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LATIN AMERICA & CARIBBEAN DEVELOPMENT FINANCE SEMINAR

MAY 15 - 18, 1988

ALEXANDRIA, VIRGINIA

Report on the Proceedings

(Task No. 19)

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I. SUMMARY

The Development Finance Seminar was organized by the Private Sector Office of the U.S. Agency for International Development's (A.I.D.) Bureau for Latin America and the Caribbean (LAC). Its objective was to review the Bureau's experience in development finance, in the context of new economic realities in Latin America and emerging trends in international financial markets. The seminar was held in Alexandria, Virginia, between May 15 and 18, 1988 and brought together private sector and project development officers from the LAC Bureau's field missions, outside experts in financial markets, and representatives from other A.I.D. departments in Washington.

The principal focus of the seminar was defined by Assistant Administrator Dwight Ink who indicated the need to "do more with less." In other words, how can limited U.S. foreign aid resources be used to leverage the large scale capital mobilization and investment needed to reactivate Latin American economies. At a time when foreign lending and investment are not available to supplement the low levels of domestic savings in most Latin countries, the key question is whether and how A.I.D. can play a catalytic role in stimulating capital mobilization and investment.

To answer this fundamental question, the seminar was divided into three parts, each covering one day. The first day provided an overview session on how financial markets work, with a primary focus on trends in international financial markets and their implications for Latin American access to outside capital. The purpose of this session was to provide participants with a common framework and vocabulary for understanding the complex world of financial markets.

The rapid change in international financial markets, brought about by deregulation and increased competition, was emphasized. Innovation and technological advances have resulted in globalization, new products and changes in the configuration of financial institutions. Clearly, Latin America (and A.I.D.) must learn to operate in a much more sophisticated and complex environment. However, the debt crisis and current interests of global financial institutions imply that Latin countries will have very limited access to international capital markets, and must focus more on domestic resources.

This session was followed by a brief review of AID/LAC's financial portfolio of projects aimed at addressing shortcomings in financial markets. About half of AID/LAC's total portfolio is committed to financial projects, of which 32% goes to productive credit and 36% to balance of payments support. The implication is that most A.I.D. money is being used as a short term measure to alleviate the weaknesses of local financial systems in mobilizing domestic and foreign capital. A panel of three mission representatives (Costa Rica, Regional Development Office for the Caribbean-R/DOC and Jamaica) emphasized: A.I.D.'s critical role in the area of development finance; the role of policy dialogue (as opposed to projects) in alleviating the underlying problems limiting financial markets; and the range of difficulties which A.I.D. faces in designing and monitoring effective institutions for mobilizing and channelling financial resources.

The second day was dedicated to four panels on: 1) the experience of private development finance corporations as vehicles for overcoming shortcomings in the domestic commercial banking system; 2) the role of investment banking and venture capital in Latin America; 3) relevant initiatives being undertaken by OPIC and A.I.D.'s Private Investment Bureau, and draft guidelines being considered to implement the Congressional mandate to support micro-enterprises; and 4) the perception of Latin America by U.S. commercial banks.

The principal messages emerging from the panel discussions can be summarized as follows:

- Commercial flows of capital to Latin America will be minimal until significant changes are made in the economic policy framework, particularly to encourage the return of flight capital, investment in solid projects and sound financial management.

- Capital that is available (through DFCs, debt-equity swaps and other vehicles) is often under-utilized due to the lack of sound investment projects, backed by solid entrepreneurs.

- DFCs and similar vehicles can be partial solutions to the need for development finance provided that they have access to reasonably priced funds, operate in a policy environment favoring investment and are managed with a long term focus.

The third day was devoted to discussions of how A.I.D. could become a more effective catalyst of financial resource mobilization and investment in Latin America. The discussion was divided into two types of issues which had surfaced in the prior sessions: strategic issues involving A.I.D.'s basic strategic approach to financial markets and development finance; and tactical issues regarding A.I.D.'s internal procedures and approaches to strategy implementation.

Discussion of strategic issues centered around the importance of:

- Developing coherent mission strategies in the financial area (cutting across traditional sectoral divisions) and letting projects emerge naturally from the strategy definition process.

- Focusing on the underlying policy and institutional problems underlying the lack of domestic savings and investment. (By focusing on projects, particularly credit, A.I.D. is helping to alleviate the symptoms, but not necessarily contributing to the long term solution of ensuring capital mobilization).

- Creatively identifying domestic and foreign sources of capital, such as blocked funds of MNC's, selected bond issues, guarantees from contractors/buyers, IFC and European equivalents, etc.

- Ensuring that all financial strategies and/or A.I.D. projects include the capability to proactively generate investment projects.

- Determining whether DFC's are the most effective vehicles for achieving financial strategy objectives.

- Improving the quality of mission communication of its experience and strategic vision to A.I.D.'s Central Bureaus and Congress, to ensure appropriate policy guidelines and technical support.

- Focusing on interventions with the highest leverage of USAID resources on savings and investment.

- Determining whether intermediary institutions (such as DFC's) should have sustainability as a key objective, or focus on maximizing development objectives (achieving sustainability may limit the latter).

The discussion of tactical/operational issues generated the following principal conclusions:

- The tendency of over-designing projects should be resisted (extremely detailed project design exercises are usually overtaken by events), and substituted with more emphasis on building in flexibility for adjustment and strengthening implementation management.

- A.I.D. officers should take an active role in project implementation, working as partners with client institutions, and ensuring close communications and a shared understanding of expectations and progress.

- The selection of the CEO, and the composition of the Board of Directors, is probably the most critical factor in determining the success of intermediary financial institutions.

- A.I.D. missions need a better way of screening out the many "investors and promoters" who come in with unsound projects, and utilize much valuable time of key officers.

- AID/Washington should have an expert or cadre of experts in financial markets and institutions, who can help integrate A.I.D.'s fragmented experience and expertise, and act as a resource to missions.

- Since policy reform often has a greater impact on savings and investment than projects, there is a need to strengthen the policy dialogue process by: negotiating with combined leverage of all relevant projects (instead of project by project); dedicating more effort to planning the dialogue effort; and more closely integrating policy dialogue and project design/implementation.

In conclusion, development finance (i.e. the mobilizing and channelling of capital into productive investment) has never been more critical in Latin America. Although A.I.D. is dedicating significant resources to this area, efforts are required along the lines described above to improve the effectiveness and leverage of its resources. Since finance cuts across all sectors and projects, and is critical to their successful development, these areas require active top level leadership at central and mission levels.

II. PROCEEDINGS

Day One: Financial Markets

Introductory Remarks: The Context

After welcoming participants, Aaron Williams, Director of the Private Sector Office, LAC, highlighted the relevance of the Development Finance Seminar by reviewing statistics on AID/LAC's private sector portfolio. These data show that approximately 51% of the Bureau's $2.6 billion private sector portfolio (including ESF) involves projects whose central thrust is development finance (i.e., mobilizing and channelling capital into productive investment). (See Exhibits I and II) This level of commitment highlights the importance of carefully reviewing A.I.D.'s experience, improving the level of understanding of increasingly complex financial markets, and discussing how to enhance the effectiveness of A.I.D.'s interventions.

The objectives of the seminar were defined as:

- Developing a common base terminology and understanding of how financial markets work.

- Understanding key trends taking place internationally, and their implications for LDC's.

- Reviewing some specific experiences -- what is working and what is not.

- Discussing policy and operational issues faced by A.I.D. officers and how best to deal with them.

To provide the economic context, seminar moderator Eduardo Tugendhat emphasized the savings and foreign exchange gaps that severely affect Latin America. The savings gap reflects low levels of domestic or external capital mobilization relative to the investment required for sustained growth. The foreign exchange gap highlights the importance of a net foreign exchange inflow for both investment and production.

EXHIBIT I
SUMMARY MASTER LIST
LAC/PS PROJECTS

Categories	Number of Projects	Amount Authorized*
1 = Policy Reform	18	553,018.62
2 = Capital Form./Mobil./Credit	25	646,323.96
3 = E/I Promotion	28	458,685.52
4 = Skills Development	27	277,794.48
5 = Micro-Small Medium Enterprise Develop.	23	222,968.68
6 = Land Purchases/Financing	3	174,759.29
7 = Privatization	6	276,106.62
TOTAL	130	$2,609,657.17

The total number of projects is actually 109. The total illustrated here adds up to more than 109, however, because some projects fall into more than one category. In those instances, the amount authorized was divided evenly among the categories.

*Amount authorized is in US $000s.

Selection criteria for including projects:

- Only current and active projects
- All ESF $ and DA funded projects
- Local currency funded projects only if greater than $500,000 equivalent
- Training projects with a private sector focus
- Agricultural projects geared towards exports
- No housing projects
- Policy dialogue activities impacting on the private sector
- Only OPGs over $200,000

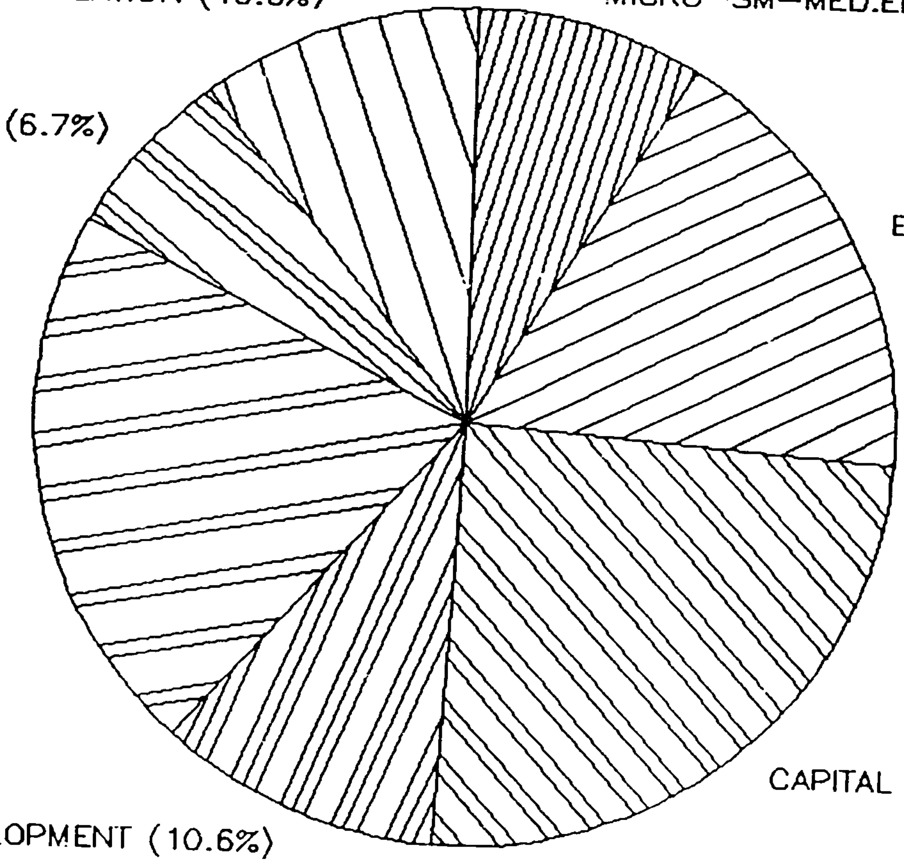
Information based upon individual USAID Mission updates and semi-annual reports from 9/30/87.

Updated: May 1, 1988

EXHIBIT II

LATIN AMERICA AND THE CARIBBEAN

PRIVATE SECTOR PORTFOLIO



	TOTAL AUTHORIZED	PERCENT
POLICY REFORM	$553,018.62	21.20%
CAPITAL FORM./MOBIL./CREDIT	$646,323.96	24.77%
E/I PROMOTION	$458,685.52	17.58%
SKILLS DEVELOPMENT	$277,327.08	10.63%
MICRO-SM-MED.ENTRPR.DEVEL.	$222,968.68	8.55%
LAND PURCHASES/FINANCING	$174,759.29	6.70%
PRIVATIZATION	$276,106.62	10.58%

Exhibit III indicates the following:

- Domestic savings in Latin America have fallen dramatically;
- As a consequence, investment has also declined;
- However, investment has fallen faster than savings;
- This is due to the loss of foreign capital inflows; and
- Domestic savings must now cover a larger percentage of investment needs compared to prior years when foreign loans and investments were available.

Exhibit IV illustrates the net transfer of resources to Latin America and its increasingly large negative margin. Exhibit V compares the experience of selected Asian and Latin American countries. Some highlights:

- Asian countries have higher investment rates;
- Savings rates are even higher and the difference has become sharper over time;
- Asia and Latin America are going in opposite directions -- In the 1960's, Asia had very low savings rates but turned them around, while Latin America had adequate rates which have since deteriorated;
- Latin America had a greater dependence on external capital rather than domestic resource mobilization;
- The current account balance is also healthier in Asian Countries, indicating less of a foreign exchange gap.

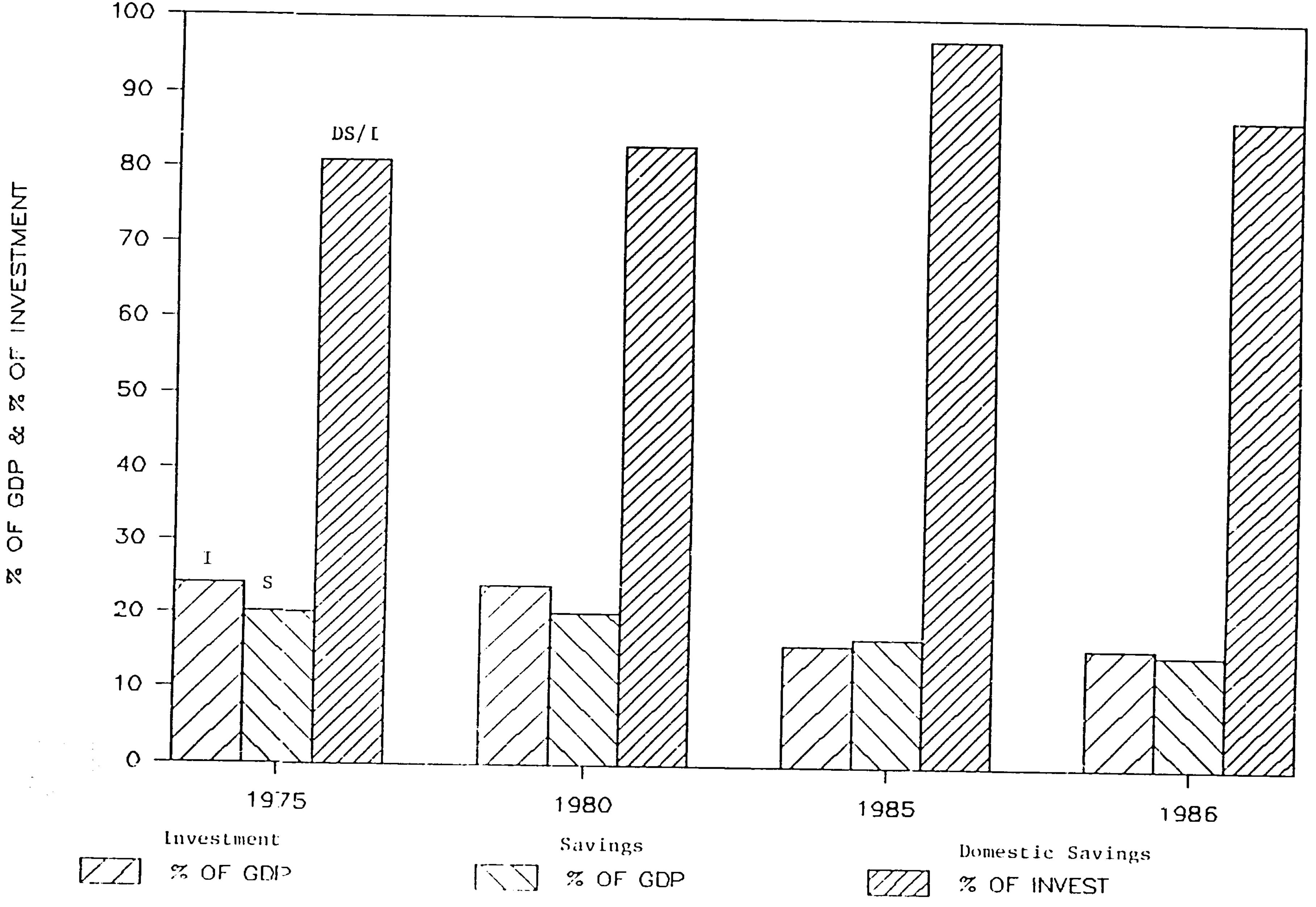
Overall, it is evident that Latin American countries must make dramatic changes in policy, and significantly improve the functioning of their financial markets, in order to mobilize the necessary level of financial resources and channel these into productive investment.

Structure and Trends in International Financial Markets

Roger Leeds, Senior Research Fellow at Harvard's Kennedy School of Government, led a session intended to bring seminar participants to a common understanding of basic concepts and trends in financial markets. The session was divided into three sections: 1) how financial markets are structured and regulated; 2) changes in international financial markets; and 3) the debt crisis and implications for Latin American access to financial markets. Key points are summarized below.

EXHIBIT III

SAVINGS AND INVESTMENT IN LATIN AMERICA



NET RESOURCE TRANSFER TO LATIN AMERICA

(BILLIONS OF DOLLARS)

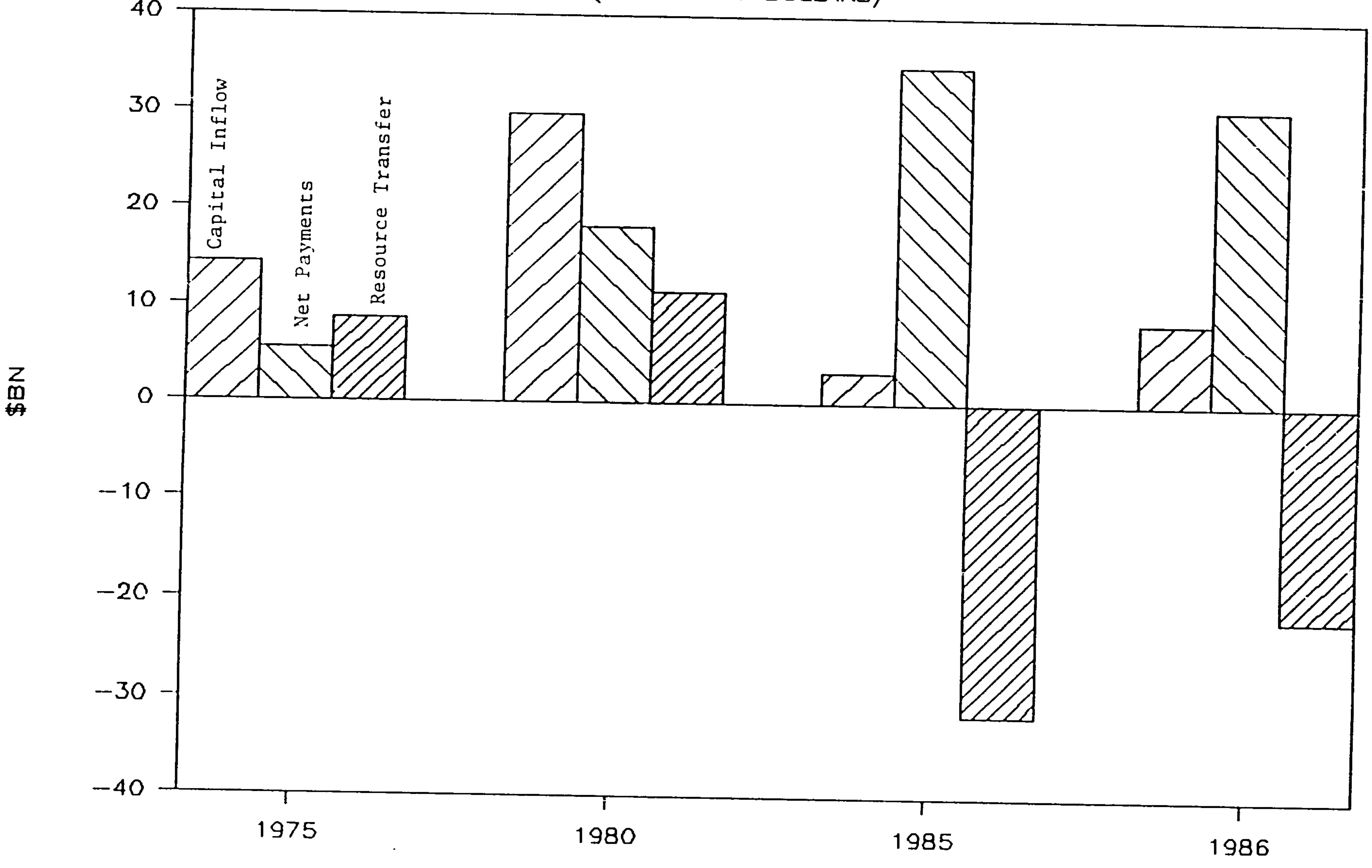


EXHIBIT V

INVESTMENT, SAVINGS AND CURRENT ACCOUNT IN RELATION TO GNP IN LATIN AMERICA

	Gross Domestic Investment/GNP		Gross Domestic Saving/GNP		Current Account Balance/GNP	
	1973-80	1980-85	1973-80	1980-85	1973-80	1980-85
LATIN AMERICA						
Costa Rica	25.5	28.0	13.8	16.1	-11.7	-11.8
Guatemala	18.7	13.5	16.4	9.9	-2.3	-3.6
Jamaica	20.3	21.6	12.6	9.6	-7.7	-12.1
Bolivia	24.9	16.0	18.2	6.9	-6.7	-5.0
ASIA						
Indonesia	24.5	29.4	24.6	26.6	0.1	-2.8
Korea	31.8	30.7	26.4	26.9	-5.3	-3.8
Malaysia	28.7	35.1	29.3	27.5	0.6	-7.6

International financial markets have been characterized by revolutionary change in recent years, both in extent and speed, affecting all market participants. An important impetus for change has been deregulation of financial markets in countries such as the U.S. and U.K.

In the U.S., for example, deregulation has ushered in a highly competitive financial marketplace, with a variety of institutions offering products and services traditionally considered within the purview of banks. The decline of the McFadden Act, which regulated interstate banking, and of the Glass-Steagall Act, which separated investment and commercial banking, and the emergence of other regulatory powers (e.g., the Federal Reserve, the Comptroller of the Currency) have altered the nature of institutions fundamental to financial market operations. Increased competition has led to increased innovation and to greater opportunities and risks for financial institutions.

One such product is securitization, the issue of paper backed by large bundles of small assets (e.g., car loans, consumer loans, mortgages), thereby making negotiable assets of those that were previously non-negotiable. Currency and interest rate swaps experienced tremendous growth from 1982 to 1986, while debt-for-equity swaps have emerged as a useful expense and debt reduction tool for banks and their LDC debtors, respectively.

Technological advances have greatly affected the functioning of financial markets; improved communications linkages and access to information have led to globalization, around-the-clock trading and increasingly complex daily transactions. The push for new products and markets in this new and rapidly changing environment has changed the nature of risk for financial market participants, making innovation a mechanism for redistributing risk.

After reviewing the supply and demand sides of financial transactions, Leeds discussed participation through financial intermediaries versus direct participation. Although Leeds suggested that the stock market, which comprises less than 20% of total financial markets, receives disproportionate attention in the financial press, it was noted that pension funds, the largest institutional player, are heavily invested in the stock market. The distinction was drawn between primary market activity (the issuance of new securities) and secondary market activity (which involves securities that have already been traded). The distinction between capital (long-term) and money (short-term, usually less than one year) markets was also discussed.

The role of the Federal Reserve in U.S. financial markets was examined. F activities take place primarily through open market operations, which control the supply of dollars in circulation and thus fundamentally affect U.S. and global interest rates. Open market operating mechanisms were detailed, and the Fed's role as an agent for foreign central banks and as an investor of Treasury tax receipts was described.

Factors determining securities prices -- maturity, quality (creditworthiness), liquidity, level of exogenous factors and regulation -- were described. The traditional yield curve, which captures the association between risk and time (i.e., longer maturities necessitate higher interest rates), was depicted.

Leeds pointed out that these factors are less significant in LDC financial markets, which are typically small and disorganized, with non-existent liquidity and restricted channels, than in those of the U.S. and other developed countries. The lack of information available, both in terms of quality and access, further distorts LDC financial markets.

Further comparison of U.S. and LDC financial markets focused on factors that make the U.S. market so resilient. The size of the U.S. market was cited as a means of providing essential liquidity, which promotes equitable access and efficient price-setting mechanisms. Size also signifies greater choice for investors, a larger spread of available merchandise and a greater variety of financial institutions in the market. Also, through the SEC, independent rating agencies and disclosure requirements, consumers/investors are fairly well protected. Finally, the quasi-autonomous nature of the Fed provides a type of checks-and-balances mechanism in the financial system, helping avoid an excessive concentration of power with a few select institutions and lessening the likelihood of conflicts of interest. This type of mechanism is absent in LDCs, which typically experience these very problems.

The appropriate degree of regulation represents an important public policy issue. Leeds contended that since there is no clear definition of a bank, it is easier for U.S. banks to conduct certain activities outside than inside the U.S., while foreign banks can undertake activities in the U.S. from which U.S. banks are prohibited. These are examples of contradictions in need of adjustment in the regulatory system.

Several important considerations will affect the nature, extent and timing of adjustment. Leeds noted that banking is different than any other regulated industry because of its major effects on individual and national interests. Banks bear an important fiduciary responsibility, not just to shareholders, employees and customers, but as keepers of the public trust essential to the conduct of business. The interbank market entails risk exposure among banks with each other, increasing the vulnerability of the financial system as a whole. The near-collapse of Continental Illinois in 1984, for example, threatened the solvency of roughly

2,000 other banks. The Federal Reserve system provides a lender of last resort for banks when they get into trouble and involves them in the exercise of monetary policy.

Another important regulatory issue in LDCs as well as the U.S. centers on capital adequacy, the most visible symbol of bank strength and an important barometer of financial system stability. It was argued that capital adequacy represents a key monitoring component for evaluating LDC financial markets. Another important regulatory issue centers on how much competition versus concentration should optimally be allowed in LDC markets.

The big growth of Eurocurrency markets in recent years has been due to their lack of regulation, which, in fact, is the very reason for their existence. A comparison of U.S. and Euromarket lending and deposit rates showed that, with the same transaction and conditions (e.g., maturity), it is cheaper to obtain funds in Europe on both sides of the balance sheet. The higher U.S. transaction costs were attributed to the greater degree of regulation in the U.S.

A discussion of risk in Eurocurrency markets was divided along three lines: credit risk, foreign exchange risk and sovereign risk, with emphasis on the latter. Sovereign risk was illustrated using an example of increased remittance restrictions enacted by the Philippine government in response to an early 1980's foreign exchange crisis. It was noted that sovereign risk is always present in cross-border transactions.

A discussion of the debt crisis involving Latin American LDCs ensued, with emphasis on the contrasts between lending in the unique atmosphere of the 1970's and lending in the high-risk modern environment. Although the magnitude of the crisis is difficult to gauge precisely because of the inexact data available, it is clear that it has had a major impact on the LDCs' current access to capital. Historically, LDC access to private sources of external capital has varied cyclically over the last 150 years.

LDC borrowing increased before the onset of the current crisis in expectation of increased growth and development, as exemplified by Mexican policymakers, who anticipated continued high oil prices after the second price shock in 1979 and borrowed accordingly. Bank loans to LDCs were motivated by the tremendous liquidity among financial intermediaries as part of the petrodollar recycling chain, reduced demand for credit by traditional borrowers and the wide spreads available at the time.

The issue of culpability for the current crisis was examined in terms of the degree to which the banks engaged in irresponsible behavior and the implications of such behavior for the international financial system. It was noted that lending after the second oil shock increased both the exposure of lenders and the debt burdens of borrowers. The onset of the crisis in 1982 due to the near-bankruptcies of Mexico, Brazil and Argentina symbolized a watershed in the treatment of LDC debtors, as a new strategy emerged for the 1982-1987 period: There was no additional private medium-term lending without rescheduling packages that included structural adjustment agreements with the IMF, and LDCs were treated on a case-by-case rather than comprehensive basis.

Despite critics' claims of irresponsible bank behavior, certain trends suggested that the structural adjustment programs were working. Interest rates dropped after 1980, the OECD countries experienced increased growth rates, oil prices dropped in real terms, LDC current account deficits dropped, and the banks became more flexible.

The contraction of voluntary bank lending between 1982 and 1986, however, resulted in a net outflow of funds from the LDC debtors to their private creditors. Other high costs of adjustment included stagnant growth, no new investment in the region and high unemployment. It was argued that the relatively worse situation of heavy debt countries in 1987 relative to 1982 indicates that the "muddle through" approach is not working. Blame can be placed on all sides: regulators were too lax and acted too late; borrowers showed a lack of self-discipline and a reluctance to undergo needed austerity; the banks abandoned normal credit risk analysis standards and got locked into a lending trap; creditor governments were not more forceful and imaginative in forging solutions; and multilateral agencies attached their own risk conditions to new funds, thus adding to LDC burdens.

A key issue is whether the debt problem is one of illiquidity or insolvency. A liquidity problem implies temporary cash-flow difficulties; this view was the rationale for approaches such as the Baker Plan, which sought to stimulate new money in exchange for policy adjustments by debtors. The failure of the Baker Plan represented a watershed in the liquidity-based view of the debt crisis.

The problem is now often viewed as one of possible insolvency, implying "bankruptcy" and the need for protected restructuring. The use of several partial solutions known as the menu approach, was reviewed. Debt-for-equity swaps exchange hard currency debt for local currency designated as funds for local investment. This tool is most suitably employed by MNCs and by countries seeking the return of flight capital. Debt relief or forgiveness approaches, typified by the Bradley plan, acknowledge the unlikelihood of LDCs meeting their debt obligations in the foreseeable future and seek to contain the dangers posed by continuing the status quo. Debt relief also recognizes that stagnant LDC growth is not in the economic or political interests of the OECD countries.

The debt relief approach poses some serious issues, such as how to ensure the survival of the banking system, the moral hazard of rewarding the worst creditors (i.e., why should the best-behaved creditors have to keep paying?) and the destruction of private lenders' incentive for providing new money. As one approach has had little success to date and the other requires thorny issues to be ironed out, LDC access to financial markets is likely to be limited in the foreseeable future, with consequent negative implications for their economic growth and development.

Panel Discussion: AID/LAC Financial Sector Portfolio

The first day concluded with a panel discussion of A.I.D.'s financial sector portfolio moderated by E. Tugendhat. The context for the discussion was provided by Exhibit VI, which divides AID/LAC's portfolio into projects aimed at: 1) mobilizing/providing domestic resources; and 2) mobilizing/ providing external resources. The first category is heavily dominated by production credit projects. Since these involve providing credit that the financial system has been unable to mobilize, they alleviate the credit problem over the short term but do not necessarily address the root issues underlying the inadequate mobilization of capital. Less A.I.D. money goes to reforming and strengthening financial markets. The same kind of situation exists in the external resources area where most A.I.D. funds go to meeting short term needs for foreign exchange.

R. Rosenberg of Costa Rica stressed the importance of policy, as opposed to projects, in promoting domestic capital formation. He cited the example of interest rate deregulation, a politically painful decision that discouraged investment over the short-term (e.g., 15% real rates). However, in the last three or four years, a mini-boom characterized by the repatriation of flight capital has resulted. There has also been a drop in the percentage of government investment to total investment, indicated by renewed private investment.

Rosenberg also described the changing sources of long-term project finance, which could be mobilized "off the street" or offshore in the 1960's and 1970's, when there was relative confidence and stability. At present, the only realistic source of long-term funds for developing country financial institutions consists of donor or government programs.

EXHIBIT VI
LAC'S FINANCIAL PORTFOLIO

I. PROJECTS AIMED AT MOBILIZATION OF DOMESTIC RESOURCES

	Ongoing Projects ($000)	Number of Projects
Policy reform	42,489	5
Micro/small business credit	45,428	13
Production credit	432,731	18
Merchant banking/DFC	97,705	7
Privatization	135,008	4
II. MOBILIZATION OF EXTERNAL RESOURCES		
Investment promotion	102,062	8
Policy reform/BOP	476,243	6
III. TOTALS		
Financial projects	1,331,666	61
Total private portfolio	2,609,657	109

DEFINITIONS

- Policy reform-internal: Projects whose primary thrust is the strengthening and reform of financial markets/institutions.

- Policy reform-external: Mostly ESF where the principal focus is balance of payments.

- Production credit: Involves mostly credit channelled through existing institutions where active project development is not a central thrust. Includes export credit, guarantee funds.

- Merchant banking: New institutions involved in project packaging or development of new financial instruments, and whose focus is new investment.

- Privatization: Included because stated purpose is usually to free up credit for the private sector. Many corporations are closely held family operations resentful of outside interference. The tax laws promote a bias toward debt financing, as equities are fully taxed, while debt expenses are deductible. Spotty tax enforcement creates a high cost of publishing financial records.

An over-leveraged corporate base has created a brittle financial structure. Efforts to develop the stock market in Costa Rica have not proved successful, and credit continues to dominate the securities market. Cultural factors are partly responsible, ascorporations are closely held family operations resentful of outside interference. The tax laws promote a bias toward debt financing, as equities are fully taxed, while debt expenses are deductible. Spotty tax enforcement creates a high cost of publishing financial records.

K. Finan (RDO/C) discussed the difficulties of equity finance and intermediate credit institutions in the Caribbean. She questioned the effectiveness and development impact of some of the Mission's private financial projects. The effectiveness of private intermediary credit institutions and/or development finance corporations was discussed in detail (see Days 2 and 3).

T. Tifft (Jamaica) emphasized monetary policy measures, including setting a floor on interest rates and setting borrowing costs as a function of the savings rate. The foreign exchange rate in Jamaica has been adjusted through an auction system so as to reduce capital flight and promote domestic savings.

A.I.D. supported the creation of three financial institutions in Jamaica -- the Trafalgar Development Bank (industry, agro-industry and tourism sectors), Jamaican Agricultural Development Foundation and National Development Foundation (micro- and small businesses) -- but adequate funding remains a problem. These institutions are structured to be very dependent on low cost sources of funds (ie., A.I.D.). The impact of these projects has been increased investment and increased private institutional development, but sustainability over the long term is a problem.

Discussion focused on sustainability as a key objective in financial projects. The record here has been mixed: after the disbursement of soft A.I.D. loans, the subsequent use of commercial bank funding with its higher costs has forced IFI's to focus on lower risk, shorter term activities with less of a development impact.

<u>Day Two: Alleviating Financial Market Constraints To Investment And Exports</u>

<u>Panel Discussion: Development Finance Corporations</u>

T. Mocney (LAAD) led off the panel on development finance corporations, giving a brief history of his organization, which has 16 large companies as shareholders and which began operating in Central America in 1971. 70% of LAAD's historical and modern portfolio has been in this region, with efforts to expand in the Caribbean and South America underway. Cooperation with A.I.D.

has been based on a sharing of the same general purposes, such as increasing foreign exchange and non-traditional agricultural exports.

The sovereign and credit risk of its portfolio was discussed. Credit risk is due to the normal risks of landing to agribusiness (undependable climate, price fluctuations, etc.) combined with the complex nature of collateral in these LDCs. At any given time, more than 50% of LAAD's current portfolio has consisted of renegotiated credits.

Sovereign risk, however, has been its key concern, with Nicaragua cited as a prime example. Panama represents another problem area, with almost certain future losses.

Ten percent of LAAD's total portfolio of $45 million is in equity, and $35 million of its total portfolio is in Central America. The average cost of capital for LAAD is low in Central America, but is rising overall because of higher costs of funds in South America. Shareholders maintain a hands-on but arm's length relationship; there are no efforts to market shareholders' products. Financing comes primarily from reserves and from A.I.D. funds.

W. Phelps of COFISA, which celebrates its 25th anniversary this year, described the diversity of subsidiary activities under the parent holding company. Of 560 shareholders, none has stakes bigger than 5%. The company began with $5 million worth of financing from A.I.D. and $1 million from local equity stakes. With the success of the Central American Common Market (CACM) in the 1960's, early lending focused on import substitution industrialization. Additional A.I.D. funding in 1969 of $5 million (plus $2 million local) was geared toward agriculture and agro-industry.

$200 million in commercial bank borrowing in the late 1970's led to a payment crunch in the early 1980's when the Costa Rican economy began to unravel. With a series of currency devaluations and the contracting economy, COFISA's local loan portfolio became problematic. Borrowers were unable to pay the dollar value of their loans. A $10 million A.I.D. hard currency loan in 1983, and $5 million in local currency, and successful rescheduling with the foreign banks, helped COFISA recover its financial footing. Today, many of its clients have been able to penetrate U.S. markets with their exports and COFISA is turning profits. Lending activity, however, has slowed down because of a lack of available resources, as commercial banks have shied away from Costa Rica; currently, only 2 institutions (short-term credit lines only) are doing business in the country.

Phelps indicated that COFISA has been successful due to a number of factors: diversification into new opportunity areas ranging from an industrial free zone to debt-equity swaps; a successful reputation which helps bring in new business; close communications with A.I.D.; and the active involvement of a strong board.

T. Pastoriza of the Dominican Development Bank began by reviewing the development of Dominican financial institutions since the creation of the Central Bank in 1947. That year also saw the establishment of an agricultural development bank in the public sector; an agricultural and industrial development bank was later established under Trujillo. In the early 1960's an industrial development corporation, modeled after a similar institution in Puerto Rico, was created.

In 1966, FIDE was created to provide a window of private investment in the central bank; in addition, laws were changed to allow commercial banks to play the role of financial intermediaries. Another law created the Dominican Development Bank, which became operational in 1968, with A.I.D. support.

By the end of 1970, only two private development finance institutions -- the DRDB and COFINASA, created by Gulf & Western, were in operation. However, by the end of 1987, 33 such institutions were operating, not including similar activities undertaken by commercial banks, savings and loans and informal finance institutions. Other statistics confirm the explosive growth of DFCs in the 1970's and 1980's: total assets were 45 million pesos in 1975 and 650 million in 1987; loans outstanding amounted to 40 million pesos in 1975 and 500 million in 1987; in 1975, 2% of funds were obtained from the public, compared to 35% in 1987. Overall, the DRDB has approved 1,300 loans worth $188 million.

Sectorally, 42% of loans are in agriculture and 47% in manufacturing, and primarily food processing. The primary sources of DRDB funds include public issues, FIDE, A.I.D. ($10 million in original funding) and the U.S. Ex-Im Bank, which provides commercial credits for imports of American machinery.

In terms of loan instruments, Pastoriza cited securitization as bringing false promise because of difficulties in executing mortgages due to collection problems involving the Dominican system of jurisprudence. Pastoriza also recommended that the equity investment portfolios of DFCs be built up, noting that DRDB investments worth $3 million had generated more income than $40 million in loans. Many investment opportunities arise when the bank is obliged to take over ailing companies. The limited stock market, however, makes it difficult for institutions to divest their investment portfolios.

Institutional flexibility is further limited by A.I.D. requirements, such as the provision mandating review mechanisms on an annual basis and arms-length and conflict-of-interest requirements. Loan-size requirements force DFCs to make many small loans at high cost. Although the emphasis on democracy (i.e., the distribution of wealth and power) is a worthwhile goal, it is not always feasible: Better loan quality and operating performance is achieved by lending to established customers who already have money and power.

Dominican tax rules discourage secondary market activity in favor of primary market activity. Bank staffing needs must be met while keeping a wary eye on the conflict between development bankers and commercial bankers, who examine project proposals from different analytical perspectives.

R. Wagner (Charter Associates) highlighted three major issues affecting development finance institutions: (1) what is the market, both at the beginning of, and during a proposed project; (2) internal planning -- the financial strategy and analysis of not just proposals, but of the development institution itself; and (3) a long- versus short-term focus. Commercial bank behavior in the developing world is viewed as rational, but narrowly focused. DFCs, in loans to the agricultural sector and in start-up ventures, take higher risks.

Risk during project assessment should be assessed in terms of several factors. The quality of management is key to the quality of the projects being financed. The market for proposed products, salability of collateral (or the purchase of the business if venture capital is involved), regulatory factors (e.g., taxes, fees), equity commitments, agility of customs and other exogenous factors (e.g., political stability) must also be considered.

Wagner views DFCs as generally good at setting up controls, such as credit analysis or administrative structures. Their fear of getting overly extended in early stages of operation is well-founded. However, they are not good at setting up new services for their customers or at managing the cost and effort involved. They also are generally not cognizant of their competitors (other DFCs, commercial banks, local banks) and are not effective in developing their own market niches. The need to generate earnings, their fear of risk and the need to meet A.I.D. requirements makes them adopt a short-term orientation.

A better DFC analysis of their own situation (i.e., products, markets, financial viability) is advocated. Other revenue-generating options, such as project design and implementation fees, other fee-based services, higher interest rates, and investment in assets with greater returns than loans, should be considered in strategy development. Keys to customer service -- availability, correct term and structure, and customer assistance -- must be kept in focus.

DFCs should gear themselves more toward large loans to promote their own financial viability; they should not be viewed as a means of promoting equity or of aiding the "poorest of the poor." Less time should be spent on analyzing project risk; more time should be spent on crucial issues, such as managerial, production and quality development and gaining knowledge of local conditions. DFCs should require better proposal quality from clients. Also, increased utilization of technical assistance grant funds would boost operational efficiency.

The need to avoid an excessive early focus on profit -- by A.I.D., company boards of directors and management -- was stressed. Insufficient balancing of short- versus long-term concerns in decision making will harm DFCs.

In discussion, the issue was raised of why institutions have not gotten more creative in dealing with constraints such as loan/mortgage collection problems, with the DR cited as an example. Difficulties in judicial proceedings in countries with legal systems based on the Napoleonic Code were cited in response. It was also suggested that means of by-pass -- such as personal guarantees small companies, or parent company guarantees for their subsidiaries -- could be developed.

Opinion was divided on whether DFC designs featured too little financial sophistication to allow for sustainability. Large loans to larger, more established companies are needed to generate the revenues necessary to sustain the losses often involved in doing development work. This view was contrasted by the opinion that the proper focus should be on developing DFC customers that can stand on their own, rather than DFCs that can stand on their own.

It was questioned why scarce A.I.D. resources should be allotted to DFCs that play a role similar to that of commercial banks in the private sector. It was responded that intervention was justified by the situation, in that the long term credit needs, and other financial services of a significant clientele were not being met. Commercial banks are unfamiliar with development lending and are unwilling to assume the risks involved; it is also difficult to establish a development lending arm within a commercial bank. Because economies are geared toward activities more suited to commercial banks, development banks must evolve as quasi-commercial banks (making loans to established operations) to survive. Fiscal policy issues must generate system-wide change, which is beyond the capabilities of development banks.

Problems also involve the cost of making development loans. Development banks cannot keep doing activities based on a cost of funds made artificially low by access to soft loans; when these dry up, the servicing of more expensive commercial bank funding requires greater returns.

A.I.D. political goals must be modified as DFCs are remodeled toward more of a profit/survival focus -- expanded activities in underwriting, venture capital and privatization must be part of such a focus.

Finally, the issue of collateral was raised. It was argued that DFCs should show more flexibility in the types of collateral they are willing to accept in exchange for soft A.I.D. loans. Collateral is still important as a demonstration of borrower commitment.
There is also a need to distinguish between volumes and types of collateral.

Panel Discussion: Investment Banking and Venture Capital

The second panel led off with L. Miller (ISTI) examining financial market constraints from an investment banking perspective. He noted that LDC financial markets share similar characteristics, mainly in terms of being primitive or less sophisticated. The first thing to look at in these markets is how they mobilize investment funds, which necessitates a look at private and overall savings rates, private and public investment, liquidity, interest rates (yield curve), and the availability of long- and medium-term capital. Borrowers often prefer short-term capital that can be extended using rollovers; this may lead to skewed investment decisions.

Investment bankers must also address existing constraints in the private sector. One such constraint is the concentration of equity holding among families or small groups unwilling to place more equity in the market, using only internally generated funds for expansion. Speculators purchase most of the stock, creating most of the turnover. Efforts to expand equity markets will not be productive without incentives to make it worthwhile for investors; in Asia, for example, there are tax breaks for companies listed on the stock exchanges.

A commonly overlooked aspect of investment analysis is whether funds are mobilized in local or hard currency (i.e., locally or externally). Donor institutions tend to think almost exclusively in terms of external currencies. Demand for financing, however is often for local currency (except for imports) since no one wants to assume the foreign exchange risk.

Another difficult aspect of investment analysis involves how projects are generated; most LDCs have poor project-generation capabilities and most commercial banks do not get involved in project generation. This ability, however, is extremely important -- governments do not do a good job because they are not driven by a fear of losses. The lack of sound projects is often more acute than the lack of financing.

There is also the need to look at the totality of financing options. Among financing techniques, DFCs typically face funding problems in providing dollars on a long-term loan basis (once their source of A.I.D. money dries up). Venture capital is frequently thought of in terms of the U.S. market, but is difficult to pull off successfully in LDCs. It depends on acceptance of outside investors (by family businesses) and agreed-upon accounting standards. Unlike the U.S., equity investments depend largely on cash flow from the project, since divestiture tends to be difficult.

Trade finance offers some promise if banks are willing to reach further back and make producer loans as well as provide commodity financing; it may be beneficial to develop this process more fully.

Enhancing investment instruments for private individuals in LDCs is an avenue that may be profitably explored. Current choices include bank deposits, real estate, or flight capital, which enables individuals to preserve their capital and investment position in inflationary environments that bring on large-scale devaluations. Foreign exchange rates and other policies thus become essential aspects of the analytical equation. Instruments for bringing back capital and mobilizing local resources are only workable within an appropriate policy framework.

E. Rey (Citicorp) provided the perspective of an investment banking unit within a commercial bank. He noted that in the 1970s, Latin America developed primarily through debt financing, an outgrowth of a negative interest rate environment and the petrodollar recycling chain. Foreign investors avoided taking equity positions.

The diagnosis of the debt crisis originally centered on short-term liquidity, and later focused on solvency. The Baker plan, with its emphasis on multi-year restructuring, served as a mechanism linking public and private sector debt. The current view of the situation as a structural problem implies the need for a long-term solution, involving multiple players (not just commercial banks).

In order to manage and reduce exposure, a range of financial engineering instruments has been developed. Exposures can be reduced by diversifying or concentrating debt portfolios through swaps.

U.S. regional banks have adopted a strategy of taking current hits to their balance sheets as they leave the international market entirely. Europeans have employed a similar strategy, and, with the establishment of the JBA fund, the Japanese banks are likely to follow.

Debt-for-equity swaps are typically used only for public sector debt; regulations vary among countries. Other considerations involve the discount off face value and appropriate uses for the local currency. Foreign equity participation is constrained by restrictions on the repatriation of profits and dividends.

Rey gave a detailed description of the Bolivian Beni-Biosphere reserve project as an illustration of debt-for-nature swaps. Conservation International acquired $650K of face value debt for $100K, in exchange for government passage of reserve-creating legislation and the creation of a local currency fund for managing the reserve. It was argued by a participant that more public relations efforts are needed to promote this type of scheme in LDCs, as they are often interpreted as a giveaway of the national patrimony (including the Bolivia case).

M. Julien (DAI) described USAID attempts to expand exports of non-traditional agriculture in the Eastern Caribbean region through the operation of an A.I.D. supported equity investment fund for agri-business. Project preparation in DAI involves business plans for investors, project technical assistance and commercialization grants. The goal is to spur investment by bringing investors with resources into the region, using seed capital and assistance as an incentive.

Julien noted the need to differentiate between entrepreneurs with ideas, drive and initiative but little capital and those with no capital but "loony" ideas. He also described impediments to the use of venture capital in development lending. The region's small size means small, undeveloped capital markets and inflexible equity instruments. The risk involved means equity positions are rarely taken. There is also a lack of effort to gain access to available capital. Archaic fiscal policies hamper the development of equity markets: The double taxation of dividends, for example, forces companies to double the returns normally obtained using debt. In small family companies, investor perceptions of ROI are different, with analyses based on perks, salaries, etc. Also, entrepreneurs have difficult access to information. There also remains an archaic legal structure, especially in areas of British settlement.

These investment constraints hinder the development of special finance facilities, because they cannot prosper on their own. Merchant banking, with emphasis on good management and well-defined markets, represents the most likely evolutionary path for development finance organizations in this region.

During discussion, it was noted that in equity or quasi-equity operations, most experiences have been negative, with the Dominican Republic being the only apparent example of long-term success in an equity stake.

The issue was raised whether venture capital or unit trust operations can survive in a small country, low per capita GNP environment. There were no documented cases of a successful venture capital operation, which was viewed as extremely risky because of the lack of exit opportunities.

The essential nature of project generation and the need to develop the institutionalization of this function was stressed. It was also noted that merchant and commercial banks have different agendas. A.I.D. field personnel should consider ways of identifying bottlenecks to investment and developing institutions to deal with them.

Regarding equity positions by DFCs, it was suggested that DFC equity stakes are often inherited (i.e., taking over the management of a failing company through the conversion of defaulted loans), as in the case of the Dominican Republic. This could represent a new business focus for DFCs -- the provision of additional financial services in return for equity or a fair return -- that may become an important aspect of financial investment analysis and planning. The use of an equity kicker as compensation for risk may become a new way of looking at investment opportunities.

The lack of project generation was used to support the contention that technical assistance funds were not being properly deployed by development institutions. However, the need is not just to look for projects, but to look for projects that meet investment criteria, and are backed by solid investors/managers. The need to distinguish between investor and investment development was also noted.

Panel Discussions: Other Donor Activities

The third panel discussed other donor activities. H. Aller (PRE) described PRE projects in three areas -- technical assistance, privatization and financial markets. A revolving fund, which approximates a merchant or investment banking checkbook, is used to make direct loans to U.S. financial institutions to collateralize letters of credit issued to local institutions.

This and other transactional structures are based on regulation and may be changed by legislation, including the establishment of a direct guarantee mechanism.

R. Dragon described OPIC programs in two areas, direct loans and guarantees of loans provided by U.S. financial institutions for which OPIC sets the terms. With the retrenchment of commercial banks from further lending activity in the region, a financial void remains to be filled.

Through a program with First Boston and Drexel Burnham in the Caribbean, tax-exempt earnings in Puerto Rico are being recycled into investment funds. Such funds are being applied to promote tourism in the DR and to privatize 13 state-owned hotels in Jamaica. Whereas the prior focus was on asset-based lending, current emphasis is on the provision of working capital and on debt-equity swaps.

P. Bittner (CLUSA) reported on the proceeding of an advisory committee to the A.I.D. Administrator on guidelines for implementing the Congressional mandate for A.I.D. lending to micro-enterprises. He contrasted micro-enterprise lending five years ago, which was undertaken in scattered fashion by foundations with no sense of project viability, with the more sophisticated and profit-oriented modern environment.

Difficulties in establishing micro-enterprise lending guidelines center on arriving at an exact definition of a micro-enterprise.

The issue was also raised whether these businesses can borrow at market rates, given the previous emphasis on subsidized loans, using viability as a strict criterion. A "stock-taking" exercise has been recently initiated to assess the sustainability of firms and financial intermediaries in this sector based on A.I.D.'s experience. Field teams will be conducting intensive assessment programs.

Panel Discussion: Commercial Banking Views of Latin America

The fourth panel was led off by B. Richter (A. D. Little), who attributed part of the origin of the debt crisis to the fact that loans to developing countries were made the wrong way (i.e., in dollars when there were no dollar earnings being generated for repayment). Part of the groundwork for the debt problem also came about when U.S. banks began investment banking activities as part of their financial intermediation after the first oil shock in 1973. With more banks competing, loan margins became smaller.

Margins narrowed further in the early 1980's after the deregulation of the financial system initiated by the Reagan administration, with the subsequent entry of foreign banks into U.S. markets. As the debt crisis set in, banks cut back their

Strategic responses have involved personnel cuts, asset sales and cutbacks in international operations. Industry consolidation through M&A has led to greater contraction.

Banks staying in the international market have taken a more selective view: First Chicago has reduced the number of countries in which it is operating and is changing its customer focus, attempting to meet the needs of domestic MNCs operating in these countries. Trade finance and project lending have been de-emphasized. The management of foreign assets has been moved from line lending to a bad loan workout group. No new voluntary money for Latin America will be forthcoming; banks will instead focus on major markets with a long-term view of reducing or eliminating foreign exposure.

The banks do share a mutual interest with LDC debtors in reducing levels of current exposure. Commonly deployed menu options include debt-for-equity, debt-for-debt and debt-for-product arrangements. Other institutions' (e.g., World Bank, IDB) involvement will enhance the likelihood of commercial banks' participation in project lending. The economics, of course, must make sense. Banks will also encourage privatization efforts where possible.

In discussion, the issue was raised as to how important the return of flight capital would be to attracting new lending. Reed responded that it probably would make a difference only in certain markets.

The difference between commercial banks, which rely on commission business for 40% of their earnings, and development banks, which live mostly on loan spreads, was again discussed. It was questioned whether development banks have enjoyed any real success, since they have provided capital that would have been better generated if a market existed and have relied for their existence on funds from multilateral organizations.

The lack of optimism concerning the use of the "menu" approach to resolving the debt situation, was noted. This is indicated by the small number of buyers of deeply discounted debt, and the lack of true equity being mobilized. Apparently, there is no real market for much of the debt. Banks are actually playing a waiting game, preferring to hold onto their paper in hopes of a turnaround, and to avoid write-offs. Only regional and European banks are aggressively moving their paper.

Reserve creation was cited as a means of giving banks more flexibility in choosing exposure reduction approaches and when to deploy them. These reserves represent a loss on financial statements, but not on taxes.

DAY 3: POLICY AND OPERATIONAL ISSUES FOR A.I.D.

The final day of the Seminar was dedicated to more in-depth discussions of key policy and operational issues, involving finance related A.I.D. initiatives which had been raised during the first two days. The purpose was to focus on how to address constraints that A.I.D. officers face in the planning and implementation of their financial sector portfolios.

The principal issues highlighted for discussion are presented in Exhibits VII and VIII. Issues involving the strategic focus or direction of A.I.D.'s financial sector portfolio are highlighted as strategic issues, and distinguished from tactical or operational issues involving A.I.D.'s implementation of strategies. The highlights of the discussion are summarized below.

EXHIBIT VII

STRATEGIC ISSUES
(Where should A.I.D. be going in the financial area)

1) Assessment of Bottlenecks

- Methodology
- Critical Constraints

2) Customizing An Appropriate Strategy

- Macro Policy vs. Project Lending

- Addressing Most Critical Constraints
  - Local needs vs. Washington Agenda
  - Local needs vs. "Typical" A.I.D. Responses

- Role of Domestic Savings and Resources

- Generation of Good Project/Investors

- Co-Financing
  - Other Sources of Long Term Funds?

- Credit vs. Financial Services
  - Response to market

EXHIBIT VIII

TACTICAL ISSUES
(How To Get There)

1) Pricing of Funds

- What are Market Rates?
- Compensation of Risk
  - FX Risk

2) Project Design vs. Implementation

- Relative Allocation of Effort (Design vs. Adjustment)
- Can the Perfect Project Be Designed
- Who "owns" the Project
  - Private Sector vs. A.I.D.

3) A.I.D. Requirements/Expectations of Intermediaries

- Sustainability
- Other Requirements
- Short Term Results vs. Other Objectives

4) Management of Private Projects

- How A.I.D. Deals with Private Boards

5) Flexibility on A.I.D. Terms

6) Personnel Problems
- Financial Gurus

STRATEGIC ISSUES

Improved Strategic Planning was highlighted in the review of the seminar findings. The following conclusions emerged regarding strategic planning in the financial sector:

- There is no need for large sector studies of financial markets (most of the studies yield results indicating there is a credit shortage -- something already known);

- There is a need for a clearer identification of key strategic issues and in particular a process that focuses upon defining a common mission strategy in the financial arena. There was some discussion of how the private sector initiative does not fall easily into one A.I.D. department and yet all financial projects and objectives need to be integrated in some manner.

- Projects should emerge from a clearly defined strategy; instead of projects defining the strategy. There was a great deal of discussion on the difficulty in some countries of developing appropriate projects and the resulting problems when a project is not in sync with A.I.D. strategy (LAAD attributes its success to a common strategy with A.I.D.)

- Project design should be market driven, based on the key needs/opportunities in financial markets. Since the setting is likely to change rapidly, the ability to respond to change is critical.

- A.I.D. needs to recognize problems in design due to differences between actual local needs and the Washington political agenda, or local needs for creative solutions versus "typical" A.I.D. responses.

Improved communication between the individual field missions and Washington was emphasized in the discussion on critical constraints to both strategy formulation and project implementation. To avoid policy guidelines from Washington which conflict with the field perception of needs, the Missions need to be more effective in communicating their vision of the situation. Moderator Terry Brown, LAC/DR, emphasized the importance of better communication between A.I.D. officers and U.S. legislators engaged in developing A.I.D.-related legislation. This need was particularly obvious from the seminar participants' responses to the presentation (Day 2) on the proposed congressional micro-enterprise lending restrictions. A number of participants expressed concern about the overabundance of regulations and restrictive definitions (i.e., average loan size of $300). The importance of pro-active mission efforts to shape the views of staffers and policy makers was emphasized. The same applies to policy guidelines developed by central A.I.D. Bureaus, such as PPC's draft policy paper on ICIs. The ability of field missions to develop customized strategies will be limited unless they can jointly work to limit the rigidity of Washington directives. It was indicated that the Private Sector office could act as an advocate in support of these efforts.

<u>Mobilization of domestic resources</u> is a critical strategic issue which does not always receive enough attention. A.I.D. is often more concerned with the design or selection of intermediary institutions to channel its own resources than in identifying ways of mobilizing domestic resources. The problem with this approach is that A.I.D.'s resources amount to only a small percentage of the capital requirements. Furthermore, providing credit does not necessarily alleviate the policy and institutional weaknesses in the financial system which are limiting resource mobilization.

It was pointed out that although numerous speakers had emphasized policy dialogue and reform as being the most effective intervention in the financial area, most of the discussion in the seminar centered around ICIs and DFCs, and the channelling of A.I.D.'s funds through individual projects. This focus on projects has several implications: policy reform does not receive nearly the same level of attention or resources; policy dialogue efforts are often fragmented since each project has its own conditionality; A.I.D.'s policy leverage is reduced since the funding of each project is relatively limited; and the resulting leverage (total impact on resource mobilization and investment) from A.I.D. resources is small.

The power of public policy in resource mobilization and stimulating productive investment was cited in numerous examples (Costa Rica, Jamaica and Dominican Republic). In the Dominican Republic, it was noted that powerful incentives for <u>local</u> investment had brought about the boom in tourism and free zones. A.I.D. projects, while helpful, provided moderate resources compared to the large domestic capital mobilization and investments brought about by the policy framework. The question is to what extent, and how, A.I.D. should get involved in policy reform, and how it can maximize its influence.

A related issue is how A.I.D. can focus more of its projects on the development of financial instruments that mobilize domestic savings in productive investment. This requires an appropriate policy framework and creative financial instruments. Sustainability of financial intermediaries, and large scale capital mobilization, is only possible if workable mechanism are developed.

Project generation is a strategic issue for the design of investment projects. Many A.I.D. financial projects provide credit or other types of financing on the assumption that there is an unsatisfied demand. However, in many projects that focus on new investment (instead of working capital for existing firms) the constraint is actually the lack of solid investment projects backed by bona fide entrepreneurs/managers. Interested entrepreneurs tend to lack other project components such as access to markets and technology. Thus, A.I.D. projects should have a component for proactive promotion of new investment proposals and for project "packaging" to ensure that all critical elements are provided for.

It was noted that "success and experience tends to breed success." For example, if a few companies are successful in a certain type of investment (e.g. flowers in Costa Rica or hotels in the D.R.), others will imitate. This implies the need to focus on product areas with opportunities for growth. Similarly, DFCs with a successful reputation (such as COFISA) will not lack sufficient projects and demand for their services.

Successful financial institutions (DFCs) also diversify as a means of addressing the limited demand for any one type of financial service. COFISA has entered a number of new areas and is constantly searching for distinct niches, each of which may generate only a limited number of specific opportunities.

In other words, successful DFCs are proactive in their efforts to generate project/demand, and count on their success as a tool in generating business. This implies that where possible, A.I.D. should focus on helping successful, existing institutions diversify and expand, rather than create new institutions.

Although sound investment projects are sometimes in short supply, A.I.D. officers often feel overwhelmed by the number of "walk-ins" looking for financial or technical support. These opportunists, who rarely have capital or realistic project ideas, consume valuable time and resources. The question is how to screen out these very low probability prospects, many of whom are Americans and as taxpayers expect some kind of support from A.I.D.

Development of additional sources of funding to supplement A.I.D. projects was emphasized and some specific suggestions were formulated:

- Utilization of blocked funds of multinationals who may seek a productive use for their local currency.

- Selected bond issues such as the recent example in the D.R. (a private company floating a private bond issue and raising 24 Million Pesos with a US Dollar guarantee arranged through Chase Manhattan);

- Incentives for stimulating local savings and investment, without creating "incentive junkies" or economic distortions from excessive incentives.

- IFC participation and other related organizations such as European development finance organizations eager to participate in development of Latin American markets (i.e. a Dutch development financing institution, DEG and a British development agency);

- Guarantees by large companies (buyers) for smaller companies (sub-contractors or suppliers).

- Debt-equity swaps or mutual funds (established through swaps) for the purpose of investing in dollar earning projects.

Although sources of financing exist, seminar participants emphasized the difficulty in generating investor interest in projects perceived as being high risk ventures and giving relatively low returns on investment. The pricing of financial products must reflect this perception of risk if additional sources of capital are to be mobilized.

Development Finance Institutions: Much discussion centered on A.I.D.'s commitment to using the DFC model as a vehicle for A.I.D. on-lending activities. The discussion introduced the following types of questions, all of which require further consideration.

- Is the primary objective of DFCs to maximize leverage of A.I.D. money in new investment and development impact or is it self-sustainability? To what extent does the latter tend to preclude the former and vice versa? Most participants argued that the former objective should be most important, even though longer term A.I.D. support would be required.

- Why should A.I.D. devote resources to the establishment of DFIs instead of assisting existing commercial banks in the establishment of a development finance "window"? Is there really a fundamental difference between commercial and development bankers? Although no consensus emerged, it was generally agreed that the key is to find financial institutions (regardless of type) which are aggressively developing new financial products and to ensure that a development oriented individual manages the program.

TACTICAL ISSUES

Project design and implementation issues were expanded upon under this topic. The need to structure flexibility into project design was discussed in more detail. Participants cited examples of project overdesign where an overly ambitious agenda needed to be amended later and examples of well-designed projects that failed to yield the expected results due to unanticipated events. The important conclusion from this discussion was that project design should be flexible. Project management and the ability to adjust to events (and the market) are perhaps the most crucial determinants of success. This implies less resources spent on project design and more on project monitoring, management information systems and ongoing strategic planning. Similarly selection of the CEO and the Board of Directors is probably the most critical set of decisions.

In addition to good internal management, AID's own involvement in the project as a "partner" was emphasized. Participants advocated active involvement of A.I.D. officers in ongoing project monitoring instead of relying upon sporadic consultant reports to provide the necessary information. The key to this monitoring is a strong management information system generating periodic reports with key information needed to assess progress and highlight problems. Costa Rica has reportedly developed a good model in its relationships with "clients" which would be replicable elsewhere.

The significance of personal relationships between A.I.D. officers and the institution's management was demonstrated in examples cited by officials from COFISA and of LAAD. Both view their relationship with A.I.D. Missions as a type of partnership. However, others cautioned that there is a danger of A.I.D.'s involvement in "micro-management", for which it is not equipped. The consensus is that key A.I.D. officers must actively seek to protect their "stake" in the project by regularly requiring information that adequately depicts the situation. Any problems or deviations from plan should immediately be addressed. These tasks should not be delegated to periodic interventions by consultants.

"Ownership" of the projects was touched upon as an underlying problem at times. The question is whether A.I.D. or the client institution "owns" the project. Surprisingly, some of the non-A.I.D. representatives from DFIs counciled A.I.D. to play an even greater role in the institutions receiving their assistance.

Whatever the case, the recurring theme was the importance of constant and long-term communication between all parties regarding expectations and roles.

<u>Demand and market studies</u> in project design were discussed briefly. Most of the remarks seemed to underline the difficulty of obtaining precise results. A true market study involves going to the potential product users -- a very difficult task in the developing markets of Latin America and the Caribbean where products and their users may not yet exist. Furthermore, economic and policy changes can rapidly alter market projections. A general agreement emerged that market and demand studies should be indicative of the types of services needed and the estimated level of demand. However, resources should not be wasted on "definitive" projections. Again, project flexibility, is more critical.

<u>Availability of financial sector expertise</u> in A.I.D. Missions, the ICIs or DFCs, and AID/Washington was mentioned as a constraint. A.I.D. has chosen to invest significant resources in private sector development through Development Finance Companies and other intermediaries. However, it does not have one or more experts in this area, such as those working for the World Bank, that can integrate the A.I.D. experience and act as a resource for the missions. The recruitment of this expert(s) to be based in AID/Washington, was strongly recommended, despite the expense of recruiting this type of talent.

<u>Managing foreign exchange risk</u> is a design issue which elicited the following comments:

- US dollar loans to exporters do not eliminate the risk if exporters are not allowed to keep the foreign exchange proceeds of their sales. In these situations, companies are hesitant to borrow in dollars.

- ICIs may not really want US$ loans from A.I.D. if the sub-borrowers do not need US dollars. In other words, the ICIs may not want a foreign exchange risk larger than required by the configuration of their loan portfolios.
- ICIs (and A.I.D.) may need to focus on obtaining local currency funds to more closely match their clients' needs.

- Unless the policy framework is adequate, it may be unfair to ask ICIs or their borrowers to accept all the foreign exchange risk A.I.D. or the local government may have to absorb the risk (or work harder to change the policies).

- Guarantee funds, using A.I.D.'s dollars, and located offshore may be one solution to this problem. PRE has experimented with this model.

Fixed rates versus floating rates

Discussion of this issue seemed to indicate that A.I.D. should consider the use of floating rates in lieu of fixed rates. PRE is already utilizing floating rates in its operations in keeping with the new emphasis on projects that can respond to market fluctuations.

A. AGENDA

LATIN AMERICAN AND CARIBBEAN DEVELOPMENT FINANCE SEMINAR
MAY 15-18
Alexandria, Virginia
(Revised Agenda, 5/2/88)

SUNDAY, MAY 15, 1988

7:30 - 9:30 P.M. o Reception
Greetings and opening remarks: Dwight Ink, Assistant Administrator for Latin America and the Caribbean(LAC), Agency for International Development (AID)

MONDAY, MAY 16 - FINANCIAL MARKETS

8:30 - 9:00 A.M. o LAC 's Involvement in Financial Projects
- Aaron Williams, Director, Private Sector Office, LAC

9:00 - 9:15 o Introduction
-Eduardo Tugendhat, CARANA Corp.

9:15 - 10:30 o How Financial Markets Function and How They are Structured
- Roger Leeds, Senior Research Fellow, Kennedy School of Government, Harvard University

10:30 - 10:45 o Coffee Break

10:45 - 12:30 P.M. o How Financial Markets Are Changing
-Roger Leeds

12:30 - 1:45 o Lunch, LAC/PS with Officers from Caribbean Missions

1:45 - 3:00 o LDC Access to Financial Markets and the Debt Crisis
- Roger Leeds

3:00 - 3:15 o Coffee Break

3:15 - 3:30 o Summary of Key Issues
- Leigh Miller, Realty Factor

3:30 - 5:00 o AID/LAC Financial Sector Portfolio
- Moderator: Eduardo Tugendhat
- Panelists: Kimberly Finan, RDO/C; Richard Rosenberg, Costa Rica; Tom Tifft, Jamaica

TUESDAY, MAY 17- HOW TO ALLEVIATE FINANCIAL MARKET CONSTRAINTS TO INVESTMENT AND EXPORTS

8:30 - 10:30 A.M. o Development Finance Corporations
- Moderator: Howard Aller
- Panelists: Tomas Pastoriza, Financiera Dominicana; William Phelps, COFISA; Robert Wagner, Charter Associates

10:30 - 10:45 o Coffee Break

10:45 - 12:30 P.M. o Investment Banking and Venture Capital
- Moderator: Tom Tifft
- Panelists: Joe Borgatti, consultant; Enrique Rey, Citicorp Investment Bank; Leigh Miller

12:30 - 1:45 o Lunch, LAC/PS and Officers from Central American Missions

1:45 - 3:15 o Other Relevant Donor Activities
- Moderator: Susan Spika, LAC/PS
- Panelists: Howard Aller; Peter Bittner, CLUSA; Luis Ernesto Derbez, World Bank; Robert Dragon, OPIC

3:15 - 3:30 o Coffee Break

3:30 - 5:00 o U.S. Commercial Banks and Latin America
- Moderator: Reese Moyers, Bolivia
- Panelists: Steve Reed, First Chicago; Bruno Richter, Arthur D. Little

WEDNESDAY, MAY 18- POLICY AND OPERATIONAL ISSUES FOR AID OFFICERS

8:30 - 9:00 o Summary of Key Issues
- Leigh Miller and Eduardo Tugendhat

9:00 - 12:30 o How to Address Policy and Operational Problems
- Moderator: Terry Brown
- Panelists: Patricia Buckles, LAC/DR; James Grossman, Honduras; Richard Rosenberg, Costa Rica

12:30 - 2:00 o Lunch, LAC/PS with Andean mission officers

2:00 - 4:30 o Summary of Seminar Results and Implications for Action
- Leigh Miller and Eduardo Tugendhat

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