FINANCIAL MARKETS DEVELOPMENT IN SUB-SAHARAN AFRICA: DISCUSSION AND RECOMMENDED APPROACHES

prepared for the Bureau for Africa

A WORKING PAPER

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TABLE OF CONTENTS

PREFACE

The following outline provides the reader with:

- a basic understanding of financial markets within the context of Sub-Saharan Africa;
- a sketch of necessary pre-conditions for successful financial markets development;
- an overview of financial markets initiatives by donor agencies and indigenous governments in the region; and,
- possible options for intervention by the Bureau for Africa.

For readers who are familiar with the subject matter, the paper may seem simplistic at times; the premises introduced herewithin appear repeatedly in the literature on financial markets in developing countries (see attached bibliography and on-line database material). Nevertheless, given the objective of this exercise, it is important for all those involved in the strategy session to possess a knowledge of the rudimentaries. It is hoped that this paper lays the necessary groundwork for the formation of an appropriate financial markets strategy for the Bureau for Africa.

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PART ONE -- EXECUTIVE SUMMARY AND RECOMMENDED APPROACHES

1.0 In Conclusion

1.1 Financial markets fuel economic growth with financial institutions serving as the catalyst to achieve development objectives. In developing countries, subsidies and governmental controls have created distortions in the economy and promoted inefficiencies in the financial system. Underdeveloped financial institutions, deficient staff and management skills and lack of a legal framework inhibits timely and effective progress in financial markets development.

1.2 The potential for success is directly related to an "enabling environment" complete with a rational legal and regulatory framework, political stability, information flow and management expertise. It is easier to undertake restructuring and financial innovation when these "preconditions" are in place. In Sub-Saharan Africa where the need is the greatest, countries must first work on the basic preconditions.

1.3 Financial markets development is not an simple task. In essence, it upsets the historical economic and political power structure in a country. As a result, local government commitment is crucial. In addition, without a supportive legal, judicial and regulatory framework, the market will be further destabilized.

1.4 Certain initiatives are necessary for successful financial markets development. Broad-based macroeconomic reforms promote competitive market-oriented financial systems. Rather than perpetuating reliance on external funding, internal mobilization of funds promotes self-sufficiency.

1.5 The introduction of new financial instruments to address the financial needs of the population builds confidence in the system. Technical assistance and training of management and investors as well as other institution building techniques have sustainable impacts on the infrastructure.

1.6 Important is the need for experienced technical advisors in the areas of financial sector reforms, banking operations and capital markets development. Historically, economists and government officers from abroad have spearheaded private sector and financial markets development efforts with similarly educated professionals in developing countries. These individuals do not have the training and experience to successfully undertake these tasks.

1.7 Development of a country's financial system is a massive undertaking. Whether pursuing a focused approach or a broad-based strategy, donors can play a pivotal role. A country's economy is a working system; therefore, lack of coordination of policies by indigenous governments and donors could be potentially detrimental. For instance, absence of private enterprise reforms in tandem with financial markets development has stifled the interrelationship between the industrial base and financial systems in many developing countries.

1.8 There are "structural adjustment" proposals and other forms of intervention that apply generally to developing countries. But, a more tailored approach will address country-specific conditions and problems.

1.9 Historically, it has been difficult to bring about change and implement market-oriented strategies in developing countries. However, recent political and economic trends suggest that governments can no longer ignore the global realities of increased competition, and shrinking access to financing. Donor focus may shift from the African continent to countries in Eastern Europe and Asia where more potential for economic development is seen.

1.10 In Sub-Saharan Africa, governments are facing desperate situations worsened by depressed commodity prices and heavy debt burden. At a time when donors may have other interests, some governments are looking to the donors for assistance. Other governments continue to ignore the situation; it is believed that when the economic pain is great enough, these countries will begin to address their problems.

2.0 A.I.D. Initiatives

2.1 The 1988 policy statement on financial markets development, stresses the importance of 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."

2.2 Although there has been some coordination within the Bureau of Africa and other divisions, this is an opportune time to review the accumulated research and experience of A.I.D. in the region. This is not only important to avoid duplication of efforts, but also to fully understand in which areas each office has a distinctive competence.

2.3 In order to be effective in its undertakings, the Bureau for Africa can not afford to be a generalist in financial markets development. Inappropriate program implementation and haphazard approaches can potentially have serious ramifications beyond the financial markets.

2.4 A.I.D. should not be constrained in stipulating and enforcing "conditions" before money is disbursed during project implementation. For instance, in a recent banking reform program in Senegal, supported by France, USAID and The World Bank, France and USAID disbursed the first tranche of funds, despite a default on a critical condition precedent. A.I.D.'s reward system, based on monies disbursed, not on program success, encourages disbursements without results (e.g. Gambia).

3.0 Recommended Approaches

3.1 The Bureau for Africa should concentrate on work in the following areas: (i) research; (ii) banking reform; (iii) capital markets development; (iv) legal frameworks; (v) financial innovation; and, (vi) semiformal financial markets. It is recommended that specialists -- professionals with hands-on, practical, private sector experience -- be hired in each of these fields. These professionals would serve a multitude of functions, acting as:

- clearinghouses of information on the subject matter;
- liaisons with the Mission, various offices in A.I.D. and the donor community; and,
- technical experts. For instance, Fred O'Regan of AFR/MDI functions as the Bureau's Sector Advisor on micro and small-scale enterprise. His knowledge and work in the field lends credence to A.I.D.'s commitment to the area.

3.2 The Bureau of Africa should focus on a variety of "support" interventions, including research, technical assistance and training. The choice of intervention is conditional on available information, local government support and other donor involvement. When possible, the Bureau should use indigenous organizations as implementing, monitoring and administrative agents.

i. Research

It is utmost important to understand the political, legal and institutional base of a country before undertaking interventions. In the past, donors have oriented their research toward the "supply"-side of financial markets (i.e., institutions and services). To complement this research, information gathering at the "demand"-level (i.e., the financial needs of enterprises, consumers, and traders) should be promoted.

Although research is an important element to program design:

- o financial markets are constantly changing; therefore, information gathering should be specific, action-oriented and responded to quickly;
- o research alone is not action; and,
- o there are specific actions that can be undertaken without excessive research (i.e., regulatory or legal restrictions can be identified and acted upon in a timely manner by knowledgeable professionals).

Much research has been done with respect to formal financial markets in Senegal and Cote d'Ivoire in West Africa, and Kenya and Tanzania in East Africa in comparison with other countries. This research has been general in nature, not identifying concrete steps to improve the markets. On the other hand, research on informal financial markets is at an initial stage, focussing primarily on Cameroon, Niger and Senegal, and should be pursued further.

Currently, the area of informal financial markets has attracted considerable attention. Various offices at A.I.D. have supported research in the field. AFR/TR has studied credit and savings institutions in the informal financial markets. The Missions and S&T, in conjunction with Ohio State University have focussed on Zaire, Niger and Cameroon. But, there has been little coordination and much overlap of these efforts. As a result, a comprehensive stock-taking of research done on this subject matter should be undertaken without delay. Moreover, research efforts should be managed from one office in the Bureau for Africa. Given A.I.D.'s limited amount of resources, this would allow for efficient use of time, money and energy.

ii. Banking Reform

A sound banking system is a minimum starting point for financial markets development, without it there will be little economic stability and investor confidence. In Sub-Saharan Africa, centralization of political and economic power prevents successful financial intermediation. Consequently, an important step towards breaking down this stronghold would be to promote liberalization policies. Since banking reform is still dependent on the government's willingness to carry out the measures, it is important for A.I.D. to work with other donors to persuade governments to undertake structural adjustment programs, privatize formal financial institutions and promote market efficiencies. When donors cooperate, they have more political leverage and strength in guiding policy.

Banking reform initiatives also should encompass programs oriented toward institutional strengthening (i.e., management and staff training, and information and monitoring systems) and infrastructure improvements (i.e., equipment, safes and record-keeping devices).

iii. Capital Markets Development

There is a fine balance between market development and regulatory needs. In the past, legal structures have been constructed before the establishment of efficient market mechanisms. Enthusiasm for securities and exchange commissions prior to developing knowledgeable management or appropriate economic and political conditions does not make sense.

Given the thin population density and concentration of wealth, there is inevitably a lack of liquidity in the markets. For this reason, it is suggested that the development of regional capital markets be investigated. As in West Africa with much uniformity of financial regulations because of the CFA, there is potential to pull these countries together. Whereas excess funds do not exist in Senegal, Togo has money to invest. Consequently, the privatization efforts of Senegal could be greatly enhanced if there was cross-border investment using the capital markets as a conduit.

Unit trusts and mutual funds, as being explored in Ghana and Malawi, can be used as a means for the public to buy shares in state-owned enterprises and extend the development of capital markets. Nevertheless, it should be kept in mind that stock markets are not necessarily a prerequisite to financial modernization. Work to develop capital markets before the preconditions noted above are in place may not be an appropriate initiative. In this case, private placements can be pursued.

Capital markets development depends on the dissemination of reliable information. The establishment of a general system of accounting procedures throughout the region would build confidence in the investor base and potentially stem capital flight.

iv. Legal Framework:

An equitable and just system is pivotal to financial markets development. Without enforcement of creditor's rights, financial institutions will not lend money. Semi-formal institutions, if their success becomes overly visible, risk becoming government-controlled. A case in point is Cameroon, where the government appropriated deposits from semi-formal entities to fund public accounts.

A clear understanding of legal deficiencies is crucial to program design and implementation. A legal system can be in place, but without a fair and impartial judicial system and a willingness to adhere to the rules, the legal framework is irrelevant. Training, technical assistance and conditionality in program design could assist in the promotion of just systems.

v. Financial Innovation:

A.I.D. should encourage activities which expand the variety of financial instruments in Sub-Saharan Africa. Work, such as with the ADB on Afro-Securities aims to broaden the financial instruments that are available in the marketplace. In an effort to gain local confidence and attract foreign financing to the region, Afro-Securities capitalize on the ADB's "name" and reputation. This "tie-in" is an interesting approach that should be pursued in other initiatives.

Other endeavors that should be furthered are:

- debt swaps, particularly in privatization efforts; and,
- the strengthening of "graduating" tontines, such as La Financiere.

vi. Semiformal Financial Markets:

Donors have achieved some success in programs aimed at integrating the informal and formal sectors. This has been accomplished through semi-formal institutions. The World Council of Credit Unions (WOCU) and innovative non-governmental organizations, such as the Get Ahead Foundation in South Africa and Council for International Development in Kenya have been used as fostering agents because of their relationship with "consumers" and extensive networks. These organizations have served as intermediaries across communities, providing the conduit for movement of liquidity from net surplus to net deficit areas.

Semi-formal institutions can be strengthen through management assistance, infrastructure improvements and development of communication networks. Other possible interventions include:

- establishing guarantee schemes to facilitate borrowing;
- encouraging the growth of regional centers to increase the reach, effectiveness and efficiency of semi-formal organizations; and,
- building new institutions, using models, such as the Banque Populaire in Rwanda, or through the introduction of the credit union concept in communities.

Additional points of note:

- the success and sustainability of these projects depend on leadership at the grass-roots level;
- although working with semi-formal institutions is more satisfying than attempting to untangle the labyrinth of laws and regulation, without changes in legal structures, the growth of the semi-formal sector will be hindered;
- strengthening of the semi-formal financial sector may undermine interventions in the formal system; and,
- overzealousness and competition among donors may cause harm to traditional systems, especially if external capital is introduced in the market.

PART TWO -- THE OVERVIEW

1.0 Background

1.1 Financial markets provide the backbone to a country's economic activity insofar as it provides the funding and liquidity necessary to spur business creation. Basically, the financial markets function by mobilizing domestic resources through savings promotion and improving the mechanisms for optimally channelling savings into productive enterprises. In developing countries, this activity is accomplished through the formal and informal financial markets.

1.2 Unlike the formal financial markets, the informal financial markets address the neglected needs of the population whether for those who also use formal institutions or more importantly, the rural communities, "poorest of poor", and women, who do not have access to formal financial markets. In the informal markets, the fact that borrower/depositor and lender/deposit-taker must know each other, both decreases transaction costs and limits the operation geographically and in scope.

1.3 The investor and issuer, lender and borrower, though their roles overlap, serve specific functions in financial markets. It is financial intermediaries, such as commercial banks or brokerage houses that bring these players together. In developing countries, the weaknesses of these institutional arrangements are significant deterrents to economic development. Deficiencies related to available instruments and organization of these markets also present difficulties to the efficient workings of financial markets.

1.4 Extensive research has shown the interrelationship between financial markets and the rate of economic growth (Fry 1988):

- o real interest rates and the prevalence of bank offices per capita have a positive effect on savings and quantity of investment, while the inflow of foreign capital has a negative effect on savings; and,

- o quantity of investment, excluding donor funds, is positively related to the availability of domestic bank credit.

1.5 Experience in financial market development has demonstrated that the greater the impact of market forces on financial systems, the greater the contribution to economic development. Likewise, the more governments repress these forces, the more the financial markets hinder development. Regulated interest rates, high reserve requirements and credit controls, while creating imbalances in the economy, also discourage the growth of financial intermediation.

1.6 In Sub-Saharan Africa, financial markets are very shallow with few institutions. Academics use the bank density ratio (bank/1,000 persons) as an indicator of market development. In Africa, the density figures are the lowest in the world -- the two extremes are Togo, 1 per 50,000 and Zaire, 1 per 400,000; this compares to 1 per 7,000 in the Dominican Republic, and 1 per 25,000 in Bangladesh. Population size and concentration of wealth in many countries has a limiting affect on financial markets development. Inflation, economic and political uncertainties, and difficulty in accessing long term capital, has created a bias toward short-term lending and limited risk taking.

1.7 The present debt crisis exacerbates problems for Sub-Saharan countries. In the international arena, the debt burden has diminished confidence in developing countries' ability to achieve stable economies and growth. Large public sector deficits -- in part from bloated budgets and outflow of interest payments -- drain indebted countries of foreign exchange. Central banks which have in the past received practically all long term credit from foreign loans, no longer have access to these funds. This has an adverse impact on investment capital available for the import of goods and services.

1.8 In the 1989 World Development Report, the World Bank Group cautions developing countries about the debt situation. The Bank emphasizes that foreign capital infusion to most developing countries is likely to be relatively small over the next few years. As a result, these countries will be forced to rely increasingly on domestic savings to cover the costs of economic development.

1.9 Particularly, in the informal sector, institutions exist which have substantial savings mobilization programs. But, these entities at present can not solely satisfy the demand for funds. Market liberalization and institution building programs are needed to strengthen and build other financial intermediaries.

2.0 Definitions

2.1 The formal financial markets are composed of banks and non-financial institutions:

- central bank, commercial banks, development banks/government banks, investment/merchant banks and foreign banks; and,
- finance companies, investment companies, insurance companies, pension funds and venture capitalists.

2.2 Generally in developing countries, central banks have been heavily involved in:

- o administering controls over money supply;
- o providing the government and parastatals with low cost funds to cover operating and budget deficits; and,
- o supporting non-performing loan portfolios of commercial and specialized banks. Loans were made at subsidized rates to government-designated priority sectors.

In Ghana by the mid-1988, the banking system had a negative net worth, having been completely depleted by large foreign exchange losses and a high proportion of non-performing loans. In Tanzania, between 1981 and 1986, as a result of ceilings on nominal interest rates and rationed credit, total monetary assets to GDP declined from 48 to 34 percent. Also during this period, money allocated to the central government and state-owned enterprises rose considerably.

2.3 Rather than mobilizing local deposits, commercial and specialized banks in Africa have relied on their governments for lower than market rate funds. Dependency on this funding as well as foreign loans has served to weaken the control and functioning of the formal institutions.

2.4 By tradition, financial markets are considered to be divided into Money and Capital Markets.

Money markets:

- o cover short term or working capital financing needs (under 1 year); and,
- o include instruments such as certificates of deposit, commercial paper, loans, trade credits and bankers acceptances.

Capital markets:

- o serve the long term needs of the business community in terms of investment in capital goods;
- o include either issuance or trading in debt instruments, bonds or equity. Primary (issuing) and secondary (trading) markets provide the conduit for the dealing in negotiable instruments;
- o include securities which are negotiable, such as stocks and debt securities or non-negotiable securities, such as, loans, leases and mortgages; and,

- require a wide network of sophisticated investor groups and systems, whether publicly traded or privately placed.

2.5 In developing countries, the money markets are usually under-developed. The limited depth and experience of the markets is due in large part to the absence of either an active trading market or market-making dealers. Without the appropriate instruments and institutions to mobilize excess funds, the markets will remain undeveloped.

2.6 To date in Sub-Saharan Africa, there exists only an inactive local securities market restricted to three to six month treasury bills held by banks under reserve requirements or treasury bonds primarily held until maturity by insurance companies and banks. Certificates of deposits and treasury bills are issued, but lack of appropriate maturities and availability hinder usage by savers. Citicorp in Kenya has attempted to address more consumers' concern over inflation with the introduction of interest bearing checking accounts. But, this product development is uncommon for formal financial institutions.

2.7 Whereas the money markets in Sub-Saharan Africa are under-developed, the capital markets are largely nonexistent -- except for some limited activity in Nigeria, Kenya, Zimbabwe and Cote d'Ivoire -- for the following reasons:

- historically, debt has been preferred over equity because: (1) long term credit at subsidized rates has been available to businesses; (2) debt holders have a priority position in bankruptcy proceedings; (3) individuals desire steady income streams (i.e., interest) over less reliable dividends payments; (4) the concept of capital gain is foreign and, (4) risk preference;

- in the primary securities market, there are usually, limitations on public offerings for issuers and underwriters, inadequate legal and tax frameworks, inexperienced professionals and the lack of equity purchasers; and,

- with a limited supply of securities for trading and no organized trading mechanisms, the capital markets can not develop.

2.8 Informal financial institutions emerge in developing countries to address the demand for financing mechanisms not otherwise satisfied through formal means.

Informal markets:

- o exist based on market forces in the informal economy where funds are provided by indigenous savers and borrowed free from government limitations, such as registration and regulations;
- o are self-sustaining, grass-roots based and flexible to changing economic conditions. Typically the development of the informal sector is positively related to the health of the formal sector; and
- o typically comprise money lenders, merchant middlemen, private pawnshops, landlords, rotating savings and credit associations (ROSCAS), tontines, supplier schemes, mobile bankers, and family members.

In Ghana, 300 mobile bankers formed the Greater Accra Susu Collectors' Association. This association is trying to establish its own commercial bank because existing financial institutions consider administration of their portfolio too expensive.

2.9 The strength of informal financial markets is based on country and community specifics. Their success depends on providing convenient savings and lending mechanisms to a population who would otherwise have no access to funds due to:

- o collateral requirements;
- o location;
- o servicing and delivery costs; and,
- o loan amount and repayment schedules.

Moral suasion and community pressure to meet financial obligations reduces the riskiness for the lender. Low operating costs due to inexpensive administrative costs, community knowledge of the participants and less complex procedures also contributes to its viability.

2.10 Semi-formal institutions bridge the gap between the informal and formal sector.

Semi-formal financial intermediaries:

- o are registered legal entities and have written statutes, but are not under central bank monetary authority (i.e., subjected to reserve and collateral regulations);
- o comprise credit unions, cooperatives and institutions, such

as Rwanda's Banque Populaire (People's Bank) and "Grameen" bank models; and,

o unlike informal intermediaries, have an "economies of scale" advantage and broader access to the benefits of the formal financial markets.

2.11 Efforts to link the traditional informal savings groups and semi-formal institutions to organized financial markets in Sub-Saharan Africa have met with limited success. There have been practices of informal credit in parastatal or government credit programs, particularly in cooperative credit schemes. But, very few have been formalized, for the following reasons:

o there is a risk that when institutions become too successful the government intervenes to control the entity. In Togo, savings in the credit union system grew by 25 percent a year and loans rose by 33 percent a year during the 1977-1986 period. The system became so successful that the agricultural bank wanted to own it. Also, an informal association in Cameroon, which in 1975 became La Banque Unie de Credit, Cameroon's sixth largest bank, was closed in 1979, when the government insisted on appointing the bank director;

o when semi-formal institutions use the formal network as a depository base, the collapse of the banking system damages the viability of the institutions (e.g. Senegal); and,

o models, such as the MUDZI scheme in Malawi designed after the Grameen Bank, may not be appropriate for Sub-Saharan Africa. Problems with this model include, the high wage structure for trained personnel in Africa and logistical complexity due to sparse population density.

3.0 Financial Innovation

3.1 Debt Swaps

3.11 Throughout the developing world, debt swaps in the form of debt-for-equity, development or nature have become a popular financing technique. Local and foreign investors in the commercial sector use debt swaps:

o to purchase shares in parastatals which are being privatized;
o invest in indigenous companies; or,
o fund subsidiaries with local currency.

3.12 The discounted debt is sold by local or foreign banks or purchased in open markets. While proponents of debt swaps view the mechanism as a means to encourage repatriation of local capital and promote investment, critics, especially indigenous governments, fear loss of economic control and argue that discounted capital provides an unfair advantage to foreign investors vis-a-vis domestic competitors. For countries in the CFA zone, ties of the region with the French treasury and the politics involved have discouraged the use of debt swaps.

3.2 Stock Exchanges

3.21 With governments in developing countries privatizing state-owned enterprises, the development of stock exchanges has become another potential financing and savings tool. Successful stock exchange development requires:

- constant flow of reliable information;
- professional and investor training;
- increases in absorptive capacity; and,
- market confidence.

3.22 To expand the depth of the market, methods such as underpricing sales to first time small investors, employee stock ownership plans, unit trusts and administrative reforms are being implemented.

3.23 Examples of Sub-Saharan stock exchanges include:

- the Nairobi Stock Exchange, one of the oldest in Sub-Saharan Africa, started in 1954. The market deals with 83 issues from 55 publicly-listed companies, and 39 Kenyan Government interest-bearing securities. Limited competition restricts liquidity in the market; there is only six brokerage firms. Brokers act only as agents for their clients and match buy and sell orders. Owing to exchange controls, trading in foreign stocks is prohibited;

- in Cote d'Ivoire, the Government in the early 1960s bought shares in foreign-owned Ivorian companies. In 1974, the Government began to transfer its shares to individual Ivorians. This served as the basis of the birth of the stock exchange. By the end of 1987, the Ivorianization rate of listed companies reached 30 percent; and,

- recently, with the aim of satisfying the demand by local firms for long term capital, the Government of Mauritius has sponsored the sale of mutual funds to foreign investors. Although the country's stock exchange has been in existence for over 100 years, by the end of 1987, activity remained stagnant and a new exchange commission was established to provide a revised regulatory framework.

3.24 While attempts to promote the development of stock markets, such as tax incentives in Cote d'Ivoire (i.e., (1) 90 percent tax abatement on industrial and commercial profits for quoted securities; (2) deduction of 300,000CFA under general income tax; (3) exoneration from transfer gains; and, (4) tax exemption on income from securities) are numerous, governments in developing countries still keep a tight rein on the markets. In Cote d'Ivoire, foreign ownership and trading is still constrained. In Nairobi, the securities and exchange commission not only oversees activities for issuers, but also focusses on investors needs. Undoubtedly, this dual purpose limits the ability to serve either party effectively.

3.3 Venture Capital

3.31 Venture capitalists serve an important role in business development. They provide equity capital and advisory services to companies that are unable to amass the long term financing needed for start-up or growth. Generally, venture capitalists:

- possess a diversified portfolio of minority positions in young growing companies for the purpose of capital gain within 10 years; and,
- invest based on their confidence in management, risk-return expectations and proper business environment for the investment.

These factors have implications for venture capitalists in Sub-Saharan Africa given economic and political instability, uncertain business profitability and investment horizon.

3.32 Within recent years, African business start-ups, expansions, turnarounds and/or diversification efforts have looked to foreign as well as domestic venture capitalists for funds. Venture funds provide long term financing to smaller enterprises because of the paucity of investment vehicles.

3.33 Currently, La Financiere, a private African venture capital company based in Cote d'Ivoire, The World Bank Group's African Enterprise Fund and the Economic Development for Equatorial and Southern Africa are addressing the needs of this market segment. However, the indigenous sustainability of these organizations will require mobilization of local resources. Until now, they have relied on financial support from international donor agencies.

3.4 Guarantee Schemes

3.41 Guarantees and insurance mechanisms have been used predominately by formal and semi-formal institutions:

- in their lending activities to micro and small-scale entrepreneurs; or,

- as a form of collateral. For instance, donor agency guarantees in local or foreign currency encourage commercial banks to make loans to informal savings groups. In 1986, USAID/Nairobi provided local currency support in the form of guarantees and overhead expenditures to the Kenya Commercial Bank for the "Jua Kali" Loan Program. This program, oriented to the informal sector, had high repayment rates, but was not sustainable due to administrative expenses.

3.42 Although some view guarantees as a means to expanding the lending capacity of formal institutions to non-traditional recipients, others argue that this practice encourages lenders to be more fund managers and administrators rather than financial intermediaries. Lenders avoid the risk of doing business and most often, do not adequately analyze the loans. This may lead to an inefficient allocation of resources.

3.43 Traditional semi-formal credit guarantee mechanisms include:

- group lending schemes -- members put their loans in a fund that would be forfeited if any member defaulted (e.g. tontines);

- mutual credit groups -- a risk sharing mechanism which incorporates the mandatory savings requirement for members, and allows them to turn this money over to a formal financial institutions savings account as a guarantee for loans to member businesses; and,

- local small investor groups -- organized to secure business credits for member businesses or to act as venture capitalists in the community. These groups serve as specialized intermediaries which leverage off of the guarantees to borrow from formal financial institutions (e.g. Caution Mutuelle and La Financiere).

3.5 Leasing and Asset-based Financing

3.51 Most often in developing countries, leasing companies have not been established, for the following reasons:

- lack of understanding between a lease and a loan:
- no tax incentives;
- high duties on the importation of capital goods; and,
- inadequate enforcement of creditors rights, resulting in inability to repossess goods upon default.

3.52 Recently, governments in Mauritius and Kenya have promoted the establishment of leasing companies. Both countries now offer tax advantages. However, in Mauritius, for instance, regulatory restrictions still prevent leasing companies from funding through deposits. Instead, the company has creatively raised financing through a 5-year corporate bond that pays rates competitive with bank savings and treasury bills.

3.53 Finance companies which exist in Kenya, Mauritius and Tanzania, tend to concentrate on asset-based lending (i.e., based on accounts receivable and inventory). These institutions have been formed by banks to avoid interest rate ceilings on savings and lending.

4.0 Pre-Conditions for Viable Financial Markets

4.1 Critical Factors

- A strong legal foundation and accompanying fair and equitable judicial system provide the framework for the development of financial markets. For domestic and foreign investors, basic prerequisites which must be enforceable are:

  - debt recovery and creditor's rights;
  - property rights and secured collateral; and,
  - investment code and contract law.

- Functioning information systems and accounting and auditing standards are necessary. Lack of proper information gathering and differences in presentation of financial reporting biases credit appraisal and increases transaction and monitoring costs. Absence of uniformity and integrity of information significantly increases the risk for investors and banks. For this reason, in developing countries, lenders usually lend on a collateralized rather than a cash-flow basis. In addition, lenders deal with repeat borrowers or borrowers with government guarantees.

- Without management expertise and organizational infrastructure financial markets can not fully develop. The importance of professional and administrative staff as well as strong intermediaries and procedures, such as brokerage houses and underwriting systems can not be underestimated.

- Political stability, economic growth and market confidence are essential. An overwhelming consideration in financial markets development is a government's commitment to private sector initiatives and a "hands-off" policy. Only in this way, will the country establish credibility with the investment community and entice domestic investors -- most importantly the middle class, if it exists --to look beyond traditional investments (i.e., land and jewelry) to financial instruments.

4.2 Financial Reform

4.21 Financial reform encompasses two areas:

- liberalization measures; and,
- regulatory change.

Effectiveness of reform endeavors depends on the managing of both components. Excessive regulation inhibits market development, whereas unbridled liberalization causes socially undesirable allocation of resources. A good mix will increase the efficiencies in the market, while providing the regulatory framework for development.

4.22 Lifting of restrictions, such as discriminatory taxes and unfavorable treatment of investment in shares has spurred greater financial sector development. But, liberalization alone can not rebuild credibility in fragile financial systems. Governmental policies toward freeing of interest rate ceilings, foreign exchange availability and pricing controls are needed at the same time to accommodate financial markets growth.

4.23 Reevaluation of financial policies in Sub-Saharan Africa began in the early 1980s as banking systems became increasingly vulnerable to international shocks and downturns in domestic performance. Many African banks saw portfolio quality deteriorate as the economies undertook structural adjustment programs. As a result, several countries with nationalized banking systems are restructuring and privatizing their financial markets (e.g. Mozambique, Madagascar, Tanzania, Senegal and Angola). In 1984, the Guinean financial system had 99 percent of loans irrecoverable. All six of its banks were liquidated and three new banks were established, each with foreign participation. It is hoped that this will restore credibility in the financial system.

PART THREE -- DONOR INTERVENTIONS

1.0 The World Bank Group

1.1 In a recent task force report, the World Bank stated that the organization in the "past had overlooked the importance of financial sector development and pursued short-term real sector objectives...fragmenting financial markets and impeding efficient resource mobilization and allocation."

1.2 The Bank in the financial sector had been principally a lender. It funnelled capital for development purposes through development finance institutions. These institutions have been negatively affected by:

- o government interference in lending decisions;
- o weak management;
- o local currency devaluations;
- o insufficient capacity to mobilize funds;
- o poor credit allocation and low interest rates; and,
- o dependence on donors.

1.3 Nonetheless, the Bank continues using development finance institutions to channel assistance. Over the past five years about 25 percent of the Bank lending provided indirect support to the private sector through these institutions. Currently, the Bank has undertaken advisory work in the hope of correcting the economic imbalances caused in part by some of its past interventions.

1.4 The Bank promotes broad-based macroeconomic reforms as well as private enterprise, financial institution building and research and training endeavors. Through its policy dialogues and adjustment lending, the Bank seeks:

- o to improve the policy and regulatory environment of borrower countries;
- o to provide consistency among donor programs by writing policy framework papers; and,
- o to facilitate structural reform.

1.5 The Bank directs these initiatives through indigenous governments and governmental entities while the International Finance Corporation (IFC) works in tandem with the business community and private institutions. With the establishment of the African Enterprise Fund and the African Project Development Facility -- in partnership with United Nations Development

Programme and African Development Bank -- the World Bank Group has extended its involvement in small and medium-sized enterprise efforts. Also, the Bank, through the IFC, promotes local venture capital funds, reorganizes commercial banks and has a leading role as adviser and investor in developing countries' capital markets.

1.6 Research is a priority for the World Bank Group. A thorough understanding of a country's financial sector is necessary to insure consistent and integrative policies. To keep attuned to the changing financial conditions in developing countries, the Bank regularly composes Country Financial Sector Surveys. In addition, the World Development Report 1989 offered a comprehensive focus on financial systems in developing countries. By highlighting financial markets, the World Bank illustrated the importance of this sector to its activities as well as to a country's economic development.

2.0 <u>OECD Development Assistance Committee (DAC)</u>

2.1 In line with the interventions of The World Bank Group, DAC countries:

- o provide technical assistance to local financial institutions; and,
- o as part of the structural adjustment program, encourage ways to expand the availability of long term investment funds for the private sector.

2.2 The following are some general initiatives:

- o Switzerland works with local development banks to offer small and medium-sized enterprises grants or loans;
- o Germany participates in funding venture capital companies in Cote d'Ivoire, Kenya and Malawi. In Kenya, the fund makes equity capital available for the rehabilitation of private small and medium-sized enterprises;
- o European Economic Community finances projects in Africa through the European Development Fund and European Investment Bank;
- o Nordic countries assist in the formation and strengthening of semi-formal financial institutions; and,
- o Germany, the Netherlands and Sweden create partnerships between their commercial banks and local banks to facilitate small-scale lending.

3.0 A.I.D.

3.1 Beginning in the early 1980s, A.I.D. has made a systematic commitment to private enterprise as the means for economic growth in developing countries. In assisting these activities, A.I.D has moved away from its traditional interventions.

3.2 In the past, A.I.D. primarily provided loans, subsidized to a large extent, to governments for on-lending to priority sectors. With little expertise in financial markets development, many Missions instituted a variety of projects, such as micro and small-scale loans, agricultural credit and exchange rate reform without insuring consistency in objectives and underlying conditions in the programs. Also, A.I.D. has accepted governmental allocation mechanisms and credit ceilings despite the consequences these policies may have had on program effectiveness.

3.3 Analysis of past A.I.D. financial market intervention demonstrates a focus on credit disbursements and allocation without measures to mobilize domestic resources. These type of initiatives have adversely impacted the sustainability of indigenous financial markets.

3.4 Over the last five years, A.I.D.'s direction has changed to encompass a wider scope of financial markets initiatives (e.g. training, policy reform, institution building and innovative financing techniques, such as debt swaps, informal finance supports and guarantees).

3.5 The strategy set forth in the 1988 A.I.D. Policy Paper, "Financial Markets Development" established the following direction:

- to liberalize business climates, including regulatory environment;
- to improve the policy environment;
- to promote savings and investment;
- to assist with the development of banking reform and legal regime;
- to design and undertake micro and small-scale credit schemes and informal financial markets initiatives; and,
- to promote capital markets growth.

3.6 In carrying out these endeavors, the Africa Bureau has been and should continue to work with indigenous private and public entities as well as foreign governments, private voluntary organizations and multigovernmental institutions. Financial markets research and information gathering conducted by various donors and within the Bureau for Africa should offer insight and direction.

3.7 The Private Enterprise Bureau (PRE), Bureau of Science and Technology (S&T), Bureau for Africa Development Planning (AFR/DP), Bureau for Program and Policy Coordination (PPC), Bureau for Africa Technical Resources (AFR/TR), the Missions and Bureau for Africa Market Development and Investment (AFR/MDI) have undertaken initiatives in Sub-Saharan Africa with the objective of promoting financial market development.

3.8 Examples are as follows:

o PPC has supported studies of tax policy and financial intermediation in Botswana and Zambia as well as studies on liberalization and privatization of financial sectors. These studies are operational in nature rather than focussed on macroeconomic concerns.

o AFR/DP has proposed a $10 million 5-year research effort to investigate coordination of macroeconomic and financial reforms, imperfections in financial markets, system stability and credibility, welfare and development objectives, and institutional design and financial innovation. These studies are informational and research based.

o In 1987, AFR/DP commissioned Wharton Econometrics to analyze the role of the African financial sector in development. Using existing financial markets' data on Mali, Kenya, Rwanda, Niger, Zaire, Malawi, Senegal, Somalia, Sudan, Guinea and Zambia, Wharton produced a comprehensive study of macroeconomic environment and financial sector strength. Points of note:

  o there are shortages and unevenness of information among countries. Thus, more research is needed; and,
  o the preconditions described in Part Two - Section 4.1 are crucial to successful development.

3.9 At the Mission level, there has been support for financial markets development as part of structural adjustment and balance of payments programs, such as:

o in the Gambia, the second phase of the Economic Recovery Program contains a $5 million sector program grant aimed at financial policy changes as well as privatization of the country's largest commercial bank;

- in Senegal, a $32 million sector program grant is tied to banking industry reforms, such as privatization and restructuring, and bank management. Tax reform is also an important component of the private sector development program in Senegal;

The Mission uses financial sector studies to understand the context in which it implements these programs. Formal financial markets research has been undertaken for Cameroon, Cote d'Ivoire, Zambia, Gabon, Uganda, Mali, Burundi, Zaire and Guinea (Conakry).

3.10 Furthermore, the Mission supports successful projects in rural financial markets, agriculture credit and credit unions, particularly in Cameroon and Togo. In Cameroon, members of the Cooperative Credit Union League -- over 60,000 members and loans valued over US$15 million -- are provided with training in financial management, savings, promotion. Through the World Council of Credit Unions (WOCU), semi-formal and informal organizations are assisted with specialized credit and technical training.

3.11 The Financial Sector Development Project of PRE in conjunction with Price Waterhouse has three main objectives:

- to disseminate financial market information;
- to conduct applied research with the assistance of S&T in the formal and informal sector for the Missions; and,
- to provide technical assistance in the design and implementation of programs in the formal financial markets.

For instance, in Kenya, PRE assisted in the establishment of the Kenyan Capital Market Development Authority. PRE also funds research for Missions, such as the 1982 study of the capital markets in Zimbabwe.

3.12 S&T works with PRE as part of its $21 million 10-year Financial Resources Management Project aimed at increasing the knowledge of rural and informal financial markets. This follows the Experimental Approaches to Rural Savings Project which aimed to expand financial services to populations. PRE's GEMINI project focuses on credit concerns for microenterprises.

3.13 AFR/MDI with PRE has commissioned studies in Senegal, Zaire and Kenya as an initial step towards gathering information on savings, investment and user requirements in the informal financial sector. Financial markets surveys through Manual for Action in the Private Sector (MAPS) offer information about the formal financial markets. Also with PRE, AFR/MDI has designed and negotiated loan guarantee programs for micro and small-scale enterprises with banks in Botswana, Kenya and Cote d'Ivoire.

3.14 AFR/MDI has been instrumental in encouraging a variety of financial markets development initiatives, including:

- the African Venture Capital Project. The project supports investor clubs which serve as a conduit to provide entrepreneurs with financial support. In addition, it works with Meridien International Bank and Ecobank to sponsor venture capital funds. Meridien's Private Enterprise Fund for Africa hopes to encourage grass-roots level ventures through debt and equity infusions, and management and technical assistance;

- OPIC's Africa Growth Fund. This provides equity and quasi-equity financing to private industries. Capital for the fund is provided by $20 million OPIC-guaranteed notes and $10 million in equity subscriptions of U.S. corporations and institutional investors;

- debt swaps programs in Madagascar, Tanzania, Ghana, Malawi and Zambia;

- legal and regulatory reform interventions in West Africa;

- design of the Gambian stock market:

- bank privatization programs in Senegal and Gambia;

- guarantee programs in five countries;

- innovative financing techniques with the African Development Bank (e.g. Afro-Securities). Afro-Securities are ADB-guaranteed AAA rated securities publicly underwritten, marketed and distributed by indigenous financial institutions to institutions and individuals in Africa and abroad; and,

- seminars for senior management and bank staff at indigenous financial institutions (e.g. recent training sessions on debt conversion in Abidjan and the co-sponsored seminars with World Bank and Ohio State University on informal financial markets in October 1989).

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