PROGRAMMING A.I.D.
FINANCIAL MARKETS ACTIVITIES:
ISSUES AND OPTIONS

Prepared for:

Asia/Near East Bureau

Private Sector Officer Workshops

April 27, 1990

Office of Government Services
1801 K Street, N.W.
Washington, DC 20006

Telephone 202 296 0800

Price Waterhouse

April 27, 1990

Mr. Gary Vaughan
Bureau for Asia, Near East and Europe
Agency for International Development

Dear Mr. Vaughan:

Re: Financial Sector Development Project
Contract No. PDC-2206-Z-00-8191-00
ANE Financial Markets Options Paper

Attached please find copies of our report entitled "Programming A.I.D. Financial Markets Activities: Issues and Options," as prepared by Price Waterhouse, Prime Contractor under FSDP.

It has been a pleasure to work with you on this activity. We look forward to working with you on this and other projects in the future.

Sincerely,

Mr. J. Richard Breen
Director, FSDP

cc: Sandra Frydman, AID/PRE

TABLE OF CONTENTS

APPENDICES

A. ACTIVITIES CONDUCTED UNDER THE FINANCIAL SECTOR DEVELOPMENT PROJECT

B. ACTIVITIES CONDUCTED UNDER THE FINANCIAL MARKETS PROJECT

I. INTRODUCTION

A. Purpose of the Paper

The purpose of the paper is to provide a summary of the issues and options faced by ANE Private Sector officers who are responsible for the planning and programming of specific activities in promotion of financial market development. In particular, the paper is intended to stimulate discussion at the private sector workshops to be held in Jordan and Thailand in May 1990.

B. Definitions

Before proceeding further, it is useful to define several terms that will be used frequently in this paper. The term "financial markets" is an all-encompassing term which refers to all markets for short-, medium- and long-term securities and loans, forward and swap contracts, financial futures and foreign currencies. The portion of the financial markets dealing with securities is divided into two subsets, depending on the maturity of the instrument involved. Financial markets refer to all securities that have a maturity of one year or less, while capital markets refers to securities with a maturity of over one year.

C. Role of Financial Markets in Economic Development

As powerfully supported by an increasing body of literature, the development of financial markets is fundamental to economic development.[1] Without strong and deep financial markets, a developing country will not mobilize the financial resources necessary for investment activity and economic development.

While foreign capital is an important contributor, the decline of foreign capital inflows means that countries will need to rely increasingly on domestic financial resources, and especially savings, to provide most of the funds required for economic development. The efficient channeling of savings into productive investments is a precondition for accelerating economic growth in countries throughout the world. Financial markets encourage this process by facilitating the flow of funds from savers to investors.

---

example, see the World Development Report 1989 on "Financial Systems and Development" or The Economist "Survey of the Third World," Sept. 23, 1989.

The objective of financial markets programs is therefore to assist in the creation of an appropriate legal, fiscal, regulatory and institutional framework conducive to increasing the volume and efficiency of this flow of financial resources.

D. Lessons Learned in the Area of Financial Sector Reform

Out of the research and operational experience of the international funding agencies, certain key issues emerge, as presented below. These are issues which, at a minimum, must be addressed in order to evaluate the scope for reform or change that exists in a particular country.

- Financial sectors in developing countries tend to be characterized by the dominance of the banking sector and the absence of money markets and long-term capital markets. As a result, companies lack avenues to increase the amount of equity on their balance sheets and are highly leveraged.

- Interest rate controls tend to channel credit to preferential borrowers and away from smaller clients and start-up companies. Such controls impede the efficient mobilization of capital by the formal banking sector.

- Prudential regulation and supervision must accompany the development of the financial sector. A modernized system of financial institution supervision and regulation is necessary to reduce the financial system's vulnerability to panic, crisis or collapse, especially as reform and liberalization measures are introduced.

- Existing commercial codes in many countries are outmoded and inhibit the development of new financial instruments and financial markets intermediaries. Frequently, laws are overly restrictive, prevent increased domestic and foreign competition or protect narrow interests.

- The lack of credible financial information impedes the regulatory process, erodes investor confidence and creates a system-wide bias for collateral-based lending. Reliable accounting and disclosure systems are the bedrock of a solid financial sector.

- Governments need to coordinate their financial system policies with policies in areas such as taxation, foreign exchange, monetary policy and the legal system. For example, the tax treatment of financial instruments may promote or impede the development of financial markets, and thus influence the whole character of the financial system.

E. Benefits of Financial Sector Reform

The benefits that come with financial sector reform can be illustrated by a brief review of several major events in Asia. For example:

- o Provisions of the October 1988 deregulation of the Indonesian banking sector produced a 38% increase in deposits of all types in 1989; savings deposits more than doubled last year.
- o Interest rates became positive again (in real terms) in Korea following the 1981 financial reform.
- o The financial sector grew rapidly (a doubling of the ratio of M3/GNP from 1973 to 1983) in Malaysia following interest rate liberalization.

The costs of neglecting the needs of the financial sector can be seen in insolvent banking institutions, weak mobilization of savings for development, and economic stagnation that results in countries that cling to wide-ranging government intervention and protectionism. The strong correlation between positive real interest rates and GDP growth has been demonstrated over and over in developing countries.[2]

---

[2] See Alan Gelb, "Financial Policies, Efficiency and Growth: An Analysis of Broad Cross-Section Relationships" as discussed in the World Bank Development Report 1989.

II. A.I.D. FINANCIAL MARKETS POLICIES AND PROGRAMMING

A. A.I.D. Policy on Financial Markets

A.I.D.'s policy on financial markets is stated in the August 1988 policy paper on that subject. According to the policy paper:

> "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."

To that end, A.I.D. supports developing countries' efforts to:

> "(a) design, adopt and implement policies conducive to the development of efficient, deep and integrated financial markets, relying primarily on market rates of interest and other terms for the efficient mobilization of private savings and allocation of credit, and (b) build and promote competition between viable private, profit-making financial institutions.

A.I.D. can serve as a catalyst for financial sector reform in developing countries through both the policy dialogue process and project assistance. In particular, Missions are advised to help develop and implement policies to encourage, mobilize and monetize domestic savings; encourage governments to adopt reforms that permit interest rates to adjust to market levels in a deliberate and timely way; and discourage developing countries from relying excessively on directed credit programs. Before engaging in such activities, Missions are expected to prepare a comprehensive financial markets development strategy paper.

B. Selected ANE and PRE Financial Sector Activities

1. ANE Missions Activities

There are a number of examples within the ANE region of ongoing credit (or credit guarantee) projects, usually focusing on small and medium-sized businesses, the export sector or agribusiness. These projects range from the $7.8 million Enterprise Development Project in Bangladesh to the $5.5 million Private Sector Export Promotion project in Morocco. Other ANE projects, such as the Commodity Import and Housing Guarantee Programs, also deal with public and private sector financial intermediaries in lending to the shelter or productive sectors.

While these projects may often have financial training or policy analysis components, they do not address financial market development per se. Indeed, the tendency of many projects to direct credit to a targetted economic sector (at times through public or parastatal institutions at less-than-market rates) may be at odds with a more general A.I.D. policy goal of allocating credit efficiently according to private market mechanisms.

Some Missions have begun to target resources more specifically toward financial markets activities. USAID/Sri Lanka, for example, funded in FY 1988 its $15 million Private Sector Policy Support Project which supports both privatization and capital markets development. In the same fiscal year, USAID/Indonesia funded its $9.0 million Financial Markets Development project which provides technical assistance, training and policy analysis to guide development of the country's expanding securities market. Finally, in FY 1989, USAID/Dhaka funded a $15.6 million project (Financial Sector Credit) with the Bank of Bangladesh, to liberalize interest rates, strengthen bank supervision, and eventually privatize a significant portion of the public sector banking system.

Future ANE Mission activities in this area range from a $7.0 million Capital Markets Development Project in the Philippines in FY 1989 to recently approved or planned private sector projects in Jordan, Tunisia and Pakistan which include a significant financial markets component.

2. PRE Activities

PRE's activities have generated a broad array of A.I.D. experience in financial markets activities. The Financial Sector Development Project (FSDP) and its predecessor, the Financial Markets Project (FMP), have worked with Missions to develop a wide variety of activities in financial markets, ranging from seminars on the potential impact of, and need for, venture capital in India in 1986 to the recently completed financial sector assessment/ reconnaissance reports in Morocco and Thailand. Under FSDP, PRE has fostered applied research on such topics as the regulation and supervision of financial institutions in LDCs, and the integration of financial markets in developing countries with global markets. Under FSDP, PRE has also sponsored the organization of conferences and workshops and the production of a newsletter to share the knowledge and experience developed under the Project with development practitioners. An overview of activities under FSDP and FMP is presented in Appendices A and B.

3. Financial Markets Programs of Other Donor Agencies

Among the major multilateral institutions based in Washington D.C. - the World Bank, the International Finance Corporation (IFC) and the International Monetary Fund (IMF) - in principle it is the IMF which deals with central banking issues. In recent years, however, given the World Bank's increasing involvement in bank restructuring and the importance of prudential regulation to sustain the banks, both the World Bank and the IMF provide technical assistance to central banks, with the World Bank operating in some countries and the IMF in others. Both the World Bank and the IFC offer loans to the private and public sectors, but the World Bank, in keeping with its charter, does not make any loan without a government guarantee and makes no equity investments as the IFC does.

Within the IFC, the Capital Markets Department provides technical and financial assistance to developing countries to improve the environment and operations of their financial markets. Among its activities, the Capital Markets Department supplies equity and loan finance and technical assistance to help establish new, or to expand existing, financial institutions. It underwrites securities issued in the international capital markets and has helped to launch several mutual funds in countries such as Thailand and Malaysia. It assists governments in the formulation of capital markets development plans, establishing an order of priorities, creating the appropriate legal and fiscal frameworks and identifying the need for specific institutions and market mechanisms. The IFC is also currently involved in both new cash and debt conversion schemes. In addition, the IFC collects information on stock markets in LDCs and provides it to subscribers of its "Emerging Market Database."

The IFC has limited resources for financing technical assistance. A recent IFC publication states: "While IFC provides technical assistance as a special service, it is principally an investment institution and thus its budget for direct non-revenue producing activities is limited. Consequently, most of the costs related to implementation programs are borne by bilateral and multilateral agencies which can fund technical assistance activities." Furthermore, while the IFC is often able to provide short-term technical assistance with its own resources, "...longer programs must be funded in large part by other sources, often including the member governments themselves."[3]

---

[3] A.I.D.'s key advantage vis-a-vis the multilateral agencies may be that the technical assistance provided by AID is available on a long or short-term basis, depending on the requirements of the particular program. A.I.D.-sponsored programs may be particularly attractive to host governments when multilateral TA budgets become exhausted or relations with multilateral organizations are

The Asian Development Bank (ADB) provides technical assistance directed at financial markets development, including improvements in the policy and regulatory environment. In Thailand, for example, the ADB is providing technical assistance in such areas as stock market regulation, establishing a credit rating agency and training of securities exchange personnel in the use of automated systems. The ADB started expanding its private sector activities in 1987. In August, 1989, it set up a new Private Sector Department to coordinate its efforts in this sector and approved a $35 million equity investment for the establishment of the Asian Finance and Investment Corporation, a variation on the IFC.

Several private voluntary organizations (PVOs) provide technical assistance, loans and equity to small and medium-sized businesses. CARE Small Business Assistance Corporation makes equity investments ranging from $150,000 to $250,000 in businesses with strong prospects for creating new jobs and earning foreign exchange through exports. Initially, most of the capital will come from the LDC debt portfolios of U.S. and European banks and "blocked funds" of multinational corporations that can not be repatriated.

---

strained. Furthermore, the World Bank, the IFC and the IMF often send non-U.S. experts to countries where American expertise in the financial markets is preferred because in certain areas, such as financial sector laws and regulations, the U.S. is perceived to be the leader.

III. EVOLUTION OF FINANCIAL MARKETS IN THE 1980s AND 1990s[4]

The 1980s was a decade of tremendous expansion of international capital markets. In 1988, the dollar value of securities issued internationally reached a record $350 billion. At the beginning of 1989, stock markets in the thirty or so emerging markets which the IFC tracks had grown in aggregate capitalization from $84 billion in 1983 to $377 billion, and the total number of company listings increased from around 6,700 to nearly 11,000. Trading volume, meanwhile, increased from $25 billion to $408 billion (see Exhibit A).

A relatively recent development is the creation of country funds. Today there are over 80 emerging market country funds listed on stock exchanges throughout the world. Pension funds and other institutional investors have sought to diversify their portfolios by investing internationally. As a result, larger amounts of capital are crossing international borders as investors throughout the world increase their purchases of foreign securities. The interdependence of world capital markets has increased the importance of developing stable and competitive banking, financial and regulatory systems in developing countries if they are to be linked to them, attract foreign credit and investment capital.

The ANE region contains some of the most dynamic and rapidly changing economies in the world. Financial market conditions vary widely, however, from the highly regulated, public sector-dominated economies of India and Egypt, to the economies of several of the Southeast Asian countries, such as Thailand and Indonesia, currently undergoing liberalization.

In view of this diversity, the next section sets forth a menu of options which Missions might consider in developing financial markets programs. The options are fairly "generic" and will need to be tailored to suit the particular needs and conditions of the host country.

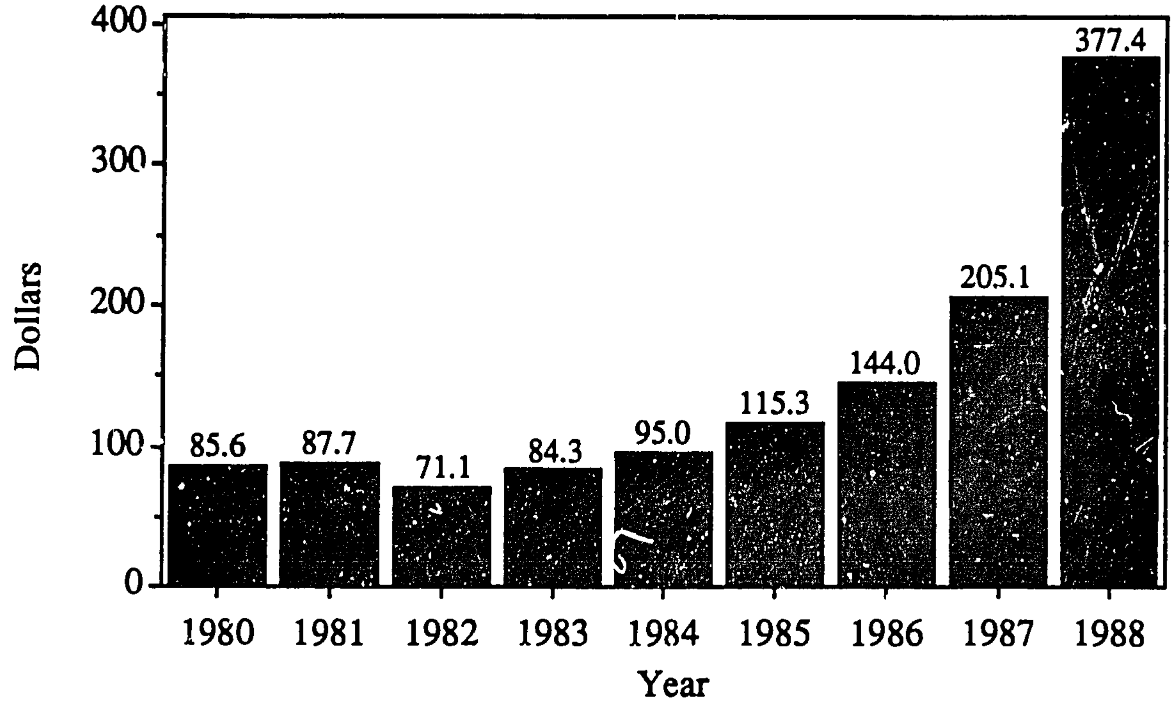
---

[4] There have been many excellent articles and books covering this subject in detail. Our purpose here is not to present an analysis of financial market trends but to set the context for the next section, the Menu of Options for Practical Interventions in Support of Financial Sector Development, which is the main subject of this report.

Exhibit A

EMERGING MARKETS CAPITALIZATION

(IN US$ Billions)



Countries:

Argentina	Malaysia
Bangladesh	Mexico
Brazil	Morocco
Chile	Niberia
Colombia	Pakistan
Costa Rica	Peru
Egypt	Philippines
Greece	Portugal
India	Sri Lanka
Indonesia	Taiwan
Jamaica	Thailand
Jordan	Trin.-Tobago
Kenya	Turkey
Korea	Venezuela
Kuwait	Zimbabwe

Source: Emerging Stock Markets Factbook 1989, International Finance Corporation.

IV. MENU OF OPTIONS FOR PRACTICAL INTERVENTIONS IN SUPPORT OF FINANCIAL SECTOR DEVELOPMENT

A country's needs for technical assistance in the financial sector will vary according to its stage of economic and financial markets development. In a less advanced country with serious economic distortions and over-regulation of the financial system, A.I.D. might focus on such measures as interest rate deregulation and increased bank competition to mobilize domestic savings for capital investment. In order to mobilize the longer-term savings needed to support longer-term investment, A.I.D. might support the development of new institutions such as housing finance companies and insurance companies.

In more advanced countries, where financial institutions tend to grow in number and become more complex and functionally diverse, A.I.D.'s programs might concentrate on promoting the growth of securities markets and diversifying the sources of domestic and foreign investment capital. The securities market development program might focus on the fiscal and regulatory environment, the improvement of corporate financial reporting and disclosure, and the promotion of specialized financial institutions such as stock brokerage and money market firms, investment banks and specialized long-term leasing companies.

In more sophisticated developing countries, businesses tend to issue more specialized financial instruments to meet specific investment requirements, and savers tend to look for new ways to save and invest. In these countries, A.I.D.'s objectives might be to help bring more investors - individuals, companies and institutional investors -into existing securities markets and to broaden the range of available financial services. These objectives can be achieved by, for example, setting up specialized institutions such as venture capital companies, merchant banks, mutual fund or investment management companies.

While many areas of technical assistance involving the financial sector are related, the main categories used for the purposes of this paper are: Expansion of Securities Markets, Quality of Information, Legal and Regulatory Reform and Commercial Banking. A menu of options for technical assistance under each of these categories follows.

A. EXPANSION OF SECURITIES MARKETS

Securities markets contribute to financial and economic development by mobilizing long-term risk capital. A company that issues bonds in the securities market is able to undertake capital investment programs without the risk that finance charges will suddenly to unpredictable levels and may achieve a lower cost of funding than that available from banks. Stock markets allow companies to redress the balance of debt and equity on their books, provide liquidity to investors, and provide venture capital companies and privatizing entities with a necessary outlet for their shares. Following is a step-by-step approach to developing the securities markets.

STEP ONE: Conduct an Assessment of the Current Securities Markets

Determine which of the following best describes the situation in the country.

Scenario 1: The target country is too small or underdeveloped to support a local capital market. If this is the case, determine which of the following options would best satisfy capital market needs:

1a. The country must rely on direct foreign investment to raise capital for large enterprise.

This is usually the only option for extremely small countries without a strong tradition of free enterprise and weak corporate management skills (ex. St. Kitts).

1b. The country should have securities of local corporations traded in a major world market (e.g. use American Depositary Receipts - ADRs - to list securities on the New York Stock Exchange).

This is an option for a small country, with few local investors but with a free enterprise tradition and the ability to create and manage successful large companies (ex. Barbados).

1c. The country should develop a regional market with its neighbors.

This is an option for a country with too few investors to support a local capital market, but with the ability to manage and develop some successful large corporations, and with similar neighboring countries (ex. Honduras, Jordan).

Scenario 2: The target country is large enough to support a local capital market but one has not developed due to structural barriers (ex. Indonesia). These barriers usually are embedded in the legal and economic system, supported by established political and business interests, and sometimes reflect a lack of a free market tradition.

If the barriers can be identified and removed, a local market may develop. However, removal of the barriers is usually dependent upon establishing a consensus that fundamental changes are necessary and worthwhile.

When the barriers are identified but cannot be removed because consensus for change cannot be reached, the country must adopt a solution under Scenario I (e.g., socialist countries, with only state-owned enterprises, must rely upon direct investment.)

<u>Scenario 3:</u> The target country already has an incipient capital market, operating on a self-sustaining, non-subsidized basis, but requires technical assistance to encourage more rapid development (ex. Malaysia). Determine which improvements are of the highest priority:

Improvements of legal infrastructure. (Corporate law, securities law, investor protection)

Improvement of institutions.

Improvement of quality of securities.

<u>Scenario 4:</u> The target country has a growing capital market, which will develop on its own without assistance. (Ex. Singapore).

Intervention is not required.

<u>STEP TWO:</u> <u>Develop a Plan of Action</u>

Note: there is no 'canned' approach. Experienced generalists should be dominant in the initial consulting team to develop a creative approach to the situation.

1) State the policy goal and how consensus may be achieved.

2) Determine resources needed.

Heavy financial resources are not usually required. Except for the development of computerized trading and settlement systems, or the creation of a financial communication network, most capital market development efforts involve technical assistance and are relatively minor when compared with other types of development efforts. The private financial sector should furnish most capital investment.

Competent, experienced consultants are the major assistance component. The challenge is to find people with senior investment banking experience that are available at the fee limitations of donor agencies. International investment bankers will often become involved at below normal rates, if they see an opportunity to get in on the ground floor of a developing market. In choosing consultants, it is important to select those with experience in similar markets to that in development.

3) List possible donors. Evaluate possibilities for a coordinated approach.

If the program calls for the development of a regional market, coordination between separate US missions and regional and international development agencies could play a significant role.

Different consultants will often present conflicting recommendations. This may be a question of different priorities and backgrounds. A coordinated approach offers a chance to benefit from these conflicts, without hindering development planning.

STEP THREE: Create Consensus for Implementation of a Plan.

Note: This may be the most difficult task. Since capital markets directly benefit owners of large corporations and affluent shareholders and since the negotiation of securities may appear as non-productive to some economists and politicians, political support is not easy to obtain when competing with programs that address immediate problems of poor countries. Consensus is particularly difficult when needed to overcome structural barriers that benefit local interests.

Techniques for creating consensus include:

a) Sponsoring seminars to discuss initial recommendations.

b) Encouraging economic research on the local capital market, comparative studies of the legal system, and analysis of past attempts to develop a market, getting local economists and economic policy makers involved in the dialogue.

c) Financing training and awareness programs for capital market executives in the public and private sectors. Such programs should include seminars and trips to different developed markets.

STEP FOUR: Implement the Plan.

Note: After consensus is achieved, market development is straight-forward. The first priority is to remove structural barriers, encouraging new participants to enter. Most tasks can be handled by the private sector with selective aid in key areas from specialized consultants.

Practical A.I.D. activities:

1. Development of laws and regulations.

a) Interest rate deregulation

b) Revised laws regarding bank competition

c) Securities commission regulations

d) Disclosure rules

Accounting rules
New issues

e) Fair market rules

Manipulation
Insider trading

TA requirements: Programs to support the development of laws and regulations typically require long-term TA in order to study reforms, draft model laws and regulations, build consensus, etc. Sources of expertise might include senior-level officials of U.S. Government institutions such as the Federal Reserve, the Treasury Department (Comptroller of the Currency's office), the Securities and Exchange Commission and the FDIC; and private sector practitioners such as securities lawyers and accounting firm consultants.

2. Institutional Strengthening.

Note: attempts to create stock exchanges without first removing structural barriers are common. Building a capital market is much more than organizing a stock exchange. Such attempts are seen in many failed capital market development programs.

a) Assistance in planning and organizing institutions.

For example, promote the development of a mutual fund industry, pension funds, insurance companies (institutional investors). Mutual funds mobilize savings, usually from small and medium-sized savers, and consolidate them into diversified securities portfolios that are managed on behalf of savers by professionals. As such, they promote returns that are higher than would normally be available to small investors. Pension funds and insurance companies assist greatly in the development of a large and stable source of contractual savings, in addition to their social value within the context of a developing economy.

TA Requirements: Programs to promote the development of new institutions such as pension or mutual funds will require long-term TA. A possible role would include conducting feasibility studies, assisting in locating domestic or foreign partners, assisting in the formulation of financial and operating policies, providing financial assistance for start-up operations in the form of loans, helping to mobilize other domestic and foreign financing - the latter through loan guarantees and co-financing mechanisms - and assisting in the recruitment and training of managers. Sources of expertise include industry executives, investment bankers and the International Executive Service Corps (IESC).

b) Training

Training of executives

Training in special skills

-- Security sales.

-- Security trading.

-- Security analysis and portfolio management.

-- Security firm administration and accounting.

-- Underwriting techniques and distribution.

c) Information Systems

Implementation of specialized accounting systems.

Implementation of trading and order handling systems.

Computerization of market institutions.

TA requirements: The training and information systems components should require shorter-term technical assistance and could be provided through contracts with a U.S. stock exchange; computer software companies providing turnkey systems and training to the securities industry; and diversified accounting firms with information technology and management consulting practices.

3. <u>Financing Key Development Programs.</u>

a) Computerization of a central securities market.

Note: Computerization is now less costly than training an entire market in the complex techniques of security market administration.

b) Financial information communication systems.

Developing countries usually suffer from less than adequate communication networks, hindering financial market development. This is a prime opportunity for coordinated assistance between donor agencies.

c) Financial information utility services.

This is a prime area for donor assistance, since impartial information utilities (for example, rating agencies, such as Standard and Poors) rarely are profitable in the early stages of developing markets, but contribute greatly to market development. Credit rating organizations provide ratings for corporate bonds, preferred stock issues, municipal bonds, bank CDs (certificates of deposit) and other debt or quasi-debt instruments using standard symbols (AAA, AA etc.). The ratings performs a credit risk function and are valuable to unknown companies contemplating borrowing in public markets and to investors interested in assessing the creditworthiness of a particular borrower. Credibility is essential to the operation of a rating organization and usually arises from its being independent of any issuer's business.

TA requirements: Sources of expertise on establishing financial information utility services include industry leaders such as Standard & Poors and Moody's. A possible role would be to support a feasibility study for such services in order to give U.S. companies an edge in expanding into new markets. Programs involving the linkage of financial markets participants to a central securities market or information clearinghouse (as distinct from systems of automation within an institution) require a communications infrastructure that is cheap, reliable and efficient. In countries where such a communications system does not exist, TA programs may need to be deferred until an adequate system is put in place. Programs to automate a trading floor may be accomplished within a shorter time frame under contract with a U.S. stock exchange (as advisor) and a supplier of computer software and hardware for the securities industry.

B. QUALITY OF FINANCIAL INFORMATION

Accurate financial information is important to an economy in allocating limited resources among competing, alternating uses. Individuals, businesses, lenders and investors use financial information in evaluating the rewards and risks associated with investment alternatives (i.e., whether a person puts his/her money in a savings account or a CD, whether governments allocate resources to highway construction or defense, whether a company invests in manufacturing a product or acquiring land, etc.) The lack of reliable financial information impedes the regulatory process, erodes investor confidence and constrains the development of securities markets and cash flow-based lending.

What are the characteristics of useful accounting information? Among other things, it should be reliable, verifiable, lacking bias (neutral), comparable with similar information derived from other firms and across time, and efficient (i.e., the cost of acquiring the information should not exceed the benefits of using it.)

Practical A.I.D. activities:

1. Development of technical standards.

   a. Auditing standards

   b. Accounting standards, i.e. GAAP[5]

      -- reporting standards
      -- standards regarding professional ethics
      -- qualification standards
      -- continuing education standards

2. Development of professional associations.

   A.I.D. could support the creation of professional associations such as the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA). The FASB is a professional

[5] GAAP refers to the methods of accounting that businesses are permitted to use in preparing their financial statements for investors and other external parties. For the most part, these principles are established by professional accounting and official governmental bodies. Since 1973, the Financial Accounting Standards Board (FASB) has been the principal agency outside the federal government responsible for developing accounting principles. (See next activity, Development of Professional Associations.)

organization that sets accounting standards, issues rulings on the interpretation of standards, makes revisions to standards according to changes in market/industry developments; maintains the integrity of standards, and polices the accounting profession. The AICPA is a professional organization of certified public accountants that sets standards for the professional ethics of its own profession; conducts research on accounting issues; and disseminates information through journals and bulletins. The AICPA provides technical assistance internationally.

3. Training.

A.I.D. could support the training of auditors and accountants at universities and technical schools.

a. Curriculum development
b. Text book development
c. Visitation programs for university professors to give lectures and teach seminars.

TA Requirements: Programs to improve the quality of financial information will require a sustained effort by A.I.D. but may consist of several related short- to medium-term projects. Sources of expertise include the major accounting firms, professional associations, the Securities and Exchange Commission, the Financial Accounting Standards Board, and university professors.

C. LEGAL AND REGULATORY REFORM

The efficiency of financial markets depends to a large extent upon the laws and regulations governing them. In most developing countries, commercial codes are outmoded and do not reflect modern business practices. For example, countries may lack the legal basis for corporate reorganization (Ch. 11) or trusteeships (necessary for the issuance of corporate bonds and asset backed securities). Many countries have company acts but no financial institution or investment company acts. (See discussion under Commercial Banking.) Certain laws and regulations are overly restrictive, prevent competition or protect narrow interests.[6] Tax

[6] Hernando de Soto's research into the difficulties of getting certification to start a small business in Peru points to the burdens of overregulation. He found that it took 289 working days and several bribes to obtain certification of a small garment factory in Lima. The same process took half a day in Tampa, Florida and four days in New York City.

laws may inhibit the mobilization of long-term savings or expansion of the securities markets. Finally, as financial markets develop, policy changes must be made and new laws and regulations introduced or existing ones amended to ensure an efficient set of relationships between savers and investors.

Practical A.I.D. activities:

1. Examine the specific laws and regulations in a country that inhibit financial market development and offer advice for adapting existing laws or drafting new ones.

2. Study the impact or burden of existing laws and regulations and the costs of weak enforcement of existing laws and regulations.

3. Assist in restructuring or reorienting regulatory entities.[7]

TA Requirements: Legal and regulatory reform requires persistent, long-term technical assistance, given the need for consensus building and the long lead times required for passing legislation. Sources of expertise include senior officials of regulatory agencies and consultants with relevant legal experience and knowledge of the country's systems. The U.S. may not have a comparative advantage in providing TA to civil and commercial code countries since the U.S. system is based on common law. In certain areas, such as bankruptcy law, however, the U.S. is probably the most advanced.

D. COMMERCIAL BANKING

Commercial banks typically play a much larger role in the economies of developing countries than they do in the U.S. and other industrial countries, since they tend to control a larger percentage of total financial resources. Typically, the commercial banking sector is highly concentrated. Government regulations limit the entry of new banks, reducing the scope for competition. Interest rate repression results in lending decisions that are influenced by personal relations and government credit policies. Bank officers are generally poorly trained, and bank systems are

---

[7] Regulation touches on several areas discussed elsewhere, e.g., banking regulation, securities market regulation, regulations concerning financial disclosure. For further discussion of regulatory TA, please refer to those sections.

not automated or outmoded. Banks and bank supervisors lack adequate financial information due to lax accounting standards and bank regulators lack sufficient legal authority to properly supervise the banking sector. Prudential guidelines are inadequate to protect depositors who seldom have the security of deposit insurance.

Practical A.I.D. activities:

1. <u>Legislative reviews.</u>

A.I.D. could support increased competition through licensing of domestic and foreign banks, introduction of laws regarding bank regulation, etc.

2. <u>Bank supervision.</u>

A.I.D. could support improved bank supervision. The important need in many LDCs is to shift away from an emphasis on mere compliance with laws and procedures to the anticipation of future problems and an assessment of management capabilities (for example, using prudency audits). LDCs in the process of removing interest rate ceilings and opening up the banking sector to increased competition especially need a good system of regulation. Banks in a deregulated system face increased competition, declining interest rate margins and, hence, more risk.

A.I.D. can help in strengthening the system of bank regulation and training bank examiners to identify weak financial institutions. This could be an important area of opportunity for A.I.D.. The U.S. is widely recognized as having vast experience in both on-site bank examinations and off-site monitoring. As a result, many developing countries prefer to have U.S. bank supervisors provide this technical assistance.

TA Requirements: Programs involving banking laws and supervision require long-term technical assistance. U.S. expertise on banking law, particularly in the area of bank regulation, may be located within the Federal Reserve, the Office of the Controller of the Currency (OCC) or the FDIC (the three organizations that regulate U.S. banks). The Federal Reserve and the OCC (part of the Treasury Department) supervise all federally chartered banks. The FDIC handles deposit insurance. Among them, the Federal Reserve and the OCC have the most extensive relations with foreign countries. Each organization provides technical assistance.

3. <u>Credit and financial analysis.</u>

A.I.D. could support the development of training programs for bank personnel. The technical skills for analyzing a borrower's financial information to determine creditworthiness are woefully lacking in most developing countries. Training in both the basic and advanced concepts of credit and financial analysis would have widespread value.

TA Requirements: Programs to provide training in credit and financial analysis could be provided on a short, medium or long-term basis, depending on whether US intends to help develop a training institute (long-term); train local instructors and develop curriculum (medium-term); or underwrite the delivery of specific courses (short-term). U.S. commercial banks have very broad expertise in the area of bank training, including overseas. A.I.D. support for bank training programs could help promote closer linkages with U.S. banks, wider use of American banking practices and opportunities for U.S. computer companies serving the banking industry to expand into receptive new markets.

4. Centralized credit information.

A.I.D. could support the creation of a credit information bureau. In some LDCs, systems to establish a central agency for credit data have been established with varying degrees of success. These often begin with the central bank, though ultimate privatization has benefits. The users of credit information are generally the financial institutions and the central bank, and the type of information collected includes the amount of outstanding loans (by borrower), names of creditor institutions, existing liens against the borrower, and the borrower's past performance on making interest and principal payments. In the U.S., perhaps the best known repository of credit information is a private company, Dun & Bradstreet. Dun & Bradstreet issues concise credit reports on prospective borrowers for a fee. There is no analogous central credit bureau within the U.S. public sector, although the Federal Reserve collects extensive information from U.S. banks for the purposes of regulation.

TA Requirements: Establishment of a centralized credit bureau assumes the existence of reliable financial information. Depending upon the extent to which the basic information is available, a credit bureau might be arranged within a relatively short period of time. The requirements to establish a credit bureau will not be as extensive as activities requiring a greater level of consensus building and should form part of a more comprehensive TA program. Sources of expertise might include the Federal Reserve and private companies such as Dun & Bradstreet.

5. Deposit insurance.

A.I.D. could assist in the development of deposit insurance scheme (cf. FDIC). A deposit insurance scheme is a system of collecting premiums from banks to provide insurance to depositors in the case of a bank failure. Perhaps more importantly, it is a vehicle for providing greater assurance to depositors of the safety of their deposits and hence a mechanism for mobilizing increased savings. It should be noted that the creation of a deposit insurance scheme **must** go hand in hand with the strengthening of bank regulation. Otherwise, the deposit insurance scheme may become a fund - easily exhausted - for bailing out the banks, as the U.S. savings and loan crisis demonstrates. (This is the problem of moral hazard.) Furthermore, any such system should be self-funding and self-perpetuating. Some countries have private deposit insurance systems such as Germany and the U.K. but coverage is small.

TA Requirements: A project to develop a deposit insurance program should be integrated into a more comprehensive long-term TA program. The best source of expertise is the FDIC.

E. ADDITIONAL AREAS

Given time and space limitations in preparing the current document for the ANE private sector officers workshops, discussion of other areas is deferred to later reports. Possible topics include:

1. Privatization.

In many countries, privatization is an important component of national programs to increase the role of the private sector and free market competition. Privatization programs must go beyond merely transforming state-owned monopolies into private monopolies; real competition, both domestic and foreign, must be part of any effective privatization. Significant improvement will not come about until genuine private owners take financial risks in running the newly privatized companies along market-driven lines.

Privatization programs are bound to be more complicated in countries lacking securities markets and a modern banking system. The privatization process must therefore be designed in conjunction with a program to create these tools of a market-based economy. Capital markets help to attract domestic capital to these "privatized" assets. They also help to broaden the ownership of these assets among the population which builds a constituency for privatization and helps attenuate any criticism of "giveaway." It is useful to note that the U.K. privatization program created 10 million new shareholders in that country (a six fold increase) and a powerful constituency for those industries.

With this in mind, possible activities might include organizing meetings and conferences to help reach consensus on the design of a privatization program; support for feasibility studies; asset valuation; prospectus preparation; and the design of employee stock ownership plans (ESOPs).

2. Venture Capital.

Although generally they exist only in more sophisticated economies, venture capital companies and venture capital funds can play an important role in the economies of developing countries. By purchasing equity shares for their own account, such companies provide seed capital to dynamic firms that generally do not possess the creditworthiness or equity base to obtain convenient financing from banks or through the securities markets.

More important, venture capital companies and fund management companies support and nurture entrepreneurship by providing managerial, financial and marketing assistance, areas in which these owners/managers tend to be inadequately prepared. Thus, venture capital companies help new companies get started in important new industries and enable existing small firms to grow.

As their investments mature, venture capital companies contribute to the development of securities markets by selling their holdings through underwritings, thus increasing the size of equity markets.

The importance of liquid stock markets and high potential returns (typically in the neighborhood of 30%) to offset the higher risks faced by venture capitalists must be recognized as a precondition to venture capital development. The required levels of equity or quasi-equity investment in start-up companies and the risks involved in operating a venture capital fund may limit an A.I.D. role to funding feasibility studies or underwriting initial operating costs.

The Africa Growth Fund could act as a possible model for future venture capital activity in LDCs. The Africa Growth Fund was established by OPIC in March 1989 with $30 million in capital. It will provide equity for U.S. companies investing in sub-Saharan Africa. The Fund represents a departure from OPIC's standard role of guaranteeing and/or making direct loans to U.S. companies for investment in developing countries.[8] The Fund is managed by Equator Bank on an incentive fee basis. It is still in a start-up phase and has not yet disbursed funds. To date, it has prepared detailed investment criteria, organized and trained staff, conducted

---

[8] Unlike A.I.D., OPIC is able to take an equity position in developing country enterprises.

briefings and marketing activities and evaluated initial proposals on more than 30 African investment opportunities. U.S. companies seeking to access the Fund's capital must submit a proposal for Equator's consideration. Typical investments will range from $500,000 to $3 million and have 3 to 15 year investment horizons.

3. Debt-to-Equity Swaps.

Simply put, a debt-to-equity or debt conversion program provides incentives for creditors to exchange their debt for equity at preferable exchange rates. Such programs help countries to reduce outstanding, foreign exchange denominated debt and increase investment. They usually include special provisions to reduce the inflationary effects of redeeming debt in the local currency and special incentives for certain types of investment. A.I.D. activities might include helping to structure and promote programs, train staff, and organize information systems.

V. THE FINANCIAL SECTOR STRATEGIC ASSESSMENT: A TOOL FOR DEFINING ACTION PROGRAMS FOR A.I.D. FINANCIAL SECTOR INTERVENTIONS

In order to determine the most appropriate financial sector activities in a country, each Mission should conduct a financial sector strategic assessment (FSSA). The FSSA is a tool for characterizing a country's stage of development; identifying areas of financial sector need or weakness; determining the priorities of the host country government and private sector; and defining action programs for financial sector intervention. A comprehensive FSSA involves examination of each of the following:

Macroeconomic Policy - interest rate controls, credit allocation, the money supply, government spending, foreign debt, exchange rates, savings vs. investment, fiscal policy, foreign trade.

Some key issues: liberalization program in place, relative incentives for debt vs. equity, international financial integration.

Structure of the Financial Sector - in particular, institutions, products/instruments and markets.

Some key issues: degree of competition and barriers to entry, profitability/solvency, efficiency, management and staff capability, automation, the diversity of financial instruments, the size and liquidity of securities markets (if any), strength of the informal sector.

Quality of Financial Information - information needed by individuals, businesses, lenders and investors in evaluating the rewards and risks associated with investment alternatives and important to regulators in ensuring prudent operations and practices.

Some key issues: reliability, neutrality, timeliness, comparability, verifiability and ease of obtention.

Legal and Regulatory Framework - for example, commercial law, securities law, property rights, company reorganization (bankruptcy law), prudent, legal and administrative controls on financial institutions.

Some key issues: simplicity, strength, adequacy and enforcement of laws and regulations.

Integration with World Markets - value of foreign direct investment, foreign credit flows, foreign portfolio investment; number of domestic companies listed on foreign stock exchanges, number of international bond issues.

Some key issues: openness of financial sector to foreign capital flows, ability of domestic companies and host government to raise capital on international markets, financial flows within the region.

Cultural and Socio/Political Factors - for example, dominant families or ethnic groups, cultural habits regarding savings or disclosure of financial information, attitude toward speculation.

Some key issues: concentration of important sectors in the hands of families or ethnic groups, political roadblocks to reform, cultural receptivity to change.

Existing and Other Donor Programs - programs of A.I.D.,the IBRD, the IMF, regional development banks, bilateral assistance programs, PVOs, the private sector.

Some key issues: finding synergies with other institutions, developing a niche for A.I.D., leveraging resources.

Once the FSSA is performed, a Mission is well-prepared to design effective programs to promote financial market development, combining a number of activities from the "menu of options" into a comprehensive technical assistance program.

APPENDIX A:

ACTIVITIES CONDUCTED UNDER THE

FINANCIAL SECTOR DEVELOPMENT PROJECT

26

Activities Conducted under the Financial Sector Development Project

Strategic Assessments

During its first year and a half of operation, FSDP has completed three financial sector strategic assessments in the ANE region.

In May, 1989, a comprehensive strategic plan was formulated for US/Jordan, which included an implementation program with over twenty recommendations aimed at introducing greater competition and a wider variety of financial instruments to the Jordanian financial sector. The study was used as the basis for a project paper on a major program in the Jordanian financial sector.

Two FSDP consultants conducted a strategic assessment of the Moroccan financial sector in November, 1989, and recommended creation of a secondary debt market, strengthening the Bourse, and a series of follow-on studies and training programs. This assessment resulted in two technical assistance projects, which FSDP is gearing up to begin shortly.

In February, 1990, FSDP completed a reconnaissance of the Thai financial sector, assessing its needs and making preliminary recommendations on key areas with the most potential for an A.I.D. role. The preliminary recommendations included examining the incentives for listing on the stock exchange and providing assistance in the development of a mutual fund industry and a competitive brokerage industry to expand the equities market; support for the establishment of a chartered financial analysts program to improve the quality of financial information; and a program of technical assistance that would enable Thailand to become a regional financial center. The reconnaissance will be followed by detailed research and a planning conference to establish a portfolio of projects that can or should be launched.

Technical Assistance

FSDP has completed TA projects for the ANE Bureau in the West Bank and Gaza, Pakistan and Egypt and technical assistance is currently being provided in Indonesia, as described below.

In February, 1989, FSDP conducted a study in the West Bank and Gaza of the feasibility of establishing a credit guarantee facility. The study contains a discussion of the current economic and financial situation and concludes that a proposed USAID/Jordan loan guarantee program has a high probability of success. The report also offers specific measures that would have an important impact on the local economy.

In May, 1989, FSDP evaluated a proposal for the privately-financed Hab River power facility in Pakistan and the capital market impediments to such deals. The FSDP team has continued to provide assistance on an ongoing basis to the Government of Pakistan in its negotiations with the project sponsors and potential investors.

Also in May, 1990, an FSDP team completed a feasibility study in Egypt on creating an Equity Finance Facility. Based on a comprehensive field survey, the team concluded that such a facility is both feasible and desirable and recommended that USAID/Cairo proceed with its efforts to establish one.

As mentioned above, FSDP is working with the Government of Indonesia to strengthen stock market supervision, regulation and operations in response to the significantly increased level of activity on the Indonesia stock exchange. In October, 1989, FSDP fielded a team of advisors who recommended a new regulatory regime for the stock market, the brokerage industry, underwriters, and other supporting professions. The team returned to Indonesia early this year to assist in the further development of its recommendations. Since that time, FSDP has been providing assistance to draft a capital markets regulatory decree, make the stock exchange a private body, and review the training needs of the capital market executive agency (Indonesia's SEC) and the Jakarta Stock Exchange.

Applied Research

To date, FSDP has completed two applied research projects and is working on an additional two projects with particular relevance to ANE as described below.

"Modernization of Regulation and Supervision of LDC Financial Institutions and Practices" was completed January, 1990 and examines the developing countries' systems of financial institution regulation and supervision and will help countries establish and enforce the "rules of the game" for their financial institutions.

"Prefeasibility of an A.I.D. Guaranty of Local Currency Bond Issues by Municipal and Housing Authorities" was completed February, 1990 and examines the feasibility of selling U.S. Government-backed local currency bonds or other financial instruments in developing country markets. The report will provide useful input in the formulation of policy decisions regarding the offering of such bonds.

A study on "The Policy Framework for Financial Sector Liberalization" is ongoing under FSDP and examines ways to forge stronger linkages between financial markets in developed and developing countries. The first phase, which consists of a review of all available literature on this topic, is in the draft final stage at this time. The second phase, which is also underway, involves the preparation of case studies (Pakistan and Chile) to evaluate developing countries' experiences when attempting to gain access to international markets and open their markets to foreign investment. The third phase will develop a set of conclusions and recommendations based on the results of the literature review and the case studies.

Research on "Large-Scale Private Power Projects and Capital Market Development" is underway to examine local capital market constraints to the development of private sector power in developing countries. This has particular importance to ANE countries such as the Philippines, Thailand, Indonesia and Pakistan which want to transfer the construction, ownership and operation of large-scale power plants to the private sector. Identifying and correcting capital market limitations will help developing countries privatize power generation and other key elements of their economies.

Information Dissemination

FSDP's information dissemination component is designed to share the knowledge and experience developed under the project with relevant groups in A.I.D. and in other international institutions involved in financial sector development through conferences, seminars and printed materials.

In February, 1990, FSDP sponsored a one-day seminar in Washington for the ANE Bureau entitled "The Role of Business Regulation in an Era of Liberalized Financial Markets." The seminar, developed for representatives of ANE and other A.I.D. bureaus, consisted of four sessions on the globalization of financial markets, banking regulation, capital market regulation, and utility regulation and its implications for the private provision of public services. Participants felt that the seminar had been effective in increasing awareness of the importance of financial sector regulation.

APPENDIX B:

ACTIVITIES CONDUCTED UNDER THE

FINANCIAL MARKETS PROJECT

Activities Conducted under the Financial Markets Project

Financial Markets Surveys

The Financial Markets Project prepared "Financial Markets Surveys" in the following ANE countries from 1986 to 1988: Indonesia (Jan. 1986), Jordan (Aug. 1986), Morocco (Apr. 1986), Nepal (Jan. 1986), Pakistan (Feb. 1986), Philippines (Jan. 1986), and the Yemen Arab Republic (Mar. 1988). Most of these studies included recommendations for and/or host country action, in addition to assessing the local financial markets.

Technical Assistance

The following is a brief overview, on a country-by-country basis, of technical assistance activities conducted under the Financial Markets Project:

India - Conducted seminars on the potential impact of, and need for, venture capital in India (July, 1986).

Indonesia - Prepared report on the legal and regulatory environment of the capital market (July, 1986); organized visitation program for two Indonesia officials regarding securities and banking regulation in the U.S. (October, 1986); prepared report on the potential for private sector power generation (August, 1987); reviewed regulations proposed for the over-the-counter market (July, 1987); provided long-term technical assistance on capital markets to the GOI.

Israel - Evaluated a proposal for the establishment of a banking institution on the West Bank (Dec., 1986); participated in meetings on the development and commercialization of technology.

Jordan - Prepared report on merger and acquisition practices with recommendations for procedural change (April, 1987); conducted feasibility study on the establishment of a mutual fund industry (April, 1987); prepared draft outline for a fund to develop and commercialize technology (Feb., 1987)

Morocco - Report and consultation on designing a mechanism for administering PL480 Section 108 financing of local ventures (Oct., 1986); provided credit specialist to assist Energy Demand Management project design team.

Pakistan - Assisted in the preparation of the project paper on CHIPS (Commercial Humanitarian Initiatives in the Private Sector) (March, 1987)

Philippines - Prepared draft outline for a fund to develop and commercialize technology (May, 1987).

Thailand - Prepared report reviewing operations of the Stock Exchange of Thailand and recommending improvements (Feb., 1987)

Research

Research projects of a general nature included development of a generic model for A.I.D. assistance to small and micro entrepreneurs and a report on the background and experience of U.S. venture capital firms.