earlier periods. As a result, laws may restrict unduly the activities of the private business sector, and even conflict with objectives to develop a securities market. [30]

In Indonesia, the Commercial Code is written in Dutch and has remained virtually unchanged in nearly 50 years. To make matters worse, the number of Indonesians who read and write Dutch decreases every year.

In contrast, financial authorities in Amman, Jordan have used company law to stimulate the supply of securities by requiring that all companies wishing to have limited liability status must go public. According to some experts, this was a major factor in the development of the securities market in Jordan in the 1970's.[31]

30 Reilly, in "ADB Symposium", pp. 186-187.
31 Gill, "Some Thoughts on the Implications of Different Financial Institutional Structures on Securities Market Development," p. 36.

d. Reluctance to Share Control Due to Inadequate Protection of Property Rights and Contracts

In many developing countries the heads of family-owned enterprises are reluctant to share control with the public or with entrepreneurs outside the family because the legal system fails to provide adequate protection and enforcement of property rights and contractual obligations. The work of Hernando de Soto and the Instituto Libertad y Democracia in Peru has been particularly enlightening with regards to the costs of such legal impediments. De Soto has found that the failure of the legal and institutional infrastructure to guarantee property rights and contracts results in an inefficient organization of production and limits the rate of economic growth.

Similarly, inadequate laws affect the willingness of owners of private firms to go public. In Bangladesh, for example, it has been found that reluctance to dilute family ownership and control is one of the major impediments to going public. Frequently, even when the company is listed on the stock exchange, few shares are available for trading because most continue to be held by the original owners. Moreover, according to Khursid Alam, former Chairman of the Dhaka Stock Exchange, "even when shares are floated in the primary market on a 50:50 basis", the initial sponsors frequently buy additional shares on the market to increase their holdings to about 70-80 per cent. This attitude is largely blamed for the limited availability of shares and the low level of trading in the secondary market.[32]

In a recent study, the Asian Development Bank found that even when a company is publicly listed, the majority of its securities are closely held by the original owners, relatives or friends. The controlling shareholders, usually the founders, often prefer to finance the company from internally generated funds or bank loans (possibly through banks that they control). According to this study, the percentage of "closely-held" shares in several Asian countries frequently amounted to 60 to 85 percent. This constitutes a major impediment to the trading of securities in the secondary market.[33]

4. Factors Limiting the Demand for Securities

Insufficient demand for securities is a common deterrent to growth of equity markets in developing countries. Some of the same factors that constrain the supply of securities, such as tax biases and inadequate laws and regulations, also diminish the demand for securities. In addition, the level of financial sophistication in most developing countries is generally low, and a large portion of the population might not use banks, much less a broker, to invest what little savings they have. In The Yemen Arab

32 Khursid Alam, in "ADB Symposium", pp. 127-131.
33 ADB, *Capital Market Development*, p. 44.

Republic, for example, over 60% of the money supply is in the form of cash outside the banking system. In addition, savers often lack confidence in the financial and political stability of the country, and thus require almost instant liquidity.

In many developing countries, ownership of securities is concentrated in a small, wealthy segment of the population. In contrast, the vast majority may hold cash or invest in jewels, land, cattle, and other "hard" assets. In these countries, cultural considerations as well as economic factors affect the choice of investment vehicle. For this reason, efforts to develop equity markets should first consider how cultural factors affect the allocation of savings in a particular country and how these factors may impede changes in the traditional pattern of savings.

The most typical impediments to the growth of demand for securities are:

a. Tax Biases/Disincentives

Tax policies represent a powerful tool with which to influence the allocation of savings between different types of financial instruments. In most countries, tax policies encourage deposit of savings in banks or investment in government savings programs. Dividends, on the other hand, frequently are taxed twice, once as corporate income, and again as shareholder income. This situation is particularly damaging to equity market growth in countries such as Egypt, Kenya, Indonesia, and Sri Lanka, among others, where most investors are yield conscious and do not think in terms of total return (income plus appreciation). Under these circumstances, if tax policies place dividends at a comparative disadvantage to other forms of interest income, such as interest earned on bank deposits, postal savings, and housing bonds, the demand for securities is severely restricted.

b. Insufficient Demand from Financial Institutions

In many developing countries, portfolio composition requirements are imposed on collective and contractual savings institutions, stipulating that a certain minimum percentage of total assets must be invested in designated financial instruments. Often, governments require institutional investors, such as pension funds and insurance companies, to invest a certain percentage of their funds in low-yielding government securities. Moreover, pension funds (both private and public) are frequently barred from investing in corporate securities either through regulation or tax treatment, and insurance companies usually are subject to similar restrictions or are limited to investing only a small percentage of their funds in corporate securities. Such requirements restrict the demand for corporate securities and, therefore, the amount of financial resources available to private sector business even when these securities offer higher yields. In addition, because mutual funds and other types of investment trusts are non-existent in many LDCs,the demand for securities remains at a low level.

c. Lack of Investor Confidence

Growth of equity investments is also constrained by lack of investor confidence in this form of investment. This lack of confidence stems primarily from: distrust of corporate managers; fear of market manipulation; absence of adequate financial information about companies; inadequate accounting and reporting standards; lack of financial sophistication; and fear of government expropriation or irrational regulation of business.

In Bangladesh, for example, the Company Law of 1913 stipulates very little disclosure of financial information. As a result, according to Khurshid Alam, Former Chairman of the Dhaka Stock Exchange, there is a lack of investor confidence that has contributed to a low demand for securities and has restricted the growth of the capital market.[34].

d. Inadequate Accounting and Auditing Standards

Deficiencies in accounting and auditing procedures can affect both the demand for and the supply of securities. On the demand side, inappropriate accounting and auditing standards discourage savers from investing in securities because they cannot obtain accurate information about the financial position of companies. On the supply side, companies may be reluctant to go public for fear that financial disclosure will result in higher taxes to the company. There is an unfortunate dilemma created in those instances where public companies are audited appropriately while private companies are able to evade taxes.

Uniform and professional accounting and auditing procedures are central to the efficiency and effectiveness of resource mobilization and allocation through the securities market. If adequate accounting, auditing and financial reporting practices are inadequate, it is not possible to ascertain the true financial position and profitability of companies. As a result, resources can be misallocated and investors can be misinformed. Moreover, in the absence of uniform reporting requirements and generally accepted accounting principles, investors cannot draw reliable comparisons among different firms. Yet, in many developing countries, financial statements are not governed by legally binding generally accepted accounting principles (GAAP) and audits are not conducted in accordance with legally binding generally accepted auditing standards (GAAS).[35] Some common problems include:

34 Khursid Alam,in "ADB Symposium", p. 127.
35 The following discussion is based on Reilly, in "ADB Symposium", pp. 181-182 and ADB, *Capital Market Development*, pp. 52-53.

- auditors are not independent of the companies they audit;
- businesses maintain two sets of books, one for the owners, and one for the tax authorities;
- there is no professional body of accountants and auditors to develop uniform principles and standards and to license and regulate professionals;
- there is no private or government authority with the power to impose duties and standards;
- there is a lack of criminal penalties for false certification by auditors.

e. Restrictions on Foreign Portfolio Investment

Foreign portfolio investment has become an increasingly important issue in capital market development, particularly in light of the debt crisis and the subsequent decline in commercial banking loans to developing countries. As noted in Chapter II, the International Finance Corporation has played an important role in recent years in the establishment of international mutual funds, unit trusts, and other collective investment mechanisms which have contributed to the internationalization of securities markets. Unfortunately, a number of developing countries still place significant restrictions on foreign portfolio investment which limit the demand for domestic securities.

The Malaysian, Chilean, Thai, and Philippine markets, for example, are relatively open to foreign investment, and Brazil, India, Taiwan, Korea, and Mexico are accessible through a variety of investment funds. By and large, however, there is still considerable resistance among LDCs to opening their securities markets to foreign investors. The most common impediments imposed are tax and regulatory barriers, including strict limits on repatriation of income, prohibition of majority ownership by foreigners, maintenance of high capital gains taxes, and foreign exchange restrictions.[36]

The most common arguments used against foreign portfolio investment are primarily three:

- It may bring in "hot money", implying that foreign investors might withdraw their capital suddenly and cause instability in national securities markets;
- It may allow foreigners to gain "control"; and
- It may allow foreigners to make profits at the expense of nationals.

36 Intrados Group, *Swaps: The Newsletter of New Financial Instruments*, Vol. 2, No. 2 (February 1988) pp. 7-8.

These same arguments, however, can also be used, and have been used, against direct foreign investment. Moreover, the above concerns can be dealt with through laws and regulations. The risk of "hot money", for instance, can be addressed by limiting foreign portfolio investment to closed-end or partially closed-end investment trusts. This has been done in Mexico, Korea, and Brazil, among other countries. Another way to deal with the "hot money" risk is to specify which instruments foreign portfolio investors can buy and to place a fixed upper percentage limit on total equity available to foreign investors. In Argentina, for example, aggregate portfolio investments may not exceed 20% of a company's share capital, and total foreign investment may not exceed 49% of share capital. The issue of control can be dealt with through such measures as limiting the maximum voting rights of individual foreign shareholders.[37]

37 David Gill, "The Interdependence of National Securities Markets," Paper presented at the 9th Annual Conference of the International Association of Securities Commissions and Similar Organizations (Toronto, 1984), pp. 46-49.

CHAPTER IV:
A.I.D. Policy and Action Options for Capital and Equity Market Development

Chapter IV

A.I.D. POLICY AND ACTION OPTIONS FOR CAPITAL AND EQUITY MARKET DEVELOPMENT

Despite the growing emphasis in its strategies and country development objectives on assisting activities leading to market-led growth, the policies and technical resources of the Agency for International Development have not kept pace with the rapidly increasing interest among developing countries in shifting more responsibility for economic growth to the private sector. This chapter of the report examines the current policies and capacities of A.I.D. to respond to this nearly universal shift in approach to development. It presents observations and recommendations for consideration by the Agency in selecting strategies and approaches for development of capital and equity markets in A.I.D.-assisted countries.

A. Policy Considerations in Supporting Equity Market Development

Agency policies related to equity market development are stated in the comprehensive guidance included in the policy paper on "Financial Markets Development" recently (8/88) promulgated by A.I.D. In addition to establishing policies that are intended to make A.I.D. credit assistance programs more effective, the paper encourages country development efforts that promote the expansion or "deepening" of financial markets. Missions are encouraged to support revisions in policies and regulations that constrain financial market development, and to "consider postponing initiation or replenishment of financial market activities until evidence exists that the host government is prepared to improve the policy environment."

A.I.D.'s policy on financial market development also requires that Missions develop a comprehensive financial market development strategy prior to or concurrent with engaging in additional financial market assistance activities. It is expected that the strategy statement will present a comprehensive description of the constraints to market development resulting from inappropriate policies and institutional dysfunction, as well as define the course of action that the Mission proposes to follow in working with the LDC government to reduce or overcome these constraints.

With regards to equity market development specifically, the policy paper notes that equity financing is an important alternative to debt financing, and that "sustained effort" to develop equity markets may be appropriate in a number of A.I.D.-assisted countries. In addition, the policy paper emphasizes that expansion of equity markets may provide important opportunities for greater popular participation in the economy through wider distribution of ownership of economic assets.

1. Requisite Conditions for Development Efforts

While all LDCs would benefit from development of their financial markets and a shift in responsibility for economic growth from the public sector to the private sector, the limited A.I.D. resources available for this activity necessitate an emphasis on countries that are likely to benefit the most. Although there are exceptions, this group is comprised of the 10-15 countries with the largest A.I.D. assistance programs. Within this group, the *single* most important criteria for undertaking an effort to assist in promoting growth of capital and equity markets is a high degree of access to senior LDC government officials. The issues surrounding fiscal and monetary policies are generally so charged with political and social concerns that only access to the real decision-makers in LDC governments can bring about some of the fundamental changes that often are required to promote capital and equity market development.

Of almost equal importance as a condition for providing assistance to promote capital market development is the capacity of the USAID Mission to support these activities. Short-term technical advisors are available to assist USAIDs in the development of policy dialogue agenda, and to participate in the dialogue once joined. However, it is essential that the Mission have sufficient personnel and other resources to be able to maintain the dialogue and to organize the assistance required to carry out the actions agreed to as a result of the policy dialogue.

a. Policy Environment

Previous chapters have emphasized the importance of the environment created by LDC government policies and regulations in promoting or retarding the growth of financial markets. In particular, the report has noted that most LDCs have failed to experience the development of financial markets that characterizes the industrialized countries because of policies that are inimical to the growth of private enterprise, and because of excessive intervention in market activities.

While in recent years a growing number of LDC governments have expressed their commitment to private sector initiatives and have recognized the importance of freeing markets in order to mobilize domestic capital, it is unrealistic to expect that it is only necessary to point out the impediments to growth created by these policies to bring about the necessary policy and institutional reforms. In most instances, these policies were established with very specific objectives in mind, and to address conditions that at the time the policies were crafted were seen as obstructing growth. Moreover, economic policies, laws, and regulations were often designed in response to pressures from powerful interest groups, or as a result of ethnic considerations or strategic concerns. Consequently, many LDC governments are limited by political and other considerations in what they can change and in how rapidly they can institute the reforms required for development of domestic capital markets.

Some of the concerns of the policy-makers are still valid. Capital flight, for example, continues to be a problem for countries that confront political turmoil and have not made their own investment climate sufficiently attractive to local investors. A commonly encountered defense employed by LDC governments to counter capital flight is to offer high interest rates, usually coupled with freedom from taxes, for bank time deposits. Yet, this practice stifles development of the capital market because of the unrealistically high yields that the market must provide to compete with the earnings on bank deposits.

A similar situation exists in countries with a large non-indigenous population that has achieved a dominant position in the economy. These countries typically pursue policies that are designed to curtail further dominance by this group, and that are in some instances, explicitly discriminatory. Unfortunately, these policies are usually only moderately successful in avoiding further concentration of wealth, but they are usually very effective in deterring growth of the financial markets that could help to bring about a wider distribution of wealth.

The challenge confronting A.I.D. in seeking to bring about greater mobilization of capital through the securities market lies in targeting those countries with the largest assistance programs and the greatest potential for policy and institutional reform. For example, no amount of traditional project assistance is likely to increase the number of companies going public, or the number of investors willing to buy corporate shares in the market if tax or other policies discourage these activities, or if political conditions are highly unstable and turmoil is widespread.

Among the targeted countries, the task of the Missions is to design projects that adequately address policy reform requirements, as well as the more traditional components of technical and commodity assistance. Policy dialogue is clearly indicated as a means for achieving policy reform, and Missions should include it as a distinct component of the project activities. Moreover, serious consideration should be given to including policy reform as a condition precedent to entering into the Project Agreement, or at least providing for amendment of the Agreement to provide for commitment of additional resources if key policy revisions are implemented. Unfortunately, project assistance often affords Missions only a limited degree of leverage with the host government, and may result only in marginal improvements in the policy environment.

b. Accessibility to Senior Officials

Policy dialogue, if it is to bring about the reforms that are prerequisites to achieving market-led growth, must address the range of economic, legal, and regulatory impediments described in previous sections of the report. Progress toward achieving the necessary reforms can only be expected to be slow and to require a sustained level of dialogue with LDC government officials. The USAID, in undertaking efforts to promote development of the capital market, must be assured of ready access to LDC senior policy makers to discuss the effects of policy reform and the restructuring assistance that might be required to complement these reforms. In the absence of obtaining such access to senior officials of the host government, the Mission runs the risk of devoting resources to an effort that is likely to be seriously hampered by existing policy deficiencies even among the targeted countries.

2. The Need to Encourage Reliance on Equity Financing

While equity financing is recognized as preferable to credit financing to meet long term capital needs, the majority of equity financing in LDCs is provided by family groups, or by companies that are held by a small group of businessmen. The reluctance of LDC companies to rely on public offerings of shares to raise capital is often the result of both cultural and economic concerns. Entrepreneurs, in industrialized as well as in developing countries, are often reluctant to share ownership of their companies with outside parties. However, the concept and the benefits of selling equity in a company are not well recognized in many developing countries and might even run counter to traditional cultural practices.

An appropriate role for A.I.D. is to encourage reliance on equity financing by making available educational materials and information on the benefits of equity versus debt financing, and by promoting, through the policy dialogue process, reform of tax and interest rate policies that make debt finance more attractive than equity.

3. Importance of Promoting Public Interest

It is generally recognized that most individual and institutional investors in LDCs are yield rather than capital gains oriented. This is understandable both in terms of the well-developed traditions of relying on banks for savings investments, and the concerns with political stability that add to the risk of holding securities for appreciation rather than just for dividends or interest.

Promoting public interest in securities is an important consideration in the sense that it provides an opportunity for wider ownership of local enterprises and joint ventures. Often, policymakers in developing countries are concerned that privatization through public offerings of shares may result in greater concentration of economic power in the hands of a small segment of the population. This was a major concern, for example, in the privatization of the National Commercial Bank of Jamaica. Hence, promoting public interest in securities investments to achieve a broader and more diversified distribution of share ownership is an important consideration in equity market development efforts.

Considerable progress toward developing investor interest can be accomplished by increasing the flow and accessibility to information on share prices and trading volume. In addition, it is necessary to organize promotional and educational campaigns to increase the level of interest and understanding of investment in securities. This is an obvious instance in which the USAID can provide considerable assistance to LDC efforts to promote widespread participation in ownership of local and joint-venture firms.

4. Importance of Designating a Central Capital Market Development Authority

As discussed in Chapter III, in many developing countries the responsibility for supervision and development of a capital market is segmented among different government agencies with the result that policies and regulations may be duplicative or conflicting. For this reason, it is generally recommended that the government designate a central capital markets authority or working group to formulate an action plan for capital mobilization and market development, and to act as the central point for analysis and discussion of capital market growth issues. Such recommendations have been made in a number of countries, including Indonesia, Kenya, and Portugal.[38]

The setting up of a central capital markets authority or committee permits a coordinated approach by bringing together available expertise and knowledge. Generally, it is recommended that representatives of the private sector, including merchant bankers and brokers, and officers of publicly traded companies, be allowed to participate directly through these committees to provide information on how the securities market works and what companies and investors need in order to participate actively in the market. Representatives of institutional investors should also be allowed to participate. Appointment of a central capital markets commission will also make clear the government's commitment to development of the capital market.

B. Resources Available to A.I.D.

All of the resources currently available to A.I.D. are appropriate for assistance in developing capital and equity markets. Over the course of carrying out a comprehensive program of capital market development it should be expected that use would be made of every form of assistance that A.I.D. can offer. The types of activities that are appropriate for the two major types of assistance, technical and financial, that A.I.D. provides are described below. This section also addresses the importance of developing A.I.D. expertise in equity market development, and the potential role of joint and cooperative activities with other donor agencies in formulating policies and programs to promote development of capital markets.

38 Reilly, "Indonesia Memorandum," pp. 9-10, and Ferris, "Kenya," p.5.

The level of assistance resources available to the USAID is also an important consideration in the decision to pursue capital market development. Resource requirements for this development activity are usually lower than those for other sector development programs because they typically do not include large commodity components. Nonetheless, the technical assistance, training and grant requirements that are identified as key to successful accomplishment of the goals of the policy reforms enacted by the LDC government can be significant. Little can be achieved by providing technical assistance in a piecemeal fashion, and the USAID should be prepared to make a commitment to a comprehensive program if it determines that an opportunity exists to promote development of capital and equity markets.

The types of assistance that are appropriate for use in the development of capital markets include all of the resources currently available to A.I.D. Economic Support Funds (ESF), when available, and technical assistance are likely to be the major sources of assistance in the initial phase of the USAID's efforts to promote capital and equity market development. The l vel of funding generally available under ESF programs usually provides the Mission with more leverage in its discussions with LDC governments than other forms of assistance. Technical assistance, whether provided through existing projects or through Project Development and Support (PD&S) activities, will probably be required to develop an agenda for policy dialogue, present proposed policy reforms, and assist in implementing the various revisions negotiated through policy dialogue. Loan assistance and training might also be required to reduce temporary adverse effects associated with policy restructuring.

1. Financial Assistance

Design and implementation of the activities directed at promoting development of capital markets will most often be accomplished through projects which provide both financial and technical assistance. The use of financial assistance in the policy dialogue process and in the development of conditionality is described below. The applicable forms of technical assistance are discussed in the following section.

a. Policy Dialogue and Conditionality

It should be expected that virtually all capital market development activities will begin with policy dialogue. As discussed in previous chapters, the political, economic, and frequently, the social issues responsible for the current state of market and business conditions are often complex and highly volatile. Financial assistance, especially in the form of program assistance, provides USAIDs with important opportunities for engaging in policy dialogue with LDC government officials and for obtaining government agreement on the set of policy and regulatory reforms required for capital market development.

Because the level of funding provided under ESF programs is generally greater than that of other forms of assistance provided by A.I.D., they are the most effective and most commonly used mechanism for establishing conditionality in negotiations with LDC governments. ESF assistance, however, should not be regarded as the only source of assistance that permits the use of conditionality. Although rarely applied, conditionalities should be set in negotiating project designs and agreements with LDC governments when the project enjoys a high priority with the government. While the ultimate objective of conditionality is reform of the policies and regulations that inhibit capital market development at the macroeconomic level, project conditionalities in support of policy reforms at the microeconomic level can have an important demonstration effect.

In complying with the recently promulgated policies on financial market development, USAIDs should include in their development strategy statements a list of the major policies and practices that the USAID views as barriers to growth in the LDC. Once these constraints are identified, Missions should be prepared to withhold approval of new or expanded assistance efforts to bring about desired policy reforms included in the strategy paper. In other words, the list of policy reforms and other proposed actions serves as an inventory of projects to address these development targets, and as subjects of conditionalities that might be attached to program and project assistance to LDCs.

b. Increasing the Leverage of Financial Assistance

The regulations governing financial assistance provided by A.I.D. limit the support that can be provided to capital market development activities to institutional strengthening primarily. For example, A.I.D. is prohibited from taking an equity position in an enterprise or capitalizing an entity in any direct way. For the most part, this suggests, at least under current policies, that A.I.D. leave the formation of investment funds and direct participation in private ventures to other donors and the private sector. Loan assistance for activities in other sectors that are of interest to the LDC might be tied to conditionality requirements affecting the financial sector. This could be a particularly effective approach in that the size of loans made to other sectors are likely to be considerably larger than those required for development of capital market activities.

In general, A.I.D. is not able to provide the large ($100 million and above) loans to LDC governments that are more typical of the World Bank and the regional development banks. As a result it frequently is not in a strong position to impose the conditions that the major international lenders include in their loan agreements to achieve desired reforms. While the availability of ESF assistance, however, does provide A.I.D. with some leverage, the amounts involved often are small relative to the resources provided by other donors. For this reason, as will be discussed later in the chapter, joint and cooperative agreements with other donor agencies can increase the relative leverage of A.I.D. in imposing on the LDC government the conditions necessary for development of domestic capital markets.

Unfortunately, the unfavorable comparison of relative leverage tends to create reluctance on the part of USAIDs to exploit the advantage that is provided by ESF and other resources available to the Mission. Nevertheless, ESF assistance has been used to apply conditionality in a number of countries, including Jamaica and Costa Rica, and Missions should be advised to examine the lessons learned from those experiences.

2. Technical Assistance

In the early stages of providing assistance in the development of capital markets, there is likely to be considerable need for technical assistance. This assistance might be provided by A.I.D. personnel or through institutional contractors and individual consultants. The nature of these technical assistance activities and potential sources of assistance include the following.

a. Assistance in Assessing Capital Markets and Developing Policy Dialogue Agenda

As mentioned earlier, A.I.D.'s recent policy paper on "Financial Markets Development" requires USAIDs to develop a comprehensive strategy for financial market development prior to or while engaging in financial market activities. In developing this strategy, it is important to conduct a comprehensive assessment of the status of the existing capital markets in an LDC prior to initiating the policy dialogue process. The purpose of the assessment is to identify those conditions that are hampering development of the indigenous markets, and the actions that are necessary to improve the climate for capital market and private enterprise development. This assessment would provide the agenda for the policy dialogue to follow.

Technical assistance may be appropriate both in conducting the initial assessment and in implementing the policy dialogue process. Addressing the issues identified in the assessment as barriers to capital market development will require protracted discussions and reference to solid examples of success attributable to the types of reforms being proposed. When appropriate, outside experts should be included in the discussions with the LDC government, both to assist in making the necessary arguments and to assure the LDC government of the level of expertise that is available to assist in implementing the actions proposed.

In addition, there would be considerable value derived from reviewing this proposed agenda with other international donors and developing a unified approach for the policy dialogue as well as the offers of assistance that might follow. For example, country representatives of the other donors might participate in the policy dialogue sessions as the first step in the coordination of activities to promote equity market development. This approach would reduce the tendency of LDC governments to deal with each donor independently and to accept overlapping assistance from several sources.

b. Assistance in Implementing Policy and Regulatory Reforms

Although ESF assistance can provide significant incentives for change to LDC governments, particularly in those countries in which A.I.D. might be the major donor, adequate attention should be devoted to addressing the structural relocations that might result initially from enactment of the reforms. This is also an instance in which a comprehensive assessment of conditions affecting capital market development can be useful in identifying the consequences of policy and regulatory revisions. The steps and actions necessary to achieve an orderly adjustment to the new conditions could be the subjects of assistance provided through other resources of the USAID, or even other donors.

Whether or not a comprehensive assessment of the financial sector is conducted, the USAID should provide technical assistance to the LDC government in analyzing current conditions and developing the appropriate approaches to implementing changes. This assistance can be provided by USAID or AID/W personnel or outside consultants.

c. Assistance in Project Implementation

While it is difficult to generalize about the nature and level of technical assistance to be provided in support of capital market development projects, most likely it will include both long-term and short-term assistance.

Long-term assistance is important in providing continuity and in maintaining momentum toward achievement of the project objectives within the LDC government. The principal long-term advisor also frequently provides effective liaison between the LDC government and A.I.D. While the role of the lead long-term advisor is vital to management and technical direction of the project, it is preferable not to rely on this individual for policy dialogue and negotiations with LDC officials related to critical aspects of the project. Short-term assistance involving senior practitioners, preferably with international standing, should be brought in to participate in these critical dialogues. Experience has shown that long-term advisors, no matter how highly qualified, tend to lose their effectiveness with LDC governments with the passage of time. On the other hand, advice delivered by a recognized expert brought in by the project just to address the specific issue has been found to have a more positive effect in some cases than the same advice from someone who is always available to the government.

d. AID/W Financial Market Assistance Mechanisms

There are several sources available to USAIDs for obtaining short-term and long-term assistance in carrying out capital market development activities. The Bureau for Program and Policy Coordination (PPC) and each of the Geographic Bureaus, i.e. LAC, AFR and ANE, have contract mechanisms that enable them to provide personnel and related support for conducting assessments or developing projects. The Bureau for Science and Technology (S&T) manages a number of projects, including a long-term project on Experimental Approaches to Rural Savings, that supports research related to financial sector activities. A follow-on project, The Financial Resources Management Project (FIRM), will broaden the project's current scope to include research on informal financial markets.

The Bureau for Private Enterprise (PRE) currently manages a Financial Sector Development Project (FSDP) established specifically to provide assistance in designing and carrying out projects and related activities leading to increased mobilization of domestic capital. This project is a follow-on of the Financial Markets Development Project (FMDP), which over a three-year period provided a wide variety of technical expertise related to the formation and operation of financial markets in over 25 countries. The new project has been designed as a means for implementing key aspects of A.I.D.'s policy guidance on financial market development. The principal components of the project are:

- Strategic Planning: This component is designed to assist USAIDs in the development of financial sector strategies.
- Technical Assistance: Through USAIDs, the project will assist LDCs in the design and implementation of financial market projects.
- Research and Development: This component aims at promoting applied research on financial market development. As of the writing of this report, this R&D component has not been activated.
- Dissemination: The objective of this component is to disseminate information on financial market activities through seminars, conferences, and publications.

Assistance can be provided under the project through Mission buy-ins to cover the entire cost of the assistance or on a cost sharing basis that can be negotiated with the PRE Bureau.

e. Seminars and Training

Properly designed seminars and training programs can be very useful tools for assisting in the development of capital markets. As a minimum, capital market development projects should include a training component that will permit appropriate LDC officials to visit and observe financial market operations in countries that are comparable to their own country, but are further along in the development of their markets. While many LDC officials express an interest in observing the operations of the New York and other stock exchanges in the United States, there is often more to be gained in visiting countries with market operations closer in scale to those of the LDC. A.I.D. should also consider alternative means of training, including educational video tapes, cassettes, and correspondent courses.

Drawing from the conditions and practices in the U.S. or other countries that more closely parallel conditions in the host country, the seminars should cover, as a minimum:

- central bank role and effects on stock and bond markets;
- securities law and regulation;
- underwriters and the underwriting process;
- trading and handling orders and depository trusts;
- fixed income securities and money markets;
- options and futures;
- investment analysis.

It is important that operation of the market and regulation of the market be treated separately in the development of seminar and training programs. It is frequently the case that LDC governments will want to have responsibility for both the regulation and the operation of the stock exchange. Regulation of the market is an appropriate government responsibility. Operation of the market is not. Nevertheless, even in the area of regulation, a high degree of assignment of regulatory responsibility by government to banking and securities self-regulatory institutions has proved more effective than government regulation alone in a number of countries. Thus, assistance can be provided in developing these separate functions by working with financial intermediaries (bankers, underwriters and dealers) and their professional staff (including lawyers and accountants) who will be members of the exchange and responsible for its operation. This group should be assisted, if necessary, in developing a code of ethics and the various rules and practices that will govern their activities. Technical assistance and training can be provided by individual experts from the United States and other industrialized countries.

Regulation and effective enforcement are both key to the successful operation and development of equity markets in LDCs. One of the most difficult tasks that confront LDC capital market regulatory agencies is enforcement of financial disclosure requirements. Little hope can be held out for development of a viable equity market, if investors have no faith in the reliability of financial statements submitted by firms in filing for registration with the regulatory agency, or as part of the annual reporting process.

Many LDCs will find it necessary to improve the quality of training provided for accountants, and to establish or raise the standards for certification of these personnel as part of the process of establishing more stringent enforcement of financial reporting. Industrialized countries subject accountants that falsify financial statements to criminal prosecution. There are very few sanctions, if any, to prevent this practice in many LDCs. Considerable opportunities exist for USAIDs to assist local universities and the professional associations to improve the skills and the standards of the accounting profession. This assistance, combined with assistance to the regulatory agency in identifying trading and other practices that threaten the integrity of the equity market, could do more to spur the growth of the equity market than perhaps any other single activity.

3. Coordination with Other National and International Agencies

Coordination of the activities of other international donor agencies with A.I.D. country programs is becoming increasingly important as these donors adopt development strategies directed at promotion of financial markets and private enterprise. For example, the United Nations has recently established a Capital Markets unit and through the ILO has begun to emphasize various business development programs. The World Bank is devoting an increasing amount of attention to strengthening financial institutions and systems, as well as to privatization through public sales of state owned enterprises. Each of the regional development banks, e.g. the Asian Development Bank, Inter-American Development Bank, is promoting capital market development by providing technical assistance and organizing both regional and country investment funds.

a. Joint Efforts

There are relatively few instances of joint efforts between A.I.D. and other international donors in addressing the economic development needs of LDCs. The comprehensive nature of the effort required to develop LDC financial markets presents significant opportunities for cooperative efforts that exploit the comparative advantages inherent in each of the international donors' approach to development. A.I.D., for example, enjoys a comparative advantage that is generally recognized by most LDCs in the ready access that it provides to technical assistance. This comparative advantage stems from the experience and skills that A.I.D. has developed in the traditional sectors over more than 30 years of providing assistance in these areas. It also stems from the ready access that A.I.D. has to U.S. technology in these areas which, with few exceptions, is regarded by LDCs as the most advanced in the world.

A similar situation exists with regard to capital markets except that A.I.D. has not yet developed the in-house capability that it has in the more traditional sectors of development. For the most part, however, the experience of the U.S. with its financial markets is still consulted by LDCs looking to promote the growth of their own markets. This experience, if made available by A.I.D. and coupled with the leverage that multilateral agencies can bring to bear in advocating politically sensitive policy reforms can be very valuable in accelerating the development of LDC capital markets.

Organizing and carrying out these joint efforts requires a more formal approach to coordination at the LDC level than typically exists now between A.I.D. and other donors. At present, the extent of coordination between other donors and A.I.D. varies considerably across Missions, and is the result more of informal working relationships that have been developed than the result of a structured approach to looking for opportunities to undertake joint efforts. This is unfortunate in that the outcome of a joint effort is likely to be more successful than independent efforts to achieve the same goal. Joint efforts increase the leverage that can be applied and enable each of the participants in the joint effort to concentrate their resources on key policy or technical assistance requirements. While one of the principal advantages of joint efforts is a more efficient use of participating donor resources, they present a convincing case for the unity of interest among donors that can be useful in future negotiations with LDC governments. In instances in which LDC governments are practicing a "divide and conquer" strategy to reduce the pressures for policy reform, joint efforts can be quite effective.

The instances of joint efforts could be increased by formulating a policy that specifically endorses teaming of A.I.D. and other international or national donors. Successful implementation of the policy will require negotiation with the donor community at the Washington level to create the appropriate environment at the country level. It could be accomplished at the country level by requiring the participation of other donors in the conceptual and detailed design phases of projects being considered by each donor. As part of its review of Project Identification Documents (PIDs) and Project Papers (PPs) AID/Washington might require evidence that Missions had involved counterparts in the international or national donor agencies in the design process. Other donors might follow a similar procedure to assure adequate coordination with A.I.D. in designing their own efforts.

While the ideal result of this approach would be a project agreement jointly signed by the participating donors and the LDC government, this is probably not possible under the current policies governing foreign assistance activities. An alternative approach would be to establish a working committee, chaired by a senior official of one of the donor agencies, responsible for coordinating the activities of the effected LDC agencies and the participating international donors. This approach would overcome the tendency of LDC governments to deal with international donors in an isolated fashion, and reduce the instances in which related activities are carried out in a parallel rather than a coordinated manner.

b. Cooperation

When joint efforts are not feasible, there should at least be formal provision for cooperation between donor agencies on projects of mutual interest. This cooperation can avoid situations in which progress on a project sponsored by one donor is held up by the pace or conflicting priorities of a project sponsored by another international donor. Until interagency cooperation is established as a routine element of the project formulation process, it might require AID/Washington intervention at the headquarters level of other donors to develop this coordination. The policy established to promote joint efforts should set specific requirements for achieving cooperation on projects of mutual interest even when a joint effort might not be feasible. This could be accomplished by requiring that the management activities of A.I.D. projects include a regular schedule of coordination meetings with other donors involved in the project outcome. While these recommendations are directed specifically to projects involving development of financial markets because of the obvious close relationship between these projects and monetary and fiscal policies that are often the targets of assistance provided by the World Bank and IMF, projects in other sectors would benefit as well from increased cooperation among donors.

4. Development of A.I.D. Expertise in Equity Market Development

The recent and somewhat dramatic increase in reliance on the private sector and market-led growth to achieve the objectives of economic development has not given international donors, including A.I.D., sufficient time to develop a large body of experience with this approach to development. Nor have the donors had time to develop an adequately large cadre of personnel with skills and experience in promoting market-led growth and development of capital markets. The heavy reliance on credit programs by virtually all donors in their previous efforts to promote private enterprise development has tended to stifle recognition of the need for alternate sources of capital, and in many instances, to even retard the formation of capital markets.

The experiences of many of these credit programs have demonstrated that increasing the availability of credit in itself is not enough to assure a satisfactory level of business formation. While the lack of stringent debt collection procedures cannot be ignored as one cause for the large losses incurred by many of these programs, often the major reason for the poor performance of these programs can be attributed to the assumption that the working and long-term capital needs of all fledgling businesses can be met through loans. This might be true of service industries, but it is seldom true of manufacturing and other processing firms that experience long lead times prior to generating sufficient revenues to meet debt repayment schedules.

Development of alternative approaches to meet the long-term financing needs of new and expanding enterprises in the developing countries will require skills and training which currently is in short supply among the resources available to international donors. Because the countries assisted by A.I.D. tend to be those at the lower end of the per capita income spectrum, the Agency can fulfill a vital role in initiating and promoting the growth of capital, including equity, markets in these countries. This assistance can be critical in moving countries along to a point at which the investment programs supported by the International Finance Corporation (IFC), and the regional development banks would be appropriate vehicles for achieving a new phase of private sector development.

The capacity of a USAID Mission to support capital market development activities is measured in a number of ways. One measure, of course, is the level of personnel resources available. Policy dialogue and the related efforts to achieve policy reform and liberalization of markets are labor intensive activities that generally must be sustained over protracted periods.

Another measure of the capacity of the Mission is the level of skills and experience in private sector and financial market development available to the Mission. While technical assistance generally is available to the USAID through its own or regionally and centrally-funded projects, as with other development activities, significant input from the Mission is required to maintain LDC government interest and momentum. These activities will require, at a minimum, dedicating the full time services of at least one individual knowledgeable in financial markets to liaise with LDC officials and organize various policy dialogue and resulting project activities.

Given the types and levels of resources available to A.I.D., it would be appropriate for the Agency to include in its development objectives responsibility for assisting LDCs establish the policies and business climate that would attract the serious attention of the IFC and other investors. In short, A.I.D. could assume responsibility for assisting LDCs establish the basic conditions that are essential to development of capital markets and promotion of private enterprise. This approach is consistent with the current restrictions on A.I.D. with regard to equity participation and on providing other than loan financing for LDC business ventures.

This approach, and the resources required to carry it out, cannot be put in place overnight. It will require a period of development and cultivation before it is an integral part of the fabric of the A.I.D. approach to providing development assistance. Seminars and well-designed training programs could help to accelerate the process that has already been started by A.I.D.

a. Seminars

Regional seminars offer considerable potential for addressing the interest and demand for knowledge that exists among A.I.D. personnel with regard to capital market development. Presentations could be tailored to address the specific characteristics of the countries in the A.I.D. region or subregion in which the seminar is being conducted. Seminar leaders would be drawn from the small cadre of organizational and independent professionals that have had direct experience in advising governments on capital market formation. Subjects covered in the seminars should include, as a minimum:

- evaluating LDC development approaches;
- policy implications for market development;
- assessing the climate for business formation;
- policy reform and restructuring;
- deregulation and liberalization.

The seminars should initially be designed to meet the needs of A.I.D. personnel and should rely heavily on presentation of case studies and lessons learned from the experiences of other developing countries. Materials from the training program could then be used to provide the core for development of seminars for LDC personnel as part of the assistance activities proposed earlier.

b. Training

At the present time, A.I.D. does not offer any training programs that provide knowledge or skills in the areas related to capital and equity market development. A.I.D. has begun to increase the number of personnel with graduate degrees in finance and related business topics joining the agency through the International Development Intern program, but it will be several years before these individuals will be actively involved in the development or implementation of capital market activities. There would be considerable value in providing a course, even one as short as two weeks, that dealt specifically with financial market operations. Training topics, geared specifically to LDC markets and conditions, to be covered would include, among others:

- unit trust and mutual fund operations;
- over-the-counter markets;
- venture capital funds;
- tax policies and implications for investment;
- regulation and enforcement;

- financial disclosure requirements;
- investor incentives and expectation.

The training could be organized by A.I.D. or an outside organization, but it would be important that the training draw upon the experience of practitioners currently engaged in these activities, and not rely exclusively on professional educators.

In addition, the training should be open to A.I.D. personnel representing a range of technical areas, and not just Private Sector Officers. Agriculture, housing and health project officers, in particular, could benefit from the insight into financing approaches that are applicable for private management of service delivery in their sectors.

C. Criteria for Targeting Equity Market Development Assistance

The goals of any capital market development strategy are to create conditions that 1) encourage the mobilization of domestic savings for investment in productive activities, and 2) encourage the formation and expansion of productive activities by providing a mechanism for meeting the long-term financing needs of these enterprises. While the goals and benefits of capital market development are common across all developing countries, the approaches to achieving these goals can differ significantly.

1. Importance of Tailored Approach

Given the diversity of political, economic and social conditions in the A.I.D.-assisted countries, there is no one approach to capital market development that is suitable for all countries. Experience to date suggests that the only two conditions that can be expected to be common to all countries are that 1) the barriers to capital market development will not be amenable to "quick fixes", and 2) effective policy dialogue is critical to achieving any progress toward development of the capital markets in an LDC. Other than these two common characteristics, the variation in conditions within each country necessitate the development of an approach tailored specifically to the individual country.

2. Summary of Country Types

Clearly, not every country assisted by A.I.D. will benefit from or be at a stage of development that is appropriate for expansion of its capital markets. Developing countries can be loosely grouped into three categories based upon their receptivity to capital and equity market development.

a. Non-Starters

There will be a relatively large number of countries on the list of those assisted by A.I.D. that can be categorized as non-starters. These are countries that are experiencing severe political or economic instability, or that are characterized by extreme degrees of government intervention in or operation of markets. Countries with economies that are based almost exclusively on agriculture are not viable candidates for equity market development.

b. Potential Candidates

Among the middle group of A.I.D.-countries as measured by per capita income and related development standards, there is a subset of countries with potential for capital and equity market development. These are countries that might be pursuing export-led growth strategies, or that possess human and natural resources that favor the development of local processing and manufacturing industries. In all likelihood these countries have not devoted much attention to promoting capital market growth, although they might be encouraging private enterprise. The latter is expected to be accomplished primarily by attracting foreign investment.

This group of countries includes potentially promising candidates for assistance in expanding the immature capital markets that are probably already operating in these countries. A comprehensive assessment of these markets and of the business environment in general would be required to determine if the potential for market development can be realized through A.I.D. assistance.

c. Strong Prospects

Among the A.I.D.-assisted countries, there are probably no more than 5-6 countries that fall in the category of strong prospects for achieving capital and equity market development. This is an important group, however, from the A.I.D. perspective. For one, they represent excellent opportunities to demonstrate the benefits of capital market development to other LDCs. They are also important in that well-timed assistance by A.I.D. can help to catapult these countries into a significantly higher plane of economic growth.

These countries are characterized by relative political and economic stability, at least marginal self-sufficiency, an embryonic capital market and probably a well-functioning informal sector, and a thin, but growing business base. The most important characteristic, however, is a visible willingness on the part of the government to make the difficult changes that will be necessary to accelerate growth of the capital and equity markets. Assistance provided by A.I.D. can be invaluable to these countries in establishing the infrastructure necessary for well functioning equity markets.

3. Alternative Approaches for Sample Country Types

While no one approach will fit every situation, it is possible to describe types of approaches that are appropriate to generalized situations in three countries. The examples are provided to reinforce the importance of conducting a reliable assessment of the conditions affecting local markets and developing a policy dialogue agenda that addresses the key issues.

Country type 1 will be found among the "non-starters" and "potential candidates" identified above. Country types 2 and 3 most likely will correspond to conditions in countries classified as "potential candidates" and "strong prospects".

a. Country Type 1 - Minimal Infrastructure

Many countries are now increasing the emphasis on promoting growth of the private sector in their development strategies. However, it will require considerable effort to overcome the effects of decades of government intervention and restrictive policies that have hampered market-led growth. Because it is unlikely that these countries will enact all of the policy reforms and deregulation that is required all at one time, it is important to identify the pressure points that, if relieved, would have the most beneficial effects on the climate for market growth and business expansion.

The most appropriate place to start in countries with a minimal financial infrastructure is with a comprehensive assessment of the business climate. This assessment will identify, among other things, the current sources of business financing and the barriers to mobilization of domestic capital. From the assessment, the USAID can identify the areas which are most critical to growth and the nature of the corrective action required. The strategy that emerges from this analysis will provide the basis for policy dialogue agenda for use with LDC senior decision makers. Assistance in conducting the assessment and formulating the policy dialogue agenda, if necessary, can be obtained through regional bureau and other AID/W staff or contract resources. Whatever the resources applied to carrying out these steps, the product of this process should be an action plan that defines the steps and the assignment of responsibilities that has been agreed to by the USAID and the LDC government to increase the mobilization of capital.

b. Country Type 2 - Restrictive Tax Policies

There are countries further along the development spectrum that have an established formal sector and moderately active business community. Typically, however, the business community is dominated by a small number of businessmen or a non-indigenous ethnic group. Widespread participation in the ownership of enterprises is hampered by lack of capital and, frequently, tax policies that either favor savings or discourage holding equity instruments, or both.

While there generally are other accompanying deterrents to investment, tax policy reform usually can be expected to have the single most positive effect on increased investment in private enterprise. In addressing tax policy issues, it is also necessary to address tax administration. Offering tax incentives to investment in local enterprises can only be effective if tax filing by individuals is enforced. Similarly, imposing higher taxes on firms that are privately held than on public companies will do little to increase public offerings if these taxes are not collected.

Because of the multiple benefits that might accrue to a LDC government in improving its tax administration system, an offer of assistance in this area from the USAID might be influential in bringing about the necessary reforms to existing tax policies. In developing the policy dialogue agenda, the Mission should meet with and survey local businessmen and accountants or tax advisors to confirm both the effects and the extent of enforcement of current policies. Local chambers of industry or commerce are frequently ideal sources of this information. If necessary, outside technical assistance might be relied on to analyze current policies and to suggest revisions that would be effective in promoting business formation and investor participation. The Internal Revenue Service (IRS) has been active in working with A.I.D. to provide tax administration assistance to LDCs and other countries. A project might be developed that would improve the capacity of the LDC tax revenue collection system and improve the effectiveness of policies.

c. Country Type 3 - Poorly Functioning Stock Exchange

There are a number of countries among those assisted by A.I.D. that have established stock exchanges, including some with relatively long histories. These exchanges, however, are characterized by a small number of listed companies and very modest levels of trading. As has been mentioned previously, often the trading is conducted by a small group of traders/investors who might not even encourage more widespread participation.

Secondary markets operated in this manner are not meeting their purpose nor providing the benefits to the economy that are derived from stock exchanges. The issues to be addressed in determining the actions necessary to expand the market are basically issues of supply and demand.

The demand for capital will be greatly influenced by the ease with which companies can be established and the various regulations, labor laws and tax policies effecting ownership and operation. The supply of capital will be affected by investor confidence, the ease of making the investment and of course, tax policies governing holding of corporate debt and share ownership. The assistance required to analyze and develop corrective actions for these conditions will generally require the services of lawyers and experts in financial intermediary and exchange operations. Many developing countries still rely on commercial codes and company laws that were put in place by colonial administrations. These laws have long since been revised by the former colonizing country, but remain unchanged in the former colonies. In some instances, these laws are more than a century old and are not even in the national language of the country in which they are followed.

Operation of the exchange, because it has been the object of attention of a small group of individuals, in all likelihood has not relied on establishment of formal regulations and procedures. However, if the exchange is to serve its purpose in providing an opportunity for wider ownership of local firms and joint-ventures, regulations and practices must be adopted that will protect investors against fraud and other abuses of investor confidence. Because of the relative ease with which A.I.D. can access the technical assistance required to develop these rules and practices, the USAID is in an excellent position to work with the LDC government in making these improvements to the operation of the stock exchange. As in the other typical situations described, an appropriate approach would be to obtain an assessment of the current operation by individuals with considerable stock exchange experience and then through policy dialogue, develop an action plan for implementation through project or other assistance.

D. Types of Responses to Equity Market Development Constraints

This section provides an overview of the types of solutions/recommendations made in response to the problems identified in Chapter III. The recommendations focus on potential approaches to correct some of the institutional weaknesses restricting equity market development, and increase the supply of and the demand for securities.

1. Potential Approaches to Strengthen the Institutional Framework

a. Incentives to Formation of Financial Intermediaries

Incentives to encourage adequate development of securities intermediaries generally include the following:

(i) Provide training to create a professional core of securities intermediaries

In many developing countries, brokers and other intermediaries have little or no training in financial analysis. Inadequately trained securities intermediaries cannot create confidence among the investing public. It is essential, for example, that brokers are familiar with and understand the financial position of issuing companies such as is provided through disclosure reports, and that they can make recommendations to their customers based on such information.

(ii) Ensure legitimate profit-making

It is commonly believed that attracting the highest quality professionals to the investment banking and brokerage community is one of the best ways to protect the investing public. Profitability attracts such individuals, but profits should not come from illegitimate activities such as "free-riding" and insider trading. Thus, it is generally recommended that regulations that limit legitimate profit-making in the securities business through the imposition of ceilings on underwriting commissions, brokerage fees, and the like, should be eliminated, or the limits raised to reasonable levels. An appropriate approach is to establish underwriting rates at a respectable minimum in the early stages of development of the securities market in order to avoid destructive price cutting, while allowing negotiation between issuer and underwriter. In Kenya, for example, it has been recommended that minimum fees be mandated to preclude predatory competition in the embryonic securities industry, with final fee-setting left to negotiation between issuers and underwriters. In Kenya, and in Indonesia too, for example, it has also been recommended that brokers act as dealers or market makers, not just as agents for their clients, and that they "band together" for the purpose of serving as underwriters. Because the level of market activity is often low, this would allow them to increase their profit potentials, thus encouraging a greater number of brokers to participate in the market and engage in broader selling efforts.[39]

(iii) Government-owned banks should not compete as underwriters

In some LDCs, underwriting activities are undertaken by government owned institutions. In Indonesia, for example, Danareksa is the major underwriter in the country. Its dominant position in the market effectively stifles development of private underwriters and discourages companies from going public.

(iv) Adequate finance

Another important issue is that adequate financing be available for underwriting, market-making and investment activities. It has been recommended in some countries that facilities be established to finance the activities of merchant bankers and securities brokers, dealers, market makers and investors. In Indonesia, for example, it was recommended that a securities rediscount facility and a securities market finance fund or corporation be established for that purpose.[40]

39 Ferris, "Kenya," p. 17, and Reilly, "Indonesia Memorandum," pp. 31-32.
40 Reilly, "Indonesia Memorandum," p. 32.

(v) Establish intermediary institutions/branches

Often, it is also recommended that branch offices of brokerage firms be established in important cities outside the main urban center. India, for example, has followed this type of approach with the objective of expanding interest in share-ownership "to the four corners of India." Financial intermediaries should be encouraged to engage in a broader distribution of securities by offering their securities to suppliers and customers in different parts of the country.[41]

b. Support Improvements in Accounting and Auditing Standards and Procedures

Recommendations to improve accounting and auditing standards and procedures generally call for the following:

- thorough review of laws and regulations governing accounting and auditing, followed by revision of necessary laws to improve financial reporting;
- training and establishment of licensing requirements for accountants and auditors;
- development and enforcement of GAAPs and GAASs, and uniform financial reporting requirements; and
- uniform enforcement of accounting requirements among publicly traded companies as well as private companies of a certain size to remove disincentives to going public.[42]

c. Training

The absence of widespread professional expertise in the securities area is a major constraint to equity market development in many developing countries. Most of these countries suffer from a lack of personnel with experience in securities market operations and development. Generally, professional accountants are few and securities brokers and other financial intermediaries have little if any training in financial analysis and techniques. Supervisory and regulatory officials also lack experience in securities market development and little is known about experiences in other countries. Therefore, it is important that government officials and private sector representatives receive training in securities market development and operations, market-making, brokerage, regulation, and accounting, among other areas.

41 *Ibid.*, pp. 31-32.
42 Reilly, in "ADB Symposium", pp. 181-182.

It is often recommended that training include courses at training institutes in the major market centers (such as the New York Institute of Finance founded by the New York Stock Exchange which offers two sessions a year for foreign professionals), and that selected candidates be sent to stock exchanges, over-the-counter regulatory organizations, and securities firms in developed countries in order to gain first-hand experience. This need is so widespread that preparation of educational videos on these subjects by USAID might be considered as an alternative. In addition, because government officials and private sector representatives in developing countries often know little about securities market operations in other countries and about the benefits of equity markets to economic development, it is also recommended that delegates from both the public and private sectors in one country visit knowledgeable practitioners in other countries in order to compare and learn about securities market developments, regulations, incentives, and benefits. It is more important, however, that these representatives visit securities markets comparable to their country conditions and market development stage, such as Brazil, Singapore, and Malaysia, than the larger markets of the United States, Japan, or the United Kingdom.

The securities commissions and other supervisory agencies can play an important role in the area of training by stimulating training programs for employees of the stock exchanges and brokerage firms. In addition, they can encourage professional examinations to set minimum standards for market operators and thus help to increase investor confidence.

2. Potential Approaches to Increase the Supply of Securities

Actions to increase the supply of securities generally take one of two forms: a) removal of impediments; or b) adoption of positive incentives. Some LDC governments, however, have also resorted to direct intervention in an attempt to encourage an increase in public issues. Some countries require that foreign or joint venture companies go public after a specified number of years as a way of increasing domestic ownership. South Korea, for example, imposes fiscal penalties on companies that do not go public after public authorities have determined that they should.6 Indonesia, until recently, limited foreign ownership to 49% and required sale of the foreign equity after 10 years.

a. Review and Revise Laws and Regulations

Laws and regulations governing the formation and expansion of private enterprise, the listing of securities, the operation of financial intermediaries, investment, taxation, and

6 Jonathan R. Hakim, ed., *Securities Markets*, IFC Occasional Papers. (Washington, D.C: IFC, 1985), pp. 21-23.

accounting and auditing have a significant impact on the development and growth of securities markets. Because these laws and regulations are often outdated and overly restrictive of private sector activities, and generally were not developed with the specific objective of encouraging development of the securities market, it is recommended that equity market development efforts begin with a comprehensive legal review to identify duplicative and conflicting laws and regulations that might impede the development and efficient operation of a securities market.[44] Such a review goes beyond attempts to increase the supply of securities; it aims at identifying all laws which affect the development of capital markets and designing a complete and cohesive approach to capital and equity market development.

b. Liberalize Pricing

One of the most important steps to encourage companies to go public is to eliminate government involvement in establishing the price of shares. Share price should be negotiated by the underwriter or sponsoring brokers and the offeror, and should follow the industry practice of giving emphasis to earnings. This assures that profitable businesses will be able to sell their shares at a fair price with the result that the cost of raising equity capital will be competitive with the cost of long-term borrowing. In addition, higher issuing prices will enable the owners to raise larger amounts of funds for future growth without concern about the large dilution of their ownership that would have taken place at the lower prices. In South Korea, for example, growth of the capital market accelerated rapidly in 1973-1974 when the Ministry of Finance liberalized the pricing process.[45]

c. Eliminate Tax Biases against Securities and in Favor of Bank Deposits and Non-Negotiable Debt Finance.

Companies will not go public as long as the cost of equity funds is greater than debt financing. Therefore, it is generally recommended that a thorough review of the tax system be undertaken in order to examine the tax treatment of different financing/investment alternatives and eliminate biases against securities and in favor of non-negotiable debt instruments.

d. Privatization of Profitable Parastatals

The supply of securities is increased if the government privatizes selected state-owned enterprises by offering shares in these companies to the public. Companies selected

44 ADB, *Capital Market Development*, pp. 68-69.
45 George Ferris, Jr., "Further Development of Korean Securities Markets" (April 1973), pp. 4-6.

for divestiture should be successful ones, in order to attract private investors. In addition, because one of the best incentives for individual investors is hearing about others' successful investment experience, privatization of well-known, stable and successful state-owned enterprises could have an important demonstration effect.

The Government of Sri Lanka, for example, has already developed plans to promote development of the securities market through privatization of certain public enterprises. In an effort to augment the supply of securities, Bangladesh has also devised a policy to divest 49% of the shares of public companies, including nationalized commercial banks.[46]

c. Promote Development of New Financial Instruments

Financial markets in developing countries often suffer from a lack of variety in investment instruments. Expanding the variety of financial instruments available to present investors with different combinations of risk and return is one way to encourage development of the securities market.

Debt to equity swaps and securitization of illiquid assets can be used to create new financial instruments, promote new investments, and assist in reducing a country's foreign debt. As such, they present important opportunities to increase the supply of negotiable securities and enhance capital market activity.

(i) Debt to equity swaps

In a debt for equity swap a lender redeems sovereign or private debt in local currency at the debtor country's central bank and then invests the proceeds locally. The exchange might be made at par or at a discount, subject to negotiations with the central bank. Debt/equity conversion programs have been implemented in several countries, including Brazil, Chile, Argentina, Mexico, and the Philippines. The advantage offered by these swap programs to the debtor country is that they accomplish two things simultaneously: they retire hard currency debts and they promote productive investment in the country. In addition, debt/equity conversion programs can lead to repatriation of flight capital and at the same time provide an important stimulus to local capital markets and local privatization programs.[47] The latter is particularly important from the perspective of securities market development.

46 Mustafizur Rahman in "ADB Symposium", pp. 10 and 59.
47 Laurence Clarke, "Debt Equity Conversion Programs: Paradigms and Experiences of International Financial Institutions," Paper presented at the National Conference on Securitization of Debt: Options for Nigeria, Nigeria, 1987, p. 3.

One major advantage of debt/equity conversions is that they can be used to support privatization through divestiture of state-owned enterprises. As explained above, divestiture can be an effective means to increase the supply of securities in secondary markets and to increase investor confidence through successful investment experience. Debt/equity swaps were used to support privatization programs in the Philippines. There, the privatization of two of the six government commercial banks, the International Corporate Bank and the Commercial Bank of Manila, involved debt/equity conversions. In July 1986, forty percent of the International Corporate Bank was sold to American Express through a debt/equity swap. Of the remainder, 1 percent is held by domestic investors and about 59% is held by the National Development Company, a government entity. In the case of the Commercial Bank of Manila, which was privatized in 1987, the First National Bank of Boston converted into equity $19 million of its Philippine debt, which had been blocked since 1983 as a result of a debt moratorium imposed by the country's central bank. The remaining shareholders include Three Eight Corporation, Ace Solid Holdings Corporation, and Cabien Corporation.[48]

(ii) Securitization of Illiquid Assets

Securitization involves the conversion of essentially nonmarketable loans into marketable debt instruments or securities. In recent years, this "securitization" or shift of credit flows from bank lending to marketable debt instruments has become a major trend in international financial markets. Banks in the United States have used securitization very successfully for several decades as a way to increase the liquidity of their home mortgage and automobile receivable holdings.

While there are several reasons for the growth of interest in securitization of international credit flows, the international debt situation has been a principal reason. The debt crisis highlighted the desirability of strengthening and maintaining the liquidity and marketability of bank assets, and encouraged banks to strengthen their capital base by issuing more long-term debt. As explained earlier, the presence of strong securities markets in developing countries and greater reliance on equity finance would have lessened the impact on LDC financial stability of high real interest rates.

The securitization or packaging for resale of illiquid assets including foreign debt, and automobile and housing loans would create a larger pool of securities for trading in the

48 Arthur Young and Stanford Research Institute (SRI), "Liberalization and Privatization of the Financial Sector: Guidelines and Case Studies," Draft Report for the Bureau for Program and Policy Coordination, November 1988, pp. 7-8.

market. This enhances the volume of financial activity and hastens the development of a capital market.

f. Provide Fiscal Incentives

Tax incentives are used most often as inducements to encourage companies to "go public". Typically, publicly-listed companies are taxed at a lower rate than private or "closed" companies. Relying on tax incentives to encourage equity market development, however, can cause distortions. Most financial market experts agree that discriminatory policies should be viewed as temporary measures. In general, it is preferable to promote equity market development by eliminating existing impediments and distortions so as to put all markets on an equal footing.

There are a number of ways in which to reduce the tax rate for publicly-listed companies below the rate applied to unlisted firms. In Thailand, for example, the corporate tax rate for listed companies is 30% compared to 40% for unlisted ones. In Sri Lanka, newly-listed companies are eligible for a 10% lower tax rate and a five to ten-year tax holiday if they invest in priority sectors such as tourism, exporting, and fishing. Egypt gives a tax incentive to companies which list on the country's Exchanges.

Other incentives might include accelerated rates of depreciation for listed companies for a certain number of years, tax credits or investment allowances for investments in plant and equipment by public companies, concessions on taxes payable in the year after a new public issue of shares is made, and others.[49]

The spectrum of tax incentives that can be applied in equity market development is broad. Such incentives for companies going public will not be effective, however, if tax laws are poorly administered and tax returns understate income. Under such circumstances, companies will not go public for fear that financial disclosure will reveal deficiencies in their tax statements. This was the case in Indonesia, for example, when the government approved tax incentives to encourage companies to go public after the Jakarta Stock Exchange re-opened in 1977. By late 1979, only two companies had gone public, even though hundreds of foreign companies were required to transfer majority ownership to Indonesian nationals and were offered tax incentives to go public. One of the main reasons such few companies responded to the incentives is believed to be the desire to avoid the disclosure requirements in light of a poorly administered tax system.[50]

49 ADB, *Capital Market Development*, p. 49.
50 Dickie, "Equity Sharing Policies," p. 91.

3. Potential Approaches to Increase the Demand for Securities

Efforts to increase the demand for securities should give attention to the following conditions:

a. Comparative Yield

To increase the demand for securities, it is important to place dividend and interest income on an equal footing.[51] This can be accomplished in a number of ways, such as removing or reducing the double taxation of dividends, removing or reducing the capital gains tax, making interest from bank deposits taxable at a comparable rate to dividends, and eliminating other tax disincentives to investment in securities. Thus, any effort to induce increased demand for securities should begin with a review of the tax structure in the particular country to ensure that it does not discriminate against the securities market. The goal in policy dialogue and other efforts should be to ensure a post-tax return on interest income from savings deposits, corporate funds and dividends that adequately reflects the investment risk involved.

Japan, for example, does not have a tax on capital gains from securities transactions. According to Kanju Sugimoto, Associate Director and General Manager of The Nomura Securities Company Limited in Japan, the dramatic increase in the number of individual investors in the country is due almost entirely to the absence of a capital gains tax.[52] Taiwan, Korea and Malaysia also do not have capital gains taxes, and have experienced rapid growth in the size of their securities markets. Securities Industry Association studies in the United States have shown that reduced capital gains taxation can produce offsetting increases in income tax revenue to the government through accelerated realization of gains.[53]

b. Measures to Increase Investor Confidence

A number of steps can be taken to increase investor confidence, including:[54]

- Enhancing the disclosure of material information by companies

Investor confidence depends to a significant extent on the ready availability of complete and trustworthy information on the financial condition of the companies concerned.

51 Ferris, "Kenya," p. 12.
52 Sugimoto, in "ADB Symposium", p. 75.
53 Securities Industry Association, *Securities Industry Trends*, Vol. XII, No. 8, New York: SIA Research Department (August 11, 1986).
54 Arnold Shipp, in "ADB Symposium", p. 53 and Reilly, in "ADB Symposium", p. 183.

Without it, the public cannot make a proper assessment of a company's financial position. In this context, it is also important that adequate accounting and auditing standards be established.

Furthermore, an adequate brokerage infrastructure to analyze corporate information and interpret the results in easily understood language is essential.

- Correcting weaknesses of the regulatory and supervisory environment

An appropriate and effective regulatory and supervisory climate is the key to dispelling or at least lessening fears of market manipulation and other abuses. This demands not only developing a complete system of stock exchange regulations and company laws, but also an effective system to enforce these regulations. Otherwise, the public may sense that the risk of market manipulation and other abuses is too high, and may decline to invest in securities.

- Establishing professional requirements for securities brokers

Financial intermediaries play an important role in the distribution of securities. Yet, brokers in many developing countries lack training and often take no responsibility for their transactions. Professional brokers are needed who can provide advice to their customers on the financial position of a particular company and will take responsible actions on behalf of their customers.

- Providing protection of minority shareholders

Company laws should include provisions to protect the rights of minority shareholders. Another alternatives is to incorporate such provisions in listed company agreements with stock exchanges.

- Building awareness among the general public on the benefits of securities investments.

Reluctance to invest in securities often stems from a lack of understanding of the benefits that can be derived from owning securities and of the way the securities market operates. Thus, education of both the general public and investors is vital to increase demand for securities and further development of the market. The securities commission of a particular country in the early stages of development can play an important role in this education process by organizing seminars, printing pamphlets, and publicizing the securities market through the radio and other news media. But, as the securities infrastructure develops, these functions should be taken over by stock exchanges, stock brokers, companies, financial institutions, and trade associations. In the United States, for example, investment and brokerage firms have been actively involved in investor education and promotion programs through seminars and other means.

c. Favorable Investment Experience

A favorable investment experience is an important stimulus to growth in demand for securities as few things attract new investors more than hearing from friends or relatives of a successful investment. Conversely, word of an unfavorable investment can be detrimental to securities market growth. It is generally recommended, therefore, that in the early stages of equity market development only the shares of well-established companies with favorable earnings potential and proven management be made available to new investors. An approach suggested earlier pointed to the merits of pursuing divestiture of successful government enterprises and public distribution of their shares. Public confidence in such companies is generally higher than in newly formed entities. Thus, distribution of privatized companies could do much to stimulate investor interest and demand.[55]

d. Foreign Investment

Foreign portfolio investment can increase the demand for securities and provide a stimulus to securities market development. The International Finance Corporation has been particularly adamant in its support for liberalization of cross border flows of portfolio investment and has focused considerable attention on the important role of such investment in solving the Third World debt crisis.[56] As described in Chapter III, however, many countries still place restrictions on foreign portfolio investment in local securities. Yet, the benefits of foreign investment funds are numerous. The major ones include:[57]

- Foreign investment funds supply an immediate source of equity capital which was previously not available.
- Investment funds bring a variety of ancillary benefits to the recipient country in the form of "investment technology transfers" such as better research techniques, investment marketing techniques, and more advanced computer hardware and software, among others.
- The introduction of foreign investment funds will help speed up the process of equity market development.
- The creation of foreign investment funds can be a country's first step in freeing its stock market to foreign equity investors. This has been the approach followed in Korea, for example, and now being implemented in Thailand and India.

55 Ferris, "Korean Securities, " p. 7 and "Kenya," p. 14.
56 Gill, "Considerations for Furthering Securities Market Development," pp. 9-19.
57 Peter Pearson, in "ADB Symposium", pp. 213-216.

The Korean government adopted a series of policies in the early 1980s designed to open the stock market to foreign investors over a ten-year period. Initial steps involved the issuance of two private placement mutual funds, Korea Trust and Korea International Trust for a total of $50 million. This was followed by the launching in 1984 of a closed-end investment trust, the "Korea Fund", which was in turn followed by a second issue of the "Korea Fund" in 1986. To attract foreign portfolio investment, Korea established investor protection procedures and acceptable accounting and auditing standards. In addition, Korean officials eliminated most of the fiscal barriers by reducing dividend and eliminating capital gains withholding taxes.[58]

The "Korean approach" of establishing foreign investment trusts can be the catalyst for much broader and rapid development of the securities market. According to Peter Pearson, Managing Director of Fidelity International Investment Management (Hong Kong) Ltd., a typical pattern of development might be the following:

- Investment in domestic equities.
- Establishment of foreign investment funds for investing in bonds and equities.
- Establishment of a domestic unit trust industry employing techniques imported by the foreign fund.
- Establishment of a limited program to allow foreign institutions to purchase selected individual shares.
- Establishment of specialized foreign funds to invest in particular sectors of the market.
- Establishment of domestic unit trusts to invest overseas.
- Complete liberalization of stock markets for foreign institutional and individual investment.[59]

e. Tax Incentives

Tax incentives can be used to influence the behavior of both borrowers and savers. As discussed in an earlier section, tax policies can influence a firm's choice between different forms of finance such as bank loans or new securities issues. Likewise, fiscal

58 Gong-Soo Pyun, in "ADB Symposium", pp. 207-210, and Gill, "Interdependence of National Securities Markets," p. 48.
59 Pearson, in "ADB Symposium", p. 216.

incentives can make equities more or less attractive relative to other forms of savings, thus influencing investors' decisions to allocate their savings among different types of instruments.

Developing and industrialized countries have provided a wide variety of tax incentives to stimulate demand for securities. Some incentives have been more successful than others. Among the developing countries, the Brazilian experience is frequently cited as one of the most successful tax incentive plans.[60] Beginning in 1965, the Brazilian government established a series of tax incentives to foster the growth of the securities market by encouraging individuals, as well as institutions, to invest in shares or debentures of publicly-traded companies. One of the most important steps the government took was the creation, through government Decree-Law No. 157, of special mutual funds (known as "157 Funds"). Tax provisions allowed individuals and corporations (currently only individuals) to deduct a proportion of their income tax liabilities as long as the amount discharged was invested in the form of quotas in the mutual funds. To encourage long-term investments, withdrawals from these funds could not begin for at least two years. The mutual funds were in turn required to invest in company securities, particularly new issues, but the government designated the proportion of funds that had to be invested in new issues and that which had to be invested in currently traded shares.

Tax-relief provisions also allowed individuals to offset against income tax a portion of the cost of buying listed stocks or convertible bonds. Another incentive provided for part personal income tax exemption of dividends, and for concessional rates of withholding taxes for shareholders in public companies which undertook steps to widen their equity base. These incentives led to a tremendous growth in individual and institutional demand for securities and produced impressive increases in the volume of shares issued and traded. According to IFC statistics, the number of "open capital" companies--those which have opened their share capital to public subscription--rose from 209 in 1968 to 551 in 1978. In addition, the value of shares traded yearly on the Rio de Janeiro and Sao Paulo Stock Exchanges jumped from US$131 million in 1968 to US$4.818 billion in 1971.[61]

60 See Roberto Teixeira da Costa, *Brazil's Experience in Creating a Capital Market*, Bovespa, Sao Paulo Stock Exchange (1985), pp. 40-43, and P.J. Drake, Securities Markets in Less Developed Countries," *The Journal of Development Studies* 13, 2 (January 1977), pp. 85-86.

61 Hakim, "Securities Markets," p. 22.

f. Role of Institutional Investors

Institutional investors such as pension funds, insurance companies, and mutual funds can play a vital role in mobilizing savings and investing those savings. Investment trusts and mutual funds provide advantages, in particular to small investors, through diversification, professional portfolio management, and continuous supervision by professional managers. As exemplified by the experience with the "157 Funds" in Brazil described above, the provision of tax incentives for investment in specialized investment trusts can provide an important stimulus to capital market development.

Some countries, including Brazil and Korea, however, have gone beyond the provision of fiscal incentives to encourage investment in equity securities. In 1985, for example, South Korea adopted a regulation requiring life insurance companies to invest a minimum 5% of funds available in equities. Similarly, Brazilian pension funds are required to invest a minimum of 20% of their available investment funds in equities[62].

Regardless of how successful these regulations may have been, the imposition of portfolio composition requirements stipulating that institutional investors must invest a certain percentage of their funds in local equities is not recommended as a strategy for stimulating the development of the securities market. Like restrictions requiring institutions to invest a certain percentage of their funds in government securities, such requirements constitute impediments to the free interplay of demand and supply factors, and can result in significant distortions of the market.

Another technique is for development banks to spin off some of their established developing company shares into closed end mutual funds distributed to the public and managed by the development bank. This frees up development funds for new venture capital.

62 David Gill, "Considerations for Furthering Securities Markets," Paper presented at the Eleventh Annual Conference of the International Association of Securities Commissions and Similar Organizations, Paris, France (July, 1986), pp. 3-4.

APPENDIX A:
Economic Development Approaches

Appendix A
ECONOMIC DEVELOPMENT APPROACHES

A. Introduction

Economic development processes can be looked at from both a quantitative and a qualitative perspective. The quantitative perspective refers to the level or stage of economic development of a country. This is usually measured by such proxies as per capita GNP, and physical quality of life indexes, among other indicators. The qualitative perspective, on the other hand, focuses on types of economic development approaches or strategies.

Many development economists, among others, believe that financial market development generally proceeds concomitantly with economic development. In most developing countries, financial markets are still at a relatively early stage of development. As explained earlier, the development of the capital market, particularly the securities segment, is even less developed. In fact, only a handful of countries, such as Brazil, Mexico, Malaysia, and South Korea have substantial and developmentally-significant securities markets. A macroeconomic environment conducive to securities market growth has various dimensions, including the level of economic and financial system development of a country. In the words of U Tun Wai and Hugh T. Patrick, "[i]t does not make much sense to rely on capital markets for resource mobilization and allocation in an economy with a low per capita income and a weak institutional structure."[1]

In general, conventional wisdom holds that countries with higher levels of economic development usually also have better prospects for securities market development. The International Finance Corporation (IFC) has conducted studies that relate the total value of outstanding equities in various countries as a percentage of GNP to per capita GNP. Generally, the wealthier, more industrialized countries have higher market valuations of equity to GNP than poorer non-industrialized countries.[2] In fact, an extremely early stage of economic development can overshadow prospects for equity market development. The IFC has found that in very low income countries, such as

1 U Tun Wai and Hugh T. Patrick, "Stock and Bond Issues," p. 281.
2 David Gill, "Successes and Failures of Capital Market Development Programs," Paper presented at the Conference on "Take-Off Time for Thailand's Capital Market," (Bangkok, 1984), p. 4.

Bolivia or the Ivory Coast, the very early stage of economic development of the country accounts for the absence or extreme shallowness of the securities market.[3]

Thus, determination of a country's level of economic development is an important consideration in securities market development efforts. Very low income countries in very early stages of economic development may not be appropriate candidates for equity market development assistance. In addition, however, "qualitative" aspects of economic development are also crucial considerations and need to be examined as part of any securities market development undertaking. Therefore, any effort to promote equity market development must also include an assessment of the development philosophy of the country of interest in order to determine whether private sector business growth and securities market growth are likely to occur.

B. General Types of Economic Development Approaches

Economic development efforts in a particular country generally are directed at achieving growth in productivity, that is, increasing the output of goods and services in order to attain a higher GDP growth rate, per capita income, and standard of living. All developing countries are eager to achieve these goals. Different countries go about the process in different ways.

Developing countries have followed multiple development paths in their attempts to achieve economic goals and targets. Moreover, differences in societal composition and political regime have given rise to different policy responses, even under similar economic conditions. Nevertheless, recent discussions of economic development approaches have tended to focus on the "inward" or "outward" orientation of development strategies and the World Bank, among others, has sought to classify countries accordingly.[4] Even within these two approaches, however, there has been considerable variety regarding particular macroeconomic policies, relative dominance of the public and private sectors, political regimes, and so forth.

3 David Gill, "Some Thoughts on the Implications of Different Financial Institutional Structures on Securities Market Development," p. 37.

4 See World Development Report 1987; John P. Lewis and Valeriana Kalab, editors, *Development Strategies Reconsidered*, Overseas Development Council (New Brunswick and Oxford: Transaction Books, 1986); Louis Emmerij, *Development Policies and the Crisis of the 1980s* (France: OECD, 1987); Bela Balassa and Associates, *Development Strategies in Semi-Industrial Economies*, (Baltimore and London: The Johns Hopkins University Press, 1982); and Hollis Chenery, Sherman Robinson, and Moshe Syrquin, *Industrialization and Growth.*, (Oxford University Press, 1986).

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In the early postwar years, most developing countries relied heavily on the export of single or few crops or raw materials on the expectation that the more they produced and supplied to developed countries, the greater their income. Pessimism about the prospects of export-led growth in light of predictions that the relative price of primary commodities faced a secular decline led many countries to turn to inward-oriented strategies, also known as import substitution (IS) strategies. Countries like Brazil and Argentina had embarked on IS strategies as early as the 1930s, but the apogee of import substitution took place in the 1950s and early 1960s when many of the newly independent countries also shifted towards IS strategies similar to those adopted in Latin America. The early and "easy" phase of import substitution typically involved producing final manufactures to replace imports and many countries enjoyed initial bursts in the growth of manufacturing. Countries with large domestic markets, such as Mexico and Brazil, experienced rapid rates of economic growth and their development experience was heralded as a "miracle". However, because production usually required imported intermediate and capital goods, sustained industrial growth depended on the expansion of exports, or on foreign borrowing, to provide the necessary foreign exchange. Countries such as South Korea that made an early transition to export expansion sustained their industrial growth. Many others did not make the transition; their industrial development was retarded and, in many cases, their economies were overburdened with foreign debt.[5]

The experiences of South Korea since the mid-1960s and of other Asian countries, namely Hong Kong, Singapore, and Taiwan, have focused considerable attention on export-promotion (EP) strategies and on the dichotomies between outward-oriented (EP) and inward-oriented (IS) approaches to economic development. Unlike IS strategies which imply overt protection of domestic industries, an export-promotion strategy, despite its name, consists of eliminating the bias against exports through realistic valuation of the exchange rate, removal of import controls, and the provision of incentives which are neutral between production for the domestic market and exports.[6]

In practice, the dichotomy between IS and EP strategies has been overdrawn, particularly in descriptions of the East Asian and Latin American experiences. Recent studies of South Korea and Brazil, in particular, have revealed that government

5 *World Development Report 1987*, p. 45, and Jagdish N. Bhagwati, "Rethinking Trade Strategy," in *Development Strategies Reconsidered* (New Brunswick and Oxford: Transaction Books) p. 95.

6 Bhagwati, in *Development Strategies Reconsidered*, pp. 92-93 and *World Development Report 1987,* p. 8.

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involvement played an important role in the export boom experienced in both countries, and import substitution was found to accompany rather than simply precede export promotion in both cases.[7] Nevertheless, for purposes of this study, the dichotomy between inward and outward-oriented approaches can provide a useful framework from which to examine the role of government in the economy under different development approaches and the implications of these approaches for overall economic development and private sector growth.

Interest in the East Asian "success stories" rests to a considerable degree on conventional interpretations that outward-oriented export promotion strategies are "market-driven", involving greater reliance on market forces and minimal government intervention. By contrast, inward-oriented IS strategies exemplified by Latin American countries, but also pursued by many African and Asian countries (most notably India), are regarded as "interventionist", requiring an extensive government role in the economy.

Thus, commitment to an outward-oriented approach to economic development implies movement towards financial liberalization and greater reliance on market forces because the success of export promotion depends to a considerable degree on "getting the prices right." This requires market-oriented policy shifts, including domestic pricing and financial reforms, removal of import controls, and adjustment of the exchange rate to bring internal prices into alignment with world market prices. The role of the government under this approach lies "in structuring these arm's length incentives into a comprehensive and consistent policy package that encourages efficient allocation of resources and signals firms of their comparative advantage."[8]

Research by the World Bank and other institutions has concluded that high price distortion (as commonly occurs under IS strategies due to support of overvalued exchange rates and of price and other types of controls) has a negative impact on economic growth and also leads to slower growth of exports and a greater likelihood of debt-servicing problems.[9] Moreover, price distortions discourage expansion of business and creation of new enterprises as they create uncertainty for investors. Thus, at least theoretically, countries committed to an outward-oriented export promotion approach to economic development should achieve higher rates of economic growth due to the more efficient allocation of resources and the increased exports that should

7 Colin I. Bradford, "East Asian 'Models': Myths and Lessons," in *Development Strategies Reconsidered*, p. 120.

8 Stephan Haggard, "The Newly Industrializing Countries in the International System," *World Politics* 38 (January 1986), pp. 350-351.

9 Bradford, in *Development Strategies Reconsidered*, pp. 116-118.

result from greater reliance on market-determined prices. In the words of Helen Hughes, "The only hypothesis that explains why some developing countries have grown rapidly, while others have not, links the adoption of a positive development philosophy with a policy framework that leads through market mechanisms to efficient resource allocation and utilization."[10]

On the other hand, the pursuit of inward-oriented strategies generally has involved extensive intervention by the government in the economic development process. The government, in many cases, has taken the role of an "entrepreneur," planning economic development, creating state enterprises, and directing the role of the local and foreign private sectors in the domestic economy.[11] Government planning in most developing countries has tended to be coupled with proliferating direct controls (on interest rates, prices, exports, imports, foreign exchange, and so forth) and proliferating bureaucracies to administer them. This in turn has resulted in price distortions that discourage private investment and lead to a misallocation of resources and balance-of-payments difficulties. In the absence of significant tax revenues, the expansive role of the government generally has implied large fiscal deficits and heavy foreign borrowing. In some cases, corruption has arisen from the administration of import and export licenses and other controls. This has discredited governments and often promoted the "wrong type" of private sector entrepreneurship, where political connections and influence become more important than technical expertise.[12]

Empirical country and more general studies have demonstrated that outward-oriented EP approaches have resulted in faster rates of economic growth. A 1986 study sponsored by the World Bank found that "economies which pursued export-led growth--as opposed to a strategy of import substitution--grew faster, industrialized sooner, had higher rates of total factor productivity growth, and tended to achieve the input-output structure of an advanced economy faster."[13] Moreover, a recent study also found that countries that have adopted outward-oriented policies have adjusted far more quickly, with less denting of their growth rates and with smaller accumulations of debt, to the wrenching changes in the world economy during the first half of the 1980s. According

10 Hughes is quoted in *Ibid.*, p. 118.

11 Jeff Frieden, "Third World Indebted Industrialization," *International Organization,* 35, 3 (Summer 1981) pp. 407-431.

12 Miguel Urrutia, "Latin America and the Crisis of the 1980s," in *Development Policies and the Crisis of the 1980s*, OECD, 1987, p. 63.

13 Chenery, Robinson, and Syrquin, *Industrialization and Growth*, p. 358. See also *World Bank Development Report 1987*, p. 8.

to this study, the flexibility gained by an outward-oriented strategy has been more than adequate to offset the vulnerability that this "openness" might imply. In comparison, inward-oriented economies have had more difficulties adjusting, in part because powerful interest-groups such as protected industries and labor groups that have benefitted from the protectionism of import substitution, have resisted fiscal reforms and elimination of the host of price distortions that overlay these "closed" economies[14].

Thus, in theory, the choice between an inward- or an outward-oriented approach to economic development has important implications for the role of the government in the economy. In practice, however, no country adheres to an "ideal" type of development approach but instead follows some variation of one of the major approaches.

Economic development approaches are dynamic processes and countries shift strategies over time and in response to different circumstances. The role of the government in the economy varies not only by approach and from country to country, but over time depending on changing domestic and global political and economic circumstances. In Japan and South Korea, for example, import protection was more important up to the 1960s than it is now. The shift from import substitution to export promotion strategies in the mid-1960s generally fits more closely with a movement towards financial liberalization and diminished government involvement in the economy. Studies of development policies in the 1970s, however, reveal a more complex story, involving a greater mix of market forces and government actions that suggest considerably more directive roles by the governments pursuing export promotion approaches. In the mid-1980s, there seems to have been a shift again in many countries towards greater reliance on market forces.[15]

Brazil, for example, which for many years exemplified the import substitution approach, has demonstrated considerable change over time regarding the role of the government in the economy from one of extensive intervention to one of greater reliance on market forces. Since the mid-1960s, Brazil has emphasized export promotion while at the same time seeking new opportunities for import substitution. Currently, there is movement toward more realistic exchange rates, higher real rates of interest, reducing the public-sector deficit, mobilizing internal savings, and providing incentives for private sector innovation and investment.[16]

14 Leopoldo Solis and Aurelio Montemayor, "A Mexican View of the Choice Between Outward and Inward Orientation," in *Development Strategies Reconsidered*, pp. 107-110.
15 Bradford, in *Development Strategies Reconsidered*, p. 119.
16 *Ibid.*, p. 120

Close examination of the actual experiences of the "Gang of Four" countries--Hong Kong, South Korea, Taiwan, and Singapore--which have so successfully pursued export promotion strategies has also shown that their governments have followed active interventionist policies, albeit with heavy reliance on market incentives.[17] Hong Kong's relatively laissez-faire approach comes closest to the conventional interpretation or "model" of market-driven export promotion based on internal liberalization. The South Korean experience, on the other hand, is furthest from the model as it reveals considerable government intervention in the economy at strategic points during the export promotion strategy. Studies of Taiwan also find it difficult to stereotype the country's development experience "*either* as a market-oriented success story *or* as an illustration of the triumph of 'dirigisme' and policy intervention." "Instead, its success is due to a mixture of both elements in effective and powerful interaction--and to a mixture, rather than sequencing, of import substitution and export promotion." In Singapore, the government has also tried to influence the allocation of resources in several ways by providing a variety of incentives for private enterprise in selected sectors of the economy.[18]

The ability of the private sector and government to cooperate closely in both formulating and pursuing a coherent development strategy has been a crucial factor in the successful development of Japan, Korea, Singapore, Taiwan, and Hong Kong.[19] The experience of these countries seems to indicate that the distinguishing feature of successful export promoters may well be the "effective, highly interactive relationships between the public and private sectors characterized by shared goals and commitments embodied in the development strategy and economic policy of the government." Thus, the seemingly dichotomous choice between market forces and government intervention may be overdrawn.[20] Government intervention, however, has been highly selective and time-bound, and the level of intervention has decreased over time.[21] Moreover, intervention has been "market-conforming" in the sense that it has been used to guide the market, change its course, and correct its imperfections, while preserving competition in the domestic market and the relationships between supply, demand, and price as much as possible.[22]

17 Chenery, Robinson, and Syrquin, *Industrialization and Growth*, p. 358 and Fry, *Money, Interest, and Banking*, pp. 347-375.
18 Quote is from Bradford, in *Development Strategies Reconsidered*, pp. 120-121. See also Fry, *Money, Interest, and Banking*, p. 348.
19 *World Bank Development Report 1987*, p. 71.
20 Bradford, in *Development Strategies Reconsidered*, p. 123.
21 *World Development Report 1987*, p. 71.
22 Chalmers Johnson, *MITI and the Japanese Miracle*, cited in Richard H.K. Vietor, *Energy Policy in America Since 1945: A Study of Business-Government Relations* (New York: Cambridge University Press, 1984), p. 353.

APPENDIX B:
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Appendix B
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