OECD DEVELOPMENT ASSISTANCE COMMITTEE

Issues for Discussion

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THE ROLE OF A.I.D IN STRENGTHENING FINANCIAL RESOURCES FOR PRIVATE SECTOR DEVELOPMENT

ISSUES FOR DISCUSSION:

A. Stimulating Private Sector Development and Broad Based Growth: Basic Implications for Financial Systems and Development Cooperation.

8a. **What are the fundamental implications for the aid system of the new priority being given to the development of domestic financial systems and the private sector?**

Background

After several decades of government intervention in promoting economic growth, an increasing number of developing countries are shifting their development focus towards the free market system. Financial markets are being promoted to allocate resources to profitable activities within a competitive environment. Deregulation and liberalization in the financial system is encouraged to nurture competition among various financial institutions and markets and to enhance allocative efficiency in the economy.

While the post-war economic development model was inward-oriented, relying upon government intervention to set pricing signals and produce goods and services, the new approach is outward-oriented through a free market mechanism where market prices play the dominant allocative role. In this era of change, the most fundamental implication for the aid system is for donors to direct their concerns to developing country policy environments. It is the policy environment, more than any other internal factor, which conditions the possibilities for growth of the private productive and financial sectors of developing countries.

The fundamental implications for developing country governments in the new outward-oriented development model are to provide a level playing field for all financial institutions through deregulation and integration. Financial development must become an integral part of the new development model.

Implications

In this context, the existence of a substantial private sector is a necessary but not a sufficient condition for economic development, which also requires open competition free of oligopolistic and privileged practices perpetuated by protective barriers and subsidized credit.

Direct aid flows to private investors, while useful, are of limited value unless the policy and structural environments within which these exist are favorable to the growth of private enterprise.

Policy and structural changes along the following lines should be pursued by the donor community:

- Macroeconomic stability, rational exchange rate policy.
- Structural changes to "outward looking" (vs, "inward looking") policies, without which market incentives remain distorted and encourage uneconomic enterprise.
- Prices set by the markets, not by governments.
- A legal environment - written and unwritten - which levels the playing field for all investors, and provides financial institutions with proper access to collateral when made necessary by default of contract. Modern rules establishing rational basis for bankruptcy and/or liquidation of firms.
- open competition which is not distorted by arbitrary government rules making for oligopoly or monopoly control of markets within these countries. i.e.
    - licensing which excludes or makes difficult the entry of new firms.
    - credit allocation based on influence or government dictate.

8b. **To what extent may the role of official development assistance in aid-reliant countries have helped or hindered the development of financial markets and mechanisms?**

The development of strong financial systems in developing countries has been most retarded by the policies and practices of the governments of the recipient countries. Financial repression and directed credit are the two most damaging policies followed by these countries.

Development of efficient financial systems has been constrained, moreover, by the lack of institutional strength and the neglect of institution building in both private and public sectors. Efficient financial markets require a certain threshold in both the number and variety of market institutions that comprise the market infrastructure. Lack of adequate government support and regulatory back-up have also hampered the growth of essential market institutions in developing countries. Even when some developing countries retain market institutions, the latter often suffer from lack of expertise, capital, and experienced staff.

In some instances, official aid donors have contributed to the weakening of financial systems. Host country financial agencies have been used by the ODA agencies as conduits for their assistance flows without giving much, if any, attention to the strengthening of these institutions as mobilizers of domestic savings within the country. Primary emphasis often has been put on the agency's (DFI, or commercial bank etc,) "expenditure performance" i.e. how fast the institution can disburse the funds to the intended sub-borrowers. Little or no attention has been given to the equally important goal of the institution's long-term viability i.e. the mobilizing of saving from its customer communities, and the ability of the institution to recover its loans through repayment of both principal and interest.

The result is obvious to all today. While the external funds have been disbursed, most public DFI's in the aid recipient countries are insolvent. They have done a poor job of mobilizing savings, and they have failed to collect the repayments due. Continued high rates of non-recoverability, even after successive restructurations and recapitalizations, put in doubt the ability of these types of public financial institutions to be viable in the future. In short, they are totally dependent on an endless flow of external aid. (The viability of DFIs is discussed in questions 15a and 15b).

Future financial policy in developing countries should increasingly be focused on the objective of improving the efficiency of the financial system, without neglecting the stability and soundness of the system. Competition policies should become a major, although not the only, policy tool for improving the efficiency of national financial systems. And financial institutions should derive their strength through their ability to capture domestic savings rather than official development flows.

In implementing policies towards improving the efficiency of national financial systems, a wide range of measures have to be devised to stimulate competition and strengthen the role of market forces. Despite recent progress in some developing countries, most developing country financial markets are still shallow and repressed with no required depth, liquidity and breadth as in developed markets. Developing country capital markets suffer from poor financial infrastructure. For example, in many places, licenses for new financial institutions are too strictly controlled by the governments.

8c. **What, in principal, are the possibilities for ensuring that a greater proportion of aid flows directly or indirectly through the financial systems to private lenders and borrowers? Can this be done using current mechanisms, or will new modalities need to be found?**

Whatever institutional means are used, donors must recognize that resources will follow incentives which are determined by the recipient countries' macroeconomic policies and the structure of their economies. If markets are relatively undistorted, and the process of investment is given ample room and incentive within the host economy, then the resources of the financial system will flow in that direction. Further distortions to compensate for existing distortions will not be necessary.

In the past, ODA donors established specialized financing institutions to try to insure that aid would flow to the "target group" - in may cases defined as the private sector. The publicly-owned DFI's mentioned above and discussed later on are examples of this. Some private DFI's were designed to involve private capital in the financial system, and to provide more competition within it. Many of these institutions have made significant contributions to strengthening financial systems. In other cases however, where the policy and structural climate were unfavorable, these institutions failed.

Specialized financial institutions remain a useful tool for aid donors to use to channel assistance to development sectors. In so doing, however, donors must be aware that they are creating a part of the financial system. Therefore, the institution they create or support must strengthen the financial system overall, and must be capable of mobilizing savings, and managing its assets such that they can be repaid.

B. Strengthening Financial Policies and Institutions in Developing Countries.

12a. **What are the major elements of reform programs for the financial sector? How do they interface with other economic reforms? Are there major issues of sequencing? How do needs and priorities differ between major regions and individual cases?**

The August 1988 the U.S. Agency for International Development Financial Markets Development Policy Paper states:

> "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."

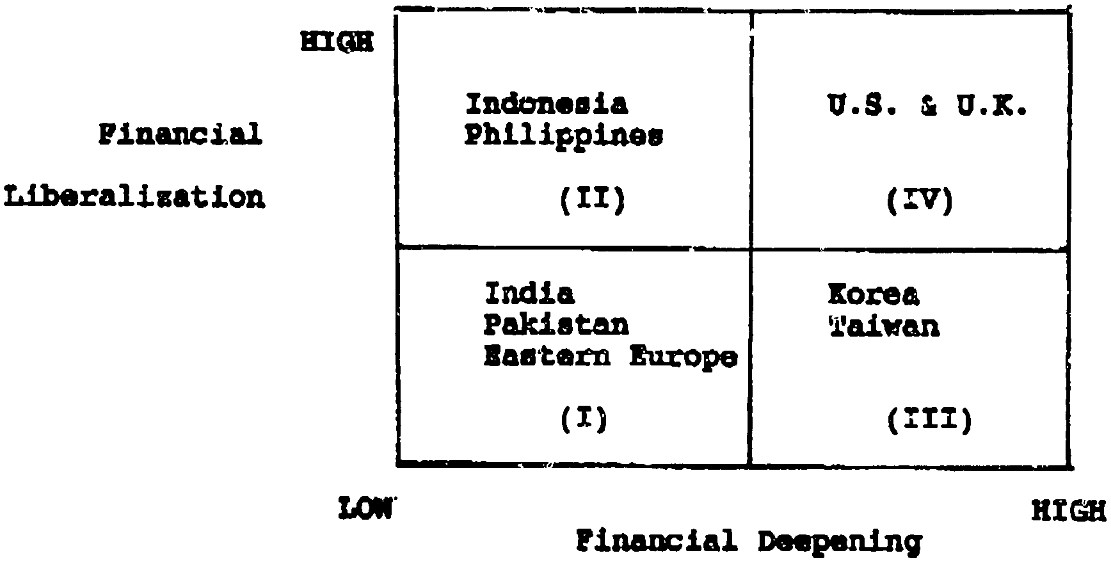
Reform programs for the financial sector are rarely useful unless conducted in the context of a macroeconomic program which provides stability and an exchange rate in realistic adjustment with the world economy. Normally, these reforms must be introduced prior to major deregulation in the financial system. Countries that have attempted financial liberalization before undertaking other needed economic reforms have suffered destabilizing capital flows, high interest rates, and corporate distress.

In the context of macroeconomic adjustment, reforms to the financial sector should begin with gradual reduction of the controls over the interest rate. The aim should be to allow markets to set interest rates, the price of money.

The gradual deregulation of the price of money and credit and its permitted uses should be accompanied with new structures of <u>prudential regulation</u> which subjects the financial institutions to a set of rules of fair play and prudence but does not interfere with their management to offer new products and services to their customers as a way of competing with their competitor banks.

Financial policies must be put in place to increase competition among the banks, and between banks and other, newer elements of a growing financial system such as money markets, long term savings and contractual savings institutions, and capital markets. Here insurance companies and pension funds are neglected institutions which promote long term savings that are vital for the development of capital markets.

Proper sequencing and speed are the keys to successful financial liberalization, especially when countries have shallow and oligopolistic financial markets. In fact, the real policy issue facing developing countries with regard to financial liberalization, is how to <u>sequence</u> the process. The policy alternative available to developing countries can be illustrated with the following figure. Most developing countries at the early stage of financial market development find themselves in Quadrant (I), while most industrialized countries with fully developed and well integrated financial markets are located in Quadrant (IV). There are three strategies open for LDC policy makers to move their financial markets from Quadrant (I) to (IV):



(1) The Big Bang Approach is to push from (I) to (IV) directly without any intermediate step involved, simultaneously liberalizing the financial sector and opening up markets to international competition. Some of the Latin American and East European countries have attempted this strategy, and it accompanies a high degree of risk. As the experience of the Southern cone demonstrates a good policy such as financial market liberalization can have a bad result due to poor implementation. It further demonstrates that financial sector development, if not properly designed and implemented, can cause instability of the financial system, which in turn may magnify macroeconomic instability.

(2) The Internationalist Approach is to move from Quadrant (I) through (II) to (IV) by liberalizing and internationalizing the financial sector immediately, without waiting for the domestic financial markets to grow and mature enough to meet foreign competition. Indonesia and the Philippines belong to this category.

(3) The Gradualist Approach involves moving to Quadrant (III) first before integrating the domestic financial markets with international markets. Japan first tried this approach successfully, being followed currently by Korea and Taiwan. This approach has already demonstrated its proven success record in the case of Japan, even though the country was almost forced to liberalize and internationalize under the pressure of her major trading partners, such as the United States.

The needs and priorities of regions and countries differ depending on their stage of economic development. Three distinct stages in this process can be delineated:

> Stage I (Industrialization and Real Sector Development): In this stage, the government and public sector institutions play the major regulator and controller for financial intermediation. Economic development plans are an important tool for the government at this stage, where directed credit programs are quite extensively applied. The economic structure is rather simple, and there is general lack of key economic infrastructure, such as transportation, energy, telecommunication and education facilities. Directed credit programs, managed by an enlightened government, can channel scarce investment capital into these infrastructure projects as well as key industrial sectors which emphasize export promotion and import substitution,

which generates precious foreign exchange.

At this stage of economic development, deficit financing and the state control of financial institutions is frequently used to provide domestic investment resources for key investments, and selected foreign borrowings are utilized to meet the domestic savings gap. If the financial sector is completely liberalized at this early stage, scarce financial resources may be channeled into certain consumption-focused sectors such as residential or rental housing, luxury restaurants, retail outlets, etc.

Stage II (Financial Sector Development): Once the economy has reached a certain take-off stage in terms of basic infrastructure and key industrial sector development, the government can afford to promote the growth of financial markets. Commercial banks may be privatized, and money and capital markets are promoted to increase the efficiency in resource allocation in the increasingly complex economy. Large companies, which have benefitted from rapid industrialization during Stage I, are encouraged to go public in the stock market in order to broaden their equity base.

Non-bank financial institutions such as merchant banks, insurance companies, pension funds, mutual funds and investment companies, leasing companies, and venture capital firms are also promoted to broaden and deepen the financial system of the country. At this stage, the government can aggressively pursue financial sector liberalization and deregulation to promote competition and diversity in the financial system.

Stage III (Financial Market Integration): Once the local financial market has become an active part of resource mobilization for the economy, the government can move towards internationalizing its financial sector along with the already internationalized trade and investment sectors. International capital flows may be liberalized, and access to local stock markets by foreign portfolio investors is progressively liberalized. Along with the move to make its currency convertible, the government may remove entry barriers to foreign financial institutions to the local markets, which can encourage competition and infusion of new financial technology.

In this sequencing process, the key issue facing the government policy makers is to identify correctly the right timing when one stage passes and the economy is ready for the next stage. Too long a delay may cause a drag in the economy, too hasty a transition from one stage to the next can contribute to financial crises. Government policy makers should be nimble enough to synchronize their degree of regulation and deregulation with the underlying economic development stages.

It is this new challenge that the aid system has to meet in order to provide developing countries with the proper guidance in identifying each developmental policy stage and carrying out the needed policy adjustment.

12b. **What kinds of assistance have Members made available for staff and management training and support? To what extent has aid been used to offset the costs of restructuring insolvent institutions? Which kinds of assistance have proved most effective and why? How have the programs been monitored and their effectiveness measured? Are there instances in which bilateral assistance has in effect prolonged inefficiencies in the financial sector and delayed needed reforms?**

Both USAID and the World Bank have historically provided assistance to the developing countries for staff and management training support. This assistance has been in the form of both formal classroom training and on the job practical training alongside a technical expert.

Because of the past commitment of both USAID and the World Bank to DFIs, they have both used funds to offset the cost of restructuring insolvent institutions. There is however a growing awareness of the magnitude of the problem, and both institutions are now questioning whether the policy should continue. There is clearly a move to reduce these interventions except in cases where no other alternative approaches exist, and we support this decision.

If we operate on the assumption that it will not be possible to eliminate all DFIs around the world, then we must find a way to better improve the performance of these institutions under the existing framework. Some of the recent work funded by the World Bank under the rubric of institutional strengthening has at least been able to make some progress on the management and organization side of these institutions. A successful example of this in a difficult environment has been the recent restructuring carried out by Price Waterhouse of the largest DFI in Columbia utilizing strategic management approaches that are normally applied to the private sector. Success has been slower on the policy side, but as governments end their subsidies to these institutions due to budgetary constraints, the DFIs have more leverage and freedom to adopt new policies that will foster their growth and development.

The World Bank undoubtedly has methods to monitor its institutional development programs, although their effectiveness is questionable. There is also the problem of the lack of project personnel at the World Bank trained in management issues (as opposed to economics and engineering) when dealing with institutional development projects.

We believe that there have been cases where continued bilateral assistance has indeed prolonged inefficiencies in the financial sector and delayed needed reform. Public sector employees in the developing world are keenly aware of their ability to do this, and have become adept at utilizing this mechanism to avoid change.

12c. **How do donors and the World Bank, IMF and other relevant agencies coordinate their efforts?**

USAID has been actively involved in policy dialogue coordination with the World Bank SAL program and the IMF stand-by agreements. This combined approach to promoting structural adjustment and macroeconomic reform is evident in a number of developing countries.

C. The Intermediation of ODA to the Private Sector

15a. **If DFIs are not working as planned in a large number of countries, can or should they be rehabilitated? Can DFIs be expected to continue their dual role as finance institution and development agency? Should this role be more clearly defined?**

There is no reason not to continue to utilize DFIs, as long as their operations are efficient. As with other financial institutions, DFIs should secure their financial base through the development and mobilization of savings and the recovery of loans. In addition they should be subject to a prudential regulatory set of controls to ensure proper supervision.

In the past, DFIs were designed to act as financial institutions and development agencies by directing financing to sectors generally considered unable to obtain financing from traditional sources.The inherent subsidy in DFI operations over the past years has been justified by the assumption that benefits were directed to and received by the poor. Studies have shown, in fact, that this often has not been the case, i.e. that the major share of the benefits of these loans, and the forgiveness has been achieved by the relatively better-off groups in society.

The projects which have financed the operation of these DFIs were justified on the large incremental gain that could be expected from the addition of new credit to the borrowers of these institutions. Financial performance is one indicator that this assumption may not have been valid, and that the sub-borrowers may not have been proper subjects of credit, may not have used the credit for productive purposes, or may have bribed officials of these institutions to forgive repayment.

Offsetting this past performance has been the experience of recent years and the interest demonstrated by A.I.D. and the IBRD, among others, in the liberalization of the financial system. Within a liberalized environment, DFIs can continue to play a role as a specialized development finance institution, but under different conditions than the past. The operating principles to be followed should be to limit support to those DFIs which can meet three conditions:

- the DFI shows capability to mobilize savings

- the DFI shows that it can manage its assets professionally and can recover its loans

- the DFI should be subject to Prudential Regulation similar to modern bank regulation. The regulatory authorities should be able to take early corrective action in cases where DFI management is inadequate to prevent insolvency.

15b. **To what extent can operational deficiencies be overcome by making DFIs more "commercial"? Are there methods for doing this which seem to have worked? What conditions are set as regards onlending rates for aid funding of DFIs, and who captures the concessional element? How is the exchange risk problem handled?**

Experience has shown that it is impossible to make government owned DFIs more "commercial". The fact that these institutions are owned by governments, means that they will always be subject to government influences that will prohibit them from acting more like commercial institutions. This matter has been documented in the World Bank and USAID reports.

The operational deficiencies of DFIs can only be overcome if DFIs are expected to manage themselves and their portfolios as commercial, profit-making enterprises would. This of course assumes that the enabling climate, especially in regards to the collectibility of collateral is favorable for any type of lending institutions.

To the extent possible the private capitalization of DFIs should be encouraged. This would assure, again assuming the proper climate, that private capital would back up the management's judgements concerning prudent lending, and collecting against collateral in cases of default.

In cases where political authorities decide to offer subsidies to protected groups, the use of financial institutions (including DFIs meeting the above criteria) to deliver these subsidies should be avoided.

One of the more successful developments has been the concept of privately owned DFIs, as has been tried in the Caribbean Basin. The Caribbean Financial Services Corporation in Barbados is a good example of this concept. This privately owned institution has a Board drawn from the private sector and has some concessionary funds from USAID, but also equity participation from the private sector. In addition, no significant restrictions are placed on the use of these funds by either USAID or the local government.

USAID policy has been moving in the direction that concessionary funds must be on-lended at market or commercial rates in order not to undercut the private banking sector. We believe that this is the correct approach. If the DFIs are Government owned, the concessional element is normally captured by the local Government, usually through its Central Bank. In the case of privately owned DFIs, these elements help to make the private sector institutions more attractive to other capital sources.

A number of approaches have been tried to deal with the exchange risk problem. In most cases, loans are only made in U.S. dollars and the borrower bears the full exchange risk. In other cases, Governments have established Credit Guarantee Funds for a fee paid by the borrower to cover part of the exchange risk.

15c. **What is the rationale for using aid to directly finance private enterprises in developing countries? What are the dangers in this approach? Are there basic principles which apply?**

In reality, ODA managers do not have the administrative capacity to make direct loans to private enterprises in LDCs. Donors, therefore, have to rely on the financial system to ensure allocative efficiency. Nevertheless, there are limited reasons why ODA countries may wish to aid a private enterprise project in a developing country. One such reason may be that the project is very large. For example, the World Bank and the IFC take on projects that may be too big for the intermediation system of the developing country to handle. Under such circumstances, it would be proper for the donor country to consider supporting such a project. In general, ODA should work through the financial system to ensure allocative efficiency. ODA should not try to circumvent financial systems. In short:

- The making of direct loans to private enterprises in developing countries would prove very difficult for the ODA agencies except for a few exceptions. They do not have the administrative capacity to make many of such loans.

- The basic principle which should apply is that aid should be channelled through financial intermediaries in a way which strengthens these institutions and the financial system in which they operate.

- In exceptional cases, where the project is of a huge size which requires the participation of many sources of external assistance, it would be appropriate for the agencies to make their loans directly to the enterprises, in conjunction with other members of the ODA community, and private sources of capital. An example here would be the Hab River project in Pakistan in which there are many scurces of credit ranging from commercial credit, planned bond issues, and a loan from the World Bank.

15d. **To what extent have donors supported financial institutions outside the traditional DFI field, i.e., leasing companies, housing finance institutions, venture capital companies, etc.?**

Since the early 1980s A.I.D. has provided extensive financial and technical support to a variety of such activities and institutions outside the traditional DFI field. These include banks, banking systems, venture capital companies, housing finance companies, leasing companies, and stock markets. A.I.D. is planning to assist countries with the development of long term savings institutions such as insurance companies, pension funds, etc.

In the past, assistance to the creation and operation of leasing activities, however, usually took place in the context of general financial and technical support for a specific public or private DFI. On occasions where DFI institutional development has advanced, needs assessments and follow-on assistance have been undertaken in the leasing field.

A.I.D. has assisted housing finance institutions since the early 1960s. The major focus in this area took the form of supporting the creation and operations of savings and loan associations (S&Ls) along with Central S&L regulatory and finance agencies. This was particularly important in Latin America during the Alliance for Progress.

The A.I.D. housing investment guarantee program was established in the early 1960s, and since the mid 1970s has become the principal assistance vehicle providing AID support for housing finance. AID also has provided assistance to support public sector mortgage banks for low income families. This assistance has mostly taken the form of technical assistance in establishing and/or restructuring such institutions.

Venture capital companies have become increasingly important recipients of A.I.D. assistance since the early 1980s, especially in the context of developing country capital market development programs. Such programs have become operational in many countries.

The record of performance of such programs/institutions has been mixed and has reflected the macro-economic policies in effect, the degree of government interference, and the quality of its management. Naturally, the quality of its institutional performance reflected the quality of public administration generally.

16e. **To what extent have Members helped reconcile these different perspectives (bankers say there are no bankable projects; borrowers say there is no financing) by assisting private borrowers in project preparation and presentation?**

For many years, A.I.D. and its predecessor agencies have provided assistance to bankers and borrowers in an attempt to reconcile these divergent positions.

When developing country bankers say there are no bankable projects they may be signalling one of the following real situations or attitudes:

- the bankers are neither interested in engaging in investment or development banking and prefer to apply their resources to less risky short term commercial lending;

- the bankers do not have in-house capability to evaluate investment projects and properly calculate their risks and return;

- the reality may be that most projects presented to them are poorly prepared and are truly not bankable according to sound risk analysis.

On the other hand, the developing country potential borrowers who say there is no financing likewise may be reflecting among the following:

- o the investment/trade opportunity, although potentially viable, may not have been well-studied, prepared or presented to the banks;
- o the opportunity simply lacks economic/financial viability
- o although one opportunity has been well studied, prepared, presented and indicated potential viability, the bankers may prefer to apply their resources to traditional commercial lending.

A fundamental constraints for both bankers and borrowers is the lack of accurate accounting and financial information. In most developing countries the quality of accounting information is often poor and standards are not enforced. This circumstance works against borrowers who are unable to present verifiable statements and against bankers who have insufficient information upon which to analyze the quality of a project based on a cash-flow methodology.

An additional basic constraint is the absence of an enabling environment. Without a legal basis for the collection of collateral, as well as other fundamental structural changes, financial systems and operations will continue to be constrained.

A.I.D.'s support for private sector development includes both country-specific and centrally-funded programs to assist both LDC bankers to understand and serve the legitimate credit needs of private investors as well as LDC borrowers to understand and meet the bankers' legitimate need for carefully selected, well-planned and presented and above all viable projects.

A.I.D. assistance in this regard would normally include
- o assistance to borrowers in project preparation and presentation
- o credit needs assessment
- o credit/financial analysis training seminars for bankers and borrowers
- o investment insurance and guarantee programs
- o grant and loan financing for specialized development programs (e.g., small business development)

A.I.D. strategy is to assist traditional LDC commercial banks to develop their institutional capabilities to serve the medium- and long-term credit needs of private borrowers while enhancing the skills of small scale borrowers in understanding the credit processes and participating effectively in them.

16f. **Have donors provided assistance in the financial structuring of projects or helped identify prospective suppliers and markets?**

A.I.D., as well as other donors, normally requires extensive feasibility analysis before the approval and funding of a project. This ranges from pre-feasibility to full-feasibility studies each of which requires thorough financial planning and structuring. In addition, well prepared feasibility studies susceptible of approval and funding normally include detailed market analyses of products, markets, suppliers, technology and comparative costs and return. A.I.D. has consistently provided technical and financial assistance to developing country entrepreneurs in the design and preparation of acceptable feasibility studies and to developing country financial institutions on project appraisal methodology and evaluation. The techniques and scopes of such assistance are well known to major donors.

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18g. Could Members identify small business financing approaches which they have found to be particularly important and successful? Which approaches were less successful and why?

18h. New approaches to identifying and tutoring "new entrepreneurs" are being developed, inter alia by the IFC. How are these initiatives regarded? Is there scope for bilateral cofinancing of individual cases?

18i. What has been Members' experience in financing micro enterprises? What techniques are likely to prove most effective? What qualities should be looked for in NGOs whose activity in this field might be supported?

Responses to the above three questions (18 g, h, and i) require a detailed level of research and analysis which we have not been able to conduct due to time constraints. To date, there has been little project activity under the Financial Sector Development Project specifically directed to small and microenterprises and to "new entrepreneurs". It is possible that other A.I.D. contracts, for example PEDS, may have more information on these issues as they fall within their scope of activity.

With regard to question 18h and the issue of bilateral cofinancing, however, it should be noted that bilateral cofinancing is nearly always an alternative to be considered in the case of reasonably viable projects.

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D. The Role of ODA in Promoting Foreign Direct Investment.

21a. **How can development cooperation be used to ease the policy constraints that frustrate potential investors? To what extent is this being done already? What have been the results?**

Development cooperation is most effective when it gives first priority to working with countries to improve their macroeconomic framework and overall business climate. Only after a proper macroeconomic framework and a conducive business climate are in place will forms of promoting investor confidence, such as investment guarantees, insurance and cofinancing by institutions such as the IFC and the IIC, be truly effective. Such steps are being taken by A.I.D. policy dialogue process and the World Bank Structural Adjustment Loan (SAL) process.

With the near disappearance of foreign loans, many countries have become convinced of the need for foreign investment. Many of these same countries, however, have investment climates that do not support an increase in foreign investment. Factors which foreign investors take into account include: government attitude towards foreign investment; legal and regulatory framework; long-term historical economic and political trends; macroeconomic framework (inflation rate, interest rates, etc.); transportation, telecommunications and other infrastructure; education level of the population; tax rates; labor laws; investment incentives; exchange controls; restrictions on foreign ownership; etc.

A number of these factors can be addressed by effective policy dialogue that links reform in areas such as regulations, tax structure, macroeconomic policy, with increase in direct foreign investment. This amounts to an enabling environment for investment.

A.I.D., the IMF, and the World Bank have worked together successfully in a number of countries and the results have been a more conducive framework for investment in a number of countries worldwide. The host government's willingness to carry out reforms should also continue to be supported by the necessary technical assistance.

An attractive investment climate in an LDC requires, at a minimum, appropriate growth and market oriented macroeconomic policies and a supportive regulatory framework applied consistently and predictably over time to provide a perception of stability. The very same requirements for an attractive investment climate must apply equally to domestic as well as to foreign investment.

The structural adjustment program and sector loans offered by AID and other donor agencies are all oriented toward policy and institutional change required for sustainable growth. Development cooperation can be helpful in easing policy constraints that frustrate potential investors, but to be effective, they must have strong political support throughout the government and among the sectors of the population. Without a forthright commitment to reform and structural adjustment, as is being practiced by President Salinas in Mexico, for example, development cooperation by itself would not necessarily improve the investment climate.

The goals and objectives of A.I.D. and other donors' programs are generally oriented to bringing about fundamental economic/financial policy and institutional changes which, inter alia, could improve the investment climate.

These free market policies, including prudent financial stabilization programs, are essential to reducing the role of the state in the economy, getting economic and financial prices right, moving ahead with privatizations, opening up the economy to internal and international competition and thereby developing a managerial class in society.

For many years, many developing country governments which benefitted from A.I.D. and other donor assistance making a full commitment to free market and open economy policies. In the late 1980s and early 1990s, as the effects of world wide recession and the debt crisis stagnated LDC economies, many countries began to take serious action to adopt appropriate macroeconomic policies. Indeed, after such talk, the pace of privatizations seems to be accelerating.

In conclusion, the answer to the question is yes; development cooperation can be used to ease policy constraints to potential investors but only in the context of broad-based policy changes entailing structural and institutional reforms to which LDC governments are totally committed.

21b. **To what extent are bilateral agencies involved in the effort to improve the investment environment in developing countries? Is there adequate coordination between multilateral actors (notably the World Bank Group) and bilateral agencies?**

USAID has been actively involved in policy dialogue in coordination with the World Bank SAL program and IMF stand by agreements. This combined approach to promoting structural adjustment and macroeconomic reform is evident in a number of developing countries.

A.I.D. and other donors have long been supportive of efforts to improve LDC investment climates. A great deal of aid resources has been dedicated to helping LDCs formulate investment promotion strategies and agencies. Experience to date shows mixed results. In countries where there was not a clear commitment to a fundamental provision of macroeconomic and institutional reform, investment promotion strategies have yielded meager results. In those countries where a major governmental commitment to reform existed, both foreign and domestic investment flows began, albeit with some delays, while the private sector developed confidence in the new situation.

Experience of Price Waterhouse in this area has indicated that investment promotion campaigns undertaken by government agencies, insensitive to private sector needs, generally have not been successful in their missions.

Coordination among donors in general has a spotty record, depending on the interest and will of the aid managers in these agencies. Also it depends on the country, the composition and scope of donor assistance efforts as well as efforts of host countries to play off one donor against another. A fair conclusion is that inter-agency coordination has taken place both through informal as well as formal mechanisms, the effectiveness of which varies from country to country. Another fair conclusion is that the extent and quality of that coordination can be improved.

22c. How, and to what extent are investors consulted about the kinds of reforms they regard as critical? How do donor agencies determine what kinds of reforms are most important to potential investors, i.e., the ones most likely to attract them to LDC markets.

A.I.D. has recognized the need for private sector development and has a longstanding policy of consulting local international and national businessmen regarding the reforms they regard as critical for the improvement of the investment climate in their respective countries.

AID/PRE has a number of notable programs, including the Financial Sector Development Project, the Center for Privatization, and Private Enterprise Development Support Project which include businessmen, investment bankers, and other private sector representatives as an integral part of their consulting teams. These individuals provide a unique perspective and can evaluate a country's investment climate from the point of view of a potential investor or financier. This type of assistance has greatly assisted A.I.D. missions worldwide to effectively focus their policy dialogue agenda in the area of deregulation and structural adjustment.

In most developing countries, there is no mystery about what should be done to reform policies and institutions in order to improve investment climates. In most developing countries, there are private sector organizations, donor agency reports and surveys and numerous other sources of information on what needs to be done. What usually inhibits action to improve investment climates is the lack of political will or consensus in the government and infighting within the government. If a potential consensus developed into action, there would be ample domestic and external sources of technical advice on how to proceed.

23d. Do bilateral aid agencies have a role to play in encouraging the liberalization of sectors closed to foreign investors?

Both bilateral and multilateral aid agencies have an important role to play in this regard. Both through policy dialogue and implementing structural adjustment programs they can analyze the direct benefits to the economy that would permit foreign investment to substitute for state investment in many economic sectors (e.g., steel, petroleum, coal, transport, power, communications).

In general, whatever can reduce the role of the state in using scarce resources to operate deficit producing enterprises would be beneficial not only in easing financial burdens but in bringing forth new sources of tax revenue, new technology gains, better management, and improved entry of exports into world markets.

More specifically, where important state-owned sectors lack sufficient investment, any rational approach to policy dialogue should not forego touching upon sectors which are critical to the country's development. In this regard, bilateral agencies have an important role to play in encouraging the liberalization of such sectors closed to foreign investors. Many countries have realized that there are mutual benefits involved in direct foreign investment and have opened up a number of sectors previously closed to foreigners.

On the other hand, a number of countries still prohibit foreign investment in so-called "strategic" sectors. Often these governments do not have the capital that would allow these industries to reach their capacity to generate growth and employment.

Effective policy dialogue aimed at increasing the role of foreign investment which is accompanied with foreign technology can be of tremendous benefit to the country. Dialogue should be a coordinated effort among donors and be focused on the benefits that the country can attain from foreign investment. It should be emphasized moreover that the State does not necessarily have to give up control of the sector. Foreign investors can join the state in the form of joint ventures, can lease activities and can perform operational, management or exploration contracts while the state maintains overall control. In the case where there is a natural monopoly the state can still maintain control over the sector through effective regulation.

Probably the most powerful tool for change in this area is the demonstration effect of other developing countries that are allowing foreigners into their "strategic" sectors. Information regarding what is occurring in other countries should be disseminated among decisionmakers.

23e. **Would it be possible or desirable for agencies to use their involvement in and support to state-owned sectors as leverage? Might this involve reducing support for state-held companies and services, or helping to rehabilitate state companies in the context of privatization programs?**

It is both possible and desirable for agencies to use their involvement in and support to state-owned companies as leverage for promoting an increase in domestic and private investment in these same state-owned sectors. This policy may involve the reduction of financial support for state-owned enterprises and services. This is only the case when countries refuse to recognize available private sources of capital.

Public capital should not be used to substitute for private capital sources. If public resources are made available to substitute for private investment, governments will be less likely to privatize inefficient SOEs. In fact many donor programs that provide large loans that take care of the capital requirements of SOEs or comprehensive rehabilitation programs work against efforts to privatize these firms. Continued support by the international development agencies, particularly the World Bank, of bankrupt state companies, have only postponed the ultimate predictable outcome. Caution is thus necessary in continuing to support state owned companies if they promise to adopt privatization as a goal. The timing never seems to be right to reach the goal.

In short, as long as the government has capital to expand SOEs it is less likely to privatize or to allow foreign capital to participate. Large loan programs increase the "turf" of government ministers and SOE managers making them less likely to support privatization. Moreover, extensive rehabilitation programs often amount to good money after bad and only postpone the privatization process as most investors would rather carry out their own reorganization programs.

On the other hand, even if successful privatization programs are adopted in a number of countries, there will always continue to be a significant public sector within the range of development assistance programs to assist these entities especially if this improvement could have a significant development impact on the country.

24f. Should ODA be used to help put together joint ventures and financial packages? To what extent is money from the aid budget already being used for this purpose?

Whether ODA should be used to put together joint ventures and financial packages is a thorny issue. The U.S. government has generally refrained from using ODA to assist private investors to compete against other competitors. However, the USG has available a "mixed credit" facility to assist U.S. firms to compete where competitors are being assisted by the ODA financing facilities of their own governments. When other normal sources of capital are not available, there could be occasions when ODA sources are appropriate.

24g. Are safeguards needed to minimize distortions and avert the possibility of competition for markets among DAC Members?

A priority among donors should remain to create a level playing field for domestic and foreign investors in developing countries. Reality has shown that a mixture of grant and credit or soft credits are often offered by developed countries to support investments by their nationals in developing countries. These types of problems are best handled in international agreements among countries regarding fair investment and trade practices. Promoting further coordination and cooperation among DAC members would also serve to mitigate this problem.

Even if safeguards were necessary to minimize distortions in the marketplace, however, it will not be simple to monitor or police these actions. Clearly flagrant situations of concessionary bribing will become obvious to all, and some mechanisms might be considered to penalize blatant occurrences.

APPENDIX A

ORGANISATION FOR ECONOMIC
CO-OPERATION AND DEVELOPMENT

RESTRICTED TO PARTICIPANTS

Paris, drafted: 17th August 1990

dist: 21st August 1990

DCD/DAC(90)19

Or. Engl.

DEVELOPMENT ASSISTANCE COMMITTEE

THE ROLE OF AID IN STRENGTHENING FINANCIAL RESOURCES FOR PRIVATE SECTOR DEVELOPMENT: ISSUES FOR DISCUSSION

(Note by the Secretariat)

This note provides a framework for discussion at the meeting of 20th-21st September 1990. It is divided into two sections. Section I is a brief introduction and overview. Section II identifies a number of issues grouped under the four main topics for discussion [as previously outlined in DCD/DAC(90)16]:

A. Stimulating Private Sector Development and Broad-Based Growth: Basic Implications for Financial Systems and Development Co-operation;

B. Strengthening Financial Policies and Institutions in Developing Countries;

C. The Intermediation of ODA to the Private Sector;

D. The Role of ODA in Promoting Foreign Direct Investment.

The meeting will be organised into four main parts, corresponding to these topics. It is hoped that the discussion will be focused and operational. Building upon the recommendations agreed last year and incorporated as Chapter I ("Enhanced International

Co-operation in Private Sector Development and Foreign Direct Investment in Developing Countries: Recommended Policies and Actions") in the recent publication, Promoting Private Enterprise in Developing Countries, the objective should be to work towards more specific conclusions on sound and effective means of strengthening financial support for private sector development.

Further background and analysis is provided in The World Bank's "Report of the Task Force on Financial Sector Operations" [DCD/DAC(90)21], and in USAID's "Development Finance Institutions: A Discussion of Donor Experience" [DCD/DAC(90)20], both of which are being circulated along with this note.

The number and range of questions to be addressed is inevitably quite large. Delegations and invited experts may wish to concentrate their interventions on certain issues rather than responding comprehensively to each set of questions.

THE ROLE OF AID IN STRENGTHENING FINANCIAL RESOURCES FOR PRIVATE SECTOR DEVELOPMENT: ISSUES FOR DISCUSSION

I. INTRODUCTION AND OVERVIEW

1. Developing country governments have characteristically made control over finance an important tool of development strategy. Intervention in the financial system was considered necessary to ensure that resources went to sectors and industries that were considered to be at the forefront of development. The financial system was used to allocate resources to projects with perceived high social returns, to redistribute income, reduce costs for state-owned enterprises, to favour particular industries or firms, and to offset the effects of overvalued exchange rates and restrictive trade policies on competitiveness. In many countries, banks were directed to open rural branches in order to supply credit to small shareholders. In some cases, the financial system was employed to provide patronage to favoured groups or individuals. Policy-makers tended to concentrate on "development" in the real sectors while ignoring or undermining the financial sector.

2. The experiences of the 1980s have shown what damage has been done to the financial systems in many developing countries. Financial institutions have suffered large losses, due in part to unpaid loans, leaving many LDC financial institutions insolvent. Many of the targeted beneficiaries have not fared well either.

3. The change in many governments' approach to development implies important changes in their approach to the financial sector as well. Financial sector development is now seen as important to efficiency and growth in the real economy. The two are mutually dependent. This is all the more important given the decline in foreign capital inflows. Developing countries must rely more than ever on domestic savings mobilization and its efficient allocation for the financing of investment.

4. As governments come to rely more upon the private sector and markets to direct the allocation of resources, the basic question for donors is how to use development assistance to help build and support financial systems that provide the incentives and institutions needed to mobilize and allocate financial resources efficiently.

5. While the development of the financial sector is seen to be important and the financing of private enterprises is a recognized problem, effective measures to increase the flow of capital to viable, competitive businesses are still in the making. Financial markets and institutions in many developing countries are insufficiently developed to effectively mobilize and allocate scarce capital. The weakness of financial institutions, legal frameworks, and management skills limits the speed with which a market-oriented financial system can be developed.

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6. The DAC's recommendations for improving Members' programmes to expand the availability of investment funds to private enterprises and to develop efficient banking and other financial institutions in developing countries are directed at these problems. The DAC Statement on Development Co-operation in the 1990s also emphasizes the role of the private sector in development and the need to increase financial resources to private enterprises in developing countries. Foreign direct investment has received renewed emphasis by DAC Members, developing countries, and the international finance institutions.

II. ISSUES FOR DISCUSSION

A. Stimulating Private Sector Development and Broad-Based Growth: Basic Implications for Financial Systems and Development Co-operation

7. An important implicit assumption underlying the aid effort has been that by helping to sustain and promote the process of economic growth, especially by investment in human resources and basic infrastructure, aid would contribute to the emergence of a strong private sector and an efficient domestic intermediation system, and as a consequence, to the generation of employment at the grassroots level. The fact that the private sector has remained very weak in many aid-reliant countries after several decades of development assistance suggests the need seriously to review this assumption.

8. In the aid-reliant countries, a large part of the resources for investment is commonly being supplied through the aid system on a government to government basis involving multiple actors with often differing interests on both sides. Thus the allocation of finance in these economies is being conducted essentially on a non-market basis. Furthermore, the sheer importance of the aid system in these countries may well be militating against the development of a market-based financial system rather than helping to foster it. And the absence of a uniform market-oriented system for pricing the use of capital in such economies has obvious implications for the allocation of capital and other resources. There is a strong likelihood that capital is being under-priced in relation to labour, with adverse consequences for employment generation and the fostering of human capital. (Aid itself, being made available on highly concessional terms, may operate in this direction.) Informal financial systems tend to develop, indicating the existence of significant domestic savings, but linkages to the formal sector are either very weak or non-existent.

<u>Questions</u>:

a) What are the fundamental implications for the aid system of the new priority being given to the development of domestic financial systems and the private sector?

b) To what extent may the role of official development assistance in aid-reliant countries have helped or hindered the development of financial markets and mechanisms?

c) What, in principle, are the possibilities for ensuring that a greater proportion of aid flows directly or indirectly through the financial systems to private lenders and borrowers? Can this be done using current mechanisms, or will new modalities need to be found?

B. Strengthening Financial Policies and Institutions in Developing Countries

9. Even when a country's policy framework is sound, the institutions themselves may also need help. Banks and other financial institutions will in many cases have to undertake substantial restructuring, management improvements, and staff training, all of which are laborious and costly. Insolvency is a problem in most Latin American and African systems, and poor management, government interference, and misdirected policies continue to hamper institutional performance.

10. Reforms need to go beyond recapitalizing insolvent banks. They must address the underlying causes of bank insolvency as well. The extent to which banks and other financial institutions can regain their financial standing depends mostly on the macroeconomic environment and on good financial and monetary policies as well as sound regulatory and supervisory systems. It is therefore important that donors work closely with the World Bank and IMF in supporting adjustment and stabilization programmes and improving core economic management capabilities.

11. A number of developing countries have taken steps to restructure their financial systems. Interest rates have been liberalized in Ghana and Indonesia, and Korea privatized its commercial banks, while Pakistan and Turkey reduced their directed credit programmes. Financial liberalization has sometimes caused problems, however. In some Latin American countries -- Argentina and Uruguay, for example -- liberalization ended in disarray, and the government had to deal with widespread bank failures. This suggests that the pace and sequencing of reform should be related to the structure of a country's financial system and the degree of macroeconomic stability. In East Asia, where macroeconomic conditions were more stable and reforms were implemented more gradually, financial sector reform has enjoyed relative success.

12. DAC Members have been involved in financial sector development in countries like Ghana, where Switzerland provided bankers to help restructure banks and improve operations, and in Indonesia, where the United States helped the Ministry of Finance with capital market development. France is engaged in a major effort to rehabilitate financial systems in the CFA franc zone. A number of other developing countries are taking or contemplating reform of the financial sector as part of broader restructuring efforts.

Questions:

a) What are the major elements of reform programmes for the financial sector? How do they interface with other economic reforms? Are there major issues of sequencing? How do needs and priorities differ between major regions and individual cases?

b) What kinds of assistance have Members made available for staff and management training and support? To what extent has aid been used to offset the costs of restructuring insolvent institutions? Which kinds of assistance have proved most effective and why? How have the programmes been monitored and their effectiveness measured? Are there instances in which bilateral assistance has in effect prolonged inefficiencies in the financial sector and delayed needed reform?

c) How do donors and the World Bank, IMF, and other relevant agencies co-ordinate their efforts?

C. The Intermediation of ODA to the Private Sector

13. The basic question about whether and how aid should be used to finance private enterprise raises a number of fundamental issues concerning the terms of and channels for such assistance. The disappointing experience with Development Finance Institutions (DFIs) illustrates some of the major points of principle and practice. This section addresses some of those points by asking whether DFIs can or should be rehabilitated, by considering how ODA might be used to help entrepreneurs secure loans, and by examining new approaches to small business financing.

14. Donors have traditionally relied on official financial intermediaries for financing private enterprises. DFIs were created to fill a perceived gap in long-term credit and to service specific groups such as small farmers and businesses. They have suffered, however, from government interference, weak management, and inability to mobilize funds. Many DFIs' survival depend on government subsidies, monopoly power in segments of the market, and other forms of protection. There is also evidence that many DFIs have not reached the groups they were intended to help, and that they may have undermined the emergence of private sector lenders.

15. Since experience with DFIs has been uneven at best, a number of donors and international finance institutions are trying to identify new mechanisms for private sector financing. These range from giving financial support to joint ventures between OECD and local investors, to assisting in the establishment of local credit revolving funds. The IFC has been involved in the creation of some 50 financial institutions outside the traditional DFI field, including leasing companies, merchant banks, and venture capital firms. Italy intends to provide Italian enterprises with concessional loans to encourage joint ventures in developing countries. The United States has sponsored a number of revolving credit funds in Latin America.

Questions:

a) If DFIs are not working as planned in a large number of countries, can or should they be rehabilitated? Can DFIs be expected to continue their dual role as finance institution and development agency? Should this role be more clearly defined?

b) To what extent can operational deficiencies be overcome by making DFIs more "commercial"? Are there methods for doing this which seem to have worked? What conditions are set as regards onlending rates for aid funding of DFIs, and who captures the concessional element? How is the exchange risk problem handled?

c) What is the rationale for using aid to directly finance private enterprises in developing countries? What are the dangers in this approach? Are there basic principles which apply?

d) To what extent have donors supported financial institutions outside the traditional DFI field, i.e., leasing companies, housing finance institutions, venture capital companies, etc.?

16. Commercial and development lenders, both domestic and international, assert that adequate private sector financing is available for sound "bankable" projects, and that multiple sources of funds exist for financing private enterprise. At the same time, would-be borrowers claim to have profitable projects for which they cannot find adequate financing. Thus, the perceptions of lenders and borrowers differ sharply about whether there is a "financing gap" for private enterprise. These different points of view might be reconciled by recognizing that many project proposals that were not initially "bankable" could become so with donor help.

Questions:

e) To what extent have Members helped reconcile these different perspectives by assisting private borrowers in project preparation and presentation?

f) Have donors provided assistance in the financial structuring of projects or helped identify prospective suppliers and markets?

17. Banks are normally reluctant to lend to small borrowers. The difficulties associated with small- and medium-scale enterprises (SMEs) lending -- how to determine risks, high lending costs, lack of collateral, etc. -- present special problems. Lending to SMEs, therefore, has been an important goal of DFIs, and a number of subsidized credit programmes have been established for SMEs, small farmers, and exporters. Some of these programmes have reached their

targets, but programme evaluations have found that borrowers are often larger than was originally intended. Small, especially very small, borrowers benefit very little from formal subsidized credit programmes.

18. Most developing countries have long-established informal financial sectors which provide services to the non-corporate sector -- house-holders, small farmers and rural businessmen. Informal banking has some severe drawbacks -- small scale lending, limited range of services, fragmented markets and sometimes inflated interest rates. Programmes to establish linkages between informal and formal financial markets would seem an obvious step, but as yet there is not much successful experience to learn from. On the other hand, some microenterprise lending schemes targeted on the poor have been both viable and effective (see World Development Report, 1990, pages 65-68).

Questions:

g) Could Members identify small business financing approaches which they have found to be particularly important and successful? Which approaches were less successful and why?

h) New approaches to identifying and tutoring "new entrepreneurs" are being developed, inter alia by the IFC. How are these initiatives regarded? Is there scope for bilateral cofinancing of individual cases?

i) What has been Members' experience in financing micro enterprises? What techniques are likely to prove most effective? What qualities should be looked for in NGOs whose activity in this field might be supported?

D. The Role of ODA in Promoting Foreign Direct Investment

19. DAC Members have considerable experience in promoting foreign direct investment (FDI) in developing countries. They have traditionally relied upon investment insurance and guarantees, and various information and promotion schemes to encourage investors to look to LDCs. In addition, aid has been used to help improve developing partners' investment promotion agencies. This section goes beyond these traditional activities by examining aid's role in improving the investment environment in recipient countries, by considering how investors might be brought into the policy dialogue, by asking how and whether aid should be used to open to foreigners sectors in which the state predominates, and finally, by reflecting on the appropriateness of aid for joint ventures.

20. Conditions for foreign investors have improved in some developing countries, but many others have not yet taken the difficult steps that are necessary to attract investors. Complicated investment regulations and procedures, strict repatriation restrictions, and unclear or contradictory policies continue to frustrate potential

investors. In light of the importance of sound policies and institutions to attract foreign investment -- and to stimulate local businesses and development generally -- some Members and multilateral institutions are working with developing country partners to improve their investment environment.

21. Foreign direct investment can bring capital, technology, and management expertise to countries with supportive policies and institutions. Many developing countries seeking to secure the advantages of FDI need help in improving their investment climate. Donors have generally tried to offer support in two ways: first, through investment guarantees, insurance programmes, joint venture schemes, and information and promotion services aimed at investors in their own countries. Second, by providing investment promotion agencies in developing countries with financing, training, technical assistance and support, and by advising on investment laws, regulations, and procedures.

Questions:

a) How can development co-operation be used to ease the policy constraints that frustrate potential investors? To what extent is this being done already? What have been the results?

b) To what extent are bilateral agencies involved in the effort to improve the investment environment in developing countries? Is there adequate co-ordination between multilateral actors (notably the World Bank Group) and bilateral agencies?

22. Since private investors make investment decisions based largely on the potential of the host country, it would seem important that investors be consulted about which policy reforms they regard as particularly necessary. A number of consultative mechanisms have been set up between donor agencies and private business associations, but these have generally not involved policy discussions.

Question:

c) How, and to what extent are investors consulted about the kinds of reforms they regard as critical? How do donor agencies determine what kinds of reforms are most important to potential investors, i.e., the ones most likely to attract them to LDC markets.

23. The possibilities for new major foreign investment may well be greatest in sectors frequently closed to foreigners, often marked by state ownership. The policy dialogue in a number of countries has sought to broaden the range of activities in which foreigners may invest.