AFRICA FINANCIAL MARKETS GUIDEBOOK

BUREAU FOR AFRICA *SEPTEMBER 1993*

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CAPITAL MARKETS • CONTRACTUAL SAVINGS • OPEN-END MUTUAL FUND • ISUSU
TECHNOLOGY TRANSFER • INFORMAL SECTOR FINANCE • INDIRECT TAXES • LEASING
SAVINGS COOPERATIVES • PRIVATIZATION • PREFERRED STOCK • INTEREST RATES
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LEGISLATIVE REVIEWS • LIFE INSURANCE • STOCK EXCHANGE • FISCAL POLICY

AGENCY FOR INTERNATIONAL DEVELOPMENT

FOREWORD

This Guidebook sets forth a comprehensive manual for financial markets development in Sub-Saharan Africa. The purpose of the Guidebook is to serve as a valuable tool for A.I.D. project officers designing and implementing financial markets projects. It is also to serve as a guide to public and private partnership opportunities for bolstering financial markets policy and institutions in developing countries.

The ensuing Africa Financial Markets Guidebook succeeds two guidebooks previously published by A.I.D. The ENE/PSD Guidebook on Trade and Investment was published in July 1990, followed by the Regional Financial Markets Guidebook for the Asia, Near East and Europe Bureau (ANE), published in 1991.

Similar in approach and organization to the ANE Regional Financial Markets Guidebook, the Africa Financial Markets Guidebook aims to provide practical methodologies and recommend useful programming areas for USAID Missions. The Guidebook has been developed with the hope of encouraging a greater sharing of ideas on financial markets strategies within A.I.D., between A.I.D. and other donors and between A.I.D. and the private sector.

Currently, the greatest challenge for Sub-Saharan Africa is the development of viable financial institutions, and increasing the financial resources available for growth and development and ensuring a more productive use of those resources. Building public confidence in the banking system is one of the most important goals in Sub-Saharan African financial sector reform, followed by the need to increase competition and develop the capital markets. This Guidebook outlines activities in the areas of macroeconomic policy, commercial banking, informal sector assistance, as well as securities market development, quality of financial information and privatization which serve to meet these goals.

We look forward to receiving any comments or information on additional experiences which may be useful to other A.I.D. personnel developing financial markets programs.

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Africa Financial Markets Guidebook

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I. FINANCIAL MARKETS STRATEGY FRAMEWORK AND INTRODUCTION

A. Financial Markets Definition

Financial markets are markets for the exchange of capital and credit in the economy. Stock markets, bond markets, commodities markets and foreign exchange markets are all examples of financial markets. Financial markets can also be viewed as an industry in its own right, which requires proper incentives, management and technology to perform effectively and competitively.

In financial markets, money is the commodity being traded. As in any market, the "price" of money is determined by its supply (savings) and by the demand for it (the need for funds for productive uses). In the case of money markets, the "price" is the "interest rate", expressed as a percent of the amount of funds being borrowed, lent or invested (the "principal"). In a free financial market, interest rates are determined by supply and demand for funds, which as conditions change can cause sharp fluctuations in interest rates. In extreme conditions, excess supply can cause hyper-inflation (sharp declines in the value of money), and excess demand or overly-restricted supply can cause a "credit squeeze" where sources of funds dry up and economic recession or depression sets in. Since national monetary authorities have control of the "supply" of local money, and since governments often weigh heavily on demand for funds, particularly if they are running large budget deficits, government policies have great impact on financial market conditions, even in the absence of direct government regulation of market conditions and interest rates.

Financial markets are generally classified as **money markets** and **capital markets**. "Money markets" refers to the market for short-term debt instruments - usually those with a maturity of one year or less. "Capital markets" refers to the market where capital funds - equity and debt with a maturity of over one year - are traded.

As depicted in Figure 1, money markets and capital markets may be further classified in terms of instruments and institutions. Money market instruments are usually characterized by term (less than one year), safety and liquidity and are used to facilitate trade, payments and short-term savings. They include Eurocurrency deposits, foreign exchange, commercial paper, bankers acceptances, treasury bills, and certificates of deposit. The sophistication of these instruments and institutions varies in accordance with the level of development of each country.

Money market institutions include central banks, commercial banks, dealers and money market mutual fund companies. Central banks issue currency, oversee the payment system and act as banker to the government and other banks. Central banks are also responsible for implementing monetary policy. Commercial banks engage primarily in deposit taking and short and medium-term lending, although many other services may be offered depending on the country's legal framework and stage of economic development. Money market dealers trade money market instruments (i.e., commercial paper, government bills, etc.), and money market mutual funds pool the resources of savers and invest them in these liquid assets for a fee. In many LDC's with few or no negotiable money-market instruments, the "money market" exists solely through financial intermediaries (banks) as deposits or as loans between themselves and with other parties, and through and with the local government's financial and monetary institutions.

Capital markets provide the means to borrow or invest funds for longer periods of time. Capital markets instruments may be either "securitized" (i.e., represented by a tradeable certificate) or "non-securitized." Instruments in the **non-securities segment** of the market include term loans, mortgages and leases.[1] Institutions active in the non-securities portion of the capital markets are savings banks, mortgage banks, and development banks of various types, as well as non-banking institutions such as leasing companies and contractual savings companies (i.e., insurance companies and pension funds) which also invest a portion of their resources in tradeable securities.

Instruments traded in the **securities segment** of the capital market include stocks and various types of bonds. These bonds differ from one another in their claim on the assets and/or income of the issuer. Some bonds may be converted into other securities of the issuing firm under prescribed conditions (i.e., convertible bonds).

Institutions in the securities segment operate in either the primary market or the secondary market. The primary market is the market for new issues of securities, which in the U.S. are referred to as Initial Public Offerings (IPOs). Once the IPO security has been purchased by investors, that security is tradeable on the secondary market where previously issued securities are bought and sold. Primary market institutions include investment banks (which handle securities trading and underwriting), brokers (who match borrowers and savers), dealers (who purchase securities and resell them) and venture capitalists (who supply risk capital). Secondary market institutions include the exchanges and over-the-counter markets, as well as brokers, dealers, mutual fund companies and others who buy and sell securities subsequent to their original issuance.

Increasingly, in advanced financial markets, the two segments are linked by the packaging or "securitization" of primary instruments such as mortgages or consumer installment obligations into asset-backed obligations that are traded in securities markets.

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[1] While such instruments are generally not traded on an individual basis, trading in securities backed by mortgages, consumer loans and other assets grew to a record volume of $177.3 billion in the United States in 1990.

B. Importance of Financial Markets

Efficient financial markets are essential to a smoothly functioning economy. Financial markets contribute to economic growth by **mobilizing savings.** They increase the rate of savings in an economy by providing a secure home for savings characterized by liquidity and a positive net return. Positive real interest rates and low inflation rates increase the incentives for savers to switch from holding real assets to financial assets.
Financial systems increase both the quantity and the efficiency of investment by **allocating savings** to investments yielding maximum returns. By providing investors access to sources of finance, financial systems increase investors' ability to take advantage of investment opportunities.

When functioning smoothly, financial systems **reduce transaction costs** involved in matching savers and borrowers. This, in turn, raises the rate paid to savers and lowers the cost borne by borrowers.

Efficient financial systems **spread information** on the term structure of interest rates (the continuum of interest rates offered on a given instrument as a function of the time to maturity and risk). This process of putting money to use as investment is known as "intermediation" and is one of the core functions of a developed financial system. The intermediation process takes place more efficiently when borrowers and lenders have access to information about interest rates.

Financial systems increase economic efficiency by providing a **means of payment** to facilitate commerce. Without such a payment system, trading costs would be high and the linking of markets would be difficult.

Financial markets also serve to **pool and distribute risk.** By allowing investors to diversify their holdings across the securities of many firms, as opposed to concentrating them in a single-stock portfolio, securities markets allow investors to substantially reduce the riskiness of their portfolios relative to the risk of the typical component security.

Financial markets also play a critical role in providing incentives for the **allocation and management of funds** and monitoring the use of those funds. Various classes of investors have different rights both to observe the behavior of management and to intervene in specified instances. Thus, financial markets are a critical link in the micro-level governance of a market-oriented economy.

Finally, diversified and competitive financial markets provide products and services to **accommodate the varying preferences** of savers and investors regarding liquidity, maturity or term, and risk.

C. Problems of Poorly Functioning Financial Markets

Financial markets operate best when free from excessive regulation and government intervention. Unfortunately, governments in developing countries have often chosen to control decisions in financial markets as a means of promoting priority sectors and controlling other economic activities. Such intervention often takes the form of subsidized interest rates, directed credit, excessive taxes and high reserve requirements for banks to generate cheap government financing. Governments justify these interventions by claiming that priority activities are poorly served by existing financial institutions. Yet, such schemes result in market distortions and generally in a misallocation of resources. The results of such interventions over the years have been weakened financial sectors characterized by insolvent banks, low savings rates and capital flight.

The financial systems of many developing countries are inadequate, or less efficient than they could be. Financiers lack the tools to evaluate, price, and monitor risks. The weakness of accounting, auditing and disclosure regulations limits the information available to lenders about borrowers. These factors, together with uncertainty about economic prospects, deter creditors from offering long-term instruments and discourage banks from lending to farmers and small businesses. Often, legal defects and other institutional limitations make it hard to write enforceable contracts along various dimensions. Many of the problems of poorly functioning financial markets are described in the World Bank's World Development Report 1989 on "Financial Systems and Development." According to this report, the financial sectors of many developing countries are in urgent need of reform. More than in the high income countries, for several decades after World War II LDC governments intervened in their financial systems to support their development policies and objectives. This left their financial institutions weak or insolvent, and as a result many were unable to withstand the global economic shocks of the 1970's and early 1980's. As some LDC governments have realized, new policies are needed to strengthen the financial sector so that it can contribute to a more efficient allocation of resources.

The fundamental condition fostered by the various forms of government intervention mentioned above is a lack of competition in the financial and in the "real" (i.e. productive) sectors. As in any non-competitive situation, such circumstances cause poor service, high costs, and unavailable credit to new and growing business, thereby stifling economic development. Therefore, measures to foster (1) competition in the financial sector, (2) the elimination of special politically driven subsidies and monopolistic privileges for state-owned financial institutions, and (3) the privatization of financial institutions, should be program goals to be implemented wherever possible.

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II. GLOBAL, U.S. AND REGIONAL FINANCIAL MARKETS

Financial markets have undergone tremendous change in the last several decades, with important implications for developing countries. This chapter discusses the international evolution of financial markets since the Bretton Woods era in order to provide a historical context for A.I.D.'s financial markets programs. It then provides an overview of financial markets in Sub-Saharan Africa.

A. International Evolution of Financial Markets

Prior to 1971, the structure of international financial markets was based on the agreements reached between forty four countries at Bretton Woods, New Hampshire in 1944. These agreements, regarded as a blueprint for a new post-war economic order, established a fixed exchange rate system backed by gold reserves. The United States had by far the largest economy in the world following the war, and as such its currency became the dominant choice for countries wanting to build up large foreign currency reserves. The automatic price discipline of a quasi-gold system and its contradiction with a single reserve currency were constraints many countries were reluctant to live with. Notably, the US felt the tension between the desire for an expansionary monetary and fiscal policy after the Vietnam war and the growing exodus of dollars.

On August 15, 1971, the Nixon Administration announced that the dollar had become inconvertible into gold for all holders. The Administration's actions effectively ended the Bretton Woods exchange rate system and the last remnant of the gold standard. Over the following two years, the industrialized countries moved towards a system of floating exchange rates. This system has remained in effect, with the result that on any given day, central banks around the world (most notably the Bundesbank and the Bank of Japan) may intervene to even out fluctuations in rates.

The period since the collapse of the Bretton Woods agreements has been marked by rapid change and innovation. There have been six key trends: **liberalization, internationalization, institutionalization, innovation, computerization, and disintermediation.**

The first trend, **liberalization**, is illustrated by the elimination of foreign exchange controls, interest rate ceilings, deregulation, and credit allocation controls in much of the world. Liberalization and has proceeded along two main lines: the relaxation of various price and quantity restrictions and an easing of limitations on cross-border capital flows and other types of financial activities. Market participants have been allowed to issue instruments that previously were not permitted, such as floating rate notes in Germany and commercial paper in France and the United Kingdom. In total, these liberalization measures have tended to blur the distinctions between segments of national financial markets, and to internationalize the flows of capital.

The second trend toward **internationalization** of financial markets has its roots in several phenomena: the explosion of huge petrodollar surpluses in the wake of the oil shocks of the 1970s; the growth of the Eurodollar market to absorb and redistribute the petrodollars (see Box 2.1); and the expansion of large banks into international markets as they followed their clients around the world. While internationalization has created many new possibilities for corporations seeking to raise financing and tap new markets, investors too have become more accustomed to global opportunities for enhancing investment returns and diversifying risk. One recent example of this trend is the proliferation of country funds, international mutual funds, and other types of institutions to manage cross-border flows of capital.

Box 2.1 The Eurodollar Market

Eurodollars are dollar-denominated deposits in a bank outside the United States, or at an International Banking Facility (IBF) in the U.S. For example, a dollar-denominated deposit in a bank in Luxembourg is a Eurodollar deposit. Similarly, a Eurocurrency deposit is a foreign-currency-denominated deposit in a bank outside the country where the currency is issued.

Eurodollar deposits came into existence in the 1950s when Eastern bloc governments arranged to place their dollar deposits in London bank accounts to avoid the potential risk that the U.S. government would place a freeze on their U.S. deposits. Eurodollar deposits quickly became attractive to a wide range of depositors because, unlike U.S. deposits, they were not subject to interest rate ceilings, reserve requirements or Federal Deposit Insurance Corporation (FDIC) premiums. Although the interest rate restrictions were gradually eliminated for U.S. deposits beginning in 1970, reserve requirements and insurance premiums have remained in effect. Because of the dollar's importance in financing international trade and investment, investors have found it convenient to hold dollar deposits in Hong Kong, Singapore, the Middle East and other financial centers around the globe. Consequently, the term Eurodollar has been joined by the "Asia dollar". Nomenclature has not, however kept up with the instruments. At the end of 1988, the gross volume of Eurodollar deposits totalled $4.6 trillion; interbank deposits, a large component, made up about two-thirds of this total.

The third trend, **institutionalization**, is linked to the growth of savings. As the level of savings has accumulated around the world, the institutions that harness them, such as pension funds, insurance companies, and commercial banks, have come to dominate the management of the world's capital and its investment.

The fourth trend, **innovation**, has been influenced by the incredible diversity of risk/return preferences of major borrowers and investors around the world. This is only partly in response to changes in tax laws; it has also been stimulated by decreased government regulations and increased competition. One has only to mention zero coupon bonds, interest rate swaps, options and futures contracts and other "derivatives" to realize the importance of innovation in financial instruments.

The fifth trend, **computerization** linked with modern telecommunications has become a modern organizational necessity. State-of-the-art technology has distinctly changed the financial services industry, obliterating the old concept of separate and distinct markets. There is now a twenty-four hour, global financial market that is linked by computers, satellites and fiber optics searching for optimum combinations of risk and return.

Arising from the combined effects of these driving forces, is the powerful trend toward **disintermediation.** Savings once confined to distinct channels (bank deposit and savings accounts, etc.) are now accessed more directly by investors without passing through traditional types of institutions. In effect savers and investors are increasingly in direct contact as companies issue their own commercial paper to the market, and savers purchase asset-backed securities which finance home mortgages - a function formerly confined to the local S&L, or bank.

LDCs

International capital markets continue to play larger and larger roles in integrating the world economy. Efficient allocation of financial resources is one major and obvious benefit that the globalization of financial markets creates for savers and investors across national economies. Developing countries can take advantage of these trends by becoming a part of the new global financial interdependence. Countries such as Singapore, Taiwan, Hong Kong, Malaysia, and Indonesia have sought to "marry" themselves to the international financial system, and are able to reap the benefits of stimulating increased investment and lower interest rates. Nations such as Brazil and Argentina, on the other hand, have lost their international financial standing and suffer the "dark side" of interdependence. The results include poor credit ratings, capital flight, and financial instability.

Prior to the early 1970s, most of the funding available to developing country borrowers came from official donors or direct investors. During the decade of the 1970s, a number of factors combined to increase their access to private sources of capital on a general obligation basis. Among these were: the excess liquidity of private commercial banks due to the petrodollar surpluses, a recession in many of the OECD countries which reduced their demand for credit, and an urgent need to borrow on the part of the larger developing countries which had begun to implement highly capital-intensive development plans.

Toward the end of the 1970s, it became increasingly clear that the debtor nations could no longer sustain the high levels of debt they had contracted. Interest rates were rising; commodity prices were falling; most of the syndicated loans to the debtor nations had been arranged using floating interest rates. Still, the banks continued to lend on the strength of the notion of "sovereign risk"-- as espoused by Citicorp's former Chairman Walter Wriston, i.e. governments do not go bankrupt. Many banks also believed that they were too heavily exposed in the developing country market to risk abrupt withdrawal.

More recently, the private banks have been reluctant to offer new loans. In fact, the net flow of financial resources to developing countries (new loan disbursements minus repayments) has been extremely negative in recent years, reaching -$50 billion in 1989.

Nevertheless, close collaboration with the IMF to implement necessary reforms has improved the creditworthiness of many developing countries.

There remain a number of options for commercial lenders to manage their exposure to developing countries. These include debt-equity swaps, debt defeasance, debt forgiveness or debt buybacks. A debt-equity swap is a transaction in which a party purchases foreign currency loans at a discount and exchanges them at a price closer to the face value in order to make an equity investment in a local company. Debt-equity swaps have gained prominence as a partial solution in the debt crisis, partly due to increased recognition by the debtor nations that foreign investment can make an important contribution to economic growth and private sector expansion. Another option is debt defeasance, whereby the existing debt is replaced by new debt, usually exit bonds, on concessionary terms to the debtor, thus exempting the creditor bank from participation in future rescheduling. Other options include debt forgiveness or a debt buyback, in which the debtor country repurchases its own debt on the secondary market. Debt-Equity swaps should be broken into counterparts:

- Repurchase of discounted external debt for cash
- Issue of money or domestic bonds to obtain cash
- Sale of domestic asset (equity) at subsidized price.

Plans for dealing with the debt crisis assume that resolution is best handled by the market, or conversely, by government intervention. The Baker Plan is an example of a market-oriented solution in that it suggests desired contributions from debtors and creditors, but it stops short of imposing them. The Brady Plan envisages debt service guarantees by multilateral agencies and debt write-offs, and thus falls into the second category of plans. The response of commercial banks to these plans has not been uniform: many smaller banks with limited exposure in developing countries have been willing to write off their loans and pull out of the market altogether; most of the larger commercial banks have reduced their long-term exposure but continue to provide short-term financing (such as trade financing) which poses fewer risks. The banks have certainly become more cautious in their approach to these markets, but many of them do not want to turn their backs on the developing countries because of their multiple ties and obligations there, and future business opportunities.

B. Financial Markets in Sub-Saharan Africa

1. Financial Markets in Africa

The present condition of the financial markets in Sub-Saharan Africa (SSA) is largely the result of three factors - the lack of financial development during the colonial period; the economic and financial policies pursued by post-colonial governments; and the effect of changes in monetary and financial conditions outside of Africa. In the pre-colonial period, indigenous financial arrangements met the needs of different regions and populations as more formal arrangements, such as commercial banks and trade-financing enterprises did not exist. During Africa's colonial period, the first banks operated in Africa as branches of foreign banks and were not concerned with developing monetary and financial policies for the colonies. Not until the post-colonial period could the independent African governments begin to promote financial development and improve their control over the monetary and financial system. Since the formation of the independent nations, the fragile financial system of post-colonial Sub-Saharan Africa was not resilient enough to withstand the shocks caused by the rapidly changing conditions of the international financial markets and has been struggling to adjust to the turbulence caused by external forces.

Pre-Colonial Period

The earliest history of finance, credit and debt in Africa can be traced to copper bars, cowrie shells, calico, iron rods, bracelets and other commodities that served as financial instruments. Salt and gold were utilized in trans-Sahara trade. Evidence indicates that, before the ravages of the slave trade, many regions of Africa were dynamic, well-governed and prosperous.

Many sophisticated indigenous financial arrangements were developed. Bills of exchange were utilized in trade in West Africa. All of these instruments, however, were "special purpose monies" or special financial arrangements; there were no "general purpose monies" (such as francs, pounds and pesetas) that were generally accepted as a means of payment on a continent-wide basis. In many parts of Africa, the search for an efficient medium of exchange eventually led to the monetization of precious metals. Metallic payment, such as coin-based instruments, was an important milestone in the development of the financial system in Africa as it simplified the payment mechanism and facilitated trade. Even though the metallic payment system provided a common means by which merchants, farmers and craftsmen could easily sell goods and services, the system was still a regional method of payment; the fragmentation of political power prevented the widespread acceptability of a particular coin or bullion. Furthermore, inconvenience and danger of carrying large sums of coins prevented the coin-based instruments from being established as a widely accepted method of payment.

The evolution to a paper-based monetary instrument used throughout the continent did not occur until the colonization of Africa by the European powers. Payment orders, letters of credit and negotiable bills of exchange became common as Europeans required more convenient and more sophisticated financial instruments. The introduction of general purpose monies by the Europeans through merchandise trade, slave trade, settler, missionaries and explorers were powerful instruments of modernization and social change. Many traditional social relations, such as the bride-price, were monetized.

Sophisticated indigenous institutions existed in the pre-colonial period and are still in use today. The rotating savings and credit associations (ROSCA), referred to as *isusu* or *tontines*, are examples of such institutions which villagers could participate in to raise capital. A clear division of labors and responsibilities is found in the organization of a ROSCA. The president of the association provides leadership, arbitrates disputes, sets policies on loans and interest rates; the "bankers" are those who monitor the transactions of the ROSCA; an assistant is appointed to help the president implement decisions; and the secretary records the members' subscriptions.

Colonial Period to World War II

The colonial period in Africa can be divided into three phases. The first phase, from 1875 until World War I, involved occupation and pacification of the sub-continent by military forces. The second phase, from 1920 to 1940, was a time of economic stagnation as Africa was not immune from the world economic depression beginning in 1929-30. During these two phases, the economic growth of Africa was controlled by private foreign companies such as United Africa Company (controlled by Unilever) and Companies Française de l'Afrique Occidentale; the colonial governments were primarily concerned with providing the infrastructure needed to support private sector activity and colonial administration rather than formulating developmental plans for the colonies. (The third phase, from 1945 to about 1960, is discussed in the next section.)

With the exception of the Union of South Africa, the change and growth of colonial Africa was mostly externally-driven, influenced by the international economy; financial institutions existed primarily as extensions of the European financial systems. Since the capital needed to explore, pacify and colonize Africa largely originated from Europe, there was no need to develop an internal African financial system as these enterprises required few financial services from local institutions. Furthermore, the profits from commercial ventures in Africa were repatriated back to Europe, providing little economic growth for the continent. Apart from the large foreign-owned trading and financial companies, such as Société Commerciale de l'Ouest Africain, major shipping agents and the mining companies, there were few other financial institutions located in colonial Africa. Where financial institutions existed, the services provided had little to do with the normal business conducted by the majority of the African population. In Nigeria, attempts by local businessmen to establish banks and financial institutions resulted in failure, largely because of the lack of capital.

Another factor that inhibited the economic growth of Africa was the employment and labor policy of the colonial administrations. The majority of Africans did not have access to higher-paying jobs and discriminatory policies prevented the growth of indigenous enterprises, resulting in low effective demand. To provide the European mines and farms with inexpensive labor, most of the administrations implemented policies in which only those who had worked as laborers were allowed into urban areas. For example, large numbers of laborers from Zambia, Malawi and Zimbabwe were recruited under short-term contracts (less than a year) to work in the mines in South Africa. The accommodation was suited for bachelors and at the end of the contract, they were repatriated. This system of periodic migration had the effect of depleting the rural sector of its young, male labor force. The effect of this system was to lower the productivity of indigenous agriculture, alter the relations of power and status within the village community and create dependence on the earnings of urban workers. The combination of employment discrimination and the system of periodic migration, combined with neglected educational and health policy, resulted in a low growth rate. It also retarded the expansion of industries such as financial services and agriculture.

This policy of neglect and discrimination was in accord with Britain's colonial doctrine which emphasized the separateness of its colonies from the imperial power; it theoretically envisaged the eventual political independence of the colonies and therefore did not warrant investment to develop the colonized nations. In contrast, the French doctrine of assimilation theoretically considered the Africans as citizens of a greater France. However, little was done to make this a reality until after World War II.

Post-World War II to Early 1960

Not until the third phase, from 1945 to about 1960, did the European colonial powers become directly involved in the growth and development of the individual colonies. The post-World War II period saw the greatest developments in SSA as the colonial powers could no longer ignore the needs of the colonies for better infrastructure, better education and adequate health standards. This was both a reaction to international criticism of the exploitative nature of colonialism and a means of rebuilding after destruction caused by the war.

Post-World War II institutional changes in the European countries also had an effect on the colonial territories. In both Britain and France, socialist governments were elected, and central to the socialist agenda was governmental control of commercial activities. This enthusiasm for governmental control also applied to colonial policy.

An example of post-World War II colonial policies was the creation of a unified French currency for the Francophone territories in Africa. Prior to World War II, each colony typically maintained its own currency at a parity that was firmly linked to the French franc. After World War II, the currencies of all the French colonies in Africa were consolidated into a single currency known as the CFA franc ("le franc des Colonies Francaises d'Afrique"). The currencies were fully convertible into French francs at the fixed parity; convertibility was guaranteed as overdrafts were permitted. Since this system allowed the free mobility of capital throughout the zone, it encouraged the growth of cross-border trade as it created a common financial zone. The remarkable feature of the CFA franc zone is that the basic system is still in place and the exchange rate against the French franc has not changed for more than 40 years.

African Independence

Characteristic of most SSA countries' post-colonial development was the enthusiasm for central planning and the belief that industrialization was the path towards modernization. This enthusiasm extended to the financial markets as the newly-formed nations viewed the role of banks, the dominant financial institution, as a powerful instrument of government policy. Consequently, these new governments devised different means to control foreign commercial banks. The level of control ranged from outright nationalization of the banks to limiting foreign ownership. For example, in Tanzania the government-owned National Bank of Commerce nationalized the assets of foreign banks and took over their branches. In Malawi, Standard Chartered was given a government contract to manage the National Bank of Malawi and the right to hold a 20% share in its formerly 100%-owned bank operations in that country.

The new mission of the banking system shifted from ensuring the viability of the system to directing credit to priority sectors regardless of risk. Government intervention often resulted in artificially low interest rates. Since inflation rates were often higher than the interest charged by the banks, voluntary savings dropped. To protect their purchasing power, savers invested in real assets, such as gold and jewelry or transferred their resources abroad. Despite the ambitious reform efforts of the last decade, these problems continue to exist today.

Compounding the commercial banks' inability to mobilize savings from the general public are tenuous linkages between the formal financial sector, of which the commercial banks are a major component, and the informal sector. In some SSA countries, the ratio of money in circulation in the informal sector to the formal sector is estimated at five to one. No more than 10 percent of rural households and businesses receive formal loans in any one year in Sub-Saharan Africa.[1] The implication of this weak linkage is important for two reasons. First, government control over macroeconomic factors, such as the supply of money in circulation, is possible only if the formal sector has a significant impact on the informal sector. Second, if the linkages were strong, loans to large banks would filter down to small and micro-enterprises including those businesses in rural areas most distant from urban centers. This has been the exception, not the rule.

The development strategy of most SSA governments in the 1960s concentrated on industrialization. Agricultural development was considered secondary and only as a means to provide raw materials and tax revenues. At first, this strategy seemed to work as strong export demand and high investment boosted GDP growth. Countries financed much of the growth with foreign funds, taking advantage of heavier borrowing abilities based on high export prices and negative real interest rates in international markets. This strategy was

[1] "A Review of the Literature on Financial Markets and Agribusiness Development in Sub-Saharan Africa: Lessons learned and Suggestions for an Analytical Agenda" by Richard L. Meyer, Douglas H. Graham and Carlos E. Cuevas, 1992.

predicated on the following factors, all of which were dictated by the economic and financial conditions outside of Africa: 1) inexpensive petroleum to fuel Africa's industrial boom; 2) continuing foreign investment to sustain its rapid industrial expansion; 3) continuous high demand for its exports; and 4) stable and strong exchange rates to ease import and interest payments.

The first oil shock in 1973-74 and its subsequent impacts on international financial markets demonstrated the precariousness of the industrialization strategy pursued by SSA nations after independence. The first oil shock and the oil shortfall in 1978-79 caused a sharp increase in interest rates worldwide, which in turn, substantially slowed the rate of foreign investment in Africa. With oil prices escalating at an exponential rate, most Sub-Sahara Africa countries' rates of production declined. As a consequence of the decline in foreign investment and the increase in energy costs, most SSA nations resorted to borrowing heavily at high interest rates to sustain production. This reliance on foreign debt instead of domestic resources had grown to crisis proportions as the amount of debt in 1989 was 115 percent of Sub-Saharan Africa's GDP.

Competition from other developing countries and sharp currency devaluations in the mid-1980s further exposed the weakness in the development strategy of the SSA nations. The emergence of other newly industrialized economies, particularly in East Asia (e.g., Korea and China), also negatively affected the demand for exports from Sub-Saharan Africa. Whereas the growth of export volume in East Asia from 1973 to 1988 was over nine percent, by contrast, Sub-Saharan Africa's growth in exports was only slightly over one percent, resulting in an almost twenty percent decline in per capita real gross domestic product (GDP) between 1974 and 1984. Overall, Africans were almost as poor in the mid-1980s as they were at independence in the 1960s.

Even though the sharp devaluation of SSA currencies in the mid-1980s helped in making exports cheaper, in reality, it severely burdened the economic system of SSA. At the end of 1989 Sub-Saharan African's debt was about $161 billion or 352 percent of exports. Since most commercial bank lending was based on floating rates, SSA borrowers were exposed to interest rate and exchange rate fluctuations. The devaluation of SSA currencies put additional pressure on the debt crisis. For example, in 1989, foreign debt-service obligations amounted to 22.1% of export revenue. According to the IMF, only twelve SSA nations have been able to regularly service their debt since 1980.[2] Adding to its woes, Sub-Saharan Africa also suffered severe droughts, famines, wars and political conflicts during these years, contributing further to the deterioration of their economies.

The effect of these developments on the Sub-Saharan financial systems was devastating. The following examples illustrate the severity of the financial crisis: in Guinea, when the new government assumed power in 1984, it inherited a virtually defunct banking system with

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[2] The above statistics were taken from *World Development Report 1989* and *African External Finance in the 1990s*, by The World Bank, and from *Africa South of the Sahara 1993*, by Europa Publications Ltd.

99 percent of loans being irrecoverable; in Ghana, the net worth of the banking system in mid-1988 was negative; in Tanzania, the losses in the main financial institutions were nearly 10 percent of GNP.

Besieged by such losses, African economic policymakers recognized that structural reforms were needed to foster viable financial systems. Considerable efforts have been made to reform, privatize or liquidate enterprises that were inefficient or were not self-sustained. The World Bank and the IMF have assisted thirty-three nations in their effort to restructure their financial systems.

2. African Financial Systems in the 1990s

The greatest challenge for Sub-Saharan Africa in the 1990s is to develop a viable financial system in order to increase the financial resources available for growth and development and to ensure a more productive use of those resources. The experiences in Sub-Saharan Africa in the last two decades have demonstrated that infusions of money from external borrowing into economies without efficient financial structures and sound plans for their utilization can result in an unhealthy dependency on continuous borrowing.

The first step in developing a strong financial system in SSA is to shift from relying on external to domestic sources of financing by better mobilizing savings of households and businesses. This will be a difficult task. As discussed earlier, a common reason for the dispropensity to deposit savings in the banking system has been government-controlled negative real rates of interest on deposits. To compound the problem, the collapse of banking systems in many SSA countries in the 1980's reduced the attractiveness of commercial banks as a vehicle for savings. Since commercial banks are the most important financial intermediaries in Sub-Saharan Africa, banking reform is a prerequisite in harnessing domestic financial resources. According to Babacar Ndiaye, the president of the African Development Bank, building the public confidence in the banking system is one of the most important goals in reforming the banking sector.[3] Some of the steps in reforming the banking sector are: 1) improve prudential bank supervision to protect depositors and to ensure the health of the banking industry; 2) train bank examiners to perform banking supervision; and 3) enforce strict accounting, auditing and disclosure standards, in order to provide accurate and reliable financial information.

The second step in cultivating a healthy financial system (given an adequate regulatory environment) is to promote increased competition among the providers of financial services. These institutions, including securities firms, mutual fund companies, venture capitalists, insurance companies etc., play a key role in fostering economic development as they increase the range of financial instruments available locally and discourage capital flight. The existence of a strong capital market is critical to a balanced financial system as it

[3] "Africa Report," January-February 1992.

provides long-term financing to those emerging enterprises with the potential to expand jobs, output and GDP in the long-run.

The capital markets in Sub-Saharan Africa are in an infancy stage. For example, the SSA stock market capitalization (excluding the Johannesburg Stock Exchange) is less than 0.1% of the U.S. market capitalization. The insurance industry is similarly underdeveloped; only in one country, Zimbabwe, does the ratio of annual premiums to GDP, exceed one percent (see the section on insurance companies in Chapter III for further information). In order to create a suitable environment for capital markets, SSA governments can: 1) draft tax laws that do not discriminate against equity financing; 2) allow market forces to regulate prices and the number of participants (e.g., insurance companies, brokerage houses, venture capitalist companies, etc.); and 3) educate the public about instruments such as stocks and mutual funds.

Reports on the high profitability and commercial success of foreign banks operating in SSA, such as Standard Chartered, Barclay and Credit Lyonnais,[4] and the creation of such investment vehicles as the African Growth Fund, the Nigeria Emerging Market Fund and the Ghana Venture Capital Fund, suggest the strong potential for commercial banking and financial services in SSA. They also indicate that, with proper management, meeting the challenges of expanding the range and quality of financial services in Sub-Saharan Africa is not an elusive goal but a real possibility.

[4] "Caution Pays Off," *Euromoney*, May 1991.

III. FINANCIAL MARKETS AND DEVELOPMENT: POTENTIAL AREAS FOR A.I.D. ACTIVITIES

A country's needs for technical assistance in financial markets will vary according to its stage of financial sector development. In a less advanced country with serious economic distortions and over-regulation of the financial system, A.I.D. might focus on such measures as interest rate deregulation, measures to increase competition among banks and between banks and other elements of money markets. Development of new institutions such as housing finance companies, insurance companies and pension funds to mobilize domestic savings for productive investment will also be useful points of intervention. A.I.D. might also focus its intervention on broadening access to credit for new and growing businesses, especially in the area of term credit for productive investment. One should be cautious, however, in designing projects that favor one or more groups in the economy. Such "directed credit" may simply add one more distortion to the financial system without bringing about change in the fundamental policies that would channel credit to efficient enterprises.

In more advanced countries, where financial institutions tend to grow in number and become more complex and functionally diverse, A.I.D.'s programs might concentrate on promoting the growth of securities markets and diversifying the sources of domestic and foreign investment capital. The securities market development program might focus on strengthening the legal and regulatory environment, improving financial reporting and disclosure, and promoting securities markets intermediaries such as investment banks and brokerage firms.

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

Determining the types of activities appropriate to a country in its unique stage of financial sector development is one of the primary objectives of conducting a Financial Sector Assessment (FSA). The process of preparing the FSA is described in Chapter VII, How to Conduct a Financial Sector Assessment.

While many programmatic areas involving the financial sector are related, the main categories used for the purposes of this Guidebook are: Macroeconomic Policy, Commercial Banking, Other Financial Institutions (development finance institutions, credit unions and leasing companies), Financial Markets and the Informal Sector, Expansion of Securities Markets, Quality of Information and Privatization. A description of each of these categories and a menu of options for practical A.I.D. activities is provided following this introduction to Chapter III.

While some of these programmatic areas are relatively new for A.I.D. (e.g. quality of accounting information), in others the Agency has accumulated a fair amount of project experience. Later in this Guidebook, Chapter V describes A.I.D. Mission experience in financial market development, not only in Africa, but in other geographic regions as well. Annex C also summarizes AID/Washington activities in financial markets (both at the central and regional bureau level) which might provide useful information and models for A.I.D. project managers. The reader may also find it helpful to refer both to the Agency's financial markets policy framework (Chapter IV), and to available technical assistance, training and other informational resources (see Part Four) as he or she proceeds to review this next section.

In the programmatic discussion which follows, many of the proposed ideas for A.I.D. project interventions focus on the provision of technical assistance and training. However, it should be noted that A.I.D. may also play a role in supporting financial markets by leveraging private sector resources through such mechanisms as credit guarantees (e.g. PRE's loan portfolio guarantees program) or by providing capital resources for restructuring of financial systems (often in conjunction with loans by other donors). While these program options are mentioned in Section III, they are also mentioned later in the Guidebook, especially in Section VI and Annex C.

A. Macroeconomic Policy

Macroeconomic policies are those that seek to influence the main aggregates of the economy - total supply and demand for goods and services, savings and investment, employment and unemployment, exports and imports, the rate of inflation. They are distinct from microeconomic policies, which try to influence particular industries, products, or prices. A government's macroeconomic policies help to frame the environment for financial markets. Good management of those policies will encourage financial markets to develop, while badly-managed policies can stifle and frustrate financial system development.

It is usual to divide macroeconomic policy into two main categories: fiscal policy and monetary policy. Fiscal policies are those that govern the central government budget - its expenditures, its revenues, such as taxes, and the resulting surplus or deficit. Monetary policies are those that influence the country's supply of money and credit, its interest rates, and the external value of its currency.

These policy categories are often, though not always, managed by different bodies within a government. In the United States, fiscal policy is arrived at by a process of negotiation between the executive and legislative branches, while most aspects of monetary policy are managed by the Federal Reserve System, the central bank for the U.S., which has a large degree of autonomy. In most LDCs there is a similar division of responsibility, though the autonomy of the central bank is often minimal, and the Ministry of Finance may then be the locus of real power over all aspects of macroeconomic policy. The degree of independence of a central bank may vary over time, depending on the prestige and political strength of its chief executive, usually called the governor.

The objectives of macroeconomic policy are, in general, to keep the economy on a stable and sustainable growth path, to minimize both inflation and unemployment, and to maintain the country's external credit and the international value of its currency. These objectives are the same for industrial countries and LDCs, and the policy tools are also, broadly-speaking, the same, but the circumstances can, of course, be quite different. In an advanced industrial country such as the United States, the great mass of the country's GNP and the inertia of its progress mean that the aggregates of economic growth, employment, and inflation most of the time move will rather slowly within a range of only a few percentage points. The policy managers have to contend with long time-lags, so that policy-making is not unlike the steering of a super-tanker. In most LDCs, particularly the smaller ones, movements of the main aggregates can be rapid and volatile, so that policy management is more akin to riding a bucking horse.

A second major difference lies in the relative importance of the domestic and international aspects of policy. In the large industrial countries, especially the U.S., policy has tended to concentrate on the domestic economy, because international trade has been a relatively small part of GNP. This has admittedly changed over the last dozen years, with international aspects of policy demanding more attention. Most LDCs are vulnerable to economic shifts abroad. For them, international economic policy issues have always been near the top of the agenda.

Even though the policy categories defined above may be managed by different bodies within a government, they are far from independent in their consequences. There are numerous cross-linkages and opportunities for conflict. For example, where a country's fiscal policy results in continuing large deficits, the monetary authority's ability to manage the money supply, interest rates, and the balance of payments will be severely constrained.

One more introductory note: macroeconomic policies are in general politically sensitive and may often be regarded as sovereign matters for which foreign advice and assistance is unwelcome. But the IMF and the World Bank have for many years used both the leverage of their programs and the prestige of their staffs to influence these policies, often with great success. The efforts of these institutions, which operate with a considerable degree of U.S. funding and influence, have almost invariably been market-oriented and helpful to the development of financial markets. Hence, while there might be exceptions, the activities of A.I.D. in the financial market area should aim at consistency with IMF and World Bank program objectives.

1. Fiscal Policy

In the industrial countries, the primary issue of fiscal policy, at least in peacetime, is whether and how to counter cyclical movements in economic activity and employment arising in the private sector. Over the past half century, it has become an accepted tenant of economic theory that deliberate changes in the budgetary balance can be used to offset cyclical movements. It is also recognized that there are automatic changes in the budgetary balance; for instance, a recession in the private sector brings a decline in tax revenue and an increase in certain types of expense, so a deficit automatically tends to appear. Imposing deliberate changes on the budget to counter a recession or an inflationary trend is not a simple task, given the time lags involved in recognizing what is happening and the necessity of obtaining legislative approval. In the United States, the record is subject to dispute: it is not at all clear that fiscal policy has been used consistently and successfully to stabilize the economy.

In most LDCs, fiscal policy issues are posed quite differently. Expenditures often tend to outrun revenues by a wide margin, and the central issue then is to find ways to augment revenue. It should be said that there are exceptions. But in the more usual case, the budgetary deficit tends to over-stimulate the economy, provoking an increase in total demand that cannot be handled within the natural growth path of the economy. The results are inflation and a deterioration in the balance of payments. When there is a persistent deficit, the government resorts to money creation and/or financial repression as a way to bridge the gap. Both methods represent implicit taxes on financial intermediation and thus push financial activity underground and offshore.

Financial markets develop most readily in a stable economic environment. Inflation inhibits savings and distorts investment, and it lessens the confidence of savers in all kinds of financial instruments. Balance of payments difficulties and the accompanying weakening of the country's currency are also deterrents to sound financial institutions.

Confidence is really the key. All financial markets operate on the belief that a piece of paper represents a value that can be recovered at a later date. This kind of belief does not survive long when fiscal policy is out of control.

Not much need be said here about the expenditure side of fiscal policy; however, a few remarks may be relevant. The largest single expense in most LDC budgets (excluding debt service) is for the wages and salaries of government civil and military employees, and this is true even though those employees may be miserably underpaid by our standards. Central banks, by virtue of their autonomy, often are able to reward their staff members with pay and benefits higher than the ordinary civil servants. This is sometimes significant in the effectiveness of monetary policy activities.

After wages and salaries, it is not uncommon to find that the second most important item of government expenditure is subsidies, including the subsidization of state-owned companies. The ultimate remedy, going beyond the removal of subsidies, is privatization, and here there is a close tie to the development of financial markets. A common method of privatizing a public company is to issue shares to the public, which are then traded on the local stock exchange. The introduction of such shares can add breadth and stability to what are often thin and volatile stock markets. Privatization programs are in some stage of planning or implementation in several Sub-Saharan African countries, including Zambia, the Gambia and Burundi. The subject of privatization is discussed further in Section G of this chapter.

The revenue side of the budget offers more linkages to financial markets. Many types of tax have an impact, more or less direct, on financial transactions.

The array of taxes imposed by an LDC typically differs markedly from that of an advanced industrial country. Whereas the United States, for instance, relies on income taxes (personal and corporate) for the largest part of its total revenue, LDCs seldom collect more than a few percent of their revenue from that source. In 1988, Thailand, a relatively advanced country, collected only about 20% of its revenue from taxes on income, profit and capital gains, and the figure for India is 14.5%. This compares to 51.5% in the U.S. in 1988.[1] Successful imposition of income taxes depends, among other things, on a highly-trained and motivated revenue staff, a blizzard of documentation, banks of computers, and a sophisticated national standard of accounting and auditing practice - a combination rare in an LDC. Almost all LDCs do, nevertheless, maintain income taxes in force and collect them as best they can. Unfortunately, collections are easiest from a rather narrow group: large firms in the big cities, white collar salaried employees of such firms, civil servants and, especially, local branches of foreign firms. Many sectors escape taxation completely, including usually the family-owned companies who are able to rig their books or bribe tax collectors to let them alone. One of the undesirable consequences of this situation is that family-ownership continues to be a means of tax avoidance, and listing on a public stock exchange carries in reality a tax penalty, as such listing involves disclosure of financial position.

Income taxes being an unsatisfactory resource, most LDCs are driven to the other broad category of revenue: indirect taxes imposed on goods and transactions rather than on people. These exist in many varieties: sales and excise taxes, customs duties, etc. The value-added tax, or VAT, while seemingly complex, can be introduced in a country that lacks sophisticated accounting procedures because of its self-enforcing character. Each firm is liable for tax only on the value that it added to its product. It must therefore document the payments it made for value added by others. An A.I.D. tax expert was once heard to remark, not altogether facetiously, that "Income taxes are easy to understand and hard to collect; no one understands the VAT but everyone pays."

Taxes on exports and imports are another major source of revenue for most LDCs, partly because trade volume is typically high in relation to GNP, and partly because the border crossing is a convenient point for assessment and collection of tax.

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[1] World Bank Development Report 1990.

Finally, most LDCs tax financial transactions: interest on deposits, the purchase and sale of securities, and transactions in foreign exchange. The utility of these taxes is open to question. They often involve a lot of paper work in relation to the amount collected, and they tend to dampen the profitability of financial markets. They can also help to drive transactions out of the legal market and into parallel or "informal" markets, which operate without legal protection and with relatively low efficiency.

Potential A.I.D. Activities:

A.I.D. can encourage the development of financial markets through fiscal policy reform, though the benefits are likely to be indirect for the most part. In particular, A.I.D. can provide:

1. Assistance in tax reform. A.I.D. could sponsor a study to determine the effect of the tax structure on investment, savings, debt, equity, exports and employment. Particular emphasis might be placed on the tax treatment of interest and dividend income and taxes impinging on financial transactions or markets. As a follow-up measure, A.I.D. could engage in policy dialogue and assist in drafting new tax legislation.

2. Assistance in tax collection. A.I.D. could support a study to determine the extent of income tax evasion and could provide technical assistance in training tax authorities, upgrading information systems and improving tax collection procedures.

3. Policy dialogue on budget preparation, with particular attention to allocations that help financial markets operate effectively. For example, the Ministry of Finance will need funding for regulatory activity, an SEC or equivalent.

Sources of expertise in the area of fiscal policy include the U.S. Internal Revenue Service, the Office of Management and Budget, the IMF and the World Bank, the OECD, the Brookings Institution, universities and international accounting firms.

2. Monetary Policy

Monetary policy, as it is practiced in the United States, in most other industrial countries, and in a few LDCs, depends on a number of specialized institutional arrangements. In general, the operation of monetary policy depends on the existence of free and competitive markets for interest-bearing instruments - for bank deposits and loans, bonds, mortgages, etc. In the U.S., it depends on the powers of the Federal Reserve System over its member banks. In particular, the Fed can, by buying or selling government securities in the open market, expand or contract the reserves of the member banks, and since these reserves are only a fraction of the banks' total assets, the total deposits of the system can be increased or decreased by a multiple of the reserve change. The money supply, which is made up chiefly of bank deposits, is correspondingly increased or contracted. Interest rates are affected indirectly, an increase in money supply tending to lower them and a decrease to raise them.[2]

The effects of monetary policy are theoretically straightforward in a closed economy. An increase in the money supply and a reduction in interest rates tends to stimulate demand on the part of both consumers and investors; a decrease in the money supply tends to constrain demand. But to the degree that an economy is "open", with exports and imports of goods and services and with capital flows across its borders, the effects are modified. There are several cases, depending on (1) whether the exchange rate of the country's currency is fixed or not, and (2) whether exchange transactions, especially for capital flows, are controlled or not. If exchange rates are fixed and capital flows are unregulated, the impact of monetary policy will be dampened, or even nullified. For example, if an expansion of money supply is undertaken and interest rates start to decline, deposit-holders will begin to move their funds out of the country, in search of a higher rate. Fixed interest rates and free capital flows characterized the relations among the major industrial countries in the 1960's and early 1970's. Dissatisfaction with the fact that national monetary (and fiscal) policies were hampered led to the end of fixed exchange rates among the leading industrial countries in 1973. With floating, market-determined exchange rates, shifts in monetary policy (the same is true to a degree of fiscal policy) fall partly on the exchange rate. For example, if the Fed elects to tighten the money supply, other things being equal, dollar interest rates will rise, and the dollar will tend to strengthen, rising until the shift to dollar deposits is less attractive.

For a variety of reasons, monetary policy as described above is rarely practiced among the LDCs, or is practiced only with substantial modifications. Very few LDCs have found it feasible to maintain an open economy including: (1) a free market for money, in which interest rates are determined by supply and demand, (2) a free market for their currencies, with the exchange rate against other currencies determined by supply and demand, and (3) an unregulated exchange system, in which all transactions, including capital transfers, are unrestricted.

Taking interest rates first, many LDCs find it politically and socially unacceptable to allow interest rates to be determined by the market. They want to be sure that certain borrowers can obtain credit cheaply - farmers, for instance, or exporters, or state-owned companies. In order to make sure that these groups receive low-cost credit, LDCs have in some instances nationalized the commercial banks, or set up separate government-owned specialized banks. In some cases the central bank itself makes subsidized loans to preferred borrowers. Sometimes, if the banks are left in private hands, they are ordered by the central bank to make a certain portion of their loans at specified rates to favored groups. Direct interest rate regulation and direct credit allocation of this sort usually mean that rates are

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[2] Besides open market operations, the Fed has two other means, used less frequently, of influencing the money supply and interest rates. It can change its rediscount rate, i.e., the interest rate it charges on loans to its member banks, and it can alter the reserve requirements of the member banks.

being set below the level they would find in a free market, i.e, the level at which supply and demand would balance. This means, in turn, that there are unsatisfied borrowers willing to pay more. The result is often some variety of evasion and corruption of the intent of the regulations. Another result is a distribution of capital along less than optimal lines. For these reasons, the IMF and World Bank regularly engage LDC governments on this issue in the context of assistance programs.

While several Sub-Saharan African countries have partially deregulated or are in the process of fully deregulating interest rates and allowing banks to set interest rates within broad boundaries, such systems usually maintain a floor for deposit rates and a ceiling on lending rates. Examples include Madagascar, which has just liberalized interest rates and Malawi and Zambia, which have completely deregulated interest rates.[3]

With regard to exchange rates, few LDCs have found it desirable to allow the exchange rate of their currency to be freely determined by the market. Too often the consequences have been a great volatility of the rate, particularly when the country is running a big fiscal deficit with attendant inflation. They may allow the exchange rate to be quasi-market-determined, but with frequent intervention by the central bank. In Sub-Saharan Africa the currencies of most countries are pegged to one of the hard currencies or to a basket of currencies, as shown in the following table. Four Sub-Saharan currencies are pegged to the U.S. Dollar; the currencies of 14 countries which are former French colonies are pegged to the French Franc; and three currencies are pegged to the South African Rand. In addition two countries' currencies are pegged to the Special Drawing Right (SDR) and nine are pegged to a different basket of currencies of the member's own choice.

Sub-Saharan Africa Fixed Exchange Rate Arrangements				
U.S. Dollar	French Franc	South African Rand	SDR Basket	Other Composite
Angola	Benin	Lesotho	Rwanda	Botswana
Djibouti	Burkina Faso	Namibia	Seychelles	Burundi
Ethiopia	Cameroon	Swaziland		Cape Verde
Liberia	C. African Repub.			Kenya
	Chad			Malawi
	Comoros			Mauritius
	Congo			Tanzania
	Cote D'Ivoire			Zimbabwe
	Equatorial Guinea			
	Gabon			
	Mali			
	Niger			
	Senegal			
	Togo			

Source: *IMF International Financial Statistics*, June 1993.

[3] African Research Bulletin, Vol. 29, No. 12, Dec. 16, 1992 - Jan. 15, 1993.

By contrast, the currencies of nine Sub-Saharan African countries are independently floating, as shown in the following table. Four countries adjust their exchange rates on the basis of indicators determined by the respective member countries in what is termed a "managed float", while Madagascar adjusts its currency according to a set of indicators on a frequent basis.

Sub-Saharan Africa Flexible Exchange Rate Arrangements		
Independently Floating	Managed Floating	Adjusted according to a set of Indicators
The Gambia Ghana Mozambique Nigeria Sierra Leone Sudan Uganda Zaire Zambia	Guinea Guinea-Bissau Sao Tome & Principe Somalia	Madagascar

Source: *IMF International Financial Statistics*, June 1993.

Finally, there is the question of exchange control. Again, most LDCs find it impossible, or at any rate undesirable, to allow complete freedom of all international transactions. Some Sub-Saharan African nations, such as Zimbabwe and Burundi, have relaxed foreign exchange controls, while others, such as Zambia, have completely abolished foreign exchange controls. Still others, such as Zaire, remain unconvertible.[4]

The absence of a true monetary policy, as defined by modern practice in the industrialized countries, places some handicaps on the development of financial markets in the LDCs. If a country regulates interest rates, it may be difficult to establish a competitive market for fixed-income securities (such as corporate and government bonds). If it maintains exchange controls on capital transactions, the country's financial markets cannot be freely linked with foreign markets and will not attract foreign capital easily. The limits to liberalization are basically to be found on the fiscal side: a country that cannot bring its government budget under control will find it difficult to permit market-determined interest rates and the other conditions essential to a market-oriented monetary policy. Financial markets will correspondingly fail to reach full development.

[4] *Exchange Arrangements & Exchange Restrictions Annual Report*, 1992, International Monetary Fund.

Potential A.I.D. Activities:

1. The most important link between monetary policy and the financial markets is the secondary market for government securities. That market provides the most convenient means for the central bank to influence money supply, and it also provides a base for all other fixed-income markets. Where a government securities market does not exist, A.I.D. could conduct a study to assess the feasibility of creating such a market. Among the questions this study might answer are the following:

- What conditions are necessary (legal, regulatory, institutional) for a secondary market for government debt instruments to function successfully?
- How would the establishment of a secondary market affect monetary policy and debt financing?
- Who are the potential suppliers and demanders of instruments in this market?
- What institutions might serve as primary dealers?
- To what extent are the banks, non-bank financial institutions and private companies interested in the development of a secondary market?
- What would be a feasible plan for the development of a secondary market in government debt instruments?
- What other types of instruments (for example, commercial paper or bankers' acceptances) might be traded in the secondary market?

2. Another major link between monetary policy and the financial markets is the market for foreign exchange. A relatively free exchange market is necessary if a country's financial markets are to have international links and therefore access to foreign capital. It is often the case that exchange controls are complex and involve more than one government agency. A.I.D. may be able to assist in simplifying and liberalizing controls by conducting appropriate studies and engaging in policy dialogue with the government. Political will on the part of the government and coordination with the IMF and World Bank are, of course, vital.

3. In countries where government interest rate policies impede the efficient allocation of financial resources, A.I.D. could conduct studies and engage in policy dialogue to eliminate or reduce interest subsidies, credit controls and direct credit. A study on the impact of credit subsidies, for example, might lead to a better understanding of the magnitude and incidence of financial market distortions due to credit subsidies, and provide the basis for policy dialogue and reform.

4. A.I.D. may also be able to assist host countries in efforts to reduce their debt burden through the formation of debt conversion programs, transaction assistance and policy dialogue on debt rescheduling.

Sources of expertise for these areas include former officials of the U.S. Federal Reserve System, the Treasury Department, the IMF and the World Bank. Many of the above mentioned reforms in fiscal or monetary policy may also be stimulated through inclusion of appropriate conditionality in A.I.D. or companion other donor balance of payments loans and grants to LDCs.

B. Commercial Banking

Commercial banks are the most important financial intermediaries in most countries of the developing world. This is especially true in Sub-Saharan Africa (SSA). Their predominant role in most of SSA is due in part to the underdevelopment, or total absence, of other financial institutions and intermediaries. Sub-Saharan African economic growth and development requires the mobilization of savings from the general public. To facilitate such growth, banks and other deposit-taking institutions harness the savings of individuals and businesses through their branch networks and are the dominant holders of financial system assets in most SSA countries.

By definition, banks are establishments for the safekeeping, loan, exchange or issue of money, for the extension of credit, and for facilitating the transmission of funds.[5] Because of their importance in a nation's economy and their role in the payments system, banks are among the most regulated and supervised of businesses. This is because the failure of one large bank or several small banks can have a devastating effect on a nation's economy.

While not as advanced in Sub-Saharan Africa as in other regions of the developing world, financial sector reform programs and liberalization of financial markets have been underway in several countries, especially in the past five years. Such reforms set the framework for genuine competition in the financial sector by encouraging all financial institutions to operate on sound commercial principles. Such reforms emphasize deregulation as to licensing, credit controls, interest rates, and financial products offered. Such deregulation, however, must be combined with modernized and effective supervision of financial institutions.

In turn, these reforms also place new demands on already weakened banking systems. In many African countries, past practices have left the banks with significant levels of non-recoverable assets, primarily loans and formally extended overdrafts. These banks, many of which are technically insolvent (i.e., a deficit capital position), are expected - in a reformed financial sector - to compete along market principles, but most lack the essential

[5] Webster's Dictionary

management skills to do so. A number of African countries would benefit from technical assistance in: 1) creating an effective regulatory and supervisory framework; 2) reviewing bank legislation; 3) managing and restructuring problem banking institutions; and 4) training bank personnel in credit and financial analysis. Other issues to be considered include the potential role of deposit insurance in mobilizing savings and the feasibility of establishing a credit information bureau to assist the banks in evaluating loan applications.

The following section presents an overview of each of these issues and describes the types of assistance that A.I.D. could provide to strengthen a developing country's banking industry. Sections 1, 2, and 3 cover the key areas of banking sector reform, these being prudential supervision, the legal framework for effective supervision, and deposit insurance. These are followed by three sections on institutional reform, which cover bank restructuring, credit and financial analysis training, and credit information systems.

1. Prudential Bank Supervision and Regulation

Bank supervision is the system used by governments to help ensure that the financial sector is stable through safe, sound, and well-managed institutions. While the term bank supervision is used throughout this section, it should be understood as supervision of all financial institutions which accept deposits from the public. In SSA, the bank supervision function normally also covers various types of non-bank financial institutions such as leasing companies, finance companies, and building societies. The term bank supervision also needs to be clarified to mean "prudential supervision," so as not to confuse it with the system in some countries in which "supervision" of banks really means direct government decisions used to allocate credit to priority sectors and otherwise keep banks in line with government policy. Thus, in this guidebook, bank supervision is used to mean the prudential supervision of deposit-taking financial institutions.

All bank supervision systems have two main objectives. These are: 1) to protect depositors; and 2) to ensure that the banking industry is healthy so that it can facilitate economic growth. Depositors need protection because the vast majority do not have the information and/or ability to determine the risks associated with a bank. This is especially true in SSA. The loss of depositor confidence in one bank can lead to a general loss of confidence in the banking system. A bank failure can have significant macroeconomic implications, including a contraction of the money supply, failure of the payments system, and large and unexpected government obligations. Most bank supervision systems also have as an objective the promotion of competition within the banking industry so as to prevent large concentrations of economic power in the hands of one or more financial institutions. Still another common objective is to promote efficiency in banking and fair access to credit within the economy.

Bank supervision has assumed a priority position within overall economic policy in many SSA countries, especially in the past ten years, though the progress varies widely among African countries. The need for effective bank supervision normally becomes prominent when there has been a failure or at least a crisis in one or more financial institutions. In addition, the establishment of modern bank supervision has become a mandatory element of financial sector reform programs when initiated by the World Bank.

Most financial sector deregulation programs include: licensing of new banks with private ownership to stimulate competition; allowing banks and other financial institutions to offer new financial products; and deregulating interest rates and thus subjecting banks to market forces. These steps make managing a bank more complex, and they almost always entail increased risk from the newly competitive environment, as well as much more sophisticated management skills. As government-directed controls are removed or significantly loosened, the financial system requires that a effective, modern, and sophisticated prudential supervision system be put in place to ensure that the banks and other deposit-taking institutions remain financially sound. In countries where entry control has been confined to a few large government-owned banks and banking has been controlled through central economic policy, bank supervision is usually not as well developed. Tanzania is a good example of this status.

Bank supervision in the United States is conducted by three Federal agencies: the Federal Reserve System, the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC). The Federal Reserve regulates state-chartered Federal Reserve-member banks, the OCC regulates nationally-chartered banks, and the FDIC regulates state-chartered banks that are not part of the Federal Reserve System, as well as running the deposit insurance program and its role with failed banks.

In SSA, the bank supervisory function is almost always performed by the central bank, as one of central banking's prime objectives is the promotion of a sound financial sector. While the central bank normally has bank supervision responsibility in SSA, several key powers, including entry (licensing) and exit (seizure and closure), are often held by the Ministry of Finance. This has tended to weaken the effectiveness of bank supervision, as the political forces in a ministry are more inclined to grant banking licenses, and Ministers are more reluctant to face the political reaction of closing an unsound or insolvent bank. Experience in SSA has shown that the entity that performs bank supervision should be largely independent from political interference and have full powers regarding the entry and exit of banks. Without this in place, even a well-trained bank supervision staff is not likely to be fully effective. Finally, the structure of bank supervision is less important than strong support by economic policy makers for its overall objectives.

To be effective, bank supervision must be based on a sound legal framework (see following section). Prudential regulation, a part of overall bank supervision, consists of the banking law, regulations for banks emanating from that law, and in some countries, policy statements issued by the supervisory authority. Examples of prudential regulations are: capital adequacy requirements, legal lending limits to one borrower or related borrowers, limitations on loans to insiders (directors, executive officers, etc.) and their interests, and minimum liquidity requirements. Prudential regulation should also enable the supervisory authority to conduct on-site examinations, receive all reports necessary to evaluate the bank off-site, and ensure that external audits are independent and done to a high standard.

Bank supervision is intended to help **prevent** problems within individual financial institutions and thus the financial system overall. Prevention depends on effective diagnostic skills and methods to detect weaknesses at an early stage and on effective means to institute corrective action when necessary. However, when the failure of a financial institution cannot be prevented, bank supervisors need extraordinary powers to declare a bank insolvent, seize control and/or close it, initiate merger proceedings where possible or appropriate, and place a bank into receivership as part of the liquidation process. (The process of bank restructuring is discussed further in a later section.)

In Sub-Saharan Africa, recent cases in which bank soundness problems have led to increased emphasis on bank supervision include Kenya, Nigeria, Ghana, and Uganda. In addition, broad-based financial sector reform in many other SSA countries has required that modernized bank supervision be established. This has been true in both Tanzania and Malawi, though under different circumstances in each. Bank soundness problems have often been linked to rapid financial deregulation (especially in licensing) that has not been properly accompanied by an upgraded or effective bank supervision system. In recent years, the World Bank has initiated financial sector reform programs involving extensive deregulation in a number of developing countries. These programs now include a greater emphasis on establishing or improving the system of bank supervision.

As indicated above, most of day-to-day bank supervision work is diagnostic, i.e. to determine the financial condition of banks, and, if weaknesses exit, the underlying causes. This diagnostic work relies on two main methodologies known as off-site surveillance and on-site examinations.

Off-site surveillance makes use of reports (returns) submitted to the central bank on a periodic basis. When such data are deemed accurate and properly computerized, bank supervisors can determine capital adequacy, profitability, liquidity and, to a lesser extent, asset quality. This is done via ratio analysis as to levels, trends, and peer group analysis (comparison of ratios to other banks with similar characteristics).

On-site examinations involve on-the-spot inspections of banks, ideally on an annual basis. The main objectives of an on-site exam are to: 1) determine if laws and regulations are being adhered to; 2) determine if returns sent to the central bank are accurate; 3) determine if sound management practices exist; and 4) determine the overall financial condition of the bank, especially in the areas of asset quality, capital adequacy, liquidity, and profitability, as well as the capacity and performance of management. While off-site examination has the advantage of providing continual updates on bank soundness issues, experience in SSA and other developing countries has shown that the full establishment of effective on-site examinations is the key to a proper diagnostic capability within bank supervision.

Because of the specialized nature of the field, an effective bank supervisory entity cannot be developed overnight. The requisite skills for a bank supervisor include accounting, credit analysis, and financial analysis, as well as some macroeconomic and legal knowledge. As an example, a widely used estimate is that it takes five years to train a bank supervisor in on-site examinations alone. Several SSA countries have worked toward successful bank supervisory systems, in part by using bilateral relationships and international organizations to take advantage of training and exchange programs to improve bank supervision staff skills and effectiveness. A good example is a semi-annual seminar for senior bank supervisors from developing countries co-sponsored by the World Bank and U.S. Federal Reserve. In addition, many bank supervisors from SSA have attended bank supervision training courses provided by the three U.S. supervisory agencies.

__Potential A.I.D. Activities:__

Prudential bank supervision and regulation as practiced in the U.S. is still relatively new to Sub-Saharan Africa. The regulatory and supervisory bodies for formal financial institutions have not, in general, developed sufficient capacity in most Sub-Saharan countries to adequately ensure the prudential regulation of formal institutions, though several countries have made good progress in recent years. Furthermore, most Sub-Saharan central banks are in need of a well-trained staff to conduct on-site examinations and off-site surveillance.

The U.S. system of commercial bank supervision is widely acknowledged in Sub-Saharan Africa as highly effective, especially in the key area of on-site examinations. Most SSA countries have chosen to model their emerging bank supervision systems on the U.S. approach which emphasizes on-site examinations, rather than the British approach which is less formal and does not include such examinations. As a result, many SSA countries have sought American technical assistance in upgrading their bank supervisory systems.

A potential A.I.D. role would be to assess the effectiveness of a country's bank supervisory system. Such a study might focus on the following:

1) Adequacy of policies for licensing new banks, and in particular, minimum initial capital requirements, management and ownership, and the effects of licensing new banks on competition within the banking industry

2) Degree to which banking laws and regulations are in harmony with international norms and are keeping pace with changes in the financial sector

3) Effectiveness of off-site supervision with respect to the authority to call for information, the quality and quantity of information available, adequacy of data processing equipment (computer hardware and software)

4) Effectiveness of on-site examinations (if in existence) or the need to establish an examination function if not yet begun, including the value of such examinations in identifying problem areas in banks and how such examinations might lead to corrective action being undertaken

5) Adequacy of personnel, both with regard to staffing and training levels.

In addition to a study as outlined above, technical assistance might be provided to the supervisory authority to upgrade systems and staff skills in bank supervision. Funding for equipment, especially computers, is a common need of bank supervisors, particularly those seeking to upgrade their off-site surveillance of banks. Finally, A.I.D. might provide assistance in staff development by facilitating contacts with the American bank supervisory agencies and by placing staff in U.S.-bank supervisory training courses.

Under A.I.D.'s Financial Sector Development Project (FSDP), Price Waterhouse conducted on-site examinations of three commercial banks in Tanzania, which represented the whole commercial banking sector. The PW team assessed the quality and risk of their credit portfolios. Additionally, the team provided on-the-job training and recommended additional steps to train staff and strengthen bank supervision over a four month period. In Uganda, Price Waterhouse conducted examinations of two banks, including the key government-owned bank. This two-month assignment was under the auspices of the Bank of Uganda (the central bank) and included skills transfer to help upgrade the skills of the central bank's supervisory staff to undertake future on-site examinations. Another PW team in The Gambia helped the central bank in developing an action plan for its Banking Supervision Department.

Sources of expertise in the area of bank supervision include the U.S. Federal Reserve System, the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC). They have all demonstrated a willingness to assist developing countries in improving their bank supervisory capabilities. As mentioned, each of these agencies operates their own training programs, and requests can be made to allot seats at such courses for African participants. In addition, joint training programs for all three agencies, usually in specialized areas such as foreign exchange, are conducted by the Federal Financial Institutions Examination Council (FFIEC) based in Washington, and bank supervisors from other countries have participated.

The IMF and the World Bank have also taken roles in helping developing countries improve their bank supervisory systems. The IMF's Central Banking Department has a longstanding program of technical assistance to central banks, with bank supervision being a major area of specialization. For example, the IMF's Monetary and Exchange Affairs Department is providing central banks with bank supervision experts to train supervisors. Countries such as Nigeria, Liberia, Kenya, Tanzania, Uganda, Malawi, Botswana and Swaziland have received assistance from the IMF in the past. The World Bank has also provided funding for placement of experienced bank supervisors in SSA as part of their financial sector reform programs. Finally, the World Bank and the U.S. Federal Reserve have jointly sponsored the aforementioned seminars for senior bank supervisors which have been attended by representatives of many African countries.

2. Legislative Reviews

Changes in the financial environment often occur much faster than those in the legal framework supporting the financial sector. This is true not only in Sub-Saharan Africa but also in the U.S., where some banking legislation dates back to the 1930s. Some SSA countries, especially those whose legal systems were established under colonial powers, still operate under laws written decades before the present financial system took form. In turn, recent central banking and financial institution laws have come into effect in recent years in such SSA countries as Nigeria, Kenya, Tanzania, Ghana, Malawi, Botswana, and Uganda. In turn, not all of these new laws have been effectively put into place, as many still lack the supporting regulations to implement the statute.

In most SSA countries, the legal framework is contained in two laws. The first is the Central Bank Act which establishes the central bank, outlines its functions and organization, and gives it various powers to conduct monetary policy and other key roles. The central banking laws enacted in SSA in the 1960s were mostly modelled on either British of French central banking practice or Dutch law. Many Sub-Saharan African countries have fully revised their central banking acts in recent years, and these newer acts are relatively standard. As of this writing, the newest is Uganda's Central Bank Act enacted in May of 1993, which is similar to many others now in effect in Africa. This Act spells out the central bank's main objectives and functions as follows:

1) To maintain monetary stability (the value of the currency)

2) To maintain and manage the country's foreign exchange reserves

3) To issue notes (currency) and coin

4) To be the banker to the Government

5) To advise the Government and be manager of the public debt

6) To advise the Government on monetary policy and to implement it (in some countries, central banks create such policy)

7) To be banker for the commercial banks and operate a check clearing house

8) To be the supervisory authority for deposit-taking institutions.

Such laws are written to ensure the central bank can do the above objectives and functions effectively. Normally, the newer, revised laws include several ways to do this, as follows:

1) The Act clarifies and strengthens the central bank's role as the monetary and supervisory authority

2) It specifies clear limits on the amount of credit the central bank can extend to the Government (a major problem in SSA when such credit has gotten out of control)

3) It ensures the central bank has control over its lending to banks

4) It includes exchange rate provisions, i.e. how the exchange rate is established (in very broad terms), that are in line with modern exchange rate policy and foreign exchange operations in central banking

5) It provides the central bank with sufficient flexibility and powers in carrying out its role of managing foreign exchange reserves

6) It gives the central bank authority to ensure that all clearing and payment arrangements are made on a sound and effective basis

7) It provides for adequate capital for the central bank itself, usually calling for a significant increase to a set minimum level.

The other major statute in a proper legal framework for a Sub-Saharan African financial sector is the Banking Act, which in recent years has usually been named the Financial Institutions Act (FIA) or some similar title. As such, it regulates and covers the supervisory aspects for all deposit-taking financial institutions, again keeping in mind the main bank supervision objectives of enhanced economic growth through a sound financial sector and depositor protection. As such, the emphasis in these laws is prudential, and most cover the following points:

1) The Act clearly establishes a supervisory authority (usually central bank) and gives it sufficient authority to perform this role

2) It establishes the licensing authority (usually the supervisory authority) and licensing procedures

3) It establishes broad capital adequacy requirements for banks and other deposit-taking institutions, which should be specified and implemented through a regulation

4) It sets prudential requirements in lending and other key areas to help ensure sound practices are always maintained

5) It authorizes the supervisory authority to receive returns with reported data to ensure proper monitoring of banks' operations and activities (off-site surveillance)

6) It authorizes the supervisory authority to conduct on-site examinations of banks and other deposit-taking institutions

7) It provides the supervisory authority with a set of enforcement powers to enable corrective action to be taken at an early stage when problems are detected - and thus to prevent further deterioration

8) It provides powers for the supervisory authority to take swift and effective action when depositors' funds are in jeopardy, in order to maintain confidence in the financial sector as a whole.

Related to these two laws, the legal framework in SSA countries should contain prudential and operational regulations for banks. The prudential regulations are intended to help ensure safety and soundness. They address such areas as capital adequacy, lending limits to a borrower or a related group of borrowers, limits on credit extended to bank insiders, asset quality, reporting, and liquidity. Operational regulations address such areas as exchange control requirements, credit extended by the central bank, interbank clearing, and banking days and hours.

In addition to the above, in some countries, the legal framework includes a set of policy statements issued by the central bank or supervisory authority. While not as formal or as closely tied to law as a regulation and often intended to clarify a law or regulation, such policy statements guide banks in how the legal framework is to be implemented.

Certain aspects of law may be outside the above legal framework but still impact banks. The best example would involve title to property and the ability to take possession of collateral pledged. In countries where such issues are not addressed in law, where the courts are sympathetic to the debtor (as has happened in several SSA countries such as Nigeria), or where title cannot be pledged or transferred (as exists in some SSA countries), banks soon become unwilling to lend against real property and levels of credit are adversely affected. Thus a full legislative review should include a study of the Companies Act, other corporate law, and even High Court decisions involving property rights and other issues.

In recent years, many developing countries have attempted financial sector reform and deregulation by instituting new policies without appropriate changes in law. This is often done in countries where the legislative process can be cumbersome. A Minister of Finance or a Central Bank Governor often wishes to institute significant financial sector reform through changes in policy, which can be done quickly, as opposed to changes in law, which may often take years. Countries where this has happened are ideal for legislative reviews, as the existing laws and regulations are almost certain to be outmoded when compared to the rapidly changing banking sector.

Potential A.I.D. Activities:

A.I.D. can play an important role in improving financial sector legislation. In order to identify countries where such assistance is needed, A.I.D. might look at where the pace of change (in terms of growth, structure, and policy) has outrun the existing legislation. Also important are when the last legislative review or major changes in the Central Bank Act, Financial Institutions Acts and their regulations took place. A.I.D. can conduct legislative reviews, spotting weaknesses and inadequacies in banking legislation. Finally, A.I.D. can recommend the most efficient approach to improve the shortcomings noted. This might include drafting of a new central bank act, financial institutions act, and appropriate regulations for their implementation.

Sources of expertise for this activity include individuals with banking, bank supervision and legal backgrounds. Three supervisory agencies, the Federal Reserve, the Office of the Comptroller of the Currency (OCC), and the FDIC, are sources of expertise on prudential regulation, enforcement powers, and other matters relating to bank supervision. Legal expertise for developing countries, including financial sector aspects, can be provided by the Harvard Institute for International Development (HIID) which works in conjunction with Harvard Law School.

The IMF has played a major role in advising member countries on financial legislation, including initial drafting of Central Bank and Banking Acts. Normally, its approach is to send missions with representation from their Legal and Central Banking Departments at the request of the government or central bank. The Central Banking Department also has on file up-to-date financial legislation from all IMF member countries. More recently, the World Bank has also taken on a role in legal framework areas as a key element in overall financial sector reform programs.

3. Deposit Insurance

Deposit insurance is a system whereby deposits in financial institutions, up to a certain size, are insured by a separate agency. The agency may be government sponsored or private. The primary purpose of deposit insurance is to protect small and medium-sized depositors, who generally lack the knowledge and sophistication to assess the safety of placing their funds on deposit with different institutions, and to enhance public confidence in financial institutions by guaranteeing that even with a failure, small- and medium-sized depositors will receive their funds. These objectives are especially appropriate to SSA, as small-and medium-sized depositors invariably have no proper understanding of bank soundness aspects. Equally important, deposit insurance serves to prevent the problems of one bank spreading to other banks due to a lack of depositor confidence in the financial system.

The U.S. deposit insurance system was founded in 1933 with the formation of the Federal Deposit Insurance Corporation (FDIC) and has had a very significant role in maintaining the public's confidence in the American banking system. The massive number of bank failures in the 1930s was due in large part to lack of confidence in the banking system, leading to depositor panic. FDIC insurance, with its blanket coverage, has eliminated the "runs" on banks by the public that were so prevalent at that time. However, the massive failures in the U.S. savings and loan industry in the 1980s, plus several large and recent failures and/or "bailouts" of commercial banks, has called into question the role of deposit insurance. Critics state that by removing the penalties for poor banking practices, deposit insurance may have encouraged excessive risk taking, a situation referred to as "moral hazard."

Developing countries in general, and many SSA countries in particular, eagerly seek to establish and/or maintain public confidence in banks and other financial institutions - in part to maximize savings mobilization. Deposit insurance schemes thus have had an instant appeal to policymakers in many SSA countries and can be mistakenly thought of by some as a panacea for problems in an emerging financial sector. While maintaining public confidence in the banking system is very important, deposit insurance should not be thought of by developing countries as a "magic cure-all" for weaknesses in the banking system. Many countries have maintained well-regarded banking systems without deposit insurance. They instead rely on effective bank supervision and judicious use of the central bank's lender-of-last-resort powers to ensure liquidity for individual banks when necessary. As a result, a developing country should carefully think out all aspects of deposit insurance before implementing such a scheme.

Governments in few, if any, Sub-Saharan African countries are willing to guarantee deposits in their banks, though an implicit guarantee exists in most government-owned banks. Thus, consideration of a deposit insurance scheme should focus on its self-funding nature to prevent large government outlays to support the insurance fund. This, in turn, leads to the costs that will have to be borne to keep the insurance fund solvent. Some deposit insurance systems charge a premium as high as 1% of the deposit base (several times higher than the FDIC's premium). Such a premium naturally adds to the cost of intermediation and is passed along in the form of higher lending rates or lower deposit interest rates.

A self-funding deposit insurance scheme relies on premiums charged to the participating financial institutions. Naturally, such premiums place a cost on the banks paying them, and these costs are normally passed along to the public. Also, when premiums are based on size of the financial institution alone, large banks naturally assume the major burden, regardless of their financial condition. As a result, a risk-based premium concept where banks deemed higher risks by the supervisory authority pay a larger premium has been debated, though the higher premium in itself will signal problems to the public and thus can affect confidence in the particular bank.

Certain characteristics of a banking sector would normally need to be in place for deposit insurance to be seriously considered. Significant private sector ownership of banks is usual, though government-owned banks can, and usually should, be deposit insurance participants in mixed (public and private) banking systems. Deposit insurance schemes are more feasible in countries with a fairly large number of banks participating, say twenty or more, so that the burden of premiums is lower on each individual bank. Also, deposit insurance, in general, should not be considered unless an effective system of bank supervision is established. Without good supervision, emerging banking problems can go unnoticed, and failures without warning, which drain the fund, are more likely.

A crucial aspect is the authority of the deposit insurance entity to take swift and effective action with regard to insolvent banks or whenever soundness concerns threaten the deposit insurance fund. The FDIC's strong powers in this area have been nothing short of a cornerstone to its success. Alas, SSA examples of deposit insurance systems have fallen short by comparison with respect to having sufficient powers, Nigeria being a good example. The Nigerian Deposit Insurance Corporation (NDIC) was modelled almost exactly on the FDIC except for the powers to seize insolvent and unsound banks, which remained with the Ministry of Finance. The result is that the NDIC collects large premiums from banks but has not intervened in cases where bank soundness issues clearly have called for action.

In summary, key issues to be addressed by countries considering the establishment of a deposit insurance scheme include:

1) Should the insuring agency be public or private? If public, what should be the ceiling of deposits covered under the scheme? Alternately, does the government intend to provide an unconditional government backing for all deposits?

2) Should risk be shared, and if so, up to what ceiling amount? For example, many schemes only insure 80% to 90% of each deposit covered, unlike the FDIC's 100% of up to $100,000 of deposits.

3) Finally, how can the scheme be structured so as to be self-funding? This means that the premiums paid by participating institutions must cover the losses paid out from failures of financial institutions as well as from the agency's own operating expenses.

While many other countries have established a deposit insurance scheme since the FDIC's formation in 1933, the American system is the most comprehensive and the model most developing countries look to when considering the need for starting their own. In addition to Nigeria, banking laws in recent years in Ghana, Kenya, Tanzania, and Uganda have all included enabling sections for the creation of a deposit insurance fund (still not in effect in Tanzania and Uganda). Enabling legislation is only the initial step in a long process of proper establishment of deposit insurance. If anything, experience has shown that SSA countries should consider this step with care, especially as to reviewing the extent of financial sector development and the appropriateness of deposit insurance within that context. Deposit insurance does not replace effective bank supervision, and this message has not been fully absorbed in some African countries.

Potential A.I.D. Activities:

A.I.D. can play a significant role in both preparing a feasibility study on the need (or lack of such need) for deposit insurance and in providing technical assistance to establish such a system. Both require specialists, and the U.S. depth of experience in deposit insurance makes it a logical area in which A.I.D. can operate.

A feasibility study done by experts is an essential step, as some SSA countries may be premature in their desire to establish deposit insurance. To date, only a few SSA countries, such as Nigeria, have put in place full-fledged deposit insurance systems, though many others have considered it. A logical and persuasive case for why deposit insurance is not presently advisable, given the stage and maturity of financial sector development, can clearly be of significant value to economic policymakers. A.I.D. could also assist in establishing a deposit insurance agency by offering technical and training courses for the agency's initial staff.

The FDIC is clearly the source of American expertise in deposit insurance, and it has shown a past willingness to assist developing countries that are considering a similar system. While the FDIC can be contacted for inquiries regarding possible help that can be provided, its own intense workload often makes it difficult for senior and/or experienced staff to be released for a feasibility study or technical assistance assignments. As a result, recently retired FDIC staff members form an alternative pool of individuals who may be available to put their career experience to use in helping a developing country make the right choices in this field. While the IMF and World Bank have both worked on the issue of deposit insurance for developing countries, they have tended to turn to the FDIC when expertise is needed.

4. Bank Restructuring

Strengthening bank management and dealing with insolvent institutions has become a topic of major importance in SSA, just as the same holds true in the United States. The 1990 failure of the Bank of Credit and Commerce International and the savings and loan crisis in the U.S. underscore the importance of both sound bank management and prudential regulation. In the United States, 1,142 savings and loan institutions (S&Ls) were closed or merged with healthier institutions between 1980 and 1992. A total of $48,220 million in assets were liquidated over this period while a total of $241,584 million in assets were merged or otherwise assisted.[6] Among commercial banks the failure rate rose from ten a year during the 1970s to more than 150 a year in the late 1970s and 150 a year in the late 1980s.

In Sub-Saharan Africa, many banks have experienced years of policy mismanagement, ineffective systems, poor infrastructure, inadequate controls and inferior bank assets, causing severe insolvency and chronic illiquidity. In Ghana, for example, the net worth of the banking system by mid-1988 was negative. The situation was caused by a high proportion of nonperforming loans and by large foreign exchange losses. Nigeria intervened in operations of an unsound bank in 1992. In Kenya, two significant banks collapsed in 1986 and several banks were in crises in 1993, with one closure. Uganda suspended operations of an insolvent bank in early 1993. Several other SSA countries have taken measures to deal with unsound banks in recent years, some of which have been done without raising public concern.

African Financial Systems in Distress

Country	Year	Description
Ghana	1988	Net worth of the banking system was negative. Cost of restructuring was estimated at $300 million, or nearly six percent of GNP.
Guinea	1984	99% of loans were irrecoverable. All six state-owned banks were liquidated.
Kenya	1986	Many of the large nonbank financial institutions collapsed.
Madagascar	1988	25% of all loans were uncollectible and 21% were "difficult to collect." The banking system had less than 5% of assets as reserves.
Tanzania	1987	Half of the main financial institutions' portfolios were nonperforming. The implied losses were almost 10% of GNP.
UMOA Countries(1)	1989	More than 25% of bank credits were irrecoverable. At least 20 primary banks were bankrupt: non-performing credits were nearly six times the sum of their capital, reserves and provisions.

(1) The Union Monetaire Ouest Africaine (UMOA), or West African Monetary Union, is composed of Benin, Burkina Faso, Cote d'Ivoire, Mali, Niger, Senegal and Togo.

Source: *World Development Report 1989*, The World Bank.

[6] Congressional Budget Office using data from the Federal Home Loan Bank Board and the Office of Thrift Supervision.

A variety of factors have contributed to bank problems in Africa, including: 1) directed lending by government-owned banks on non-commercial terms; 2) stringent interest rate controls; 3) high loan concentrations in certain priority sectors of the economy; 4) weak internal controls and management; 5) inadequate risk and credit analysis and the poor quality of financial information flows; 6) the inadequacy of legal codes; 7) fraud and political interference; and 8) weak systems of bank regulation and supervision. Unfortunately, in many cases banks tend to take greater risks as they get into trouble, thus aggravating their problems. Moreover, many bank officers in SSA see their institutions as distributors of funds and not as managers of risk. This attitude toward risk is in itself clearly unsound.

Many governments are reluctant to tackle insolvent banks as political patronage may be at stake, and a close analysis of a bank's finances could expose serious problems which the government would prefer to keep secret. There is also the risk of undermining public confidence in the entire banking system. A sudden panic or loss of confidence in banks could lead to a "domino effect" with dire economic and political consequences, including widespread bank failure, capital flight, disruption of the payments system and a blow to national pride. This dilemma, which may be characterized as "regulatory moral hazard," quite commonly leads to a worsening of the problem, and generalized weakening of financial institutions.

The actual process of bank restructuring may be divided into seven steps.[7] The first step is to determine the condition of the bank. The bank's problems are identified and quantified through loan portfolio analysis. Often this requires the help of a large public accounting firm.

The second step is to examine the bank regulatory and supervisory system which allowed the bank to get into such trouble. The components of a sound bank regulatory and supervisory system were discussed in the preceding section.

Step three, the "surgical phase", consists of carving out the non-performing loans from the balance sheet. These assets are often segregated and moved to an *ad hoc* institution for foreclosure and disposal, thereby eliminating them from the books of the bank.

The fourth step is to decide whether the bank in question should (a) merge with another, stronger bank, (b) function on its own, (c) be sold outright, or (d) be allowed to fail. In making this decision, many factors must be considered, including the rights of depositors and shareholders, the role of the bank in the country's payments system, and the potential impact of the decision on the country's credit rating.

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[7] This discussion is based on a speech made by Diana McNaughton of the World Bank at the Financial Sector Development Project conference: "The Financial Sector in Developing Countries: Issues for the 1990s," Washington D.C., March 14-15, 1989.

After the fate of the bank is decided, the fifth step is to allocate financial losses. The World Bank, it may be noted, urges banks to recapitalize and cut their dividends; allow private shareholders to absorb the bank's losses; and ensure that depositors are protected.

The sixth step is financial restructuring according to generally accepted principles. The government may need to provide a direct injection of capital and should consider the probable impact this will have on its fiscal deficit.

The seventh and final step is the "changing of the guard." It is a cardinal rule that the management of a failed bank must be changed, but this can be a problem in some less developed countries. There may not be enough trained people to manage large financial institutions. In this case, a significant area for possible A.I.D. intervention is in training personnel and developing human resources.

The above steps should be seen as a broad and generalized approach to bank restructuring. As such, it should be kept in mind that each bank restructuring case will have its own unique challenges and must be dealt with as such. It is equally important to fully understand the political ramifications to large-scale restructuring, especially with regard to government-owned banks (which are the most likely candidates for restructuring in SSA). The skill to put a proper restructuring in place is widely available. It is the will to take such steps, which are often politically unpleasant, that is usually the main obstacle in a Sub-Saharan African context.

Potential A.I.D. Activities:

A.I.D. can provide assistance to SSA countries in implementing any of the seven steps presented above by providing experts in accounting, prudential bank regulation and supervision, bank restructuring and human resource development. In addition to financial restructuring, the new institution may need assistance in each of the following areas:

- Strategic review
- Planning, budgeting and performance measurement systems
- Credit policy and business development policy
- Treasury management
- Accounting systems
- Internal auditing systems
- Management information systems

- Management and training of personnel.

U.S. sources of expertise in these areas include the three Federal agencies that regulate the U.S. banking sector, management consulting firms and large international accounting firms. In turn, it should be kept in mind that through its financial sector reform programs, the World Bank has been the lead proponent of SSA bank restructuring programs in recent years.

5. Credit and Financial Analysis Support

Credit analysis and financial analysis can be thought of as relating to the same subject. In a technical sense, credit analysis is determining the credit risk of an entity, including: a country, a government unit within a country, a bank, a corporation, or an individual. Credit analysis should be thoroughly done prior to extending any form of credit and should be updated regularly after the loan or other type of credit is made to monitor the borrower's ability to service the debt properly.

Financial analysis is somewhat broader in that it is simply determining the financial condition of an entity or individual, without necessarily extending credit. Bank supervisors, for example, do financial analyses of banks to determine the banks' overall financial condition. (It should be noted that both credit analysis and financial analysis are key skills for bank supervisors, and their training in these areas are important aspects in overall strengthening of bank supervision.) Since the skills needed to do credit analysis and financial analysis are virtually the same, the terms are often interchanged.

The ability to properly analyze credit risk is fundamental to sound banking. Extending credit involves risk by its very nature, but the well-trained credit analyst can determine the likely degree of risk, and if it is judged too high, he or she can recommend against extending the credit or call for stricter lending conditions (such as more collateral) to make a credit facility more viable. Credit analysis includes performing ratio analyses of balance sheets, income statements and sources and uses of funds statements, and making cash flow projections. This, in turn, is dependent on the viability and degree of reliance that can be placed on such financial information. The credit analysis can and should also involve an evaluation of collateral and even some economic forecasting, depending on the type of industry to be financed.

Credit analysis skills are very weak in most SSA countries for several reasons. First, there is a dearth of accurate and timely financial information on borrowers, especially in countries where accounting systems are not well developed and accounting standards (applicable to external auditors) either do not exist or are not well established or practiced.

Second, financial institutions in many developing countries have become far too prone to lending on collateral rather than on the borrower's capacity to service the debt and ultimately repay in accordance with a set payment schedule. This issue is especially true in

SSA where outdated banking practices have led to extensive financing on open-ended arrangements (authorized overdrafts) often based solely on nominal values of collateral. In addition, such collateral is often found to be inadequately documented or cannot be realized through legal channels. The result of this is that all too often, credit is extended through an authorized overdraft which does not include a repayment schedule. So long as the assumed value of the collateral pledged exceeds the outstanding balance, the bank considers the credit satisfactory, even if the borrower lacks the capacity to reduce or clear the overdraft. Often times, the collateral is overvalued and a large loss is taken when liquidation of the collateral becomes necessary.

The third reason is poor education and training in the areas of accounting, finance, and other related fields. Thus, banks and other types of financial institutions in SSA countries hire individuals with no formal credit training, and banks' own internal training programs for credit analysis either do not exist or are of poor quality.

The credit analysis weaknesses described above have been a major reason why so many financial institutions in SSA countries have asset quality problems, in some cases leading to bank insolvency (though other factors exist, including political pressures to lend to priority sectors). If banks and other credit institutions lack staff trained in credit analysis, the result will almost always be poor lending standards and practices. Banks in industrialized countries rely heavily on lending officers and analysts well trained in credit to both determine if credit should be extended and to closely monitor outstanding credit to spot deterioration at an early stage and take corrective action. When such skills do not exist, loan portfolios usually contain large numbers of poorly-structured credits which are quite likely to become non-performing and result in eventual losses.

Policymakers in many developing countries have recently recognized that intensive credit training for both bank staff and bank supervisors is greatly needed in order to improve credit quality and thus bank soundness. In addition, bank supervisors need much- improved training in the financial analysis of banks so that they can detect problem banks at an early stage and call for corrective action to restore bank soundness. In determining to what extent credit and financial analysis training would be of value in SSA, the following points should be taken into consideration:

1.) **The quality of financial information available.** Trained credit analysts are only effective if they have accurate and timely financial information with which to work. In general, SSA countries which have local affiliates of international accounting firms, or in which indigenous accounting firms are well established and have good reputations for independence and competence, are somewhat more likely to have available reliable financial information on borrowers and financial institutions. However, even this assumption should be challenged and reviewed carefully, as some major international firms have allowed, over time, a decline in standards in some of their affiliates in SSA countries.

2.) **Lending practices in financial institutions.** Training in credit analysis is most useful where lenders are prepared to increase their volume of term lending based on a borrower's capacity to service debt over and above non-amortizing types of credit (such as overdrafts) based primarily on security.

3.) **The pace of growth of the financial sector.** Such growth, both in monetary terms and in the numbers of new institutions, will normally result in a shortage of experienced bank staff with credit training.

4.) **Present training opportunities.** Countries which lack: 1) educational programs in accounting and finance; 2) a bankers' training institute; and/or 3) banks with strong well-established, internal training programs, are clearly in need of credit analysis training for staff.

Potential A.I.D. Activities:

Suggestions by A.I.D. to help facilitate training programs in credit and financial analysis are likely to be very well received by central banks, commercial banks, and other type of credit institutions. In particular, A.I.D. can help to provide training either in-country or in the U.S. as follows:

1. A.I.D. could support efforts to bring experienced instructors into the country, usually on a short-term basis (normally 2 to 4 weeks) to offer selected courses. Such training can be made available to a wide range of people working within the financial sector, so long as the focus is well defined. Courses could either be broad in scope, such as accounting fundamentals or basic financial analysis, or target specific areas. An important example of the latter would be training in credit analysis of small- and medium-sized enterprises which are closely-held, and represent special problems for banking institutions.

2. A.I.D. could arrange for placement and funding of selected individuals in U.S. credit training programs. These would normally be for short-term courses but could also include longer term funding for promising individuals who wish to work toward a certificate or diploma in an accounting or finance related area.

3. A.I.D. could support the development or strengthening of bank training institutes which might offer courses for bank employees of all levels on an ongoing basis. Seed money might be offered to defray the costs of curriculum development and the procurement of computer equipment, library and training materials.

4. A.I.D. could assist bank supervisory authorities in developing training for their staff. Bank supervisors need training in credit analysis so that they can determine the soundness of large credit facilities and thus properly classify credit exposures where weaknesses are disclosed in the analysis. Training is also needed in the financial analysis of banks so that

the supervisors can effectively analyze a bank's capital, liquidity, and profitability, along with credit quality, to determine its overall financial condition.

There are several excellent sources of U.S. expertise in the area of credit training. The organization that has the deepest involvement is the American Bankers Association (ABA) where training of bankers is a fundamental objective. The ABA sponsors a wide variety of training courses throughout the U.S., and credit analysis is covered in depth. Through the ABA, A.I.D. can also contract retired bankers who might be interested in taking part in credit analysis training programs in LDCs, as an extensive list of such individuals is maintained.

Another source of expertise is Robert Morris Associates, a private entity whose credit analysis training programs are widely used by such organizations as the Federal Reserve in its credit training for bank examiners. The main sources of expertise in training of bank supervisors are the Federal Reserve, the Office of the Comptroller of the Currency and the FDIC, as previously mentioned.

Another complementary way for A.I.D. to get banks to strengthen their lending skills is to draw upon credit guarantee programs. Such partial guarantee programs can encourage banks to expand into newer portfolio areas such as lending to small businesses or to enterprises in rural areas. Technical resources to assist missions in this specific area are available from AID/PRE, the Financial Sector Development Project, or from among other technical assistance and training resources listed in Chapter X.

6. Credit Information Bureaus

In the United States, banks, retailers, and other entities which extend credit use the services of credit bureaus to evaluate the credit standing of potential borrowers. Credit information is maintained on individuals and companies, both large and small. In most developing countries, credit information bureaus, if they exist at all, have a narrower focus. Such bureaus provide financial institutions with basic financial information on major borrowers. These are usually companies, but large personal borrowers are sometimes included.

In an African context, it should be noted that credit information bureaus seldom exist at all, and any that have been attempted are very unlikely to be fully reliable. Still, African bankers and central bank supervisors have an awareness of the value of a limited-scope credit bureau (see following paragraph) in reform of the banking sector, as many borrowers from African banks take advantage of the lack of such a data base to shift poor quality loans from bank to bank or add to the pool of poor quality loans.

In limited-scope credit information bureaus, the participating financial institutions report basic credit information on all large borrowers, or related groups of borrowers, to the information bureaus on pre-designed forms. It is common in the initial stages for a credit information bureau to be organized and managed by the central bank, though ideally it should be privatized at later stage, as this is not a proper central banking function. The basic data reported to the central bank (or other managing entity) would normally include:

- Amount of credit presently outstanding
- Names of all specific borrowers within the group
- Liens outstanding against the borrower
- Collateral pledged
- Payment performance with regard to both principal and interest
- High and low levels of credit outstanding within the past year or more.

The bureau is organized by having each participating institution pay a fee for the service. In turn, each participant has access to all data compiled by the bureau.

Decisions to extend credit to potential borrowers often depend on whether there is outstanding debt or whether collateral promised has already been ple :ged to another bank or credit institution. Credit judgments made on incomplete or inaccurate information often lead to weakness in the bank's portfolio and within the banking sector overall. Strong credit information bureaus, on the other hand, can provide banks (and potentially other financial institutions) with sound information on which to base credit decisions. Credit information bureaus can also protect borrowers. Without a credit information system, credit decisions are often based on reputation alone, often coming from rumor or gossip about the borrower's financial history.

Credit information bureaus are important in the reform process of financial sectors, especially in countries where new licenses have been given to credit institutions in recent years. As the number of lenders increases, borrowers naturally have a choice as to where to obtain credit, and the need for accurate data on other borrowing relationships becomes necessary. As new financial institutions eagerly seek to build up loan portfolios, they are particularly vulnerable to poor credit judgments made from lack of accurate and up-to-date data.

For a credit information system to be effective, a mechanism should be in place to help ensure the accuracy and timeliness of the data reported to the bureau. On-site examination to review the accuracy of submitted information is one available mechanism for countries where the central bank manages the bureau and is also the supervisory authority.

Potential A.I.D. Activities:

A.I.D. can play an important role in supporting the creation of credit information bureaus. As such bureaus are likely to be start-up projects in most of Sub-Saharan Africa, A.I.D. could conduct a preliminary study to determine what type of assistance is needed. If one already exists, A.I.D. could take a critical look at its effectiveness, including how satisfied financial institutions are with credit information at present. If the report is widespread dissatisfaction (as is likely), A.I.D. could prepare a feasibility study and business plan for the establishment of a credit information bureau including:

- Estimates and projections of the demand for services of the credit information bureau

- Estimates and projections of the amount of incoming information and the associated processing requirements

- Recommendations regarding service standards (response time, reliability and completeness of credit information, confidentiality, etc.)

- Estimates and projections of total operating costs and recommendations for alternatives to cover these costs

- Recommendations for staff development, recruitment, and both initial and in-service training.

Forming a credit information bureau is not as specialized as some of the other topics included in this section. As a result, its establishment could come in conjunction with other projects, especially those strengthening bank supervision. This is because of the need for accurate credit information in examining and supervising banks. In addition, putting any credit information bureau in place would require extensive computer expertise, as all modern credit information systems are fully computerized.

Sources of expertise in this area include U.S. credit agencies such as Dun & Bradstreet, which investigates, analyzes and maintains records on the credit responsibility of commercial firms, and TRW which focuses on consumers.

C. Other Financial Institutions

Important financial intermediaries found in virtually every developed and developing country include development finance institutions and credit unions or cooperatives. These non-bank financial institutions are often established for the purpose of supporting specific economic groups or sectors whose needs are not considered to be met by traditional banks. They are subject to different laws and regulations and therefore should be considered separately.

Leasing companies are increasingly popular institutions in many LDCs as an alternative to traditional bank financing of large equipment purchases. The following section provides an overview of development finance institutions, credit unions and leasing companies and describes areas in which A.I.D. might provide technical assistance.

1. Development Finance Institutions

Pioneered in the 1950s and 1960s, development finance institutions (DFIs) were a key feature of the "era of public investment" - when it was widely believed that state-owned enterprises would ignite development where the private sector failed to invest. Most development finance institutions are public or para-public organizations that receive the bulk of their funding from the government or bilateral and multilateral funding agencies. Unlike banks which lend for shorter periods at commercial rates, the DFIs were originally created to provide subsidized long-term finance to small and medium-sized enterprises and priority economic sectors that were judged too risky or unprofitable by other lenders. Many sectors, including agriculture, housing, industry and tourism, were often targeted for such subsidized lending.

Virtually all developing and developed countries have at least one DFI, and many have a specialized institution for each priority sector, such as agriculture, housing and tourism. The Botswana Development Corporation (BDC) is an example of a DFI in Sub-Saharan Africa that has played a key role in the development of its country's financial system. As designed, this DFI was able to serve as a conduit for moving external and government funds into the private sector and was a source of technical assistance for newly emerging industries.

The BDC, established in 1970, is owned by the Government of Botswana and three foreign agencies, including the International Finance Corporation, which own nonvoting preference shares. Its financially sound position is attributable to its alternative approach to lending. New projects have been identified and established through wholly-owned or joint-venture subsidiaries of the BDC. In addition, the BDC requires its loan beneficiaries to take a significant equity position in the companies, providing them with a better gearing ratio and therefore helping them to raise working capital and complementary funding from the commercial banks.[8]

When some of BDC's earlier clients no longer needed its financial or technical assistance BDC began selling off the BDC stakes to other national owners and then recycling the money realized into further investments in other companies. This was done first by placing stakes in nine BDC companies into an investment trust and then selling off parts of the diversified portfolio. As of 1989 less than 1 percent of the total loan portfolio was in arrears and only a few of the companies in which it has equity holding were showing losses.

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[8] *World Bank Developmeent Report*, 1989.

BDC has been successful not only in narrow commercial terms but also in helping to support the emergence of an embryonic capital market in Botswana. The combination of a strong and growing economy, a conservative investment and lending strategy, independent management and a highly qualified staff have all contributed to its achievements.[9]

Many other DFIs, however, have not been so successful. Industrial DFIs, agricultural DFIs and housing finance institutions all encountered difficulties in mobilizing resources. In many Sub-Saharan nations, commercial criteria were largely thrown away and replaced by essentially political objectives. This has resulted in the failure to mobilize funds other than those provided by donors and governments. DFIs have generally maintained excessively concentrated portfolios and have suffered from poorly developed markets for longer term debt instruments. A lack of supervision and scrutiny of activities by the central bank and the fact that most DFIs were not allowed to pursue loans are reasons central to their weakness and failure. In Ghana, most DFIs face serious financial difficulties arising from huge foreign exchange exposure and/or loss, a substantial non-performing portfolio, and a complete erosion of net worth.[10] DFIs have, by and large, contributed only minimally to stimulating more broad-based financial development.

A World Bank study of financial intermediation published in 1985 concluded that, with some notable exceptions, a large portion of DFIs faced serious problems. A study published by A.I.D.'s Center for Development Information and Evaluation (CDIE) in 1990 (see Chapter XI, Annotated Bibliography) reaches similar conclusions. About one-third were significantly in arrears and had low or negative returns on assets. Very few DFIs had successfully mobilized domestic or foreign resources and therefore most depended on government and international official support for their continued existence.

Moreover, a 1989 World Bank survey of 18 industrial DFIs worldwide revealed that, on average, nearly 50% of their loans (by value) were in arrears. Because the rescheduling of overdue loans and growing loan portfolios reduce arrears ratios, the situation could actually be worse than revealed by the numbers. Reasons cited for the poor performance of these industrial DFIs included the limited diversification of loan portfolios (resulting in increased vulnerability to swings in the business cycle), a narrow funding base, insufficient professional analysis of prospective borrowers, lenient lending policies (especially for politically favored borrowers), performance evaluations based on the volume of disbursements, and problems in recruiting and retaining competent staff. Finally, in some cases it became apparent that many borrowers did not believe they should repay a public institution loan and refused to do so.

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9 *Financial Systems and Development in Africa*, Economic Development Institute of the World Bank, 1991, page 21.

10 World Bank Development Report, 1989.

Although the inherent subsidy in DFI operations over the past years has been justified by the assumption that important benefits were directed to and received by the poor, studies have shown that this has often not been the case. In fact, the major beneficiaries of these loans and of loan forgiveness have been the relatively better-off groups in society. Moreover, a number of case studies have shown that the availability of subsidized agricultural credit has had little, if any, effect on farming productivity. Without strict (and costly) supervision, it is difficult to guarantee that borrowers have used the funds toward their stated investment purposes. Credit project evaluations in countries as diverse as Kenya, Mexico and the Philippines have revealed that the use of funds for purposes other than the ones stated at the time of borrowing was a major factor that severely limited the programs' effects on productivity increases.[11]

Potential A.I.D. Activities:

DFIs will continue to operate throughout many parts of the developing world despite their weak performance. A.I.D. could play an important role in improving the performance of DFIs targeted for restructuring (perhaps in connection with a World Bank or IMF structural adjustment package). In determining the eligibility of DFIs for assistance, the following criteria should be met:

- The DFI demonstrates its capability to mobilize domestic savings or diversity in sources of funding.

- The DFI shows that it can manage its assets professionally, investing in viable, sound and profitable enterprises, and can recover its loans.

- The DFI is 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.

- The DFI is not required by political authorities to offer subsidies to protected groups and is not influenced by the authorities in its lending decisions.

The operational deficiencies of DFIs can only be overcome if DFIs are required to manage themselves and their portfolios as commercial, profit-making enterprises would. This of course assumes that the enabling environment, especially with regard to the collection of collateral, is favorable for lending institutions.

To the extent possible, the private capitalization of DFIs should be encouraged. This would assure, again assuming the proper climate, that private investors would periodically assess

[11] Braverman and Huppi, "Improving Rural Finance in Developing Countries," Finance & Development, March 1991.

management's decisions regarding prudent lending and enforce provisions regarding the collection of collateral in cases of default.

One of the more successful developments has been the creation of privately-owned DFIs, as has been tried in Barbados with the Caribbean Financial Services Corporation (CFSC). This privately-owned institution has a board of directors drawn from the private sector and has some concessionary funds from A.I.D., but it also has equity participation from the private sector. CFSC has been successful in mobilizing local funds and has been able to identify and invest in numerous viable projects. In addition, no significant restrictions are placed on the use of these funds either by A.I.D. or the local government.

A primary focus of A.I.D. intervention in policy dialogue regarding DFIs and the financial system in general (as discussed elsewhere in this report) should be to assist in removing obstacles to the efficient functioning of credit markets. This includes the gradual removal of subsidies, the deregulation of interest rates and the elimination of special privileges regarding access to government rediscounting facilities. This may also call for the termination of failed DFIs and encouragement of alternative private sector financial institutions. Depending on the country situation, A.I.D. may be called upon to help in the restructuring of carefully selected DFIs. In such cases, it is recommended that A.I.D. condition its participation on the four criteria mention above.

With respect to the types of assistance required, A.I.D. could:

1. Assist DFIs in conducting a thorough analysis of their organizational structure; management functions; operating policies and procedures; financial and administrative systems; human resources and training; and information technology. To the extent possible, DFIs should be encouraged to mobilize their own resources through the provision of savings products.

2. Provide training to managers, supervisors and loan officers on such topics as accounting, credit analysis and marketing.

3. Assist in the design and implementation of improved accounting, auditing and management information systems, and train personnel in their use.

4. Assist DFIs in diversifying their range of services and developing additional sources of income.

5. Provide technical assistance in portfolio management and loan recovery.

2. Credit Unions

A credit union is a private not-for-profit financial institution offering a variety of financial services to its members. While the services provided by each credit union may vary, in addition to savings and checking accounts many offer payroll deduction plans, money orders, credit and debit cards and Individual Retirement Accounts. Larger credit unions may offer mortgages and home equity loans.

Each credit union is governed by its members, who are typically employee groups, religious or fraternal organizations and residents' or other associations. From its ranks, the membership elects unpaid, volunteer officers and directors, who establish the policies under which the credit union operates. As not-for-profit organizations, money earned on the various products is returned to members in the form of dividends, interest rebates and expanded services.

In the United States, the first credit union was opened in 1909 in Manchester, New Hampshire. In 1934, the Federal Credit Union Act was passed, allowing credit unions to be organized anywhere in the U.S. Since then, they have proliferated and become a viable alternative to commercial banks. As of December 1992, there were 13,379 credit unions in the United States, with a total membership of over 64 million.[12] Approximately 65 percent of these credit unions are federally chartered and regulated by the National Credit Union Administration; the remaining 35 percent are state chartered and regulated by State Credit Union Commissions. The total number of credit unions has decreased in recent years due to a large number of mergers.

One of the primary advantages of a credit union is that, as a member organization, it has the ability to provide much-needed credit to those sectors which are unable to obtain affordable credit elsewhere. This type of financial institution is particularly useful for providing smaller loans for basic needs such as materials for home repairs and improvement. In the U.S., some view credit unions as a particularly stable form of financial institution because the bulk of their funding comes from members' share capital, contributed on a monthly basis via payroll deductions. Because most credit unions are formed around some common activity or goal, there tends to be a high degree of identity of interests among members, which has also added to their success and stability.

The existence of credit unions in developing countries is particularly important as a large portion of the population in these countries, particularly small-scale farmers, face severe difficulty in obtaining credit from banks. Studies of developing countries have shown that, given the opportunity to do so, even small farmers do amass significant savings. Normally, the informal sector captures these savings. Those borrowing from informal sector

[12] Statistics provided by the Credit Union National Association.

moneylenders pay excessively high interest rates. Yet not only do borrowers borrow at these rates; they repay as well - with a record most banks in developing countries would envy.

Credit unions have emerged in a number of developing countries to operate as formal institutions. In fact, credit unions are often the only legal financial institutions with both savings and loan services in rural areas. Almost half of the credit unions which are members of the African affiliate of the Word Confederation of Credit Unions, the African Confederation of Cooperative Savings and Credit Association (ACCOSCA), are classified as rural or predominantly rural. In Malawi, 80% of credit unions (in terms of their membership) cater to small-scale farmers and in Lesotho nearly 70% of credit union members are rural women.

The ACCOSCA reports over twenty thousand registered credit unions in 1991 within the 25 Sub-Saharan member countries. The average African credit union has about 450 members and assets of approximately $90,000. About 25% of the credit unions have a paid manager with the remainder of the staff consisting of volunteers. They typically offer small, unsecured, short-term, personal loans with nearly uniform fixed interest rates. The member's personal character, savings record, and future earning potential are usually the prime considerations in loan approvals. Collateral has only recently become an important factor, with co-signers the preferred form of guarantee. The following table details the number of credit unions registered in the twenty-five Sub-Saharan Africa countries in which the ACCOSCA is active. It also indicates the total number of members, savings and loans for all credit unions in each of the countries.

Sub-Saharan African Affiliates of the World Council of Credit Unions (1991)				
Country	Registered Credit Unions	Members (millions)	Savings US$ (millions)	Loans US$ (millions)
Benin	18	6.0	1.5	0.4
Botswana	10	5.0	6.7	6.5
Burkina Faso	163	14.0	2.0	1.0
Cameroon	255	76.0	42.2	24.6
Congo	n/a	n/a	n/a	n/a
Cote d'Ivoire	78	12.0	2.4	0.9
Ethiopia	406	95.0	36.4	41.2
The Gambia	10	0.7	.05	.05
Ghana	230	45.0	3.3	2.6
Kenya	1,580	864.0	19.7	283.5
Lesotho	72	30.0	1.2	1.0
Liberia	71	20.0	10.4	7.6
Malawi	121	19.0	1.7	1.6
Mauritius	80	31.0	4.4	4.7
Nigeria	15,000	2.7	33.8	36.9
Rwanda	124	384.0	31.9	14.0
Senegal	20	2.0	0.3	0.3
Seychelles	1	6.0	3.4	3.5
Sierra Leone	87	5.0	.02	.02
Tanzania	405	96.0	2.1	2.3
Togo	138	29.0	9.3	7.0
Uganda	656	316.0	1.8	0.7
Zaire	115	274.0	4.7	1.0
Zambia	317	147.0	1.3	4.1
Zimbabwe	165	15.0	2.6	0.2
TOTAL	20,122	2494.4	223.2	445.7

Source: *International Credit Union Statistics*, World Council of Credit Unions, 1991.

Credit unions are playing an increasingly important role in Malawi. Traditionally, the main source of lending in the rural areas were the "katapila", who charge 50-100% interest on loans and require repayment within three to six months. The Malawi Union of Savings and Credit Co-operatives (MUSCCO) was formed in 1980 to develop credit unions into viable alternatives to the "katapila". MUSCCO received assistance from the World Council of Credit Unions beginning in 1981. The organization worked to expand the number of credit unions, their membership, and savings and productive loans. Over time, the credit union movement in Malawi evolved into an effective national financial cooperative system that supports the needs of the rural population. This is evidenced by the increase in the number of credit union members from 24 in 1981 to 88 in 1989.[13]

Because of the important role that credit unions have played and can potentially play, government agencies, international donors, and foreign governments have historically used them as an instrument through which to direct credit to specific sectors or programs. Unfortunately, credit unions which are supported by government- or donor-backed loans often have poor payback rates. One reason for this is that borrowers often view the loans as grants and are therefore less inclined to pay them back. For the same reason, the credit union itself often lacks the incentive to effectively monitor investment and repayment behaviors of their borrowers. Perhaps most importantly, when credit is directed to a particular sector for social reasons, there is often insufficient emphasis placed on the ability of the borrower to repay the loan.

Future prospects for credit unions in developing countries will be at least partly linked to their institutional capacity, particularly to the soundness of their financial and administrative practices. Unfortunately, the inadequate institutional structures of many credit unions have prevented them from becoming self-sustaining financial agents. Some of the major factors adversely affecting the efficiency and effectiveness of credit unions in developing countries include:

- Lack of experienced managers with sufficient training and experience to make appropriate lending decisions (i.e., screening techniques, portfolio diversification, and loan recovery methods)

- Deficient accounting practices and largely manual systems which, in addition to increasing the likelihood of errors or misuse of funds, fail to produce the information required by managers to make informed decisions

- Inadequate monitoring and audit coverage, which leads to poor adherence to profit and accountability constraints

- Absence of well-defined institutional policies and objectives which would create a consistent and cohesive organization

- Lack of documented operating procedures

- Insufficient staff training at all levels.

Many credit unions in Sub-Saharan Africa would benefit from technical assistance. For example, in the early 1980s credit unions in Togo generated no financial statements and

[13] Credit Union World Reporter, African Credit Unions, May 1990.

loans were generally for personal reasons (such as family events, school fees, medical care). With the support of ACCOSCA credit unions now prepare standardized financial statements complete with statistics concerning membership, loans granted and delinquency rates. In addition, the purposes of the loans have shifted to more productive purposes (primarily working capital loans for women traders, crop loans, and equipment for microenterprises), resulting in a lower delinquency rate. Probably the most important reason for successful outcomes of this technical assistance was the project's emphasis on field staff training and accounting systems development. Substantial systems development and technical transfer were also crucial to the credit unions' development.[14]

Potential A.I.D. Activities:

A.I.D can expand its role in promoting credit unions in Africa by providing technical assistance to strengthen these financial institutions, thereby removing the institutional barriers to their efficient operation. The first practical way in which A.I.D. could do this would be to identify key institutions and provide assistnce in determining specific institutional functions which require improvement. These may include:

- Policy environment and strategic direction
- Operational processes and procedures
- Organizational and management structure
- Information technology
- Administrative and financial systems
- Record keeping and internal controls
- Human resources, training and education.

Technical assistance in the above areas will assist the credit unions in developing the appropriate infrastructures and skills to succeed after the donor assistance is terminated. The most important message to relay is the need to mobilize of savings to maintain self-sufficiency.

As referenced above, a source of expertise in this area is the World Council of Credit Unions and its African affiliate, the African Confederation of Cooperative Savings and Credit Association (ACCOSCA). The headquarters for these institutions is located in

[14] Credit Union World Reporter, African Credit Unions, May 1990.

Madison, Wisconsin, sponsor training and institutional strengthening programs as well as other forms of technical assistance.

3. Leasing Companies

Leasing has become an increasingly popular alternative to conventional bank financing in both developed and developing countries. A "lease" is a contract by which one party conveys the use of an asset to another for an agreed term at a specified rental price. There are two basic types of lease agreements: the operating lease and the capital lease. With an operating lease, ownership remains with the lessor at the end of the contract. The lessor provides maintenance and insurance for the leased asset and bears the risk of obsolescence. Car rental companies, for example, lease cars by the day or week on an operating basis. While rental charges generally total more than the cost of buying equipment outright, with an operating lease a company can:

- Avoid the many risks associated with ownership
- Better manage the risk of the equipment becoming obsolete
- Increase operating flexibility in the face of business cycles or circumstances in which the equipment is only needed on a periodic basis
- Avoid financial risks associated with holding loans for equipment
- Conserve cash, which is especially important in start-up ventures
- Keep a balance sheet free of debt.

With a capital lease, the lease is viewed as a form of borrowing to purchase the equipment at the termination of the agreement. The lessee bears the risk of obsolescence and pays all maintenance fees, insurance premiums and taxes. This arrangement is similar to a conditional sale agreement (U.K.).

The development of leasing as an important alternative source of equipment financing began in the U.S. in the 1950s. Aided partly by tax laws, the industry grew rapidly. In 1992 the American Association of Equipment Lessors (AAEL) estimated that companies spent $120 billion on leasing equipment in the United States. The AAEL also estimates that eight out of ten firms in the U.S. lease some kind of equipment on an annual basis, ranging from office equipment to computers, and from heavy machinery to jumbo airplanes. Although independent leasing companies write most of the leases, original equipment manufacturers and some banks have important leasing businesses.

In developing countries in general leasing has become increasingly important as a means for businesses to meet their capital equipment needs. Interest rates on leased equipment may run several points higher than bank debt but the advantages to smaller and thinly capitalized companies is that generally no down payment is required and the leased equipment is the only collateral needed. According to the World Bank, the share of leasing in capital formation (excluding building and construction) was 8% in Korea and 14% in Malaysia in 1985, compared to 8% in Germany, 9% in Japan and 20-28% in five other industrial countries.[15]

In Sub-Saharan Africa, most leasing is not done through commercial banks but separate financial institutions. In turn, many SSA leasing companies are wholly- or partially-owned by commercial banks. In SSA, leasing companies normally fall within the broad definition of credit institutions (non-bank deposit-taking financial institutions) and are thus subject to supervision under the Financial Institutions Act, especially if all or part of the funding comes from time and savings deposits from the general public. As such, leasing companies are also normally subject to capital adequacy requirements, liquid asset requirements and some lending limitations to a single customer or related group of customers, though the appropriate prudential regulations will usually differ from those for banks.

In order for leasing companies to operate successfully they need legal, tax and regulatory systems that support this type of financing. With respect to contract and property law, the rights and obligations of both the lessor and lessee should be clearly defined. A country's tax laws should specify the tax obligations and credits (including depreciation) which the two parties should expect. It is not necessary to create special tax advantages for the leasing industry to grow; rather, tax laws concerning leases should be both clear and neutral as to whether an enterprise finances an acquisition of productive assets through bank loans or leasing.

Finally, regulations for the leasing industry should be considered. In Sub-Saharan Africa, as mentioned above, most leasing companies are separate entities and are subject to the law for financial institutions. This includes requirements for licensing, prudential supervision, liquidity, financial reporting and minimum capital amounts. Because leasing companies usually commit their financial resources on a medium-to long-term basis, most countries impose restrictions with regard to their deposit structure (for example, prohibiting demand deposits) to avoid mismatches with respect to their sources and uses of funds.

Potential A.I.D. Activities:

By supporting the development and expansion of leasing activities, A.I.D. would help to (a) increase the supply of medium- and long-term funds for new capital investment, (b) mobilize additional sources of finance for SMEs, often a dynamic sector and (c) increase competition

[15] World Bank Development Report, 1989.

and innovation in financial markets by encouraging a more positive attitude toward risk and security and the use of techniques such as cash-flow based lending by financial institutions. In particular, A.I.D. could:

1. Develop a detailed assessment of the nature of the demand for lease financing. Areas to be examined include:

- Types of instruments that would provide viable financing alternatives in the host country

- Specific sectors where leasing could be applied.

2. Define the specific legal, tax, regulatory and accounting adjustments needed to make leasing a more cost-competitive and efficient means of finance:

- Review tax law as it affects the establishment of leasing operations

- Review contract and property laws relating to secured (collateralized) financing and the transfer of property rights

- Make recommendations for achieving a balanced regulatory structure

- Review lease accounting and, in particular, under what conditions a leased asset is to be accounted for on a lessee's or lessor's balance sheet.

3. Act as a catalyst for prototype leasing ventures by bringing together domestic sponsors, foreign technical and financial partners and government authorities to ensure that the project is commercially viable, well managed and organized on sound operating and financial principles.

4. Provide financial support to leasing companies through guarantees of local currency loans.

Sources of expertise in this area include former executives with leasing companies, bank leasing departments (Citibank, Chase Manhattan, Chemical Bank and others) and the American Association of Equipment Lessors which sponsors seminars and workshops on many topics related to leasing.

IV. FINANCIAL MARKETS POLICY FRAMEWORK

A. United States Government Policies

United States Government policies regarding international financial markets have evolved as financial transactions have grown and markets have become increasingly integrated and globalized. Government policies that are relevant to A.I.D. and to international economic development issues can be classified into three broad areas: support for free trade, strategies that address Third World debt, and policies that support international prudential regulation.

1. Trade in Financial Services

Financial markets are figuring more prominently in the current GATT Uruguay Round, with developed and developing countries often differing on more liberalized treatment of international financial operations. Free trade in services was included in GATT for the first time under the framework of an agreement on "services". (In addition to banking and securities, trade in services includes the insurance, tourism, construction services, communications and other information-related services such as data processing.) The overall thrust of the United States' negotiating position is to achieve national treatment, including equality of competitive opportunity, in major and growing markets throughout the world. Other objectives are rights of establishment, increased participation for developing countries, and provisions for unrestricted transfers of capital. Exceptions to free trade necessarily will be allowed for governments to restrict payment for monetary policy purposes (i.e. balance of payments) and for prudential regulation. The treatment of services provided by expatriate professionals, including lawyers and doctors, and even some non-professionals, is one of a number of outstanding issues. Negotiations, which are conducted by the U.S. Trade Representative's Office and the U.S. Treasury Department, are continuing.

2. Third World Debt Crisis

One of the most pressing problems facing the international financial community has been the Third World debt problem. Over $889 billion of foreign debt is owed to private and official creditors from developing countries. The magnitude of the problem, coupled with the Third World's continuing need for external sources of finance, has resulted in increased attention to the problem from the United States Government. Since 1985 the U.S. Government has been officially committed to resolving the debt crisis through the support of market-driven voluntary debt reduction mechanisms. Market-driven debt reduction includes commercial bank debt rescheduling, debt/equity swaps, debt conversions, and cash buybacks. Since 1986 roughly half of all debt reduction has been privately rescheduled and the other half was transacted through a global secondary market for Third World debts.

Initially, through the "Baker Plan", creditors as a group were strongly urged to include new loans in their debt rescheduling agreements without any intervention from the United States Government. However, at the end of 1988, despite the emergence of some successful debt reduction programs, serious economic problems remained - capital flight, low growth, stagnating levels of investment and savings and commercial bank reluctance - that were perceived as barriers to meaningful levels of debt reduction.

In March 1989 the United States Government issued a revised strategy that was dubbed "The Brady Plan". The Brady Plan urges developing countries to work with the World Bank and the IMF to adopt economic reforms that promote savings and investment and put in place sound trade policies. In return, the World Bank has set-aside funds to specifically support market-driven debt reduction programs. Creditor governments have been encouraged to continue rescheduling their credits through Paris Club, to provide new money, and to consider ways to encourage voluntary debt reduction programs through changes in national accounting or tax treatments. Commercial banks have been requested to take a broader, more realistic and less unilateral approach to debt reduction.

The Brady Plan was met with skepticism and resistance from some borrowers, creditors and observers, particularly in Latin America. However, since its inception, six highly-indebted countries have reduced their debt overhang, including Mexico, Venezuela, Costa Rica, Philippines, Morocco and Uruguay through a combination of World Bank loans and market oriented instruments. (Argentina and Brazil are considered to be two failures.)

3. Prudential Regulation

Liberalization and internationalization of financial markets creates new challenges for bank and securities regulators. Concerns about bank safety, financial market stability, the risks of clearing systems and the integrity of markets move from domestic arenas to international forums. The United States Government participates in two international forums, the Basle Committee on Banking Supervision and the International Organization of Securities Commissions (IOSCO). Both forums focus on industrialized countries, but are increasingly involving the interests of developing countries.

The Basle Committee (known informally as the "Cooke Committee") and headquartered in Switzerland, was established in 1974 by the central bank Governors of the Group of Ten industrialized countries. Its objective is to strengthen collaboration among national banking regulators. The group's major policy initiative has been a 1988 accord on international standards for banks' capital adequacy.

More recently, the Basle Committee on Banking Supervision has introduced three proposals. If enacted, these proposals would liberalize the terms of the 1988 Basle Capital Accord with regard to the measurement of credit risk, capital charges for the risks associated with price changes in open positions in debt and equity securities, and set forth a common approach to the measurement of interest rate risk. These proposals are seen as measures which promote the 1988 accord's dual objectives of strengthening the soundness and stability of the international

TABLE 1

A.I.D.'S FINANCIAL SECTOR INTERVENTIONS BY REGION

	NEAR EAST	ASIA	LAC	AFRICA	AID/W	TOTAL
POLICY REFORM	1	4	3	8	--	16
COMMERCIAL BANKING	4	2	24	6	3	39
SECURITIES MARKETS	7	5	2	5	3	22
FINANCIAL INFORMATION	1	1	1	0	0	3
OTHER FINANCIAL INSTITUTIONS	1	1	24	26	7	59
PRIVATIZATION	1	2	4	5	0	12
MICROENTERPRISE DEVELOPMENT	5	5	20	21	4	55
DIRECTED CREDIT	4	6	40	22	7	79
TOTALS	24	26	118	93	24	285

TABLE 2

TRENDS IN A.I.D.'S FINANCIAL SECTOR INTERVENTIONS

	1980–1985	1986–PRESENT	TOTAL
POLICY REFORM	5	11	16
COMMERCIAL BANKING	22	17	39
SECURITIES MARKETS	6	16	22
FINANCIAL INFORMATION	3	0	3
OTHER FINANCIAL INSTITUTIONS	43	16	59
PRIVATIZATION	1	11	12
MICROENTERPRISE DEVELOPMENT	33	22	55
DIRECTED CREDIT	47	32	79
TOTALS	160	125	285

banking system and achieving a greater degree of competitive equality among internationally active banks. These are also seen as furthering the convergence of supervisory policies across national boundaries and across classes of financial instruments.

With a long tradition of communication among the world's central bankers, this organization is increasingly serving as a supplier of senior level expertise. It is also playing an incipient role as international banking regulator. The U.S. Treasury, Office of the Comptroller of the Currency, and the Federal Reserve Board participate in Basle Group activities.

The difficulty of coordinating the regulation of financial institutions which have extended their network to a world-wide scope and whose base is not in a country with strong regulatory expertise and authority has been well demonstrated in the recent BCCI scandals. Various regulatory bodies are developing better methods of coordinated regulation of such trans-national institutions.

IOSCO, headquartered in Montreal, Canada was also formed in 1974 as an organization for securities market regulators. Its purpose is to guide the evolution of international capital markets and to cooperate on regulatory matters both domestically and internationally. The group also supports the development of securities markets in developing countries and many countries are working to take advantage of the group's expertise. Although the organization has achieved a high level of cooperation amongst its members one difficulty faced by IOSCO is that it lacks the authority to implement its policy recommendations. The United States Government participates in IOSCO through the Securities and Exchange Commission and the Commodities Futures Trading Commission.

B. Agency for International Development Policies

The broad lines of A.I.D.'s policies for financial markets are determined by guidelines for U.S. government policy established by the Treasury Department. The principal theme of U.S. government policy is that economic growth can best be accomplished through the support of free, open and competitive markets. Underlying this theme is the understanding that every developing country depends upon the mobilization of financial resources to realize such economic growth. U.S. Government interventions, then, whether they be regulations, policies, or project assistance are all based upon similar commitments to competitive and free markets, sustainable economic growth and democratic societies.

1. General Policy

The rationale for financial market development programs comes from two of the six broad principles set forth by Administrator Roskens in his Statement of Mission. They are, support for free markets and broad-based economic growth, and concern for individuals and the development of their economic and social well-being. The development of financial markets is fundamental to economic development. Without strong and deep financial markets, a developing country cannot effectively mobilize the financial resources necessary for investment activity and economic growth. In addition, indirectly, because of their reliance upon the free flow of information, development of financial markets furthers another of Administrator Roskens' principles, the support for democratic principles.

Financial market programs are acknowledged as an integral component of A.I.D.'s overall private sector program agenda and the "Open Market, Open Societies" policy of the Europe and Near East Bureau. Many of the potential benefits of economic liberalization, including increased trade and investment, reduced capital flight, and private sector growth, are dependent upon the ability of a country to effectively mobilize its financial resources. Efficient financial markets help to promote more widespread ownership of assets in a society. A larger number of citizens in a developing country will thereby have an opportunity to participate in, and enjoy the benefits derived from, the growth of their country's economy. Policies and programs that support strong financial markets will ultimately lead to a strengthening of private sector intermediation. Also, viable financial markets are essential towards meeting long-term privatization objectives.

More recently, the December 1990 Business and Development Partnership Initiative announced by the Administrator specifies "financial services" as one of the "emerging sectors in development", defined as being one of a few select industries that promise extraordinary economic development impact from private sector investment. The business internship programs for emerging markets will be relevant and helpful for financial markets development also. The new commitment to capital projects, through a Capital Fund, will require more sophisticated financial markets and increased cooperation with financial institutions.

2. Financial Market Development Policy

A.I.D. already has developed a relatively complete set of policies and guidance for programs in financial market development. These policies are set forth in the "Financial Markets Development Policy Paper" dated August 1988. (See Annex F for complete text.) The broad policy statement is as follows:

> "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 [these] savings to investments yielding maximum returns, and maximizing the participation of the general populace."

The policy states that A.I.D. should support and encourage countries to develop financial markets, and should act as a catalyst for liberalization through policy dialogue and project assistance. A.I.D. should encourage countries to adopt policies that eliminate credit allocations and interest rate ceilings and to adopt policies that provide a suitable regulatory and tax environment for financial markets to grow. Reforms that increase access to formal sources of credit should be encouraged. A.I.D. should study further the informal market. The primary source of capital should be domestic resource mobilization.

Programs should be mission-directed, flexible, and closely guided by comprehensive country studies. A.I.D. credit projects should take into consideration the broader issues of financial markets. Attention should be paid to the reasons why credit needs are not being met from domestic sources and the costs embedded in credit subsidies. Efforts should be made to work with private financial institutions in strengthening and broadening existing institutions. Where appropriate missions should assist governments with the development of capital markets, venture capital, and support of debt/equity conversion programs.

3. Challenges and Innovation - Some Issues to Consider

Financial market development is one of the most complex areas in the field of international economic development. Financial markets programs offer new challenges for A.I.D. and call for innovative programming. A.I.D.'s existing experience with a wide variety of credit projects, its good working relationships with Ministries of Finance, central bankers and private financial institutions, combined with the technical expertise and resources of private U.S. and local financial intermediaries, places A.I.D. in a good position to meet the challenge and to develop innovative and effective programs. Some issues to consider in developing programs are as follows:

- Financial markets programs should be seen as a process for mobilizing and allocating resources, in this case financial resources.

- Although financial markets policy dialogue and project assistance may not require large amounts of funding, these policies and programs may be highly visible within a country and may require a strong commitment on the part of the country's leadership. For example, a comprehensive reform program, in a country with extensive financial problems, may entail considerable political opposition. Elimination of directed credit programs may be opposed by those receiving the credits. Interest rate reforms may affect vested interests in politically sensitive sectors, such as rural agriculture. Strengthened private sector financial institutions, and the elimination of the privileges of the state-owned financial institutions, may run into stiff opposition from local government authorities seeking to preserve their personal or institutional control (and that of their allies in the state-owned banks) over the banking and financial system.

- Actions taken in the financial sector will affect the productive sector as the two are interrelated and mutually dependent. Financial reforms for interest and exchange rate policies may not be successful or recommended unless trade and price reforms have been implemented in the productive sectors. In productive sectors, particularly capital inte: ve sectors such as housing and power, the ability to finance future developments may depend heavily upon the ability to mobilize the financial resources from the domestic economy.

- A country's needs vary according to its stage of economic and financial development. In a less advanced country with serious economic distortions A.I.D. might focus on such measures as interest rate deregulation and increased bank competition to mobilize domestic savings.

  In more advanced countries, where financial institutions tend to grow in number and become more complex, A.I.D.'s programs might concentrate on promoting the growth of securities markets and diversifying the sources of domestic and foreign investment capital. In some countries financial systems have grown very rapidly and regulation and technology are lagging.

  In countries with a high level of external debt (either official or private), debt conversions programs may be encouraged.

  In more sophisticated developing countries, businesses tend to issue more specialized financial instruments to meet a larger number of savings requirements. In these countries, A.I.D. might help increase and broaden the ownership of companies and bring more investors - individual and institutions - into existing securities markets.

- Informal markets are especially important in A.I.D.-recipient countries because these markets provide the credit and savings mobilization functions for a major portion of A.I.D.'s target groups. Informal sector enterprises often face serious market access and entry barriers that need to be addressed. While informal markets can be efficient in many ways, it is still a highly segmented market that is limited in its supply of credit. These issues should be addressed within the framework of A.I.D.'s assistance to the financial sector as a whole. Rather than provide the informal sector with additional credit, methods of mobilizing savings and linkages between the two sectors should be encouraged.

- Lending programs and other financial sector activities should focus on sustainability in their design; indeed, this should be a prerequisite to A.I.D. support. Institutional capacity, loan spreads, and repayment rates are important considerations.

- Savings facilities are an important complement to credit and other financial services and should be a key part of any financial sector program. The lack of such facilities is a serious structural impediment to the success of any program as borrowers lack a facility to store value and hence repay loans.

- The United States' experience and expertise in financial markets make it well suited to provide such assistance to developing countries, especially in many dynamic and growing economies in the Asia and Near East region. The size and sophistication of its markets, its diverse regulatory framework and its technological expertise in related areas of telecommunications and information systems endow the United States with a strong comparative advantage in assisting developing countries in financial markets.

C. A.I.D. Policy Regarding Informal Sector Finance

The following two documents outline A.I.D.'s policy regarding informal sector finance:

- *Financial Markets Development* (PN-AAV-465, dated August 1988) focuses on the development of effective financial markets that are both horizontally and vertically integrated.

- *Microenterprise Development Program Guidelines* (PN-AAV-466, dated October 1988) offers guidelines for channeling resources within the informal sector to the poorest entrepreneurs.

Both documents discuss the role of the informal sector in financing the operations of the smallest enterprises and advocate the integration of small businesses and microenterprises with the formal financial system. A.I.D.'s policy with respect to interest rates, institution building and development, and lending through PVOs is also addressed. In addition, *Financial Markets Development* discusses credit allocation policies and savings mobilization.

Informal credit markets are part of a continuum of financial services that allow for capital mobilization and movement into productive activities with better than average rates of return. Accordingly, informal financial markets serve a wide spectrum of individuals, including the smallest and poorest businessmen who typically find access to formal credit and other services to be expensive or difficult (when the borrower's full transaction costs are included). In addition, informal markets contribute to the savings potential of formal markets and act as a "safety valve" whenever policy measures stifle the growth of formal markets. However, because informal financial markets operate without regulation and outside the realm of macroeconomic policies, there is some concern that the informal sector may also create market segmentation and monopolies, with informal lenders earning disproportionate profits.

A.I.D. Missions need to formulate strategies that deal with a comprehensive approach to financial market development, rather than trying to support informal markets in isolation. Potential A.I.D. assistance to the informal sector includes:

- Projects that help to improve the operations and efficiency of financial markets in general

- Projects that foster business relationships between formal financial institutions and informal agents

- Projects that promote the establishment or expansion of intermediaries equipped to accommodate the credit needs of small borrowers and incorporate them in the formal sector.

Policy reform in the financial sector is clearly critical. Without an enabling policy environment and a stable macroeconomic framework, little improvement in the financial sector is possible. Enhancing the capability of intermediaries to operate in competitive markets is a beneficial use of A.I.D. resources. A.I.D. has worked with formal sector financial intermediaries and Private Voluntary Organization (PVO)-sponsored financial programs intended to serve small farmers and entrepreneurs. The use of PVOs and other intermediaries serving smaller borrowers and lenders has advantages due to their operational flexibility and direct knowledge of clients. These advantages need to be more fully exploited. The experience of these PVOs, whose characteristics often mimic those of informal lenders, can demonstrate to formal sector intermediaries the dynamics of efficient and profitable small-scale lending. PVOs can develop useful linkages with formal intermediaries and thus serve as the conduit for the flow of funds between the informal and formal sectors.

In this regard, the following points concerning financial markets should be kept in mind:

- Financial self-sufficiency, without recourse to subsidies, should be a primary goal for all intermediaries.

- Interest rates on loans, either between A.I.D. and financial intermediaries or between the intermediaries and their clients, should cover the full cost of the loans, as well as ancillary administrative costs incurred in extending loans and other financial services.

- Savings generation must be one of the goals: dependence on external sources of funds is an important weakness contributing to the failure of many borrower-dominated or multi-technical and financial service institutions once donor support is withdrawn.

A.I.D. provides very specific guidance on credit allocation policies. Directed credit and differentiated interest rates are discouraged because they distort financial flows and undermine the viability of financial institutions. Instead, market-driven interest rates are encouraged, as is the use of flexible collateral requirements or higher interest and/or service rates to overcome the risk of lending without collateral. But this does not mean that institutions and instruments do not need to be promoted which serve particular client groups - as is the case with PVO credit programs frequently using group guarantees and screening mechanisms. As one A.I.D. official phrases it, the special groups need to be embedded in credit programs, not targeted.

A.I.D. considers savings mobilization to be a driving force behind any financial system and encourages combining savings and lending activities. This allows for greater financial viability, lower transactions costs, and lower loan delinquency rates for lending institutions. As savings are guaranteed, the host country will be faced with the need to subject these "new" institutions to some form of prudential regulation in order to prevent fraud or irresponsible investments of depositors' money. Any program which attempts large-scale savings mobilization needs prudential oversight. The concern is to balance that oversight with the demands of informal activity for flexibility. A.I.D. has not worked out specific policy for how this prudential oversight should be carried out for informal savings collectors but different and flexible approaches have been taken by different Missions.

1. A.I.D. Project Assistance in the Informal Sector in Sub-Saharan Africa

Since the late 1970s, A.I.D. has sponsored research, technical assistance, and credit activities in the informal sector. These activities have addressed the needs of populations in developing countries, particularly in the form of assistance to small savings and loan programs. As A.I.D.'s knowledge of the informal sector has developed, its assistance has become increasingly focused on building linkages between the formal and informal sectors and making these integrated elements in the financial system. Assistance to PVOs in Africa has been provided by A.I.D. to extend credit to informal sector enterprises. More programs that teach self-sustained credit and savings to existing PVOs will be very beneficial.

A.I.D. has sponsored the development of many research studies on the informal sector. During the late 1980s, for example, USAID/Dhaka and the Asian Development Bank financed a series of studies on the urban informal financial markets and industrial subsectors of Bangladesh[1]. The studies, covering nine subsectors, concluded that the introduction of new financial instruments, such as extended use of trade credit, would result in better integration of small business subsectors with mainstream financial markets[2].

Through GEMINI, A.I.D. sponsored a study in late 1990 of the Moroccan informal sector, assessing its magnitude and structure and recommending methods to transform informal activities into formal ones[3]. During 1988 and 1989, A.I.D. undertook a major "stock-taking" of its experience in microenterprise development, assessing alternative methods for delivering credit as well as technical assistance and training to informal sector businesses. The study, which covered 32 projects out of A.I.D.'s portfolio, discovered that most programs served a few hundred clients. Exceptions to this included some relatively large financial institutions. Three categories of programs were identified. Those that worked to get poor people to start enterprises, those that assisted existing microenterprises, and those that assisted the smaller informal enterprises to move into the formal sector. The programs assisting existing

[1] The case studies were undertaken by the Bangladesh Institute of Development Studies.

[2] The subsector studies covering construction, leather products, urban retail, overseas remittances, textiles, employees credit, and the gold jewelry trade—in conjunction with informal financing.

[3] GEMINI Technical Report Number 3, dated November 1990.

microenterprises were generally "minimalist" financial institutions. The other two categories were typically higher cost, harder to determine the impact of, but certainly important to a private sector development effort.

2. Other Informational Resources on the Informal Sector

An excellent publication for tracking trends across most donor agencies and academic institutions in research, theory and practical interventions in the informal sector is the quarterly review *Savings and Development*, published by the FINAFRICA Foundation of Milan. The review covers financial innovations worldwide and presents articles summarizing the findings and conclusions of forthcoming studies, as well as revised versions of papers presented at seminars. It includes papers presented at A.I.D.-sponsored seminars. The Agricultural Economics Department of Ohio State University also publishes extensive material and maintains bibliographies on informal financial markets.

Between 1986 and 1989, the Asian Development Bank was involved in a series of case studies on the informal financial systems (rural and urban) of Bangladesh, India, Indonesia, the Philippines, and Thailand. Though these countries use diverse informal sector financing agents and have varying policy orientations, legal environments and degrees of integration and interaction with the formal sector, a common set of issues were studied, thus allowing for a comparative analysis. The ADB study concluded that informal financial actors needed to be linked with formal sector ones; formal sector actors needed to mimic the promising characteristics of informal actors; and that some prudential regulation, particularly in the savings area, was required.

In preparation for a 1987 conference in Honolulu on "Domestic Savings Mobilization through the Formal and Informal Sectors," the OECD sponsored case studies on India, Indonesia, and the Philippines. In April 1991 the OECD Development Center published a study on financial dualism in developing countries. The study suggests that financial dualism can be explained by financial repression in the formal sector. The report recommended the financial integration and interlinkage of the formal and informal sector, as well as the preservation and use of those characteristics which constitute its strength and the elimination of its negative characteristics.

V. A.I.D. MISSION EXPERIENCE IN FINANCIAL MARKETS DEVELOPMENT

A. An Overview of A.I.D.'s Financial Sector Interventions

A significant portion of A.I.D.'s resources are oriented toward supporting the financial sector in developing countries. In fact, an estimated eleven percent of all funds obligated by A.I.D. in 1990 supported financial sector development. The purpose of this chapter of the guidebook is to describe the types of interventions A.I.D. Missions have undertaken in the financial sector over the past decade, as well as some of the key trends in the Agency's financial markets programs.

In order to obtain an overview of A.I.D.'s programs, the Bureau for Africa compiled summary descriptions of many of the Agency's interventions in the financial sector from 1980 to 1991. Descriptions of projects and programs were drawn from the data base of activities created by the Center for Development Information and Evaluation (CDIE). Given that the data base is coded by key words, it is possible that some projects with significant financial sector interventions may not have been included. Nonetheless, the data base contained nearly 200 projects funded by A.I.D. since 1980 that have had significant interventions in the financial sector.

Project interventions were then classified in accordance with the categories of financial sector activities described in Chapter III of this guidebook. Two additional categories, Microenterprise Development and Directed Credit, were added because of their importance in the A.I.D. portfolio of financial sector activities over the past decade. The categories in which A.I.D. interventions were classified include:

- Policy Reform
- Commercial Banking
- Securities Markets
- Financial Information
- Other Financial Institutions
- Privatization
- Microenterprise Development
- Directed Credit

Since many of A.I.D.'s projects are multi-faceted, a single project often has activities in several of these categories. For this reason, the African Bureau classified the financial sector projects in terms of "interventions." For example, a project which creates and agricultural loan fund and provides institutional assistance to the bank managing the fund would be classified as having interventions in two categories, directed credit and commercial banking. Table 1 below shows financial sector interventions by region. Table 2 compares the types of interventions undertaken from 1980-1985 with those form 1986 to 1991.

There are limitations to looking at the numbers of "interventions" in each category, as opposed to dollar resources. For example, there were 93 financial sectors interventions in the Africa region over the decade, the second largest number interventions in an A.I.D. region.

Despite these limitations, the data does provide some telling results and help to illustrate the types of financial sector interventions A.I.D. has undertaken and how interventions have changed over time. To summarize some of the key results:

- Directed credit is by far the most significant category in terms of the number of A.I.D. interventions. The number of directed credit interventions would appear to be diminishing over time, yet it remains an important type of intervention.

- The interventions supporting the development of "other financial institutions" also dropped significantly. This category includes assistance to development finance institutions and credit unions, both of which have tapered off in number.

- Commercial banking interventions declined. This drop can be attributed in large part to a decline in the number of projects in which A.I.D. has established credit funds. A.I.D.'s activities supporting institutional reform of banks have actually increased in number.

- Areas which are clearly growing in importance include policy reform, expansion of securities markets, and privatization. In the policy reform area, 11 of the 16 interventions occurred after 1986; in privatization, 11 of the 12 interventions occurred after 1986; and in the area of securities markets, 16 of the 22 interventions occurred after 1986.

- A.I.D. has supported few interventions in the category of financial information. All three of the interventions listed in the project data base were initiated before 1985.

The trends outlined above represent a change in A.I.D.'s focus in the financial sector over the past decade. The growing debt problems of developing countries and the subsequent lack of growth in the 1980s drew attention to the importance of financial markets development to the overall development process. Within the donor community, new emphasis has been placed on policy reform and private sector growth as vehicles for development assistance. Efforts undertaken after 1986 represent, by and large, an effort to strengthen the development of financial markets and their role of intermediation in the development process. The nature of these efforts is examined in greater depth in the following section.

B. A.I.D. Financial Sector Interventions

1. Policy Reform

Financial market policy reforms generally seek to achieve three objectives: (a) to create a "level playing field"; (b) to reduce the role of the state and leave economic choices and risks to market participants; and (c) to strengthen government's ability to formulate and implement sound monetary and fiscal policy.

In recent year, a growing number of A.I.D. programs have accorded cash transfers to governments to assist them in the transition period following policy reform. **The African Economic Policy Reform Program (AEPRP)** was specifically created for this purpose. Under the umbrella of the AEPRP, a number of country-specific programs have been developed to support economic policy reforms in Africa. **The Costa Rica Cash Transfer Program** also developed a cash transfer program that is tied to financial sector policy reforms. The program helped private banks gain guaranteed access to a greater proportion of Central Bank funding and encouraged policy changes that relaxed restriction on deposits. A.I.D. cash transfer conditionality also encouraged the reform of the Central Bank Law that opened a direct rediscount operations window in the Central Bank. Several people interviewed for the evaluation of this project indicated that financial market liberalization would have been implemented in Costa Rica eventually, but that the A.I.D. conditionality provisions facilitated the process.

Many missions have been able to play a critical role at the policy dialogue table. This often takes the form of conducting background studies on the types of reforms required; both the **Near East Regional Private Enterprise Support Project** and the **Macroeconomic Analysis Project in Ecuador** are examples of this type of approach.

USAID/Lesotho sponsored a technical assistance effort to evaluate the structure of the country's economy and financial markets. The technician focused on constraints caused by the dependence of Lesotho's economy on that of the Republic of South Africa, since this dependence affects the formulation and execution of fiscal and monetary policies. A number of measures were recommended for the monetary authorities in Lesotho could undertake to facilitate the provision of credit for agricultural activities. The recommendations included: introducing graduated payment obligations or tailoring loan repayments to borrower's capabilities, instituting refinancing arrangements, and establishing tax incentives to certain types of activities.

Since A.I.D. is usually unable to provide the large loans that the World Bank and the regional development banks often provide, collaborative approaches enable each of the actors in the effort to concentrate their resources on select policy or technical assistance requirements; A.I.D. often best assists by focusing on a small part of the reform program, aiding with technical assistance while providing overall financial support.

The Bangladesh Financial Sector Credit Technical Assistance project is an excellent example of the value of collaborative efforts between A.I.D. and other donor institutions in supporting policy reform. The Bangladesh Government initiated a major financial sector reform program in the late 1980s. The World Bank (International Development Association), USAID/Bangladesh, and the IMF jointly agreed to support the government's reform program.

Close collaboration at the design phase and "parallel financing" of various components enabled each institution to provide assistance to support the government's reform efforts. As described in the Project Identification Document, the World Bank/IDA was to provide $175-200 million over a three year period as the Government of Bangladesh met specific certain policy targets. USAID Bangladesh was to finance the technical assistance needed to implement the necessary reforms. The International Monetary Fund was to provide additional technical assistance to help the Bangladesh Bank develop monetary policy and to strengthen supervision of the financial system.

Another example of a multi-donor effort is the **Economic Policy Reform Program** in The Gambia. In 1987, A.I.D. provided The Gambia with a $6 million grant to support a series of financial and agricultural marketing reforms. The sectoral reforms were designed to encourage greater private sector involvement in productive activities and discourage the Government from regulating and controlling activities that could most efficiently be done by the private sector. Specifically, the Government of Gambia agreed to: implement appropriate policies regarding term lending, agricultural credit, and development lending; enforce market-determined interest rates; prohibit preferential access to credit; and ensure equal allowances for all buyers involved in agricultural marketing.

2. Commercial Banking

Non-directed credit lines place with commercial banks constitute a large portion of A.I.D.'s interventions in the commercial banking sector. Such interventions are, and will continue to be, an important part of A.I.D. development assistance, providing liquidity and foreign exchange reserves. At a time when the indebtedness of developing countries continues to grow, such programs are a necessary part of international assistance. The size of such programs, however, will clearly not be sufficient to stem the problem of international capital flows from developing countries.

In order to assist developing countries to better mobilize their own resources, A.I.D. has increasingly focused on developing financial skills in the commercial banking sector. **USAID/Costa Rica's Training for Private Sector Development** was designed to provide training for officials form private banks, as well as officials form the Costa Rican Central Bank, including professionals within the Banking Audit Authority. Financial offices will receive financial systems training in the U.S. and in-country. Similarly, **USAID Ecuador's Financial Sector Training** provided a grant to the "Instituto de Practicas Bancarias y

Financieras" to strengthen its training programs for financial personnel from the private and public sectors.

Selected missions have worked toward promoting a more active role for the private sector in banking, while strengthening the ability of the public sector to set appropriate policies and regulations. For example, under the **African Economic Policy Reform Program Grant**, A.I.D. initiated a program to assist the Government of Senegal strengthen private sector banking. The five tranches of this $32 million sector grant are conditional upon the Government of Senegal meeting the following goals:

- reduce state ownership to less than 25% of any bank;
- improve bank management and credit allocation by allowing managers to make personnel and lending decisions without government interference;
- reorganize, consolidate, and/or close illiquid or insolvent banks;
- establish targets and timetables for recoveries of bad debt;
- reduce taxation on savings; and
- increase the frequency of inspections and improve banking supervision.

As a complement to the program described above, USAID/Senegal mission designed the **Banking Sector Reform Program** The aim of this program was to provide the necessary technical assistance to reform the Senegalese banking sector. More specifically, the project is designed to fund assistance in areas such as accelerated recovery of bad debt, improved bank management, and bank privatization.

A somewhat unique intervention in the commercial banking sector is USAID/Bolivia's project, **Strengthening Financial Markets.** This is a $6 million project to establish a Bolivian Deposit Insurance Fund. The Fund was to be created as an independent public corporation to insure deposits in commercial banks; in cooperation with the Superintendency of Banks, (which is being established under a World Bank project), it was also intervene to prevent the failure of weak intermediate credit institutions.

3. Expansion of Securities Markets

Improving access to funds through the provision of debt and equity instruments is an important part of A.I.D.'s financial markets development strategy. However, securities markets development is a new field for A.I.D.; as noted previously, 16 of 22 interventions in this area have occurred since 1986. The growing need to mobilize domestic capital and to deepen financial markets have resulted in increased interest in the development of securities markets.

In the forefront of developing programs to stimulate securities markets is USAID/Indonesia. The mission's $9 million Financial Markets Development Project was developed in response to the impediments lack of finance place on the growth of the Indonesian private sector. There was an extremely limited number of securities traded in the money and capital markets in Indonesia and virtually no active secondary markets. Most companies were highly leveraged due to the need to rely exclusively on short-term debt financing, and small firms were virtually unable to obtain finance.

The purpose of the Financial Markets Development Project is to increase the number of financial instruments available to investors -- including debt and equity securities and commodity contracts -- as well as the volume of trading in these instruments. The project is providing policy-based assistance to improve the environment for financial markets, and technical assistance/training to strengthen those institutions involved in financial markets development. Three resident advisors focus on capital markets development, specifically regulation of the markets, development of the trading/underwriting industry, and privatization of the stock exchange. A fourth long-term consultant focuses on money market development as a means of improving the Indonesian government's ability to execute monetary policy. In sum, the Financial Markets Project is clearly a departure form traditional A.I.D. interventions in that it aims to create new financing instruments for mobilizing capital, rather than relying on external sources of capital.

At the request of USAID/The Gambia, technical assistance was provided to analyze the feasibility of establishing a stock market in The Gambia since the absence of an equities market wa as an obstacle to privatization. The analysis determined that a stock market was presently not feasible. Analysts recommended alternatives to the establishment of an organized trading exchange, and offered strategies aimed at creating the necessary pre-conditions for equities trading at a future date. For example, the Central Bank is targeted to work with commercial banks to "open a window" for information and trading of publicly-owned shares.

In Uganda, USAID sponsored a securities project to assist the Kampala Stock Exchange in establishing a local group that includes the Governor of the Central Bank and has the approval of the President of Uganda. This group will target areas of possible assistance identified by USAID technicians to promote the stock exchange. Primary areas of emphasis will be on securities industry education adapted to local needs and conditions.

AID has also been active with pilot programs for venture capital in Thailand and several African countries. Venture capital funds usually provide funds to growth companies through purchase of equity in sufficient quantity to participate in the company's management for a period of time. This type of direct investment in company equity can initially by-pass stock markets through private placements and secondary markets. It may be a useful technique for addressing capital needs in countries with a less developed institutional base.

4. Financial Information

According to the CDIE date base, A.I.D. has financed very few interventions to improve the quality of financial information. All three financial information interventions occurred before 1986.

An example of a project which has focused on improving the quality of financial information is the **Egyptian Business Support and Investment Project.** This $9.1 million project linked activities to stimulate investment in long-term securities with strengthening the standards for accounting, auditing and financial reporting. The project provided assistance to the Syndicate of Commerce Professionals which would enable it to establish a financially self-sustaining accounting and auditing association. The aim of the association was to provide professional training, certify accountants and auditors, and develop professional standards for the accounting industry. The project also provided long and short-term overseas training for the professional staff of the Syndicate and private sector professionals. The Mission is currently providing support to the Syndicate through an umbrella private sector project.

5. Other Financial Institutions

Intermediary financial institutions are a prominent, albeit somewhat less than successful figure in the panoply of financial sector institutions serving developing countries. Some of these banks, namely development financial institutions (DFIs), have as their primary objective to promote economic growth and development through targeted lending, often on subsidized terms. In many cases, these institutions have been a privileged conduit for loans to state-owned enterprises, loans which have often never been repaid. A.I.D.'s Center for Development Information recently conducted an evaluation of development financial institutions. The evaluation found that DFIs have had limited success in reaching their target beneficiaries, few have achieved financial self-sufficiency, and that in general, DFI's have not been effective in contributing to financial markets development. Historically, A.I.D. has supported the creation and strengthening of development banks and other state-owned financial institutions. More recently, however, its attention has focused on promoting a larger role for the private sector in banking and finance and curtailing that of the public sector.

Traditionally, A.I.D. has also provided support for credit unions and cooperatives. A large number of projects have been undertaken in this area, particularly in Africa and Latin America. USAID/Malawi, for example, has worked closely with both the **Malawi Union of Saving and Credit Cooperatives (MUSCCO)** and INDEFUND, a development finance institute. With USAID support, MUSCCO provided savings and credit services to 79 Malawian villages, most of which had no other formal credit sources.

A.I.D. has also supported venture capital activities in Africa. Under the Africa Bureau's **Africa Venture Capital Project (AVCP)**, which is managed by Harvey and Company, A.I.D. seeks to promote growth of the small and medium size private sector enterprises in Sub-Saharan Africa through the effective use of venture - risk - capital. Two of the most prominent grants that have been awarded under the AVCP have been awarded to the Commonwealth Development Corporation (CDC) to start venture capital companies in Ghana and Tanzania. The Ghana Venture Capital Fund became operational in November 1992 with investment capital over $2 million of which more than 50% is from six local institutional and corporate investors. Planning for the Tanzania Venture Capital Fund began in early 1992 leading to an AVCP grant to CDC in December 1992; formation and incorporation of a management company occurred in June 1993; and, the Fund is expected to be launched in October 1993.

6. Privatization

Privatization represents a relatively new focus for the Agency. A.I.D. has encouraged a process of privatization for several reasons: (1) and influx of capital is often required to restructure state-owned firms; (2) private management is thought to be more efficient; (3) private risk is an insurance for the commonweal against poor economic decision making on the part of individuals. Moreover, the privatization process has important financial sector implications; it can promote capital mobilization, spread the ownership of assets among a broader segment of the population, and contribute to the development of a securities market.

In The Gambia A.I.D. provided assistance in designing the management, operation, and structure of the Asset Management Recovery Company. The creation of this company is expected to reduce the heavy financial cost of privatization of the Gambian Commercial and Development Bank. The sale of the assets and deposits of the GCDB raises the number of privately owned banks in The Gambia to four and is expected to result in a gradual reduction in the structure of interest rates. (Please see Annex B for more information on The Gambia.)

USAID's Private Sector Policy Support Project in Sri Lanka is illustrative of missions' efforts to integrate capital markets development with privatization. The project's design includes four components; one supports privatization by providing assistance to the Sri Lankan Presidential Commission on Privatization, while another provides assistance for capital markets development via the Securities Council and the Columbo Securities Exchange. While these are separate and distinct components of the project, many of project's activities serve to promote both capital markets development and privatization. For example, the project planned to fund the design of a public education/publicity campaign to stimulate public interest in purchasing shares of privatized firms. This activity would serve to strengthen the Securities Exchange, mobilize resources for the privatization effort, and generate broader interest among investors in newly privatized firms.

USAID/Tunisia also closely tied its privatization program to the development of financial markets. Although the mission's top priority was privatization, interventions to promote financial markets development were perceived as an essential corollary to privatization, and hence were identified as the Mission's second priority for its **Private Sector Development and Technology Transfer Project.**

Through a buy-in to the Center for Privatization, a centrally-funded project in the Bureau for Asia and Private Enterprise, the Mission provided a long-term advisor to assist the Office of the Prime Minister in Tunisia. The aim was to provide confidential advice to promote changes in the legal, regulatory, and institutional environment affecting privatization. The project provided assistance in privatization planning, financial analysis, company valuation, the marketing of public enterprises, and the financing arrangement involved in privatization. Long and short-term technical expertise was also provided the stock exchange to activate securities trading.

USAID Tunisia's experience in private sector development bears important lessons, particularly for missions with limited resources. It focused its resources on a limited number of areas in which the government and the private sector had a keen interest and a serious commitment. Moreover, the missions targeted private sector activities that would be mutually reinforcing -- such as privatization and financial markets -- to ensure maximum impact with limited resources.

7. Microenterprise Development

Microenterprise interventions have been and will continue to be an important element of A.I.D.'s development programs and projects. Many microenterprise related interventions have a strong financial sector component, in addition to providing technical services and training. Indeed, in 1990, half of total funding obligated to microenterprise programs was heavily oriented toward credit; most of the remainder was evenly divided between training and technical assistance to microentrepreneurs. Increased emphasis on credit has been a trend since 1988; hence, microenterprise programs are clearly important to examine in the context of reviewing A.I.D.'s experience in the financial sector.

The types of microenterprise programs supported by A.I.D. vary widely by region. As noted in the most recent report to Congress on the Agency's microenterprise activities, A.I.D.'s support to microenterprise has always been strong in Latin America and the Caribbean, and it has tended to focus primarily on credit. Most Latin American countries have developed institutions that are able to deliver credit; now, the major challenge is to build institutions that can expand by attracting commercial sources of funding and mobilizing savings. The Inter-American Development Bank is planning loan projects that are less concessional than many intermediary institutions have used in the past; A.I.D.'s strength is to provide technical assistance and institutional support to help institutions use the loan effectively.

Nearly every major A.I.D. Mission in Africa carries out some microenterprise activity. However, financial sector interventions play a less critical role in the context of Africa because few institutions have the capacity to issue large number of loans. While several successful credit program has been initiated with A.I.D. funding in recent years, a much higher percentage of A.I.D. funds goes to training, technical assistance an institutional support in Africa.

Microenterprise program are also important in selected countries of the Asia and Near East region, in particular, Egypt, Indonesia, Bangladesh, Sri Lanka and the Philippines. The mission in Indonesia has been very successful in helping to build financial systems capable of lending to the smallest enterprises. Its Financial Institutions Development Project (FID) is particularly noteworthy because of its focus on mobilizing domestic resources as a means toward expanding the availability of credit for small borrowers.

The project was designed on the basis of several key premises. First, market interest rates must prevail for a credit program to be sustainable. Secondly, general credit programs are more market-oriented and thus more sustainable than targeted credit. Thirdly, savings is the flip-side of investment, and a necessary companion to credit programs; and lastly, technical assistance and training are at least as important as system capitalization for creating a rural banking system.

Phase I of the FID project ($22 million) was initiated in 1984 and is providing assistance to help rural banking systems become self-sustaining operations based on commercial banking principles. The project has strengthened operational and accounting procedures, improved auditing, inspection, and supervision; developed a reliable management information system; and established an efficient saving system. The fact that savings now represent 90% of the value of the loan portfolio is an important indicator of the progress toward self-sustainability.

The second phase of the project ($16 million) has used a similar model of assistance to assist the nation-wide Bank Rakyat Indonesia establish a network of village-level credit and savings outlets which are now self-sustaining and profitable. The result is the development of one of the few financial systems in the developing world that is capable of reaching even the very poor.

One of the many important lessons of the Indonesia FID project is that subsidized credit programs often destroy the incentive for mobilizing capital in an economy; indeed, moving to a system based on market-rate lending appears to have been the key toward giving rural banks a real incentive to mobilize their own lending capital. While market rated of interest appear high, loan repayment has not been a problem in either phase of the FID Project. Access to credit appears to be far more important than its price and has been the key ingredient for expanding microenterprise finance in rural areas.

8. Directed Credit

Directed credit is the classification representing the largest share of interventions, indeed 28 percent of all interventions over the past decade. There was significant fall in the number of directed credit interventions after 1986, a trend which is indicative of the Agency's reorientation toward comprehensive financial markets approaches in the mid to late 1980s.

A.I.D.'s financial markets policy explicitly discourages excessive reliance on directed credit. As stated in the policy document, over-reliance on directed credit often results in severe misallocations of scarce investment resources that undermine the strength and viability of financial institutions and retard the growth of financial assets. This is in part because directed credit programs have often involved high subsidies, which are clearly unsustainable over the long-term.

The Agency's focus on creating efficient and sustainable financial systems suggests new approaches toward the development of credit mechanisms -- mechanisms that are based on market rates of interest that allocate credit to its most productive use. Some forms of directed credit continue to be employed in order to encourage financial institutions to reach the unmet needs of selected target groups, such as small and microenterprises. However, the terms on which these programs are being developed are clearly different and emphasize the development of financially-sustainable credit mechanisms.

C. Conclusion: Trends in A.I.D. Programming for Financial Markets Development

A.I.D. has a long history of support for financial markets development efforts worldwide; however, the nature of this support has changed considerably over time. It is difficult to generalize about the evolution of A.I.D.'s financial sector portfolio given the variety of environments in which the Agency operates. However, several different patterns are beginning to emerge. Based on the examination of the Agency's involvement in the different areas of financial sector development described earlier in this chapter, the following principal trends have been identified:

- A Shift from Directed Credit Programs to Comprehensive and Systemic Development of Financial Markets
- Clearer Definition of Appropriate Roles for the Public and Private Sectors in Financial Markets Development
- Integration of the Linkages Between Financial Markets and Privatization in Project Design and Implementation
- Greater Recognition of the Importance of Informal Financial Markets
- Closer Collaboration with other International Donors.

Each of these trends is examined briefly below.

1. A Shift form Directed Credit Programs to Comprehensive and Systemic Development of Financial Markets

While A.I.D. has long been involved in promoting financial sector development, the nature of these activities has clearly evolved over time. Until recently, the focus of the Agency's financial sector interventions was primarily on the delivery of financial resources. Many of A.I.D.'s financial sector interventions involved directing credit to specific target sectors or groups, at times at subsidized rates, or creating institutions which could serve as vehicles for providing credit. With respect to private sector activities, A.I.D. most often addressed financial constraints and market imperfections by providing loans to governments for on-lending to local businesses through various intermediary financial institutions.

While filing a critical gap in the supply of credit, these approached rarely addressed the other side of the financial market equation: the mobilization of financial resources. The capacity to mobilize resources has become more crucial in recent years given the limited flow of foreign private and international donor funds to developing countries. As a result, developing countries must rely more than ever before on their own capital market to finance economic growth.

Moreover, these early approaches often led to greater government involvement in the formulation of financial sector policy, and failed to address some of the fundamental causes of inadequate capital mobilization. These fundamental problems, which rest primarily on the legal and regulatory framework and the macroeconomic policy environment in each county, have been discussed in detail in early sections of this report and need not be repeated her. The point is that, given global changes in the mobilization of financial resources and increased awareness of the importance of the policy and institutional frame work to financial markets development, A.I.D. is making a conscious effort to adopt a more comprehensive approach to financial markets that addresses the core problems limiting efficient capital mobilization and allocation in developing economies.

The many project reviewed in the course of preparing this report indicate that A.I.D. has been re-directing its efforts in financial markets development away form directed credit interventions and towards "holistic" approached that address different aspects of financial markets development. This approach has let to greater emphasis on the following activities in the design and implementation of A.I.D. projects and programs:

- Establishing a policy and institutional environment that is conducive to financial markets development:

  A.I.D. programs and projects pay increased attention to policy dialogue directed at change in macroeconomic policy. The main message to LDC governments is to liberalize policies in order to create a "level playing field" and eliminate distortions in prices and interest rates. More recently, A.I.D. has also begun to emphasize the role of laws and regulations on capital mobilization and economic development in general. As a result, more attention is being given to the "institutional" framework that governs financial and capital markets.

- Strengthening private financial institutions:

  The focus of institutional building efforts in the financial arena has shifted away from public sector development banks and other para-statal financial institutions and toward increased reliance on private intermediary financial institutions. Thus, training programs, technical assistance, and loans and guarantees are provided directly to private IFI's. Moreover, the terms of A.I.D. loans are more likely to reflect market rates of interest and project efforts are increasingly directed at existing institutions rather that at creating new institutions. The end goal is to create private, competitive financial institutions that can effectively mobilize saving and allocate those saving to the most productive investments.

- Mobilizing domestic saving through creation of alternative financial instruments an mechanisms:

  Financial innovation is an increasingly important emphasis in the design of A.I.D. projects and programs. This comes form recognition the domestic resources needs to be mobilized in light of cutbacks in international private and public flows of capital. Thus, A.I.D. has become more interested in enhancing opportunities for venture capital, developing specialized financial instruments, and promoting development of securities markets in conducive environments.

The four trends discussed below also form part of this comprehensive approach to financial markets development.

2. Clearer Definition of Appropriate Roles for the Public and Private Sectors in Financial Markets Development

Since 1981, A.I.D. has made a clear commitment to use the private sector as the primary mechanism for economic development. It has taken some time, however, to grasp exactly how AID assistance should be channelled to the private sector and what the role of the public sector should be. In the financial markets arena, A.I.D. has recognized the important relationship between private sector growth and financial markets development, and between them and the macroeconomic policy and institutional environment.

An environment that supports private enterprise development is a necessary condition for success of financial and capital markets development efforts. Financial and capital markets sere the dual purposes of encouraging savings and providing a channel for directing those savings into investments that finance the growth of private enterprises. A favorable climate for business formation and expansion will promote the development of financial and capital markets as businesses seek ways to obtain financing. Conversely, financial and capital markets will not grow in an environment in which political turmoil, tax policies, regulations, or laws discourage formation of new companies, or expansion of existing enterprises.

A.I.D. has adopted a policy that supports financial liberalization and deregulation. The emphasis is on curtailing the role of the public sector in the mobilization and direction of financial resources. The role of the state is more that of a "guarantor" who much ensure the appropriate policy and institutional framework to enable financial markets to operate efficiently. Moreover, as mentioned earlier, institutional building efforts seek to strengthen private intermediary financial institutions. A.I.D. is no longer interested in creating or supporting state-owned development banks. On the contrary, it is encouraging the privatization of state-owned banks and para-statal financial institutions. It is the role of the private sector then to mobilize and channel financial resources, and to direct economic activity.

3. Integration of the Linkages Between Financial Markets and Privatization in Project Design and Implementation

Financial markets development and privatization are inter-dependent and often mutually reinforcing. Indeed, as noted in Chapter III of this guidebook, the very reforms which strengthen financial markets can also contribute to the success of privatization.

An efficient and well-functioning capital market is critical for successful privatization, in part, because buyers of state-owned enterprises need access to long-term finance to purchase and restructure newly privatized firms. Moreover, financial markets provide a mechanism for transferring equity form the public to the private sector, particularly if privatization is to provide wide-spread benefits. The danger of promoting privatization without well-functioning capital markets in that the beneficiaries are more likely to be limited to a few families or institutional investors.

Conversely, privatization programs reinforce financial markets development. In selling shares to the public, privatization stimulates the mobilization of capital, which can then be used as a source of investment for enterprise development. Privatization is also a vehicle for stimulating the development of a local stock exchange. In privatizing a few large enterprises, a country can rapidly increase stock market activity and draw new investors into the market.

An explicit recognition of the strong links between financial markets, privatization, and overall private sector development is thus a growing trend in the design and implementation of A.I.D. programs. Indeed, few Missions are attempting to engage in financial markets development without some effort to promote privatization, or vice versa; the ties between financial markets development and privatization are often well-integrated into the design of Mission's private sector programs.

4. Greater Recognition of the Role and Importance of Informal Financial Markets

In recent years, increased attention has been given to the role and contributions of the informal; sector, and to the importance of informal financial markets. As mentioned earlier, informal financial markets facilitate capital mobilization for productive activities with better than average rates of return. They serve a wide spectrum of individuals, especially small and miroentrepreneurs with very limited access to formal credit and other services. These individual entrepreneurs have been, and will continue to be, an important focus of A.I.D. programming. Thus, informal credit markets are becoming the focus of increasing financial sector interventions by A.I.D.

It is known that informal financial markets mobilize large sums of capital, including billions in foreign remittances form overseas workers. Tapping these resources is an increasingly important objective of A.I.D. programs. To accomplish this, A.I.D. is exploring the linkages between formal and informal financial and designing programs that support informal markets as part of a comprehensive approach to financial markets development. Indeed, A.I.D. currently has a number of centrally-funded and mission-funded projects that are highly innovative and offer important opportunities for exploring and promoting the integration of informal and formal financial markets.

5. Closer Collaboration with other International Donors

The comprehensive nature of the effort needed to develop financial markets in developing countries presents significant opportunities for collaboration between A.I.D. and other international donors and U.S. government agencies. Clearly, "donor coordination" has long been a laudable objective in development assistance; however, it has also proven to be a difficult objective to put into practice. In light of these difficulties, the trend toward increased donor collaboration in the area of financial markets development is particularly noteworthy.

One factor which may contribute to increased collaboration in the area of financial markets development is that each of the relevant institutions brings a unique approach and unique types of resources and capabilities. Collaborative efforts offer an opportunity to exploit the comparative advantage of each institution's approach to financial markets development.

A.I.D., for example, enjoys a comparative advantage in its world-wide network of field Missions (and consequent close relations with the public and private sectors in host countries), bolstered by an even broader access to technical assistance. The Agency can provide access to U.S. technology and expertise in financial markets development which, with few exceptions, is regarded by developing countries as the most advanced in the world. The most appropriate areas for A.I.D. assistance generally fall into the following areas: (a) analysis of the policies needed for financial markets development; (2) assistance to local governments in implementing policy reform; and (3) institutional strengthening.

The regulations governing financial assistance prohibit A.I.D. from taking an equity position in an enterprise or capitalizing an entity in any direct way. Therefore, with few exceptions, A.I.D. must leave the formation of investment funds and direct participation in private ventures to donors such as the I.F.C., OPIC and the private sector. Moreover, A.I.D. is usually unable to provide the large loans that the World Bank and the regional development banks often provide. As a result, it frequently is not in a strong position to impose the conditions that the major international leaders include in their loan agreements to achieve desired reforms. While the availability of EFS assistance provides A.I.D. with some leverage, the amounts involved are often small relative to the resources provided by other donors.

Join and cooperative agreements with other agencies can increase the relative leverage of A.I.D. in imposing the conditions necessary for development of financial markets. Furthermore, they enable each of the participants in the effort to concentrate their resources on key policy or technical assistance requirements. Lastly, unity of interest among donors strengthens the case for policy reform, which can then be applied in negotiations with developing country governments.

The process of collaboration between A.I.D. and other institutions has begun. However, there is no doubt that increased collaboration would be to the benefit of each institution and the countries in which they work. The policies and programs of other international donors and other U.S. government agencies -- as well as the opportunities for increased coordination -- are examined in greater detail in the following chapter.

D. Classification of A.I.D. Interventions

A classification of A.I.D. interventions is useful in creating a common conceptual framework for A.I.D. financial markets programming. It also helps in discerning potential linkage between financial markets activities.

The suggested classification for A.I.D. financial markets interventions consists of four categories:

- Strengthening the Enabling Environment
- Institutional Strengthening
- Technology transfer
- Transactions assistance.

While these categories are somewhat artificial and overlapping, they are commonly used in describing other types of A.I.D. development assistance, and thus are discussed here.

Strengthening the Enabling Environment refers to measures taken to create a legal, regulatory and macroeconomic environment that is conducive to financial market growth. Practices and policies which suppress financial market development are common in many developing countries. Examples of A.I.D. interventions in this category include preparing studies, engaging in policy dialogue and providing technical assistance to reform or strengthen fiscal and monetary policies, update securities markets laws and regulations and improve accounting and auditing standards and develop debt reduction programs.

Institutional strengthening involves efforts to develop new institutions and to improve existing institutions through technical assistance and training. Institutional strengthening may be as bold as creating new financial markets intermediaries (such as mutual fund companies or credit rating agencies) or as fundamental to the smooth functioning of financial markets as providing training to bank supervisors and securities markets regulators. Programs to strengthen the enabling environment, such as the reform of securities markets laws and regulations, may require an institutional strengthening component in order for the government authorities to be able to carry out their new responsibilities. These two categories of intervention are highly complementary.

Technology transfer denotes the introduction of new financial instruments and mechanisms in developing counties. Examples of A.I.D. interventions in this category include examining the markets for leasing and venture capital and acting as a catalyst in developing such new activities. Before attempting the transfer of new financial markets technologies, improvements may be necessary in the enabling environment; laws regarding property rights and collateral, for example, may need to be revised. A.I.D. might also engage in institutional strengthening in order to create the entities capable of launching these new operations.

The **transactions assistance** classification entails facilitating the mobilization of financial resources, such as for the restructuring of insolvent banks, the privatization of public enterprises and support for innovative venture capital deal-making. A/PRE's Private Sector Revolving Fund is another good example of this type of activity.

Figure 2 provides an overview of possible A.I.D. interventions in each of the following areas:

- Macroeconomic Policy
- Commercial Banking
- Expansion of Securities Markets
- Quality of Financial Information
- Other Financial Institutions

- Privatization.

These and other possible A.I.D. interventions are described in Chapter III. Financial Markets Development: Potential Areas for A.I.D. Activities.

CLASSIFICATION OF A.I.D. INTERVENTIONS

TASKS	CLASSIFICATIONS: STRENGTHEN ENABLING ENVIRONMENT	INSTITUTIONAL STRENGTHENING	TECHNOLOGY TRANSFER	TRANSACTION ASSISTANCE
C. EXPANSION OF SECURITIES MARKETS (CONTINUED)				
o Examine market for mutual funds, act as catalyst in developing prototype fund			X	
o Sponsor seminars on new financial instruments			X	
o Conduct feasibility for the development of a credit rating agency		X		
o Examine climate for venture capital, support the development of venture capital operations			X	X
o Provide technical assistance in introducing new contractual savings products			X	
D. QUALITY OF FINANCIAL INFORMATION				
o Provide t.a. in developing or improving accounting, auditing standards	X			
o Support training programs for accountants and auditors and the development of professional associations		X		
E. OTHER FINANCIAL INSTITUTIONS				
o Design programs to strengthen the organization and management of DFIs and credit unions		X		
o Support training programs for DFI and credit union staff in credit analysis, accounting		X		
F. PRIVATIZATION				
o Conduct policy dialogue on legislation necessary to facilitate privatization	X			
o Facilitate the design of privatization strategy	X			
o Conduct financial and operational appraisals of firms				X
o Define alternatives for transferring ownership and aid in selection, implementation				X
o Assist in establishing capability to monitor privatization process on ongoing basis		X		

CLASSIFICATION OF A.I.D. INTERVENTIONS

TASKS	CLASSIFICATIONS: STRENGTHEN ENABLING ENVIRONMENT	INSTITUTIONAL STRENGTHENING	TECHNOLOGY TRANSFER	TRANSACTION ASSISTANCE
A. MACROECONOMIC POLICY				
o Conduct study, policy dialogue on tax reform	X			
o Provide training/t.a. in budget preparation		X		
o Conduct study, policy dialogue on creation of a secondary market for government debt instruments	X			
o Conduct study, policy dialogue on simplifying and liberalizing foreign exchange controls	X			
o Debt Reduction Programs	X			X
B. COMMERCIAL BANKING				
o Conduct study of effectiveness of bank supervisory system	X			
o Provide training/t.a. in bank supervision		X		
o Assist in restructuring weak or insolvent banks		X		X
o Conduct banking legislative review and policy dialogue	X			
o Prepare a feasibility study and business plan for the creation of a credit information bureau		X		
o Support training in credit and financial analysis		X		
o Conduct study, policy dialogue on developing deposit insurance agency; assist in establishing one	X	X		
o Examine market for leasing, act as catalyst in developing prototype leasing operation			X	X
C. EXPANSION OF SECURITIES MARKETS				
o Review securities markets laws and regulations, conduct policy dialogue	X			
o Assist in establishing securities market regulatory agency		X		
o Recommend improvements in securities exchange organization		X		

VI. ROLE OF OTHER DONORS AND U.S. GOVERNMENT AGENCIES

This section discusses the international organizations that currently have ongoing financial market programs and organizations that possess the expertise to implement financial market programs. These entities fall into two broad categories: multilateral and regional development organizations, and agencies of the United States Government. Other donor countries have programs of their own, but they are not addressed in this section.

Included here are the financial market development activities of the World Bank and the International Finance Corporation, the IMF, and certain research and program activities of the United Nations. The activities of the United States Government are also covered, including those of The Overseas Private Investment Corporation, The Export Import Bank, The Securities and Exchange Commission, and The Federal Reserve System. Specific addresses and contact people for each of these institutions are contained in Chapter X, Technical Assistance and Training Resources in Financial Markets.

A. The World Bank

The World Bank's programs for financial market development are extensive and are expected to increase in the 1990's. Program activities encompass multiple objectives and large amounts of funding. The World Bank is active in programs that support macroeconomic adjustment, financial sector reform, strengthening of domestic financial institutions, provision of funds for on-lending, and increasing international capital flows through debt-reduction and co-financing programs.

1. Structural Adjustment Lending

Structural adjustment lending related to financial markets has focused primarily on exchange rate and interest rate liberalization, and more recently on assisting countries make the transition to a market-oriented system through privatization.

In recent years in response to financial system distress, The World Bank has increased the number of adjustment loans specifically targeted towards the financial sector. The objective of financial sector adjustment lending is (i) to develop well-functioning, competitive, market-oriented financial systems, (ii) to ensure that supportive legal and regulatory frameworks are in place and that supervisory institutions are strengthened, and (iii) to ward off the likelihood that financial systems insolvencies happen again.

These loans generally are quick-disbursing loans with accompanying loan conditions based upon targeted levels of macroeconomic performance. Each loan generally will include specific actions that are monitored by the bank over a 12-18 month period. Typical conditions for financial sector policy loans include the elimination of credit allocations, removal of barriers to entry, elimination of restrictions on bank activities, removal of taxes, improvement of information systems, and movement towards a more supportive legal, regulatory and administrative structure.

The use of funds varies from loan to loan, depending on the needs of the sector. A large proportion of the money has been used for financial restructuring of insolvent banks. More recent loans have had more meaningful technical assistance components. For example, a recent $66 million Financial System Modernization loan for Hungary contained a very large technical assistance component, as follows:

- <u>Hungary</u>
  - Technical assistance for changing legislation, regulations and bank supervisory practices. ($1.4 million);
  - Technical assistance and training for development of the securities market in collaboration with the IFC ($2.4 million);
  - Modernization of accounting and auditing standards ($0.8 million);
  - Technical assistance to banks for institutional development and restructuring, if necessary. (Budapest Bank, Commercial and Credit Bank, Hungarian Credit Bank, and National Savings Bank) ($34.9 million).
  - Technical assistance for bank infrastructure including a training center, bank clearing house, and a central bank information system ($19.7 million).

Structural adjustment loans with conditionality tied to the financial sector have been made in Algeria, Morocco, Tunisia, Turkey, Yugoslavia, and Pakistan. In the past two years the World Bank has approved financial sector adjustment loans totalling over $1.695 billion to Mexico, Bangladesh, Morocco, Bolivia, Pakistan, Senegal, Philippines, Venezuela, Kenya,and Hungary.

It is too early to tell how effective conditionality on financial sector adjustment loans will be. The bank is just beginning to conduct its own assessment and many of the reforms are long-term in nature. One important measure will be the effect of these conditions on the reduction in banking failures.

Expectations are that the World Bank will continue to make structural adjustment loans to the financial sector for the course of the decade. Over the next several years attention will be focused on operational and evaluation issues of these relatively new financial sector lending programs.

2. <u>Adjustment Lending for Debt Reduction</u>

In 1990 the World Bank began a program of debt-related structural adjustment lending where the reduction of principal and/or interest payments on a government's external debt was a primary objective of the loan. The objective of this type of lending is as a complement to adjustment operations, as a means to increase investor confidence in a country, and as a way to reduce and stem capital flight.

In 1990 four debt-reduction facilities totalling $1.3 billion were approved - for Mexico, Venezuela, Costa Rica and the Philippines. The Bank considers these loans as successes, but the true success, measured by the ability of the countries to obtain new loans and the medium-term growth of their economies, can't be determined for several years.

The four loans provided each country with debt-relief through combinations of new money, conversion of debt into discounted collateralized bonds or other similar securities, and debt buy-backs. In one case, Mexico, funds were also used to support interest payments. The Philippine agreement is summarized below:

- Philippines — The agreement offered banks the choice of selling debt to the government at 50 cents to the dollar or providing new money. In support of this agreement the World Bank approved a $200 million loan for the Philippines to buy-back some of its debts. This agreement allowed smaller commercial banks to reduce their Philippine exposure with a one-time loss and for the larger banks to provide new money and maintain the face value of their assets.

For debt-reductions, lending will continue to proceed on a case-by-case basis. New guidelines and funds have been set-aside to offer debt reductions from IDA funds.

3. Loans to Financial Intermediaries

Revised World Bank policy for loans to financial intermediaries now seeks to ensure that new loans will serve to strengthen financial institutions and the financial sector. Each loan is to include an assessment of the impact the loan is expected to have on the financial sector. This policy shift was laid out in a Task Force Report on Financial Operations in 1990 and currently is in the process of implementation.

4. Increasing International Capital Flows

The World Bank is active in programs that are designed to increase international capital flows. Several of these programs are designed to elicit support from the private sector, such as the Expanded Co-Financing Guaranty Program (ECO). The ECO program was designed to access not only commercial banking money, but also other sources of long term capital such as the bond and private placement markets. The program was started on a pilot basis in 1989 and was recently re-authorized to continue.

The Expanded Cofinancing Guaranty Program, or ECOs, is a credit enhancement program designed to increase developing countries' access to new sources of medium and long term private capital and, also, to leverage the direct lending capabilities of the World Bank.

Currently the program is available for World Bank supported projects only. Also the ECO program is available for countries that have not officially rescheduled their commercial bank debts. Under this program the bank assumes certain contingent obligations that reduce private lenders' risk of repayment. Contingent obligations usually take the form of partial guaranties of principal and/or interest on loans or bonds, but may also include guaranties of other financial instruments such as guaranties of letters of credit or standby lines of credit. An example of a completed transaction is as follows:

- Hungary — The World Bank issued a partial guarantee of a ten-year bond issue for the State Development Institute of Hungary, an executing agency under an existing World Bank project. The $200 million bond was structured as a ten-year bullet maturity. The World Bank issued a 100% guaranty of the full principal amount due in the tenth year. No interest payments were guaranteed. The World Bank will receive a guaranty of repayment from The Government of Hungary. The purchasers of the bond do not make any direct payments for the credit enhancement features.

To date the list of eligible countries numbers 15 and includes: Algeria, China, Colombia, Czechoslovakia, Fiji, Hungary, India, Indonesia, Malaysia, Pakistan, Papua New Guinea, Romania, Thailand, Tunisia and Turkey. Initially started as a pilot program, the ECO program has demonstrated to the World Bank its usefulness and has recently been re-authorized. It has the authority to issue up to $2 billion of contingent obligations, but to date has completed one $200 million transaction in Hungary. Several other transactions are under consideration.

B. The International Monetary Fund

The International Monetary Fund's purpose is to promote international monetary cooperation, international trade, and exchange stability. While its primary programs are its balance of payments lending programs, the IMF also provides technical assistance and training, principally through its Central Banking Department, but also in its Fiscal Affairs Department and Bureau of Statistics.

The objective of the Central Banking Department's technical assistance programs is to assist countries in strengthening their technical and organizational capabilities in managing monetary policy and in regulating and supervising financial systems.

In recent years, financial sector reforms and modernization of monetary policy instruments have become key features of many Fund-supported adjustment programs. A significant share of technical assistance (over 20%) is thus related to these financial structural and reform programs.

Most of the assistance provided by the Central Banking Department takes the form of staff advisory missions, assignment of long-term experts, and provision of information. In 1988/89 staff members undertook 31 advisory missions providing advice on a wide range of assignments. Over 100 long-term experts were in place in 1988/89. IMF Central Banking staff frequently are members of World Bank appraisal missions for financial sector reform loans.

Priority is given to assignments that serve to implement Fund-supported policies and reforms generally take the form of an advisory function rather than executive positions. Generally no more than three advisors can assist a country at any point in time. The training of counterparts is a standard part of most technical assistance and a key factor in the evaluation of the programs.

Representative assignments include the following:

- Nepal — An advisory mission prepared a report on the development of money and government securities markets which prompted the Nepal Rastra Bank to request further technical assistance to implement measures on treasury bill auctions, open market operations, pubic debt management, and develop institutional arrangements for a secondary market in treasury securities. An expert was assigned for six months as Advisor on Market Operations.

- Tunisia — Two advisory missions to review the financial liberalization program were conducted. The first mission reviewed ways to improve the functioning of the money market and advised on the introduction of treasury bills. The second mission focused on ways to improve the regulatory and institutional framework of the banking system in order to stimulate interbank competition.

Other Departments within the IMF such as Fiscal Affairs Department and Bureau of Statistics provide a great deal of technical assistance, a smaller portion of which is related to financial market development. Examples of representative assignments related to money and banking undertaken by the Bureau of Statistics are as follows:

- Bangladesh — To review the implementation of a new reporting system for commercial banks including adding more information on deposits, new credit flows and on the financial position of the banks. To facilitate accurate reporting training was provided.

- Philippines — Technical assistance was provided to reconcile differences in data, to establish a single reporting system in providing data to the IMF, to review the impact on monetary accounts of the transfer of non-performing assets and liabilities of two government-owned banks to the national government.

Countries requesting technical assistance are expected to pay at least one third of the expert's salary. Some of the IMF's technical assistance programs are funded by World Bank missions.

Much of the short-term advisory work is undertaken by IMF staff. Panels of experts are used to supply a reservoir of expert talent and to select experts for assignment. In most areas there is a shortage of available experts.

Judging by the demand for technical assistance, which remains high, the program has been successful. In part this may also be due to careful selection of assignments. Limited success in training local staff due to lack of university graduates, noncompetitive compensation and political changes continues to be a problem.

C. International Finance Corporation (IFC)

The IFC, an affiliate of the World Bank, was established in 1956 to further economic growth in its developing member countries by promoting productive private investment. Much of IFC's assistance takes the form of long-term loans and risk capital, without government guarantees, to private enterprise that have difficulty raising funds from other sources on reasonable terms. The following discussion, however, will focus on that subset of IFC activities which specifically promote the systemic development of financial markets in developing countries.

The IFC established a Capital Markets Department in 1971, although the department's activities did not receive any notable market acceptance until the early 1980's. The group's objectives are to increase the size, depth and efficiency of domestic financial markets and to provide increased access for private companies to international financial resources. Emphasis is placed on programs that increase the flow of longer-term financing.

The Capital Markets Department's programs fall into three broad categories, domestic financial market investments, improving access to international capital markets, and technical assistance. In addition, other financial market activities are also conducted by a new Corporate Finance Services Group. These programs are described below.

The activities of the capital markets group have grown rapidly in recent years. In FY 1990 $423 million of capital markets projects were approved for 33 projects, a substantial increase over FY 1989 approvals of $160 million for 20 projects. In addition to increased levels of investment, the group also has pioneered several innovative programs.

1. Domestic Financial Markets Investments

Domestic financial market investments primarily consist of creating new financial institutions and/or expanding the services of existing institutions. IFC's role typically includes project identification, feasibility analysis, investment (through equity, loans or syndications,) membership on an institution's Board of Directors (where an equity investment has been made) and project monitoring.

Over the years IFC has invested in a wide variety of institutions; the type of institution or transaction supported depends upon the structure and stage of development of a particular country's financial market, and to a certain extent, on trends in financial market development from year to year. IFC has supported the creation or expansion of money market firms, investment and merchant banks, mutual funds, housing finance companies, leasing companies, commercial banks, development finance companies, venture capital firms, and insurance companies. Also, on-lending programs for small and medium scale enterprises and export projects have been popular.

Recent transactions have included an investment to establish the first merchant bank in Pakistan, an investment in a venture capital company in India to promote commercial development of new technologies, and investments in six leasing companies.

2. Improving Access to International Capital Markets

Over the last several years emphasis has been placed on the development of new programs that increase the level and diversify the sources of international financial flows to developing countries. IFC's programs are targeted towards increasing equity flows and longer-term maturities of debt, and towards obtaining investment capital from institutional and other portfolio investors, particularly from the world's largest securities markets in New York, London and Tokyo. A syndications division was created within IFC's Capital Markets Department to focus on these efforts.

The IFC has been a pioneer in the sponsorship and participation of a series of publicly-traded and privately-placed country and regional investment funds, debt/equity conversion funds, and in the underwriting and placement of securities issued by private companies in developing countries. The investment funds have been closed-end mutual funds that purchase securities traded on the stock markets of developing countries. In addition IFC has created The Emerging Markets Data Base, an important source of statistical information for this new group of investors and investment managers.

As of 1991, the IFC has participated in ten publicly-traded country funds, 11 privately-placed country, regional or global funds, six debt/equity conversion funds and six international corporate securities offerings. Its first country fund was established for Korea in 1984. IFC's participation has been in traditional investment banking roles as underwriter and as agent. IFC also has invested over $85 million of its own money in these funds. IFC has promoted debt/equity conversion funds in Chile, Philippines, Brazil and Argentina and has committed to invest $40 million in them.

In the area of new securities offerings, in 1990, the IFC participated in the underwriting and placement of a $100 million dollar issue on the New York Stock Exchange for the Compania de Telefonos de Chile which represented the first time a Latin American equity issue was available on the New York Stock Exchange.

The Emerging Markets Data Base is generally considered a success given the void that previously existed regarding statistical information on developing countries' stock markets. In particular the IFC has developed systems to calculate market indexes and data on returns that are consistent for all reporting countries.

3. Technical Assistance and Advisory Services

Technical assistance programs provide advice to governments regarding legal issues, regulatory and fiscal policies, and institutional development issues relevant to financial market development. Specific financial institutions are offered technical assistance for operational, managerial and training needs.

Sample areas of technical assistance include fiscal policies to promote long-term savings, financial leasing regulations, the role and organization of securities commissions, secondary market mechanisms, particularly stock exchanges, financial market information requirements in general and securities market disclosure in particular, and regulations concerning foreign portfolio investment.

Demand for technical services has outpaced IFC's ability to provide assistance, and with the inclusion of Eastern European countries, demand has surged. Therefore, IFC tends to take a pragmatic approach to choosing its assignments with the likelihood of success and the receptiveness of the recipient country being the two most important criteria in acceptance of an assignment. Projects that will lead to investment opportunities for IFC are also favored.

Technical assistance is provided by IFC's capital markets staff who have many years of experience as capital markets generalists. Specific technical expertise from outside IFC is sometimes arranged, but is funded from other sources. Most of the assistance is short-term in-country advisory work.

As of 191, IFC was providing approximately 8-10 person-years of technical assistance in 45 countries. It has provided assistance to Hungary in the development of its stock exchange.

Assistance was also provided by the United States Securities and Exchange Commission and the World Bank.

4. Other Financial Markets Related Activities

A new Corporate Finance Services Group, which works on restructuring and privatization transactions, was formed in 1990. Several of the privatization transactions, especially those in Eastern Europe, will involve new issues of securities on domestic exchanges. For example, in Poland, a public offering of shares in connection with the privatization of a furniture factory is being arranged for a fee.

5. Future Plans

Expectations are for continued expansion of activity throughout the 1990's. Emphasis will be placed on creating new types of institutions in countries where they are currently lacking, such as investment banks, venture capital companies, and contractual savings institutions.

Over the next several years IFC expects to do more advising, investing and structuring of international securities offerings and assisting companies gain access to international markets by helping them obtain credit ratings and comply with other regulatory and market requirements. Also, IFC expects to be involved in promoting the securitization of assets. It may be that the international markets' interest in regional and country investment funds has thinned out; the level of new funds is likely to be lower than it was in the last three years. IFC expects to expand its technical assistance programs, but expansion will be constrained due to the scarcity of funds and the limited staff available with the requisite technical skills.

D. The United Nations

Two programs operated by the United Nations are expected to assist in financial market development. One is a new program sponsored by the United Nations Development Programme in its newly-established Division for the Private Sector in Development. The other program, International Programme on Savings and Credit for Development, a policy research and symposium program is operated through the Department of International Economic and Social Affairs of the United Nations Secretariat.

The UNDP program is new. One of its primary objectives is to "create a predictable enabling environment in which entrepreneurs and investors will be encouraged to thrive and to move into the mainstream of development."

The other program, The International Programme on Savings and Credit for Development was established in 1971. From inception it has focused on the importance of domestic savings mobilization and credit allocation for economic development. Of particular focus has been the mobilization of informal savings and the allocation of credit to small farmers and entrepreneurs.

1. United Nations Development Program (UNDP)

UNDP recently e .ablished a Division for the Private Sector in Development. The group will be the central point of UNDP on all private sector matters. It will provide support to the field offices on private sector projects.

Relevant areas of focus will include:

- Assistance to governments in a creating suitable environment for private investment and entrepreneurship. Assistance could take the form of advice on legislative and regulatory procedures and fiscal systems.
- Capital market development and investment promotion - which could include creation of stock markets and nurturing of other capital markets.
- Privatization - Helping governments to privatize economies and specific enterprises. Emphasis will be placed on evaluating the economic and social effect of privatization, especially in Eastern Europe.
- Small and Medium Enterprise Development - emphasis will be placed on small scale business credit programs and business incubators.
- UNISTAR - reservoir of volunteer management consultants and technical experts.

Special Private Sector Advisors have been appointed and are already functioning in several countries. A mechanism has been established to work with executing agencies including the World Bank, the IFC, regional development banks and bilateral donor agencies. Assistance has been provided for the privatization plans in Poland, Bulgaria, Czechoslovakia and Morocco. The ground work is being laid for establishment of venture capital funds for Tunisia, Indonesia and sub-Saharan Africa. Assistance with enabling environments has occurred in cooperation with IFC in Guinea, Indonesia, Morocco, Sri Lanka and Tunisia. UNDP has provided feasibility funding for a venture fund that was established in Zimbabwe and financed by the International Finance Corporation.

In Indonesia, a "Fund for Indonesia" was created to provide technical assistance for venture capital projects including work on business plans, managerial and marketing support. Capital was raised from Indonesian private business groups, financial institutions and foreign investors.

2. UN Secretariat

Under the umbrella of the United Nations Secretariat, Department of Economic and Social Issues, a group of representatives from ministries and central banks, private and public banks, savings bank associations, and non-governmental organizations have been convening to further their financial sector technical assistance projects, and their research and policy agendas. The group also promotes co-operation and co-ordination among its members. The findings of its workshops and symposium have been published by the United Nations as reports titled Savings and Development.

Membership of the steering committee includes the bilateral aid agencies and savings bank associations of Denmark, Germany, France, Norway, Sweden and the United States.

Most recently the group, in cooperation with the Danish Savings Banks Association and the International Savings Banks Institute, organized the International Conference on Savings and Credit for Development. Much of the work of this group is directed towards savings institutions and the participation of the informal sector in savings. The group conducts research on the links between the formal and informal sectors. Another area of focus is financial sector reform and the impact of macroeconomic policies on savings. This program is currently in its third funding phase. The first phase (1971-1978) consisted of four workshops and publication of the workshop findings. The second phase (1979 - 1987) the group sponsored several more symposia and published the findings. In 1989 the program was formalized through the establishment of a Steering Committee. The program has been successful in providing a forum for donors to exchange information and policy research, and as a means of pooling resources. This group plans to hold international conferences on savings and credit biennially. Regional symposia will be organized and held annually. A regional symposium for Africa was held in Cote d'Ivoire in June 1991. It was jointly organized by the United Nations and the African Development Bank.

E. The Asian Development Bank

The multilateral Asian Development Bank provides loans and technical assistance to its developing member countries. Most of its loans are used to procure the foreign exchange requirements of specific government-sponsored developmental projects. Some loans support programs or sector activities. Technical assistance id provided to assist countries identify, design, formulate and implement programs and projects. Technical assistance is also used for institutional strengthening, for policy formation and to foster regional cooperation. Technical assistance is financed by grants and loans. In addition to direct lending the Asian Development Bank pursues co-financing opportunities to leverage its resources and has entered into equity investments and guarantees as well as direct loans.

In recent years, through its Programs Department, the Asian Development Bank has provided loans and technical assistance to the financial sector for policy-based reform lending in the financial sector, for institutional strengthening, to enhance prudential regulation, for bank managers training, and for other financial market programs.

In addition to its regional program departments, the Asian Development Bank also has a Private Sector Department which is responsible for activities aimed at assisting the growth and development of the private sector and the financial sector, including capital markets. Apart from emphasizing improvement of the policy environment to encourage private enterprise, it provides financial and technical assistance to a wide range of financial intermediaries and industrial and commercial enterprises. Finally, in 1990 the ADB established an IFC-like corporation to provide investment and expertise directly to private sector projects in the region.

A description of some of the ongoing and planned financial market program activities (as of 1991) are described below:

- Indonesia — A $300 million program loan for the Bank of Indonesia will provide a comprehensive view of the capital markets sector including the banking industry, pension fund, insurance, venture capital, leasing, mutual funds and the securities market. Technical assistance will examine measures required to move the banking sector, particularly state-owned banks, towards more internationally accepted levels of performance and soundness. A $600,000 capital market institutional development component will recommend rules and guidelines to the government for licensing private sector forms in the mutual fund business, to examine the feasibility of establishing a domestic credit rating agency and to provide assistance in the establishment of the credit rating agency.

- Philippines — The Third Development Bank of the Philippines Loan will provide a policy based loan to help strengthen balance of payments position and to promote the development of a long-term credit framework. ($100 million).

  The Capital Markets Programs for the Philippines primarily consists of technical assistance components as follows: (i) advisory assistance for institutional strengthening of the Securities Exchange Commission, (ii) a study of stock market trading practices, (iii) a study of the establishment of a credit rating agency, (iv) establishment of a central depository for securities transactions, (v) institutional strengthening of private sector financial institutions, (iv) privatization of the retail arm of the Development Bank of the Philippines, and (vii) a feasibility study for consolidation of credit guarantee schemes. (Total funding approximately $1.5 million with some activities conducted in conjunction with the World Bank.)

- Regional — Regional activities in financial markets include seminars on monetary and fiscal policy issues, training in regulation of capital markets for government official and managers of financial institutions, training courses for loan managers in international finance, a regional fund for privatization study on the establishment of a regional fund for privatization, and sponsorship of the Third Annual Pacific-Basin Finance Conference in Seoul, Korea.

Other financial sector projects are also being considered or have been approved for India, China, Sri Lanka, Bangladesh, Bhutan, Nepal, and Fiji.

F. The Overseas Private Investment Corporation (OPIC)

OPIC is an independent, financially self-supporting corporation, fully owned by the U.S. government with offices located in Washington, D.C. It provides finance and insurance to U.S. companies in more than 100 developing countries. While the main thrust of OPIC's programs is to increase foreign direct investment, several of its programs serve to increase the business activities of the United States financial services industry in developing countries. Two of these programs, political risk insurance coverage for commercial bank loans and coverage for branch bank capital, have been in existence since OPIC's inception.

Since 1986 OPIC's finance department has been active in the development of investment funds that provide capital on a regional or global basis. The purpose of these funds has been to provide a source of equity capital to markets that have long had only debt to rely upon. Other objectives of the growth funds are to increase the supply of marketable securities, to encourage the creation of an environment for third party ownership and a precedence for minority shareholder rights.

1. Political Risk Insurance for Financial Transactions

OPIC insurance policies can be purchased to cover specific financial transactions. Insurance is provided to eliminate the political risks of currency inconvertibility, expropriation, or loss due to war or revolution. The existence of such insurance coverage serves as a credit-enhancement feature for banks or financial institutions; it enables banks to take a more active role in Third World markets without assuming unacceptable risks. Also in some instances, OPIC insurance coverage on bank loans eliminates the need to report the loan as cross-border exposure for United States regulatory purposes.

Examples of recent insurance policies for financial transactions are as follows:

- Pakistan — Foreign banks in Pakistan are able to increase their domestic lending operations by using a foreign currency deposit program under which the foreign bank accepts US dollar deposits and sells the deposits to the State Bank of Pakistan which guarantees reconversion into U.S. dollars upon maturity at the original exchange rate.

Foreign banks can profit from two sources of interest receipts - from the State Bank and from new borrowers in Pakistan. However, the foreign bank must assume the risk that the State Bank will return the deposits, in dollars.

OPIC provided insurance coverage to the Pakistani branch of the Chase Manhattan Bank on one of these deposits. Coverage for Chase provides protection against the State Bank's failure to provide dollars when due. The amount of new capital that flowed to Pakistan under this transaction was $15 million.

- Costa Rica — OPIC insured an investment by a financial institution via a debt/equity swap. The financial institution converted Banco Central de Costa Rica promissory notes into local currency and invested the proceeds in a manufacturing enterprise in exchange for preferred stock. OPIC insured the payment of dividends on the preferred stock and the redemption of the stock at par value on its due date. The investment in equity was for $4 million.

2. Political Risk Insurance for Branch Bank Capital

Since its inception OPIC has insured branch bank capital against certain political risks. This coverage encourages banks and other financial institutions to establish banking business in developing countries as well as to expand existing in-country banking operations. Coverage is available for capital investments and for reinvested retained earnings. From a developmental perspective the program transfers U.S. banking technology and increases competition in local financial markets. This program has been popular with banks for twenty years. Citibank and Chase Manhattan Bank have been steady and frequent users of this program.

As mentioned above, the insurance of U.S. branch capital has been an ongoing program that is very popular with money center banks that have extensive branch networks. In the late 1970's and early 1980's insurance on bank transactions was not a popular program because the added cost of insurance reduced margin spreads on loans. Recently, particularly in Latin America, where loan pricing is not as critical as it is in Asia, banks have been more amenable to purchasing political risk cover. In FY 1990 OPIC issued nearly $650 million of bank transaction coverage, an increase of over 50% from previous years levels.

The insurance department continues to explore new ways to work closely with banks and other financial institutions. New transactions are likely to be created that stimulate medium-term trade capital flows, that provide insurance cover for loans used in privatization activities, and that provide coverage for debt/equity conversion funds. New programs are being developed to provide political risk insurance for commodity and financial swaps. Existing programs will be continued.

3. Financial Guarantees for Investment Funds

Over the last three years OPIC has sponsored and committed its investment guaranty authority towards the creation of three privately-owned and managed investment funds.

The first to be completed, The Africa Growth Fund, is a $30 million venture capital equity fund for private sector projects in sub-Saharan Africa. The fund is a limited partnership privately-owned by five U.S. corporations and managed on an incentive-fee basis by an affiliate of Equator Bank. An important objective of the Africa Growth Fund will be to sell its equities to third parties within a 3 to 15 year years in order to return capital to the Fund's owners and to develop a new source of securities for African markets.

A fund for equities of Eastern European countries and a global fund for environmental projects were approved by OPIC and are currently being formed. OPIC's participation in these funds has been through its investment guaranty authority whereby investors are offered full guaranties of interest and principal when due. In order to structure the investments to be as "equity-like" as possible, most of OPIC's participation will be guarantees of zero-coupon bonds or loans with single bullet maturities.

A $100 million investment fund for Asia has recently been approved (OPIC's participation will be an investment guaranty of $50 million.) It will be managed by Hambrecht and Quist, a San Francisco based investment banking firm with extensive venture capital experience and a presence in several Asian cities.

G. The United States Export-Import Bank

The main objective of the U.S. Export-Import Bank (EXIM) is to promote exports of United States goods and services. None of its programs have financial market development in developing countries as an objective. However, certain programs, such as insurance for bank letters of credit and leases, have provided indirect benefits for certain country's financial sectors. The benefits of these programs consist of access to new sources of credit, in this case short and medium-term trade credits. The leasing programs also provide an additional source of credit to developing countries.

EXIM bank sells letter of credit insurance to U.S. exporters and banks to cover the risks of trade transactions with foreign banks. Foreign banks apply to EXIM for maximum credit amounts and in effect obtain revolving lines of credit from EXIM for the importation of

U.S. goods and services. The leasing programs offer U.S.lessors coverage against non-payment on operating and financial cross-border leases.

There are many developing countries where EXIM does not operate, or where its operations open and close depending upon the status of a country's loan repayments and claims. In order to make EXIM programs available in more developing countries, a joint EXIM/A.I.D. trade credit insurance program (TCIP) was developed. In this program, EXIM conducts its programs as usual, but is counter-guaranteed by A.I.D. This has allowed EXIM to operate in countries where normally it would have closed.

Recently, EXIM announced a similar trade credit insurance facility for Mexico that is similar to the EXIM/A.I.D. facility, but that will operate without A.I.D. guarantees.

A new process, known as "bundling" has been established for Mexico. Under a bundling facility several local Mexican banks can aggregate a group of trade credits and deliver the notes to EXIM which then funds the aggregated notes in the United States capital markets through the use of its guaranty. This program allows local banks to participate directly with EXIM and at the same time provides them with access to the United States capital markets.

The bank letter of credit insurance programs are well-used programs, particularly for Latin American countries. In FY 1989 EXIM issued over $4 billion of short and medium-term credit insurance.

Over the five years that the EXIM/AID trade credit insurance facility has been operational, it has provided over $800 million of credits to the banking system in Central America. El Salvador and Guatemala were the heaviest users of the facility followed by Honduras and Costa Rica.

Under the recently announced trade facility for Mexico, two Mexican banks have received lines of credit, Bancomext for $75 million and Nafin, for $50 million.

The leasing programs have not been as popular, but are operational.

H. The Federal Reserve System

The Federal Reserve Board, in cooperation with the World Bank, offers a three week seminar for senior bank supervisors from developing countries. The seminars were started in June 1987 in recognition that in most countries highly specialized bank supervision and examination skills have been learned on the job, with only the largest and most developed countries having the resources to establish training departments and courses.

The objective of the training seminars is to familiarize participants with the supervisory problems faced by developing countries and the constraints such problems pose to economic growth; to discuss solutions for dealing with bank insolvencies through deposit insurance schemes and bank restructuring and to build basic bank supervision and examination skills. The Federal Reserve Board training seminar is designed for senior bank supervisors from developing countries, including directors, deputy heads or high level staff involved in bank supervision policy formation. In addition, a limited number of World Bank staff are invited.

The first week of the course focuses on the principal policy issues facing bank supervisors in developing countries. The focus of weeks two and three is skill development. Topic include: loan portfolio management, credit analysis, classification of assets, bank analysis, foreign exchange risk, interest rate risk, the CAMEL rating system, costs of intermediation, and internal and external auditing.

Demand for the Federal Reserve course for bank supervisors has been high. To date approximately 350 people have attended. The World Bank is responsible for the follow up on the course. The World Bank has stated that in many countries the policies, procedures and skills have been transferred particularly in regard to the closing and restructuring of insolvent financial institutions. From time to time staff of the Federal Reserve System (the Board and the various Federal Reserve Banks) also provides ad hoc advisory and technical assistance when requested. Such assistance may be at the request of the World Bank or the IMF.

The Federal Reserve Bank of San Francisco has formed The Center for Pacific Basin Monetary and Economic Studies. The objective of the center is to promote cooperation among central banks in the region and to enhance public understanding of major economic policy issues. Over the years conferences have been sponsored and research published.

The Center for Pacific Basin Monetary and Economic Studies sponsors programs of staff research, a visiting scholars program, and an outreach program of affiliated research associates.

I. The Securities and Exchange Commission

The SEC is involved in international financial issues because of the growing globalization of the world's securities and the linkages between the U.S. and foreign markets. The SEC has provided training and advice to securities regulators from countries with developing securities markets and has formed a committee to advise SEC on the provision of such assistance.

In May 1990 the SEC announced the formation of the Emerging Markets Advisory Committee (EMAC). EMAC is comprised primarily of private sector representatives from investment banking firms, stock exchanges, clearing houses, law firms, banks, academia, and accounting firms. Several U.S. government departments, including the Departments of Treasury and Commerce, have participated in EMAC meetings.

EMAC representatives assist and advise the SEC in responding to technical assistance requests from countries with emerging securities markets. Requests for assistance may include advice on developing disclosure systems and reporting, how to set up settlement and clearing systems, trading, how to license professionals, how to enforce markets, etc. Because many of the countries seeking advice have not had securities markets or personnel to operate and regulate such markets, one of the key needs of these countries is the training of personnel.

The EMAC as a group has met three times for general organizational purposes and to discuss specific assistance projects. Four working groups have been assembled: corporate finance, market regulation, financial institutions and intermediaries, and legal.

The SEC is a member of the International Organization of Securities Commissions (IOSCO). It currently chairs the IOSCO Technical Committee, and also participates in meetings of IOSCO's Market Development committee.

The SEC may provide short-term advisory assistance, or personnel from other countries may attend training programs at the SEC, such as the International Institute for Securities Market Development. In June 1990 a Memorandum of Understanding Between the SEC and the Republic of Hungary State Securities Supervision and Budapest Stock Exchange was signed regarding the provision of technical assistance. The agreement calls for the training of personnel and the provision of information and advice on the development of the Hungarian securities markets. Pursuant to this agreement the SEC staff reviewed the existing Hungarian company act and securities laws and recommended legislative changes, and conducted a training program on how to review prospectuses.

The SEC has also provided direct technical assistance to a number of other countries. In particular, advice was given to the Government of Bulgaria on a draft securities law; comments were given to Poland's Ministry of Finance on certain aspects of Poland's draft securities law; and extensive comments were given at the request of the World Bank on Bolivia's securities laws. In addition, assistance has been provided to government authorities in Brazil, Greece and Indonesia. Internships at the SEC have been provided to government authorities from countries including Hungary, Czechoslovakia, Chile, and Israel.

Recently, SEC established an International Institute for Securities Market Development to provide training in the formation and operation of securities markets. The first program of training was held in Washington D.C. from April 22 to May 3, 1991. The program is designed for officials responsible for securities regulation. The faculty for the training program consisted of SEC, World Bank, IFC, U.S. Treasury, Federal Reserve System officials and EMAC members. The SEC also arranged internships for some of the course participants following the seminar. Most of the internships were with organizations whose personnel are members of EMAC.

J. Areas of Cooperation to Date

Although financial market development programs are a relatively new program area for A.I.D., the Agency is already working with many donor organizations. A description of current cooperative activities is as follows (this list is not intended to be comprehensive, but illustrative.)

For example, A.I.D. and the World Bank are cooperating in financial sector adjustment lending in Bangladesh. A.I.D. has provided funding for technical assistance to support deregulation of the financial system, to modernize the banking system, to develop capital markets, to support the IMF in upgrading bank supervisory capabilities, and in providing studies to promote private sector participation. A.I.D.'s commitment of $25 million is part of a much larger World Bank adjustment loan. Other countries where the World Bank and A.I.D. are jointly involved in financial sector reform programs are Senegal and Kenya.

In the area of prudential regulation, bank supervision, securities market regulations and legal reform, A.I.D. has cooperated with several of the organizations that provide technical expertise in these areas. For example, training has been funded and arranged by A.I.D. for LDC bank supervisors to attend the Federal Reserve/World Bank training courses in Washington, D.C. A.I.D. has arranged for securities regulators to attend the SEC's new course in securities regulation and to remain in Washington for week-long SEC internships.

A.I.D. has cooperated with OPIC in the creation of two venture capital funds. A.I.D. provided the Africa Growth Fund with $1.5 million to be used for the Fund's initial operating costs. The private corporate owners of the Africa Growth Fund have stated that they would not have invested in the fund without the money from A.I.D. More recently A.I.D. provided feasibility funding to assess the demand for a venture capital fund for ASEAN countries. The feasibility study results were positive and consequently OPIC is proceeding with the development of an investment fund for Asia.

A.I.D. and the United Nations have worked together on the International Programme for Savings and Credit in Development. A.I.D. is a member of the newly formed steering committee for the program.

The joint A.I.D./Exim Trade Credit Insurance Program for Central America and for Poland is a good example of cooperative activities designed to provide increased external capital to LDC's.

K. Suggested Areas of Cooperation in the Future

As A.I.D. becomes more involved in financial market development programs the opportunities and benefits of cooperation will increase. Some suggestions are listed here.

A.I.D. could work more closely with the World Bank in many areas regarding policy dialogue. A.I.D. can continue to provide a portion of an adjustment loan in conjunction with the World Bank. The two organizations can jointly design technical assistance components for projects. Examples include studies on tax reform, government securities markets, bank licensing procedures, bank supervision (both on-site and off-site), and technical assistance to upgrade supervisory skills. In connection with World Bank projects A.I.D. could provide funding for computer equipment for information systems in a country's banking system. Technical assistance can be provided to establish accounting and auditing standards and to upgrade skills. A.I.D. could provide grants or loans for specific bank restructuring or bank privatization transactions.

A.I.D. could work cooperatively with several of the securities and bank regulatory agencies of the U.S. Government and international regulatory bodies to pursue financial sector reforms in regulation and supervision. Suggestions in this area include:

- Establish closer ties with the Federal Reserve System, particularly with the staff that provides ad hoc technical assistance to the financial sector. A.I.D. could provide program funding to enable the Federal Reserve staff to increase the amount of technical assistance it can provide.

- Establish a relationship with the Basle Group to ensure that a country's government is more involved with issues addressed by the Basle Group such as the harmonization of international financial markets and capital adequacy. Assist countries' to attend Basle group meetings or become members.

- For projects involving securities regulations the SEC can be an important player. The SEC could be requested to participate in technical assistance. Technical assistance components involving the Emerging Markets Advisory Committee can be designed. The SEC does not have very much money for its activities in developing countries. Consequently, A.I.D. funding that would allow the SEC to devote additional staff for technical assistance could become very important.

In working with the Federal Reserve and the SEC, however, A.I.D. project officers should be mindful of these agencies' primary role as domestic regulatory (rather than development) institutions. This outlook will both focus such agencies' areas of possible cooperation with A.I.D. given the Agency's different, and broader programmatic mission in developing countries. Much of the expertise of these agencies, however, can also be tapped through consultants under the PRE Financial Sector Development Project.

For countries that continue to be saddled with large amounts of external debts, official and private debt reduction schemes, in conjunction with World Bank lending for debt reduction, could be designed. A.I.D. can also play an important role in encouraging countries to establish debt/equity conversion programs and to assist in a debt/equity conversion program's design and implementation. Development of debt/equity funds could be done jointly with IFC or OPIC. In the area of debt reduction, A.I.D. also will need to work with the U.S. Treasury Department as it continues to establish policies regarding official and private debt reduction.

In the area of domestic financial institutions, A.I.D. and IFC could cooperate on joint projects. One suggestion is for A.I.D. to provide feasibility study funding for potential IFC investment projects. This might include funding commercial feasibility studies for a mutual funds, venture capital companies, credit bureaus, or leasing companies. For projects that appear to be feasible, A.I.D. could provide funding for necessary technical assistance or for initial operating costs to get a financial intermediary organized and operating.

In addition, A.I.D., through its private investment guaranty program can provide co-financing with IFC for domestic financial institutions. In some projects local currency guaranties can also be considered. For projects that include United States investment, similar co-financing can be done with OPIC.

Also A.I.D. and IFC could work together on contractual savings institutions - to assess, create, strengthen and/or institute reforms in these institutions.

A.I.D. can cooperate with an organization's programs that are designed to increase international capital flows by ensuring that the enabling environment in a country encourages the country's integration into the world's global and regional financial markets. Examples of cooperation in this area would include working with international organizations such as the Basle Group and IOSCO and ensuring that issues specific to developing countries are addressed in other international forums such as the GATT.

In this program area, A.I.D. could also cooperate with U.S. EXIMBANK in finding innovative ways to increase the ways in which domestic financial institutions can benefit from EXIM programs. Important also is to find ways in which EXIM programs will be available in more countries.

VII. HOW TO CONDUCT A FINANCIAL SECTOR ASSESSMENT

A. Purpose of the Financial Sector Assessment

The Financial Sector Assessment (FSA) is a tool for characterizing a country's stage of development; identifying areas of financial sector need or weakness; determining the priorities of the host country government and private sector; and defining action programs for financial sector intervention. The FSA is meant to provide a comprehensive means for identifying the major obstacles to financial sector growth in order to determine how best to increase the private sector's access to capital.

The FSA, as a tool for systematically evaluating a country's financial system, can be used as the basis for a strategy for the development of that sector. This diagnostic can also be used on a selective basis, as some Missions will not wish or need to apply equally rigorous efforts to every aspect of the diagnostic. In many cases, Missions have already identified the elements of the financial sector on which they wish to focus. The financial sector may have received extensive scrutiny in the reports of the World Bank, Asian Development Bank and other institutions. It is expected that Missions will apply the sector assessment selectively, working with the Regional Bureau and PRE's Financial Sector Development Project in defining specific assessment needs.

While the FSA can be used as a means for developing information needed for a comprehensive financial sector strategy, it can also be used to help develop PPs and PIDs. In addition, the assessment can provide a more knowledgeable basis for A.I.D. Missions as they approach their policy dialogue responsibilities with host governments.

B. Contents of the FSA

A comprehensive FSA involves examination of each of the following:

I. Policy Framework

II. Structure and Characteristics of the Financial Sector

III. Integration with World Financial Markets

IV. Socio-Economic and Cultural Factors

V. Existing and Other Donor Programs

These topic areas are described in further detail below. Their presentation in outline form is intended to facilitate the task of identifying those parts of the FSA of immediate relevance to A.I.D. and the Missions. In many cases, reports of the host country government, the A.I.D. Mission, the World Bank and other assistance agencies will have addressed many of these topics, eliminating the need for primary research in each of the areas. The project officer should also check to see if local or foreign private financial institutions, exchange or trade associations have already completed similar basic research. The process of conducting an FSA is discussed in Section D of this chapter.

I. Policy Framework

A. Price and Wage Policy

- Direct price controls
- Price subsidies
- Wage controls or indexation

Key issues:

- Impact of non-market pricing
- Effect of distortions in the market on resource allocation

B. Credit and Monetary Policy

- Monetary policies
- Interest rate structure
- Credit allocations

Key issues:

- Extent of interest rate liberalization or repression (and whether there is alignment between interest rates and market forces)
- Effectiveness of the central bank in monitoring and controlling the money supply, controlling inflation while providing for economic expansion
- Extent of use of credit ceilings or credit allocation policies
- Extent of credit subsidies (and the difference between subsidized and market rates)

C. Fiscal Policy

- Debt policy - foreign debt, domestic debt
- Direct taxes - personal income, corporate income, property, others
- Indirect taxes - value added, sales, export and import duties, others

Key issues:

- Debt management (effect of government's debt management practices on (i) interest rates, (ii) the condition of banks and (iii) availability of credit for the private sector)[1]
- Existence of debt conversion program (debt-for-equity, debt-for-debt swaps, etc.)
- Effect of tax structure on investment, savings, debt, equity, export, employment
- Tax collection and evasion
- Fiscal deficit and methods of financing

D. Exchange Rate Policy

- Relationship between domestic currency and hard currencies
- Policies and practices for allocation of foreign exchange for trade, investment, and other needs of public and private sector
- Multiple rate systems
- Degree of openness of capital account
- Foreign exchange reserves

Key issues:

- Government policy on convertibility of currency
- Impact of exchange rates on domestic savings mobilization, foreign trade and investment
- Foreign exchange resources involving including the ability to draw down international reserves in case of balance of payments difficulties
- Integration of country financial system with world financial system
- Existence of a forward market in foreign exchange to permit local importers/exporters to cover their foreign exchange risks.

E. Privatization

- Size of the public sector as compared with private sector
- Type, size and nature of commercial activities presently being conducted by government
- Official attitude toward privatization

[1]Practices which suppress financial market development are common in many countries. There are techniques that governments can use to finance themselves without creating major distortions in the financial sector (i.e., open market operations).

- Degree of efficiency of the private sector enterprise
- Steps taken (if any) toward privatization

Key issues/components (assuming goal is to privatize):

- Development of a privatization strategy based on clearly defined goals and objectives
- Identification of the major constraints including labor issues, financial condition of SOEs, development of capital markets, public attitude, technical and managerial capabilities
- Development of policies, legislation and public information campaign to facilitate privatization
- Elaboration of privatization program (including formulation, analysis, implementation, monitoring and adjustment stages)

F. Structural Adjustment Policies

- Existence (if any) of structural adjustment policies, structural adjustment program

Key issues:

- Expected impact of program on balance of payments, interest rates, money supply, etc.
- Expected ability of financial system to become integrated into international financial markets
- Terms of agreements with IMF, World Bank
- Likely ability to meet targets, uphold agreements
- Readiness of private sector to continue structural adjustment

II. Structure and Characteristics of the Financial Sector

<u>Overall:</u>

- Extent to which the financial system is developing the diversity of instruments and institutions needed to support development

A. Institutions

1. Central Bank

- Role and authority
- Tools for controlling credit and liquidity, such as open market operations, discount and rediscount policies, reserve requirements, etc.
- Means of protecting depositors and ensuring the soundness of the banking system (deposit insurance schemes, prudential regulation and bank supervision)

<u>Key issues:</u>

- Level of autonomy and independence of central bank from political influence
- Quality of bank oversight and supervision
- Technical capabilities of Central Bank; extent of automation; training programs for own staff as well as for financial institutions

2. Credit Institutions

- Commercial Banks
- Finance and Leasing Companies
- Savings and Loan Institutions
- Cooperatives and Credit Unions
- Development Finance Institutions (such as housing banks and agricultural banks)

<u>For each of the above:</u>

- Ownership
- Management and operational efficiency
- Resources (human, financial) and training programs
- Profitability
- Competition (including foreign)

- Regulation and supervision
- Signs of financial distress (such as loans in default), loan recovery policies and practices
- Extent of computerization and automation of banking operations
- Accounting and auditing standards and practices
- Laws regarding property rights, collateral, bankruptcy and reorganization

3. Capital Markets Institutions (sources of risk capital)

- Stock exchanges
- Investment/merchant banks
- Commodity exchanges
- Brokerage firms
- Venture capital companies
- Insurance companies
- Pension funds
- Mutual Funds

<u>For each of the above:</u>

- Ownership
- Management
- Products/Instruments
- Resources (human, financial, information, technological)
- Profitability
- Competition (including foreign)
- Regulation (including licensing, capital, liquidity and reporting requirements)
- Accounting and auditing standards and practices

4. Informal and Semi-formal Sector Institutions

- Moneylenders
- Pawnbrokers
- Providers of retail or trade credit
- Group savings and loan associations

<u>Key issues:</u>

- Implied need to strengthen formal sector institutions

- Potential for establishing linkages between informal and formal sector institutions
- Impact of government policies and extent of government regulation (if any)

B. Instruments

1. Short-term

- Treasury Bills
- Commercial paper
- Bankers acceptances
- Euro-Currency
- Certificates of deposit
- Purchase agreements
- Bank overdrafts
- Receivables financing (trade bills)
- Pre-export financing

2. Long-term

- Term loans
- Mortgages
- Leases
- Stocks
- Bonds
- Debentures
- Repurchase agreements
- Rediscountable medium-term loans
- Export credit (long-term suppliers credit)

Key Issues:

- Type and size of financial instruments available
- Ease in broadening the range of financial instruments available in the market (i.e. laws regarding property rights, collateral, trusts, etc.)
- Regulatory constraints on the types of instruments which may be employed by financial institutions

C. Markets

- Money markets
- Equity markets -- listed and unlisted

- Debt markets -- government bonds and corporate bonds and debentures
- Over-the-counter and curb markets

<u>Key issues:</u>

- Legal structure
- Level of activity
- Types and numbers of issues traded
- Supply of and demand for securities
- Market volatility
- Market regulation (including financial disclosure)
- Ability of legal system to facilitate financial intermediation (such as procedures for settling disputes)

III. Integration with World Markets

- Participation of foreign financial institutions in domestic market
- Extent of foreign direct and portfolio investment
- Restrictions on capital flows
- Volume and growth of interbank exchanges and transactions

<u>Key issues:</u>

- Government policies with regard to foreign investment
- Openness of financial sector to foreign capital flows in terms of foreign investment laws and regulations
- Differential in cost of funds between domestic and foreign markets
- Ability to raise capital on international markets in terms of financial standing, creditability and management skills
- Compatibility of the domestic financial systems with international financial systems and prospects for further integration

IV. Socio-Economic and Cultural Factors

- Major cultural and socio-economic groups (i.e., dominant families, ethnic groups, military and religious groups)
- Habits regarding savings
- Population growth, density, distribution
- Distribution of wealth and income
- Educational levels
- Status of employment and unemployment

Key issues:

- Concentration in ownership or control of key sectors
- Political roadblocks to reform
- Cultural receptivity to change
- Potential sources of political and social instability
- Human capital
- Attitude toward short-term speculation versus long-term investment

V. Existing and Other Donor Programs

- A.I.D.
- I.B.R.D.
- Regional Development Banks
- Bilateral Assistance Programs
- Foreign Private Sector Contracts

Key issues:

- Synergies with other institutions
- Developing a niche for A.I.D.
- Leveraging A.I.D. resources

C. Standard Classifications for Financial Markets Development

One of the main purposes of conducting an FSA is to be able to characterize a country's stage of development along several dimensions in order to determine the priorities of the host country government and private sector and appropriate action programs for financial sector intervention that might be supported by A.I.D.. In addition, by grouping A.I.D.'s client countries into a few meaningful categories, A.I.D. might coordinate its assistance to countries in similar stages of development; identify more systematically the types of technical assistance appropriate to countries in each category; and uncover certain "lessons learned" from countries successfully advancing from one stage to the next.

Given the multi-dimensionality of developing country financial sectors, any attempt to classify a country's stage of development using one or two descriptions is likely to oversimplify the process. Instead, the suggested approach is to examine the country's stage of financial sector development along several dimensions, as explained below. For each dimension, a country's financial sector may be defined as "Least Developed," "Intermediate," or "Advanced." Countries with "Advanced" financial sectors - as opposed to Newly Industrialized Countries ("NICS") such as South Korea, Taiwan, Singapore and Hong Kong - may be viewed as at a threshold stage, on their way to becoming a full-fledged NIC.

While some countries may fit the standard classification along every dimension, it is also possible for them to share certain characteristics (in terms of their financial sectors) with countries at other stages of overall development. Recognizing that one country's financial sector development "lags"or "leads"along certain dimensions may prove useful in the design, monitoring and adjustment of technical assistance programs.

While the criteria that could be used to characterize a developing country's financial sector are many, it is important to select those offering a relatively easy basis for comparison from country to country and those that may be used repeatedly over time. Brief descriptions of the indicators are offered below and are summarized in Figure 3.

The first dimension along which the development of a country's financial sector might be measured concerns **financial depth**. The depth of financial markets is a measure of their strength: deep financial markets are inherently less fragile than shallow financial markets. In "Least Developed" financial systems, deposit banks tend to dominate the financial sector, holding the vast majority of financial system assets. The focus of the commercial banks is primarily on short-term deposit-taking and lending. When central banks are included, the predominance of the banking sector is even greater. Assets held by deposit banks and the central bank may be 90 percent or more of the total financial system assets. The size and importance of the informal sector is greatest in "Least Developed" financial systems and tends to diminish as the country's financial sector develops. Monetization (the ratio of money to GDP) is weakest in LDCs, suggesting that the formal financial sector is a weak mobilizer of funds.

The relatively small role of non-bank intermediaries and contractual savings institutions stands in sharp contrast to their much larger role in "Intermediate" and "Advanced" financial systems. In the "Intermediate" and "Advanced" systems, these institutions compete for a limited pool of savings by offering a more diverse array of financial instruments. The proportion of financial system assets held by pension funds, insurance companies and mutual funds increases dramatically. At the advanced end of the spectrum, as much as 20% or more of financial system assets are invested in equities or are held by contractual savings institutions.

The second dimension for classifying a country's financial sector concerns **financial efficiency**. Financial markets are efficient when they mobilize funds from savings at the lowest possible cost and distribute those funds to investments that offer the highest potential returns (adjusted for risk). Efficient financial markets are those in which prices and costs accurately reflect market realities and provide useful information for financial decision-making. In "Least Developed" financial systems, such markets signals are distorted through government actions to allocate credit and administer interest rates.

As financial systems develop, market forces play a greater role in distributing credit, however some direct controls may remain. In the most advanced countries, such controls are virtually absent; the monetary authorities adjust the money supply and interest rates indirectly through the purchase or sale of government securities, using what are called open market operations. The development of competitive markets in government short-term debt instruments gives rise to a base rate or "risk-free rate" used by financial institutions in determining customers' borrowing and lending rates. The emergence of liquid capital markets in "Advanced" financial systems enlarges the range of options available for more efficient savings mobilization and resource allocation and provides a source of long-term financing for economic growth.

The third dimension, **financial integration**, refers to a country's participation in international markets as reflected in statistics on cross-border capital flows. Important measures include the level and growth of direct foreign and portfolio investment and the volume and growth of interbank exchanges and transactions. The volume of direct foreign and portfolio investment provides insights into the perceived attractiveness and stability of domestic policies and institutions. As participation in foreign markets increases (an attribute of "Intermediate" financial systems), the flow of funds for trade, investment and credit transactions should also increase. With fewer controls over capital flows in "Advanced" financial systems (compared to "Intermediate" and "Least Developed"), domestic and international markets are closely linked. Trade and foreign direct and portfolio investment is more substantial.

D. How to Conduct a Financial Sector Assessment at the Mission Level

An FSA is often a useful starting point for a Mission in determining its next steps in financial markets program development. Prior Mission project experience, combined with information gleaned from current contacts from the host country's public and private financial sectors, should be considered in shaping a financial markets strategy and in determining the need for additional outside technical assistance. If little previous comprehensive analysis has been carried out, a full-scale FSA similar to the model provided below, may be indicated. In other situations, prior studies by A.I.D. or other donors may either limit or more sharply focus the need for FSA-type assistance. In 1990, for example, USAID/Thailand opted for a 6 person-week recognizance TA team (later followed by other specialized short-term TA teams) to build upon over 12 person-months of previous work by an I.B.R.D. financial sector assessment team

Depending on the complexity of the financial sector in the host country, a Financial Sector Assessment team might be formed with individuals representing the following areas of expertise:

- Macroeconomics
- Capital Markets
- Banking
- Legal and Regulatory Structure

The team should be able to draw on the skills of a Financial Analyst and a Researcher/Editor as necessary. An individual familiar with A.I.D. and other donor programs would also help to round out the team. Depending on the judgment of the Mission, additional expertise might be needed in the following areas:

- Privatization
- Informal Sector
- Accounting and Auditing

Once a team has been assembled, the process of conducting an FSA consists essentially of four steps as described and illustrated in Figure 4:

<u>Step One</u> **Assess Financial Sector Environment**

Referring to Parts I to IV of the outline above (i.e., Policy Framework, Structure and Characteristics of the Financial Sector, Integration with World Markets, and Socio-Economic and Cultural Factors), the team should first decide which areas of the outline require close examination. Certain topics may not be relevant to the host country; others may already be covered in detail in recent reports.

Based on a review of the information available and the needs and priorities of the Mission, a scope of work and list of sources of information should be developed. The sources of information include:

- Interviews
- Government reports and documents
- A.I.D. in-house documents and consultants' reports
- IBRD and other donor agency reports
- Reports of local institutions (economic research reports, financial reports, plans, etc.)
- Newspapers and periodicals
- Surveys or questionnaires (lenders, corporations, etc.)

<u>Step Two</u> **Assess Existing Efforts and Programs**

Programs of the I.B.R.D., regional development banks and other donor programs should be examined with respect to past, ongoing and projected activities. An assessment should be made of the relationship between A.I.D.'s programs and those of other donor agencies. Opportunities to leverage A.I.D. resources through joint programs and possible synergies with other donors' activities should be examined.

Sources of information include interviews with representatives of other donor agencies and government and donor agency reports.

Step Three **Identify Gaps, Key Needs, Requisite Changes to Meet Needs, AID's Capability to Meet Needs**

A thorough examination should be made of the financial sector's key areas of need or weakness, the requirements for change, and A.I.D.'s capabilities to provide support for financial sector reform. Programming options for supporting financial sector development are discussed in Section III of this guide. A Sample of Technical Assistance and Training Resources in Financial Markets is presented in Section X.

Step Four **Develop Strategy**

Once the above steps have been completed, the Mission staff should be able to write indicated sections of the Country Development Sector Strategy or other appropriate strategy document that responds to the financial sector's areas of weakness in the most appropriate way.

VIII. HOW TO DESIGN A FINANCIAL MARKETS PROJECT

The purpose of this section is to provide some practical guidelines for designing financial markets projects. Since each project will be designed within a local country context and overall Mission strategy, the intention of this section is not to be "prescriptive", but rather to provide some broad generalizations. Specific design considerations will depend on the country context and should emerge from the Financial Sector Assessment described in Section VII.

A. Flexibility

An important consideration in the design of financial markets projects is the need to be flexible. No one single approach will make sense for every project. Most projects will need to be tailored to fit the stage of development of the particular country. Many projects will entail comprehensive objectives and long-term commitments. During the implementation phase these projects will benefit from the ability to make changes and to respond to windows of opportunity. For example, although interest rate liberalization may be the overriding objective in a macroeconomic reform program, a flexible approach that accommodates a gradual easing of interest rates over time may emerge as a better alternative than a one-time shock to the economy. By the same measure, progressive liberalization of the financial sector must be completed by the similar liberalization of the real sectors.

Projects should have a certain level of built-in flexibility that enables the Mission to encourage fruitful areas of policy dialogue; there should be a willingness to discard ideas if the timing is not right. Projects should allow flexibility to adopt alternative means of achieving the same objectives. In Indonesia, for example, an objective to increase the depth of the domestic capital markets is being achieved through support for the strengthening of the stock market instead of through the development of a venture capital industry, which had been the initial proposal.

The Financial Sector Assessment described in Chapter VII (or a similar analysis performed by another group) will provide the best basis to determine a Financial Market Strategy and project identification. From a list of objectives developed from the Strategy paper, discrete activities can be defined. Capabilities of local institutions and indicators that will define performance should be clearly identified.

B. Need for a "Portfolio" Approach

One of A.I.D.'sstrengths (relative to other donor agencies and other agencies of the U.S. Government) is its ability to design country-specific programs that involve a wide range of activities in both the private and public sectors and include also a wide variety of assistance types (policy dialogue, sector assessments, cash disbursements, guaranties, technical assistance and training, credit enhancement and funding for policy research). As a result, A.I.D. is in a good position to adopt a "portfolio" approach to financial sector programming. A "portfolio" approach would utilize a menu of programs and projects to develop a specific financial market development strategy for a particular country. In countries where the World Bank and other donors have macroeconomic and financial sector reform lending activities, A.I.D. may not take he lead in providing funds, but can work collaboratively.

C. Need for Favorable Policy and Enabling Environment

One of the "lessons learned" from financial markets programming is that a certain degree of macroeconomic stability is required for financial markets projects to meet their objectives. The experience of Latin America, where financial markets were liberalized in the face of severe economic instability, points out the questionable effectiveness of embarking on financial market reform in a country with high inflation or volatile external capital flows. Many financial sector reforms can have implications for fiscal policy and the budget as well. Care should be taken not to design reforms that will cause distortions in other segments of the economy without accommodating these distortions.

Some intangibles, such as investor confidence and perceptions of a high level of country risk, may present barriers to reaching many financial markets project objectives. These intangibles cannot be ignored.

The commitment of a country's leadership and the willingness of a government to implement reforms are other important design considerations.

D. Sequencing

Project design will involve making decisions on the order and timing of financial markets interventions. Although traditional theory suggests that price and trade reforms precede financial sector reforms, it is also important to keep in mind that certain institutional activities, such as creating a stock exchange, or being a catalyst to a venture capital industry, can take years to implement, and perhaps should be encouraged in anticipation of the success of other policy interventions. Another sequencing issue involves the decision to tackle the most serious policy distortions first, leaving other, lesser problems to be addressed at a later date.

E. Identifying Expertise

Financial markets projects require a combination of highly specialized technical assistance providers and the transfer of some fairly basic skills and knowledge in the broad area of finance. Care should be given in choosing technical expertise that closely matches the objectives of any particular component of a project. Financial markets specialists represent a fairly segmented group of professionals. Different specialties exist in investment banking, central banking, credit, banking operations, banking supervision, tax, accounting, securities regulations, etc. Many financial markets specialists can provide expertise in only one of these specific areas. In many instances it will be necessary to obtain approval to pay higher rates for financial markets expertise. Some financial markets specialists are in short supply, others are accustomed to charging high rates. Consideration should be given to finding ways to pay market rates.

On the other hand, particularly in the United States, there are financial markets training groups that have "off the shelf" training programs that may be useful for transferring basic banking, finance and credit skills. (A selection of these training programs is found in Chapter X.) This type of training program should be considered.

Local trade associations or training institutions, if they exist, may also be relied upon to provide technical assistance (as well as act as an intermediary to the private or public sector institutions.)

F. Coordination with Other Donors and the U.S. Government

It is important to sustain a high level of coordination and collaboration with donors in financial markets projects. Some donors such as the World Bank and the IMF may already be extensively involved in structural adjustment lending and financial sector reforms. It will be important to know the status and objectives of these programs. Donor coordination can enhance consensus building with governments.

Many donor organizations have complementary talents and can collectively design projects which draw upon such talents. For example, A.I.D. has a comparative advantage in obtaining technical assistance, an advantage that is enhanced by the United States' preeminence in the financial services industry. A.I.D. also has a comparative advantage in assisting local governments implement policy reforms and in a variety of institutional strengthening activities.

Much of the financial markets work conducted by donors is done on an international or regional basis. Missions should make an extra effort to involve some of these international organizations in their projects. The IFC's Capital Markets Group, the IMF's Central Banking Division, and the World Bank's Financial Systems Division are examples of groups that are extensively involved in financial markets activities on an international basis.

Other agencies of the United States Government may be able to provide technical assistance. The SEC and the Federal Reserve System are two examples. Additional suggestions of ways to collaborate with other donors is found in Section J of Chapter VI.

IX. HOW TO EVALUATE A FINANCIAL MARKETS PROGRAM

Financial markets programs must be periodically evaluated against measures of effectiveness to determine, among other things, whether program objectives are being achieved. Appropriate indicators, both quantitative and qualitative, must be defined to serve as benchmarks against which to measure the extent to which these objectives have been met.

The evaluation of financial markets programs presents some unique challenges. To a greater extent than one finds in other sectors, progress in the financial sector is crucially dependent on intangibles such as perceptions of country risk and investor confidence. In turn, these underlying attitudes are shaped by trends in key macroeconomic variables (prices, exchange rates, growth in output). Clearly, one could not expect to make substantial progress on financial sector issues in the face of macro economic instability. Even when new policies succeed in restoring a measure of stability to the macro economic environment, perceptions of high country risk will remain in the minds of investors and savers for long after the event. Moreover, the financial distress which accompanies such periods of turbulence will leave in its wake a frame of insolvent financial institutions (especially banks) unable to function normally without effective restructuring and recapitalization programs.

Investor and saver confidence may also encounter other obstacles of a non-financial nature. A well functioning financial sector -- increasing in the range and diversity of its products and services and deepening in relation to the total output -- cannot be achieved separately from the total package of measures which, taken collectively, amount to an "enabling environment" for the private sector. Excessive government restrictions which hinder private sector investment, state control of important economic sectors which "crowd out" private investment opportunities, as well as inadequacies in commercial law, bankruptcy law, and accounting standards, will also show up as weaknesses in the financial sector and its institutions. Analysts aiming to design and evaluate a financial sector program should seek to discriminate between those financial sector weaknesses which can be addressed directly by helping financial institutions, and those which are due to flaws in the overall "enabling environment" for the private sector.

The following is a range of possible objectives and indicators which may be considered in the design and evaluation of financial markets projects in each of the following areas:

- Macroeconomic policy
- Commercial Banking
- Expansion of Securities Markets

- Quality of Financial Information
- Other Financial Institutions

A. Macroeconomic Policy

For a program aimed at macroeconomic policy reform, the broad objective should be to create an appropriate environment for stable, sustainable economic growth. Such a program might be evaluated using the following indicators:

Quantitative

- Growth, stability and diversification of components of GDP
- Growth, stability and diversification of exports
- Net internal/external capital flows
- Extent of interest rate liberalization or repression
- Effects of credit controls and credit subsidies
- Money supply as a percentage of GDP (as a measure of the degree to which the formal financial sector is a strong or weak mobilizer of funds)
- Distribution of assets among financial institutions (central bank, deposit banks, specialized lending institutions, contractual savings institutions, long-term debt securities, equities, etc.)
- Impact of tax structure on saving and investment
- Scope of activity under debt conversion program (if any)

Qualitative

- Effectiveness of central bank in monitoring and controlling the money supply, inflation
- Effectiveness of Treasury's debt management policies (such as through open market operations)

B. Commercial Banking

The broad objective of a commercial banking program should be to develop a healthy, stable and competitive commercial banking sector, capable of mobilizing savings from the general public and facilitating economic growth. Appropriate indicators might be as follows:

Quantitative

- Number of banks, their profitability and capital adequacy
- Number of insolvent banks in need of restructuring
- Ratio of demand deposits to GDP
- Ratio of unsecured loans to secured loans; collateral requirements for secured loans
- Number of bank personnel trained in credit and financial analysis
- Volume of leasing activity (as an alternative form of financing)

Qualitative

- Adequacy of bank legal and regulatory framework
- Effectiveness of bank on-site and off-site supervision
- Adequacy of bank loan recovery procedures
- Effectiveness of bank training programs
- Quality of services provided by credit information bureau(s) (if they exist).
- Strength of banking sector
- Existence of privileges, monopolies or subsidies of certain banks versus others
- Range of credit instruments and availability of credit to all sectors of the economy and categories of borrower

C. Expansion of Securities Markets

The overall objective of a program aimed at security market expansion should be to develop resilient, liquid capital markets capable of raising funds for long-term investment. Relevant indicators might be as follows:

Quantitative

- Stock market capitalization as a percentage of GDP
- Number of companies listed on the stock exchange(s) and the average daily value traded
- Volume and diversity of financial instruments
- Capitalization and diversity of financial institutions

Qualitative

- Existence of appropriate licensing, capital, liquidity and reporting requirements for securities markets intermediaries
- Establishment of independent capital market regulatory authority.

D. Improve the Quality of Financial Information

The broad objective of a program aimed at improving the quality of financial information should be to increase access to financial information that is reliable, comparable and consistent, in order to promote the mobilization and efficient allocation of financial resources. Examples of performance indicators include the following:

Quantitative

- Number of licensed accountants and auditors
- Number of institutions offering training programs for prospective accountants and auditors
- Number of professional associations and size of membership
- Number of enforcement cases related to failure to comply with professional standards

Qualitative

- Conformity of local accounting and auditing standards with international standards and conventions

- Quality of educational programs

- Effectiveness of standard-setting organization.

E. Other Financial Institutions

For a program aimed at promoting other financial institutions, such as development finance institutions and credit unions, the objectives might be to increase their capability to mobilize domestic savings and to manage their portfolios in a commercially-sound manner. Appropriate indicators might include the following:

Quantitative

- Loan default and recovery rates

- Number of personnel trained in credit and financial analysis

Qualitative

- Adequacy of operating policies and procedures

- Capability of management

- Quality of training programs available.

Evaluating Informal Sector Projects Focusing on Finance

Based on the research and fieldwork completed thus far in the informal sector, the evaluation of informal sector projects involves factors such as client incorporation into the informal financial system; financial self sufficiency; savings mobilization; institutional arrangements and training. Each of these is discussed briefly below.

a. Client Incorporation into the Informal Sector

While it has been determined that the poor are creditworthy, the best method for incorporating them into the formal system has not yet been identified. Techniques for moving small borrowers up the financial scale into large, long-term, fixed capital loans consist mainly of a two-tier system. The first tier uses group loans and similar devices for motivating savings and loan repayment; the second relies more on individual loans with collateral requirements. The number of borrowers moving from the second-tier into the formal financial system does not appear to be high (though it appears to be much higher in Asia than elsewhere). However, this may be the result of the lack of sophistication of most of these borrowers. They lack the skills to apply for and negotiate loans with the formal sector. Letter borrowers signing with their thumb print rather than a signature is one way of dealing with this problem. Other solutions should be sought.

b. Financial Self-Sufficiency

Institutions delivering credit exclusively have the potential to be sound and fully self-sustaining without external subsidies. If institutions offer services other than credit, such as business planning, training, and market analysis, this is not necessarily the case. However, even when credit is the primary service, institutions may find themselves operating at a loss, and thus depleting their loan fund. In some cases, elements critical to financial self-sufficiency are a high savings deposit-to-loan ratio; an interest rate or fee structure covering the cost of funds and of administering the loan; low-cost but effective client screening techniques taken from informal sector finance; and advancing borrowers from small loans to larger loans as efficiently and quickly as possible.

c. Savings Mobilization

Savings mobilization is a critical feature of successful lending programs. It not only provides the capital basis for loans at the institutional level, but also the psychological basis for good loan repayment, proper investment behavior, and self-help measures at the borrowers' level. Savings and credit can be linked directly by making loan disbursements conditional on savings levels. Even if the lending program is not operated by a dual purpose financial institution, savings can be deposited in a bank. Savings as collateral can also be used for re-lending, the credit to savings ratio increasing with every successful loan repayment.

There exists a corollary to the need for reciprocity between savings and lending facilities. It states that donor funds should never be directly introduced into the savings-credit cycle established by the PVO, semi-formal institution, or formal bank.

d. Institutional Forms

Institutional arrangements for channeling credit to and from the informal sector need to reflect local socio-economic, policy, and regulatory conditions and take advantage of existing organizations without adding too many layers of complexity or risk to the project. Whenever possible, banks should be preferred over non-banking intermediaries, both because of the assured presence of savings facilities and the greater tendency to operate in a business-like manner. Banks may limit themselves to an administrative function, supplying funds for borrowers screened by a different specialized intermediary, such as a PVO familiar with the clients. Alternatively, banks can assume a more direct credit role, relying on the more desirable features of informal finance, such as peer groups and compulsory savings to assure an acceptable loan repayment rate. In terms of organizational structure, banks with extensive branch networks have strong advantages, similar to PVOs, in reaching small borrowers. For this reason, apex credit delivery systems are preferable to institutions with a single operating site, because of the broader array of financial services, broader market coverage, and wider client base.

e. Training

Training or institution building is a critical element in all projects focused on small borrowers. PVOs, banks, and generally any institutions embarking or expanding on an existing lending program need assistance with strategic planning, staff development, service delivery, and management of information systems for baseline data to determine whether or not objectives are met.

f. Conclusions: Type and Timing of Donor Assistance

Donor assistance should concentrate on two broad areas: improving the policy environment in which formal and informal financial institutions have to operate; and allowing these institutions to service the credit needs of small borrowers through program expansion or pilot projects. Assistance should always be in support of new financing mechanisms, improving existing programs, or encouraging the entrance of formal institutions into the financing of informal sector institutions. To reduce risk and unnecessary expenditure, new programs or institutions should be tested on a pilot basis, and then expanded over a wider geographical area once the operational problems are resolved.

g. A Checklist of Useful Questions

In addition to considering the issue raised above, other questions may be asked to ascertain project viability.

- Does the project develop savings?

- Is the project to be under the auspices of a bank, PVO, or SHG, with a proven track record?

- Can the proposed institution respond quickly to changes in client needs and market conditions?

- Can the sponsor assure repayments of loans?

- Who are the ultimate beneficiaries? Are there any alternative sources of assistance, whether official or unofficial?

- Does the cost of servicing the loan compare favorably with the interest rate spread earned by the lender.

- Does the project entail a subsidy which will endanger financial viability in the long run? If the project does, are there explicit plans for phasing out the subsidy?

- Is the project to be located in a backward, under-developed area? If the latter, are there any special incentives offered under the regional development program that tie into the project?

- Does the project involve any inputs requiring foreign exchange? Does the country have sufficient foreign exchange to meet this need?

- What is the record of servicing loans by cooperatives, credit unions, and commercial banks in the region? Is the delinquent loan rate higher for the region than the national average?

- What are the typical obstacles to development in the area, (i.e., power, transport, water supply, storage, access to raw materials)? How do they affect productivity and sources of income for the area?

- How does the project tie into the formal financial market? Does the project take advantage of existing linkages between the formal and informal sector, or will it create a new link, easing the flow of funds between sectors?

- Does the project provide a viable alternative to credit from strictly informal sources?

- Do the lending policies and procedures proposed respond to the needs of small borrowers? Will the project reduce market segmentation, monopoly profits and the cost of funds in the informal sector?

h. Project Screening: How to Identify Successful Projects

There are many different criteria for judging the success or the significance of projects. Whereas general criteria cover project goals, specific criteria address the means to attain the goals. In terms of goal setting, projects must be judged on two levels: (1) the extent to which they link together the informal and formal financial systems; and (2) the degree to which they channel assistance to unserved borrowers. Questions to ask in this regard may include:

- Has the project helped formal financial institutions become used to dealing with small borrowers, either directly or indirectly?

- Have the project beneficiaries developed "borrowing" skills, useful in complying with the requirements of traditional formal financial institutions?

- Has the project assisted groups generally without access to formal credit, including landless laborers, small farmers, women, microentrepreneurs?

- Have the assisted groups been able to expand their business output, unemployment and investment?

- Have both the former financial institutions and the project-assisted groups found it in their interests to continue the relationship?

Although most projects to date have been more effective in providing general assistance to poor groups than in incorporating borrowers into the formal financial system, many banks in Asia have already been developing services to compete directly with informal lenders. Donors interested in the informal sector should concentrate on assisting those individuals that are still bypassed by formal banks.

Projects should be judged for their efficient use of funds and impact, as measured by the following standards:

- While the loan volume should be high, easily attaining millions of dollars, loan size should reach the smallest commercially serviceable size.

- The savings rate should be as high as possible in aggregate terms, and savers should outnumber borrower at ratios of at least 3 to 1.

- The percentage of recurring operating costs covered by earnings, as well as the percentage of total operating costs covered by earnings should be well over 100.

- There is some debate over what type of enterprise should be served by specialized credit programs. Generally,choice of enterprise should reflect the viability of the business plans and the opportunity for successful repayment of the loan.

- The number of borrowers who have been able to attain higher levels of income and/or production and who have been able to obtain formal sector loans should be high, and can cover millions of individuals.

- The degree to which interest rates reflect market forces.

RESOURCES FOR FINANCIAL MARKET DEVELOPMENT

The purpose of the next two chapters is to provide an illustrative listing of resources available to A.I.D. project officers and their host country counterparts involved in financial sector development. Given the breadth and complexity of the field of finance this section is only indicative of the wide range of resources which the officer might tap in advancing his or her knowledge in this area.

The following is a synopsis of material presented in the next two chapters:

Chapter X: **"Technical Assistance and Training Resources in Financial Markets"**

This chapter provides an illustrative listing of technical assistance and training resources. This list is necessarily brief. For example, it does not include the major rating agencies of Standard and Poors and Moodys which are broadly interested in the development of international capital markets. Nor does it include a wide array of consulting firms which either work with A.I.D. in a variety of developments areas (including finance) or specialize in finance and work largely with the private sector. While most of these technical assistance and training resources are based in the U.S., a few which are foreign-owned (such as Euromoney and Business International) have nonetheless been included given their general importance and wide degree of recognition in this field. The final section in this chapter provides a directory of key A.I.D./Washington resource people in financial market development to provide Mission Personnel with ready contact points for further information.

Chapter XI: **Annotated Bibliography**

This chapter provides an annotated list of some key publications which may be referred to for further information in this field. Publications are categorized from the U.S. Government, multilateral donors, commercially available references, guides/pamphlets, and periodicals. This chapter also contains short descriptions of relevant graduate-level text books, television programs and training videos.

A.I.D. Mission comments on the relevance of these two chapters' resources to financial markets programming in their particular countries are welcome. We would also be interested in learning of other materials or resources of which your are aware so that we could share them more widely within the Agency.

More current information on upcoming events or other available resources in the field of finance are available either through periodic A.I.D. publications, such as "FSDP Update" (distributed through PRE/EM), or through the many commercially available magazines noted in Chapter XI.

X. TECHNICAL ASSISTANCE AND TRAINING RESOURCES IN FINANCIAL MARKETS

A. Technical Assistance & Training Resources

1. Illustrative Sources of Technical Assistance in Financial Market Development

Dun and Bradstreet

Dun and Bradstreet's basic function is to furnish information about the American Business Community to interested buyers and sellers needing this information to make business decisions regarding credit, insurance, marketing, etc. Dun provides this information in its Business Information Reports. Dun's other services include: Analytical Services for assessing risk; International Services analyzing political, economic and industry specific data; and Financial Industry Services specifically designed to help financial service companies adapt to an evolving environment.

Dun & Bradstreet has greatly expanded its international business in recent years, responding to the credit information needs of a growing and increasingly interdependent global economy. In the Asia/Pacific region the company has offices in Japan, Australia, New Zealand, Hong Kong, and Singapore, and correspondents in Indonesia, Malaysia, Thailand, India, Philippines, Taiwan, South Korea, and China. The Europe and Near East operations are serviced by D&B's London office.

For further information concerning D&B Credit Services or D&B Information Services, please contact D&B's Murray Hill Headquarters:

One Diamond Hill Road
Murray Hill, NJ 07974-0027.

Tel: (908) 665-5000
Fax: (908) 665-5803

Customer Service is available to answer any questions at (800) 234-3867.

The Financial Sector Development Project (FSDP)

The **FSDP** is a long-term PRE contract which brings together the skills needed by AID Missions overseas to address the problems of the financial sector. Principal areas of expertise that are readily available for buy-in by any USAID Mission are: Financial Sector Assessments, Banking, and Finance - especially programs for bank restructuring, and training for bank personnel; Capital Markets advisory services are available in such areas as capital markets regulation, and regulatory institution strengthening, stock market, structuring, operations, and automation including clearance and settlement and depository systems. Assistance is also available to work with brokerage and underwriting industry through program of strengthening and training promotion.

For further information about the Financial Sector Development Project, please contact:

Rebecca Maestri, PRE/EM
U.S. Agency for International Development
Room 500 SA2
Washington, D.C. 20523

Tel: (202) 663-2342

Financial Services Volunteer Corps

The Financial Services Volunteer Corps (FSVC) was created in April 1990 in response to President Bush's initiative to encourage volunteerism. In partnership with the Agency for International Development, FSVC makes available the expertise and experience of leading financial-sector professionals to assist the emerging democracies of Central and Eastern Europe and other selected countries in their pursuit of free market economies.

FSVC is comprised of specialists from commercial and investment banks as well as legal, accounting, insurance and other allied professions, who provide their services on a volunteer basis without the expectation of commercial reward. FSVC's advisory services are provided at the request of the host country. The scope of work is generally determined in consultation with State/AID.

Volunteer assignments are short-term, requiring one to two weeks overseas, with some follow-up evaluation and consultation from the volunteer's home office. To date FSVC's advisory services have focused on two broad areas: i) central and commercial banking; and ii) the development of capital markets.

For further information concerning FSVC, please contact:

Mr. Timothy T. Frost
Program Director
425 Lexington Avenue
New York, NY 10017

Tel: (212) 455-3549
Fax: (212) 455-3999

Harvey and Company

Harvey and Company is currently managing the Africa Venture Capital Project (AVCP) for the U.S. Agency for International Development. Under the AVCP, Harvey and Company provides technical assistance, training, education and grants for future venture capital start-up initiatives.

Information regarding equity mobilization and venture capital initiatives in Africa can be obtained from Harvey and Company.

Mr. Douglas Leavens
Harvey and Company
1910 K Street, N.W.
Suite 302
Washington, D.C. 20006

Tel: (202) 785-4150

The Institute of International Finance Inc.

The Institute, incorporated as a non-profit organization, came into being in 1984. Its purpose is to serve as a center for dissemination of information, particularly about developing countries. The Institute acts as a forum where Members (167 commercial banks and 13 other financial and business entities) can communicate with borrowing countries, multilateral organizations, and regulators to ameliorate the process of international lending.

Much of the economic analysis undertaken by the Institute concerns world growth, trade, commodity prices, and exchange rates. The papers commissioned by the Institute are of current interest to Missions; they treat topics such as Financial Sector Reform and creating market economies in Eastern Europe.

For further information of the Institute's activities, contact:

The Institute of International Finance, Inc.
2000 Pennsylvania Ave., NW
Suite 8500
Washington, D.C. 20006-1812

Tel: (202) 857-3600
Fax: (202) 775-1430

The New York Stock Exchange

The NYSE is the largest organized marketplace in the U.S. for channeling savings into investment. The Exchange offers training courses in security exchanges and their roles within a financial system. The NYSE devotes a majority of its time to stock market regulation, important aspect for a well defined and efficient marketplace.

The Exchange is willing to meet with officials of countries interested in security market development and explore specific opportunities on a case-by-case basis between the NYSE and the needs of developing countries.

Mission personnel who feel there are candidates in the host country who would benefit from such training should contact:

Mr. James E. Shapiro
Managing Director
Economic Research
The New York Stock Exchange
11 Wall Street
New York, NY 10005

Tel: (212) 656-6499
Fax: (212) 656-2081

Robert Morris Associates

Robert Morris Associates (RMA), a national trade association for bank lending officers, was founded in 1914 to provide services to expand the professional expertise of individuals involved in commercial lending and credit. The agency segments its seminars into groups based on the needs and levels of the participants. The initial level is the Mentor program designed to serve an institution's training and continuing education requirements.

RMA is organized into Divisions responsible for developing the products and services for bankers who identify most closely with the specific area of responsibility. The Divisions of interest to the Agency are the Policy division responsible for international capital market activities, and the securitization and the Lending/Finance Division which develops services for bankers providing commercial lending and capital market products for both domestic and international clients.

For further information on technical assistance, contact:
Robert Morris Associates,
One Liberty Place
1650 Market St.
Suite 2300
Philadelphia, PA 19103-7398

Tel: (215) 851-9100
Fax: (215) 851-9206

Securities Industry Association (SIA)

SIA is the trade association representing over 600 securities firms headquartered throughout the U.S. and Canada. Its members include investment banks, brokers, dealers, and mutual fund companies. The Association's New York and Washington offices concentrate most of their efforts in representing member firm's views to legislative and regulatory agencies at the Federal and State level. However, SIA has a limited number of lobbying and information activities in international finance (centered principally on developed countries.)

For further information on SIA's international activities, please contact:

Mr. David G. Strongin
Director, International Finance
Securities Industry Association
120 Broadway
New York, NY 10271

Tel: (212) 608-1500
Fax: (212) 608-1604

Group of Thirty

The Group of Thirty, established in 1978, consists of approximately thirty members world-wide from the financial sector's business and academia. The Group aims to provide an independent and non-partisan viewpoint to the debate on issues of public policy and private practice. It concentrates on international economic and financial matters. The Group meets twice-yearly in Plenary Sessions to identify and debate international issues. The Group publishes Occasional Papers and Studies on timely international matters.

For a list of the Group's Occasional Papers and selected pamphlets contact ENE/DR/PE/FTI. For further information on the Group, please contact:

Mr. Charles R. Taylor
Executive Director
Group of Thirty
1900 M Street NW
Washington, DC 20036

Tel: (202) 331-2472
Fax: (202) 785-9423

National Association of Securities Dealers, Inc. (NASD)

The NASD is the largest self-regulatory organization in the U.S. Its principal mission is to protect investors through the enforcement of federal securities laws as well as the broader ethical requirements of its own rules. The NASD is the owner and operator of the NASDAQ (National Association of Securities Dealers Automated Quotations) System, an electronic quotation display system for the NASDAQ market. The computerized system receives, stores, and transmits price and volume data and market statistics for more than 4,900 domestic and foreign equity securities for dissemination to the public and institutions in the U.S. and abroad.

NASD's system has served as a model for overseas markets in London, and Singapore. This system would likely be appropriate for advanced developing countries whose infrastructure is capable of supporting large transmissions of data flow.

For further information on the NASDAQ system, please contact:

Mr. Gene Finn
Vice President, Chief Economist
National Association of Securities Dealers, Inc.

1735 K Street NW
Washington, D.C. 20006-1506

Tel: (202) 728-8000
Fax: (202) 728-8882

2. U.S. Government and Multinational Agencies: Synopsis of Program Activities

International Bank for Reconstruction and Development (The World Bank)

The World Bank provides concessional loans to member governments of developing countries. In the area of financial markets, loans are provided for structural adjustment lending linked to macroeconomic policy reforms, for financial sector adjustment programs, for external debt-reduction purposes and for on-lending to development finance institutions and other financial intermediaries. The World Bank also operates a co-financing facility.

For more information concerning The World Bank, interested parties can contact specific country offices. For information specific to the structuring of financial sector adjustment programs, contact Millard Long in the Office of Financial Policy and Systems Division in the Country Economics Department at (202) 473-7474. Information on Co-financing can be obtained by contacting Sanjivi Rajasingham at (202) 458-0013.

The World Bank
1818 H Street NW
Washington, D.C. 20433 U.S.A.

Tel: (202) 477-1234

The International Finance Corporation (IFC)

The IFC's Capital Markets Department operates programs that develop domestic financial institutions and instruments and programs that encourage foreign portfolio investment. IFC's programs primarily consist of loans and equity investments, but also comprise some technical assistance. The Emerging Markets Data Base provides data on stock market performance of markets in developing countries.

For information on the Capital Markets Department call Rudolf van der Bijl at (202) 473-8871. For information on the Emerging Markets Data Base contact Peter Tropper at (202) 473-9110.

Capital Markets Department
International Finance Corporation
1818 H Street NW
Washington, D.C. 20433 U.S.A.

The International Monetary Fund (IMF)

The IMF provides concessional loans to member governments, primarily for short-term balance of payment support and for structural adjustment purposes. The IMF also provides technical assistance, primarily through its Central Banking Department.

For more information contact:

The International Monetary Fund
700 19th Street NW
Washington, D.C. 20431

Tel: (202) 623-7430

The United Nations Development Programme (UNDP)
Division of the Private Sector in Development

UNDP recently established a central division to coordinate and plan its private sector development programs. The division expects to be active in the creation of a more favorable and predictable enabling environment for private sector development. It plans to be active in financial markets development in the creation of country investment funds, venture capital, small and medium enterprise development and privatization.

For further information contact Galal Magdi at (212) 697-3939.

UNDP
One United Nations Plaza
Room TM-908
New York, NY 10017

The Overseas Private Investment Corporation (OPIC)

OPIC operates programs that provide political risk insurance, loans, investment guarantees, and equity in support of United States foreign direct investment in developing countries. In the areas of financial market development, OPIC operates programs for political risk insurance for financial institutions and coverage for specific financial transactions. Investment guarantees have been used to support the creation of regional and global investment funds. A fund for Asia/Pacific countries is in the process of formation.

For information on insurance coverage for financial institutions and transactions, contact Julie Martin at (202) 457-7114. For information on regional and global funds, or other information on OPIC's investment guaranty, loan or equity programs, Graham Williams at (202) 457-7105 may be contacted.

OPIC
1615 M Street NW
Washington, D.C. 20537

The United States Export Import Bank (EXIMBANK)

EXIMBANK operates programs that support U.S. exports of capital goods and services. Its programs consist primarily of direct loans, loan guarantees, and exporters insurance. Certain exporter's insurance programs are beneficial for foreign commercial banks and several new programs, called "bundling" may also be of interest to foreign commercial banks.

For further information on exporter's insurance, specific country officers should be contacted. For information on new products and planning the Policy and Planning Office at (202) 566-8861 may be contacted.

Export Import Bank
811 Vermont Avenue NW
Washington, D.C. 20571

The Securities and Exchange Commission (SEC)

The SEC is involved in assisting developing countries to create and regulate securities markets through the provision of ad hoc technical assistance and internships, through the creation and operation of the Emerging Markets Advisory Committee, and through the operation of the International Institute for Securities Market Development.

Information on technical assistance, internships and the Emerging Markets Advisory Committee information can be provided by the Office of International Affairs or the Office of the General Counsel. Contact Joseph G. Mari at (202) 272-2306 or Thomas L. Riesenberg at (202) 504-2427. (See section on training for contact information on the Institute.)

The Securities and Exchange Commission
450 Fifth Street NW
Washington, D.C. 20549

The International Organization of Securities Commissioners (IOSCO)

IOSCO is an international organization whose members are securities market regulators from around the world. The organization sponsors the research of several working groups and committees on issues of relevance to its members. The work of the Market Development Committee is of relevance to developing countries. The working papers of the committee are available to the public.

For information on the research results of the committees contact Jean Pierre Cristel at (514) 875-8278.

IOSCO
800, Square Victoria 17th floor
Montreal, Quebec
CANADA H4Z 1G3

The Basle Committee on Banking Supervision

The Basle group is an international organization of bank supervisors. The Basle Group's activities are conducted under the supervision of the Bank for International Settlements. The group convenes several times a year to strengthen collaboration among banking supervisors. Issues of discussion concern ways to strengthen bank supervision in an era of deregulation. The group has issued an accord that sets international standards for commercial bank capital adequacy. The committee issues a report twice a year.

For information on the Basle Group contact Executive Secretary, P.C. Hayward at (61) 2808054.

Basle Committee on Banking Supervision
c/o Bank for International Settlements
Postfach
4002 Basle
SWITZERLAND

3. Illustrative Sources of Training for Financial Market Development

The Adam Smith Institute

The Institute, named after the father of free market economics, is a market economics think-tank which promoted a number of public policy issues that have been implemented both in Great Britain and abroad. The Institute is sponsoring the Sixth London Conference on Privatization and Commercialization in July, 1992. The theme of the June 1991 Conference was Privatization and Commercialization strategies for reforming enterprises without necessarily turning them over entirely to private ownership.
For further information on the Adam Smith Institute or future conferences, please contact:

Mr. Robert Thomas
Adam Smith Institute
23 Great Smith Street
London, SW1P 3BL UK
Tel: 44-71-222-4995
Fax: 44-71-222-7544

American Bankers Association

The American Bankers Association is a professional membership organization composed primarily of U.S. financial executives. Though the organization focuses mainly on U.S. domestic banking issues, each summer it offers an International Banking Summer School. This two-week multi-disciplinary program brings together bank management executives from different countries to study the major developments in banking; to develop useful perspectives on global banking issues; and to promote closer personal relationships among bankers from many nations.

For further information, please contact:

Ms. Janet George
American Bankers Association
1120 Connecticut Avenue, NW
Washington, D.C. 20036
Tel: (202) 663-5015
Fax: (202) 828-4544

American Management Association

The American Management Association is a membership organization that offers a wide variety of training courses to individuals and companies. The AMA runs a number of courses in financial management, including Financing International Trade; Managing International Operations; and Foreign Exchange: Advanced Strategies and Techniques. Courses are held in a variety of U.S. cities and run from $895-$1025.

For information, please contact:

American Management Association
135 West 50th Street
New York, NY 10020

Tel: (518) 891-1500

Bankers' Association for Foreign Trade

The Bankers' Association for Foreign Trade (BAFT) is a professional association representing virtually all of the U.S. commercial banks with significant international operations and many foreign banks with U.S. operations. BAFT has three primary areas of operation: government relations, member services and communications, and professional development. It carries out the majority of its training and educational activities through the Center for International Banking Studies (CIBS). Programs cover topics such as international lending techniques, trade financing and foreign loans, sovereign risk, capital markets, and foreign exchange.

For information on BAFT's programs contact:

Ms. Janet Petrillo
Bankers' Association for Foreign Trade
1600 M Street NW, 7th Floor
Washington, D.C. 20036

Tel: (202) 452-0952
Fax: (202) 452-0959

Business International

Business International, a member of The Economist Group, has been providing financial and business information to the corporate community for over 36 years. BI runs a variety of specialized conferences on diverse topics and regions throughout the year.

For information on BI's conference offerings contact:

Ms. Jennifer Bird
Business International
215 Park Avenue South
New York, NY 10003

Tel: (212) 460-0600
Fax: (212) 995-8837

Center for Pacific Basin Monetary and Economic Studies at the Federal Reserve Bank of San Francisco

In July of 1990 the Federal Reserve of San Francisco established a Center for Pacific Basin Monetary and Economic issues at the Bank. Since 1974 the Federal Reserve Bank of San Francisco has been active in promoting cooperation among the Central banks of the Pacific Basin region and increasing public understanding of the economic policy issues affecting this region. The Center will host conferences on major Pacific Basin economic policy issues at two- or three-year intervals. Seminars by Visiting Scholars, Associate members, as well as the Bank's research staff on their research will be presented and published in a monograph series entitled Essays in Pacific Basin Economics.

For information on the Center, please contact:

Mr. Hang-Sheng Cheng
Vice President and Director
The Center for Pacific Basin
Monetary and Economic Studies
Federal Reserve Bank of San Francisco
101 Market Street
San Francisco, CA 94105
Tel: (415) 974-2166
Fax: (415) 974-3429

Economic Development Institute (EDI)

Established by the World Bank in 1955, the purpose of the Institute is to help build development capacities and institutions by organizing training and discussion, and by assisting institutions in the developing world engaged in similar activities. Beginning in 1989, EDI developed a new strategic plan emphasizing three elements: macroeconomic management, public sector management, and the effectiveness of poverty reduction efforts.

EDI offers a variety of seminars in the following areas: Worldwide and Non-regional Programs, Regional Courses and Seminars, National Courses and Seminars, Senior Policy Seminars, Trainer Seminars, and General Institutional Assistance.

For more information on the Institute and detailed information on seminars, please contact:

Mr. Socorro de Paez
Training Support Unit
The World Bank
1818 H Street, NW
Washington, D.C. 20433

Tel: (202) 473-6351

The Economics Institute

The Economics Institute is a nonprofit educational center sponsored by the American Economic Association and affiliated with the University of Colorado. The Institute offers a variety of coursework in economics, business administration, and computer and information science. Each year for the past four years it has sponsored a two-part course in World Banking and Finance.

The objectives of the course are to introduce participants to new thinking about world banking and finance; to allow them to interact with professionals from other countries with similar interests; to expose participants to new features of banking and finance in the U.S.; and to acquaint them with common problems of banking and finance around the world. Major topics covered include: Banking and Finance Policies; Managing Financial Institutions; and Providing Financial Services to the Poor.

For information on the World Banking and Finance program and other courses offered by the Economics Institute contact:

Ms. Sandra Baumann
The Economics Institute
1030 13th Street
Boulder, CO 80302-7306

Tel: (303) 492-3000
Fax: (303) 492-3006

Euromoney Conferences

Euromoney Conferences offers seminars throughout the year on subjects of interest in the areas of multinational investment and management. The variety of topics undertaken is vast, and in many cases expands upon the in-depth articles which comprise the monthly magazines. Examples of past conferences of particular interest to the Agency were "Opportunities in Hungary: Business and Investment in a Developing Economy" and "Thailand: Prospects for a Fast Emerging Newly Industrialized Country." Transcripts of past conferences are can be ordered subject to availability for 60 Pounds Sterling.

For further details concerning future conferences, please contact:

Euromoney Conferences
Tel: 44-71-779-8888

For transcript requests, send orders to:
Euromoney Publications Plc
c/o Eddington Hook Distribution Limited
406 Vale Road, Tonbridge, Kent TN9 1XR, UK
Fax: 44-732-770219

Euromoney Training

Euromoney Training offers courses in the U.K. and the U.S. to Banking, Corporate, and Financial Services Executives and Professional Advisers. Courses offered include: corporate finance; capital markets; investment management; treasury management; general banking and finance; trade and project finance; accounting and taxation; and financial law.

Courses are taught by faculty with practical experience in the financial subjects taught, aided by case studies and computerized market simulations. Depending on the nature and complexity of the subject, the duration of the courses varies from three days to two weeks. Courses are offered year round. Schedules can be obtained from either the U.S. or the U.K. office.

For further information, please contact:

Mr. Gerard Strahan
Director, Euromoney Publications Plc
Nestor House
Playhouse Yard
London, EC4V 5EX UK

Tel: 44-71-779-8888
Fax: 44-71-779-8799

or

Ms. Eileen Green
Euromoney Inc.
145 Hudson Street
New York, NY 10013

Tel: (212) 941-5880
Fax: (212) 941-5805

Federal Reserve Bank of New York

The Federal Reserve Bank of New York offers a two week Central banking seminar. The seminar provides an introduction to Central Banking, Financial Institutions and markets in the U.S., as well as other pertinent international financial issues. Space is limited in the program and entrance is competitive.

Missions interested in further information concerning host country personnel should contact:

Mr. Joel Stein
Federal Reserve Bank of New York
33 Liberty Street
New York, NY 10045

Tel: (212) 720-5000
Fax: (212) 720-6331

The Federal Reserve System also offers a number of training courses in banking, capital management and risk management each year. These courses are offered in a variety of locations across the United States.

For more information, please contact:

Mr. Sarkis D. Yoghourtdjian
Federal Reserve System
Training Program
Washington, D.C. 20551

Tel: (202) 452-3193

Federal Reserve Board and The World Bank

The Federal Reserve Board's Division of Banking Supervision in Coordination with the World Bank, conducts a three week course in Bank Supervision and Regulation for Central Bankers from Developing Countries. Past courses have focused on restructuring the financial systems in Eastern Europe and other developing countries, privatization of banks, deposit protection schemes, credit analysis, costs of intermediation, interest rate risk, foreign exchange risk, international capital markets, and international banking etc. In general, the first week of the course is policy-oriented to discuss the major issues of bank supervision, financial sector reform, and the key issues and problems of bank restructuring. The second component, which spans the latter two weeks, comprises in-depth lectures on credit analysis and bank supervision with the intent of upgrading the technical skills of bank supervisors.

Missions interested in further information for host country personnel should directly contact:

Mr. David Scott
The World Bank
Financial Policy and Systems Division
Country Economics Department
1818 H Street, NW
Washington, D.C. 20433

Tel: (202) 473-7461
Fax: (202) 334-0476

INTRADOS/International Management Group

Founded in 1980, the Intrados Group provides advanced support services in international finance, investment and management. The Intrados Group develops training programs and compiles strategic information for government agencies and Fortune 500 companies, both in the United States and abroad. Intrados offers a number of financially focused courses and seminars each year, including: Building Effective Financial Markets; New Financial Instruments for Development; Privatization Strategies and Techniques for Development; Foreign Investment Analysis and Negotiation; and Securities Market Management in Emerging Economies; Banking Reform through Regulation and Supervision; and Banking Restructuring through Management Initiatives.

Accessible under subcontract with the International Privatization Group (Privatization and Development Contract) through PRE/EM.

Ms. Margaret Ghadar
President
INTRADOS/International Management Group
2020 Connecticut Avenue, NW
Washington, D.C. 20008
Tel: (202) 667-8270
Fax: (202) 223-8791

Management Advisory Services, Inc.

Management Advisory Services offers training courses for Bank/Credit Officers and Small Business Owners/Entrepreneurs from Developing Countries. The objectives of the Banker program entitled "Financing the Closely Held Business" focuses on cash flow lending versus collateral based lending. The program also addresses practical aspects of giving counsel to and communicating with business owners regarding their financial position. Additional emphasis is placed on sound banking practices, effective communication with the small business owner/manager, adequate credit underwriting, understanding repayment sources, and enhancing the lender's understanding of the profitability of small business lending.

The objectives of the Business Owner program entitled, "Financial Management for the Closely Held Business" stresses the owner/ manager's ability to apply basic financial management principles to their particular business. Additional emphasis is placed on sound financial management practices, management of growth, how to communicate effectively with the bank, and how to speak the language of finance.

The two programs, while having specific aims, communicate the skills necessary for each party to deal effectively with the other. Training is accessible under a subcontract through PRE/I. For further information concerning Management Advisory Services, please contact:

Mr. Steve L. Cranfill
Principal
2401 4th Avenue, 3rd Floor
Seattle, WA 98121-1436
Tel: (206) 441-0500
Fax: (206) 728-9107

The New York Institute of Finance

Since 1922 the New York Institute of Finance has offered courses, self-study material, seminars and books to the financial community. As new investment and financing products are created, the Institute develops courses and materials to introduce them to professionals in the financial and non-financial worlds. The Institute offers a variety of short-term courses for financial and non-financial executives. Areas of focus include: Security Analysis; Technical Analysis; Comparative Accounting; Futures; Options; U.S. Money and Capital Markets; Interest Rate Management; Foreign Exchange; Portfolio Management; Clearance and Settlement; and International Corporate Finance - Raising Capital. Courses generally run five days, with the exception of U.S. Money and Capital Markets, which is twenty days in length. For further information, interested parties should contact:

Mr. Bill Rini
New York Institute of Finance
2 Broadway, 5th floor
New York, NY 10004-2207

Tel: (212) 344-2900
Fax: (212) 514-8423 or (212) 344-3469

Overseas Private Investment Corporation

OPIC plans to hold several financial training courses between July and September 1991 for government employees from A.I.D., Eximbank, OPIC, and TDP. Possible topics to be addressed are new financing vehicles and working with export letters of credit. Those interested should contact OPIC for information on timing, location and cost:

Mr. Jeff Kaplan
Overseas Private Investment Corporation
1615 M Street, NW
Washington, D.C. 20527

Tel: (202) 457-7200
or
Mr. Elmer Fales, AID/PM/TD
Tel: (202) 663-2344

Unit Trust of India, Institute of Capital Markets.

The Unit Trust of India, Institute of Capital Markets (UTI-ICM) has been created to be a center for promoting advanced professional education, training, and research in the area of capital markets. The Institute is affiliated with the Bombay Stock Exchange. The focus of training and research will be both Indian and international capital markets. UTI-ICM is interested in including overseas participants in its training programs. The Institute has already conducted courses for participants from neighboring countries such as Bangladesh, Indonesia, and Nepal. Some of the courses offered by the Institute are: fund managers courses; risk management for financial services; corporate strategies for capital market access; and functioning of mutual funds.

For further information on the Institute and course offerings, interested parties should contact:

Mr. D. C. Anjaria
Principal
Unit Trust of India, Institute of Capital Markets
Plot 82, Sector 17, Vashi
New Bombay 400 703
INDIA
Tel: 91-215-672204
Fax: 91-215-672206

World Trade Institute

The World Trade Institute (WTI) offers international business training to government officials and business leaders from around the world. Their courses aim to help participants to better manage the economies and infrastructures of their organizations and countries. WTI offers a number of financial courses including: Fundamentals of Foreign Exchange; Foreign Currency Exposure Management; Strategies in Foreign Currency Exposure Management; Options on Bond Futures; and Letters of Credit. Courses are often offered more than once a year in a number of U.S. cities. They can also be delivered overseas.

For information on course offerings and schedules, please contact:

Mr. Vincent Seglior
World Trade Institute
One World Trade Center
New York, NY 10048

Tel: (212) 466-3175
Fax: (212) 321-3305

4. Educational Programs

a. Business School Training

Business Schools

The June 1990 issue of North American International Business, lists the top twenty graduate schools for International Business. Contact persons and phone numbers are listed in the second column. The majority of these twenty institutions offer flexible executive development courses to mid-career professionals. A variety of programs are generally available either on a part-time or a short-term basis, depending upon whether or not a degree is desired.

In addition, many large U.S. business schools offer a variety of monthly short-term training programs related to Finance of potential interest to A.I.D. officers. For example, the J.L. Kellogg Graduate School of Management, at Northwestern University, offers a range of three-four week programs year round, as well as an executive Master's program. The Master's program is offered on alternating Saturdays and Sundays, in order to accommodate working schedules. Short-term course offerings many as short as one week include: Managing Financial Risk with Futures and Options; Strategic Financial Planning; Art of Venturing; Credit Analysis and Financial Reporting; and Corporate Financial Strategy.

Wharton, at the University of Pennsylvania, offers similar programs. Specialized programs and courses include: Finance and Accounting for the Non-Financial Manager; Financial Management; and Strategy Analysis for Finance and Marketing. Those interested in an executive development course or program should contact the school of interest directly in order to obtain a catalogue and tuition information. You may also contact A.I.D.'s STET training program regarding program offerings by various schools.

b. Part-time Study at Washington, D.C. Area Business Schools

For those project officers either posted or on extended TDY in Washington, a variety of local colleges and universities offer evening courses in business administration, including the field of finance. These institutions include: The American University, George Mason University, The George Washington University, Florida Institute of Technology, Golden Gate University, and University of Maryland, College Park. In addition, most major business schools offer both short term executive development courses as well as longer term degree programs, many of which focus on finance.

Further information on the programs and admission requirements can be obtained from Yvonne Williams, in charge of A.I.D.'s After Hours Training Programs, in PM/TD.

5. Sources of Technical Information in AID/Washington

Agency for International Development
Center for Development Information and Evaluation

CDIE's Development Information Division (CDIE) is dedicated to providing timely, accurate, and complete information services for Agency project, program, and policy managers. CDIE/DI draws on both A.I.D. and other development organizations and experts in selecting and obtaining the latest, most relevant information suited to individual research and management needs.

CDIE/DI provides research support by identifying, analyzing, and selecting relevant publications, preparing customized literature searches, and making referrals to appropriate experts and organizations. Reference services are offered through the

A.I.D. Development Information Center where A.I.D. patrons have access to up-to-date collections of books, periodicals, and micro-fiched documents on economic development and foreign assistance. CDIE/DI also offers access to and analysis of worldwide economic and social data obtained from such sources as the IMF, the World Bank, and the United Nations.

CDIE/DI maintains the Agency's Development Information System (DIS), a collection of data bases that includes Agency project and program documentation and other information that helps the Agency learn from its experience. For the DIS to be useful, Agency staff need to contribute A.I.D.-sponsored documentation to CDIE Acquisitions at the address below. To make an information request, or for more information on CDIE/DI's services and resources contact:

PPC/CDIE
Room 209 SA-18
Washington, D.C. 20523-1802

Research Services:	(703) 875-4807
Reference Services	(703) 875-4818
Economic and Social Data Services:	(703) 875-4912
Agricultural Research Services:	(202) 245-5827
CDIE telefax	(703) 875-5269
Cable or ICS	PPC/CDIE

You may also contact one of CDIE/DI's liaisons in the ENE Bureau who will either answer your request or refer it to appropriate CDIE/DI staff:

Peter Hobby (Research Services)	(202) 647-7099
Charlies Corey	(202) 647-9971

To keep the Agency current on the latest information resources available, CDIE/DI publishes the following:

Requests & Responses -- A monthly bulletin describing information obtained and research support provided in response to Agency requests for information.

Current Contents Bulletins -- A quarterly publication of the table of contents of development journals in the A.I.D. Development Information Center.

Topical Updates -- Bimonthly bibliographies citing the most recent additions to development literature on such topics as AIDS, Democratization, and Informal Sector.

New This Month -- A monthly bulletin of new books and other resources added to the A.I.D. Development Information Center collections.

A.I.D. Research & Development Abstracts, A.I.D. Technical Reports -- Two publications reporting on new additions to the A.I.D. Development information System, the collection of databases that houses the Agency's institutional memory.

6. A.I.D. Training Resources for USDH and FSN Staff

In addition to CDIE's services, the Agency also has a Training Division within its Office of Personnel Management (PFM/OPM/TD). This division offers a variety of courses year round. For example, one recently held seminar (July 29-August 9, 1991), was on Financial Analysis.

STET

Short-Term Technical and Executive Training (STET). AID personnel interested in participating in any in-house training programs should contact the training division for more information on course content, dates, registration deadlines and costs.

Toni Mitchell
Agency for International Development
Room 114
State Annex 14
Training Division
Washington, D.C. 20523

After-Hours Training Program

A.I.D. offers an after-hours training program which allows employees to take job-related courses at universities, colleges and other accredited schools in the Washington D.C. metropolitan area. Priority training needs are in development-related topics, such as: economics, program management, technical fields related to A.I.D.'s project areas and accounting. Applicants are responsible for identifying courses of interest and getting supervisor approval for any time off necessary to attend the course. Applicants are limited to $1,000 in Agency support per application period.

For further information contact:

Judy Alexander
After-hours Training Program
AID/PM/TD/AST

Tel: (703) 875-1565

XI. ANNOTATED BIBLIOGRAPHY

A. U.S. Government Publications

U.S. Agency for International Development

Development Finance Institutions: A Discussion of Donor Experience. Center for Development Information and Evaluation, U.S. Agency for international Development. 1990. 15 pages.

> The paper focuses on three questions: (1) How effective have development finance institutions (DFIs) been as intermediaries for targeting credit to priority groups? (2) Are DFIs sustainable? and (3) Have DFIs contributed to the development of financial markets in developing countries? By comparing donor evaluations of DFI programs the report concludes that DFI's have had limited success in reaching target beneficiaries and few have achieved sustainability.

Financial Markets Development: Policy Paper. U.S. Agency for International Development. 1988. 17 pages.

> The document outlines AID's policy on financial markets development (see Annex F).

Rhyne, Elizabeth and Otero, Maria. A Financial Systems Approach to Microenterprise. U.S. Agency for International Development. 1990.

> The paper discusses the issue of financial services to the poor. It explores the feasibility of microenterprises as financial service clients and examines the policies required to foster financial services for them.

Modernization of Regulation and Supervision of LDC Financial Institutions. Bureau for Private Enterprise, U.S. Agency for international Development. 1990. 32 pages with annexes.

> The report provides a basis for sound technical assistance and training in the areas of regulation and supervision of financial institutions, in the context of financial liberalization. The components of a prudential regulation and supervisory system are identified, as are critical areas in which developing countries need assistance.

The A.I.D./Washington Private Sector Handbook. U.S. Agency for International Development, 1992. 55 pages.

The Private Sector Handbook contains basic information on central bureau private sector projects. An introductory matrix provides a summary of all of the projects' activities and areas in which they provide assistance. A majority of interventions are classified under finance as one element within a broader framework. Each project is then briefly described with a statement of its aim, and, where applicable, the available resources, how they are accessed, projects' recent activities, any recent cable references on the project, and the name, telephone, and fax numbers of the appropriate A.I.D. contact person. Projects are grouped by A.I.D/W bureaus and offices.

The Private Sector Agenda for the 90's: Perspectives from Asia and the Near East. Bureau for Asia, Near East and Europe, U.S. Agency for International Development. 1990.

The report outlines the proceedings of private sector workshops held in Jordan and Thailand in May 1990. The workshops focused on three of the most important elements of an effective private sector strategy: promoting trade and investment; improving financial markets; and strengthening the enabling business environment. Financial topics covered include: banking, privatization, and financial market support.

The Role of Business Regulation in an Era of Liberalized Financial Markets. Bureau for Private Enterprise, U.S. Agency for International Development. 1990. 13 pages.

The report summarizes the proceedings of a one day conference on business regulation, held by the Bureau for Private Enterprise and the Bureau for Asia, Near East and Europe in February 1990. The report covers four topics: an overview of changes in global financial markets and the implications of those changes for AID programming; banking regulation in the U.S. and around the world; capital market regulation and its impact on the mobilization of domestic risk capital; and utility regulation and its implication for private provision of public services.

U.S. Treasury

"The Brady Plan." U.S. Department of the Treasury. March 10, 1989.

> Nicholas F. Brady's speech to the Brookings Institution and the Bretton Woods Committee at the 1989 Conference on Third World Debt. The speech gives a clear outline of U.S. policy on international debt reduction.

Securities and Exchange Commission (SEC)

Background papers for the April 22 - May 3, 1991 conference in Washington D.C. on "The Formation and Operation of Securities Markets", sponsored by the SEC's new International Institute for Securities Market Development. A monograph based on the conference will be available during the fall of 1991.

B. Multilateral Donor Organization Publications

The Organization for Economic Cooperation and Development

Systemic Risks in Securities Markets. Organization for Economic Cooperation and Development. 1991. 76 pages.

> This report focuses on features of market structure and regulation which have aggravated or failed to reduce the danger of an international financial crisis. It explores the scope for improving arrangements designed to contain systemic risks in securities markets in areas such as market mechanisms, clearance and settlements, supervision and capital requirements. The report argues that major structural and regulatory changes in world capital markets which have not yet run their full course support the trend towards more interdependent, but also more vulnerable financial systems.

Promoting Private Enterprise in Developing Countries. Organization for Economic Cooperation and Development. 1990. 103 pages.

> This study describes what the members of the OECD's Development Assistance Committee and some multilateral agencies are doing to promote business and investment in developing countries. Based on OECD field studies and analytical work, it also contains recommendations for improving donors' programs to promote the private sector.

Germidis Dimitri, Denis Kessler and Rachel Meghir. Financial Systems and Development: What Role for the Formal and Informal Financial Sectors? Organization for Economic Cooperation and Development. 1991. 239 pages.

> Based on extensive case studies in twelve developing countries on three continents, the authors provide an analysis of the overall framework for financial intermediation in developing countries, including both the formal and informal sectors, and the economic policy environments in which they operate. The book looks very specifically at domestic savings, and concludes that overall financial development cannot be achieved by focusing attention on formal sector institutions alone, but neither can the informal sector be left to its own devices if financial dualism and its impact on development are to be reduced. The authors propose ways to improve the efficiency of the financial system in developing countries by linking the two sectors in order to establish a more balanced economic, financial, and monetary environment.

Venture Capital: Context, Development, and Policies. Organization for Economic Cooperation and Development. 1987. 60 pages.

> This paper examines the development of venture capital markets, the various forms they take in different countries and the role played by governments in this context.

OECD publications can be ordered from:

> OECD Publications and Information Center
> 2001 L Street NW
> Washington, D.C. 20036
> Tel: (202) 785-6323

The United Nations

Herman, Barry. International Finance of Developing Asia and the Pacific in the 1990s. Department of International Economic and Social Affairs, United Nations. 1991. 57 pages, with tables. (Restricted Distribution)

> The report addresses the question: will the international financing that many rapidly growing Asian economies enjoyed in the 1980s continue, in what forms and with what implications for their development? The paper focuses on private financing that the Asian economies have benefitted from, as well as official finance and aid. It discusses the question of the purpose of aid and the role of multilateral development banks in Asia. Finally, it begins to define a research agenda on financing for Asian nations in the 1990s.
>
> A copy of the report can be obtained from:
>
> United Nations
> DME Section
> Room DC 2-2116
> DIESA
> New York, NY 10017
>
> Tel: (212) 963-4747
> Fax: (212) 963-4324

Report of the International Conference on Savings and Development. United Nations. May 1990. 32 pages, with annexes.

The report outlines the proceedings of the U.N conference on Savings and Credit for Development held in Denmark in May 1990. It focuses on the impacts of economic conditions as well as monetary and fiscal policy on the mobilization of personal savings and the efficient allocation of credit. Policies that provide the framework for influencing financial sector activities, such as bank regulation, bank supervision, financial legislation and training of financial manpower, are covered in the paper. Also discussed are possible means by which donor countries and multilateral agencies could expand their assistance to developing countries in the areas of macroeconomic, sectoral and institutional reform.

The World Bank

Financial Systems and Development: World Development Indicators, World Development Report 1989. The World Bank. 1989. 251 pages.

The twelfth annual World Development Report focuses on the role of financial systems in development. Among topics covered by the report are: the evolution of financial systems; financial sector issues in developing countries; foundations of financial systems; issues in informal finance; and possible steps toward more liberal and open financial systems.

Copies of the report can be obtained from:

The World Bank Bookstore
1818 H Street, NW
Washington, D.C. 20433

Report of the Task Force on Financial Sector Operations. The World Bank. 1989. 52 pages. (Restricted Distribution)

The report explores past World Bank financial sector operations and presents suggestions for a new, integrated approach to financial programs for the Bank.

Long, Millard. Financial Systems and Development. Economic Development Institute of the World Bank. 1990. 17 pages.

This document gives a brief overview of the financial challenges faced by developing countries over the last twenty five years. It then goes on to outline the steps necessary to build efficient financial systems, covering: (1) restructuring; (2) financial infrastructure; (3) the policy environment; (4) institutional development; and (5) financial reform.

Popiel, Paul A. Recent Developments and Innovation in International Financial Markets. The Economic Development Institute of the World Bank. 1989. 11 pages.

The paper examines recent developments in international financial markets that sharply intensified the process of financial innovation. The paper traces the forces that stimulated financial innovations, surveys briefly the causes and effects of the structural changes that took place in international financial intermediation and reviews the main new financial instruments. In conclusion the paper discusses some of the benefits, risks and consequences associated with financial innovation.

Sheng, Andrew. Bank Supervision: Principles and Practice. The Economic Development Institute of the World Bank. 1990. 26 pages.

The paper argues that because the banking system is an important part of macroeconomic management, sound supervision is a vital component of overall central bank management of the financial system and the economy. It outlines (1) the principles of bank supervision; and (2) the practice of bank supervision. The essential components of the bank regulation process are discussed, including: information disclosure; risk control limits; liquidity requirements; capital adequacy requirements; and information pooling and coordination.

Copies of The World Bank's EDI papers can be obtained from:

Edith A. Pena
The Economic Development Institute of the World Bank
Finance, Industry and Energy Division
Room M-P1-010
1818 H Street, NW
Washington, D.C. 20433

Tel: (202) 473-6313

C. Reference Guides/Pamphlets

Duttweiler, Ellen, ed. Fact Book. New York Stock Exchange, 1990.

This fact book reviews the activities of the Exchange for the year 1989 as well as portraying the market's performance within the broader scope of the economy. The book explains how stocks are traded, the types of trades executed, and lists relevant statistical data. In addition, definitional and statistical sections are included on inter alia: bonds, The exchange community, foreign markets, futures, and securities market credit.

Copies of this text have been distributed by ENE/DR/PE/FTI to A.I.D. Missions. For further information on other NYSE booklets, please contact:

New York Stock Exchange, Inc.
Publications Department
11 Wall Street
New York, NY 10005

Morris, Kenneth M., Alan Siegel, Richard Saul Wurman. The Wall Street Journal Guide to Understanding Money and Markets.
Prentice Hall Press/Access Press Ltd., 1989.

This Guide defines and compartmentalizes the various types of markets which make up capital markets in the U.S.: stock, bond, commodity, mutual fund, futures, and options. The book also explains in detail the functioning of the particular market, the terms specific to each market, the users of each market, and the purpose the market serves.

The book may be ordered for a cost of $13.95 plus a $3 shipping fee. To order, please contact:

Access Press Limited
P.O. Box 664
Holmes, PA 19043

Tel: (800)-345-8112.

The Investment Company Institute. Mutual Fund Fact Book.
The Investment Company Institute, 1990.

The 1990 Mutual Fund Fact Book is a guide to mutual fund trends and statistics observed and recorded during the year 1989. For these data to be meaningful, the text also explains what a mutual fund is, the different types of funds, the historical background on mutual funds, their growth and development, means of acquisition, and information regarding the management of the fund. The statistical data provided details among other things, the dollar amounts invested in the various funds and various classes of shareholders, e.g. individuals, institutions.

The Mutual Fund Fact Book is available at a cost of $9.95. For further information, please contact:

Michelle Worthy
Investment Company Institute
1600 M Street NW Suite 600
Washington, D.C. 20036

Tel: (202) 293-7700

The Investment Company Institute. Reading the Mutual Fund Prospectus.

This pamphlet contains the seventeen most important items that one is likely to encounter when reading a mutual fund prospectus, including those items funds are required by law to include. Also contained in the pamphlet are typical questions and answers a prospective investor might ask before reading a prospectus.

Copies of this pamphlet have been distributed to Missions. For information on other publications please contact:

Michelle Worthy
Investment Company Institute
1600 M Street NW Suite 600
Washington, D.C. 20036

Tel: (202) 293-7700

Tobin, Jean E., ed. Institutional Investor Fact Book 1991. New York Stock Exchange, Inc. 1991.

This booklet provides a brief background on the NYSE and U.S. Capital Markets. The majority of the booklet concentrates on the role and importance of the various types of institutional investors (e.g. private pension funds, life insurance companies etc.) in U.S. capital and equity markets and the flow of funds. The flow of funds data compartmentalizes flow of money to the equity markets from the various economic units, i.e. households, foreign sector, insurance companies, etc. Relevant statistical data accompanies the text.

Copies of this text have been distributed to Missions. Other booklets of interest include The Capital Market for all Investors and Marketplace: A brief History of the New York Stock Exchange. For further information on other NYSE booklets, please contact:

New York Stock Exchange, Inc.
Publications Department
11 Wall Street
New York, NY 10005

D. Periodicals

Business International

Business International, a member of the Economist Group, is a specialized publication serving the information needs of the international manager. The BI subscription comprises six major elements: a) BI Country Monitor - a weekly newsletter covering the major business opportunities and dangers worldwide. b) Prospects for Profit - three-year forecasts for key countries on crucial economic, political, and investment issues. c) Europe/Eastern Europe Monitor - information on the latest initiatives in the EC and Eastern Europe. d) Global Operating Climate at a Glance - trade and foreign investment rules, licensing regulations, tax rate and exchange controls around the world. e) Corporate Strategy Reports - ongoing analysis of the problem solving techniques and innovative long-term strategies being developed by leading MNCs. f) Bimonthly Special Supplements - analysis of critical international management issues and solutions for the 1990s.

Additionally, BI publishes separate newsletters geared to specific geographic regions plus a wide array of research papers on individual countries and topics such as financing foreign operations and world-wide financial regulations. These papers and newsletters are available separately at additional cost.

For subscription information, please contact:

Order Fulfillment Department
215 Park Avenue South
New York, NY 10003

Tel: (212) 460-0600
Fax: (212) 995-8837

Euromoney

A monthly magazine devoted to the issues of international finance and banking. Euromoney covers the globe with the issues important to the U.S., Europe, Eastern Europe, the Far East, Latin America, and the Middle East, etc. Issues such as country risk, international lending, and privatization in developing countries are treated in-depth. Euromoney publishes special editions on supra-national agencies which focus heavily on development, such as the World Bank and the IMF. Supplements concerning the latest financial innovations, corporate finance, and country studies are often published in conjunction with the monthly issue. Each

January edition contains an index to the previous year's articles. The index is organized by author and by subject.

The cost for a yearly subscription to Euromoney is $226. For subscription information, please contact:

Quadrant Subscription Services,
Oakfield House
Perrymount Road
Haywards Heath, W Sussex RH16 3DS, U.K.
Tel: 44-444-440421
Fax: 44-444-440619

The index is free to subscribers. Additional copies may be ordered at a cost of 3 Pounds Sterling. Please contact:

Subscriptions Department
Euromoney Publications Plc,
Nestor House
Playhouse Yard, London EC4V 5EX U.K.

Tel: 44-71-779-8888
Fax: 44-71-779-8623

International Trade Reporter

A weekly publication produced by the Bureau of National Affairs. The International Trade Reporter covers trade policy developments within the U.S. government, as well as many country and region-specific changes in trade policy. GATT activities are monitored and export and international financing opportunities are covered. The publication carries a weekly calendar of international trade and finance conferences and training sessions conducted by public and private organizations.

The price for a one year subscription is $816, overseas airmail additional. For subscription information contact:

International Trade Reporter
The Bureau of National Affairs
1231 25th Street, NW
Washington, D.C. 20037

Privatisation International

This UK monthly publication details the privatization process presently underway worldwide. Each month the journal lists either industries, or companies within industries, to be privatized in a specific country. If industry of company specific information is not available, the government's intention vis-a-vis privatization is elaborated upon. These summaries also tell the method of privatization, e.g. public offer vs. private placement, and the intended types of shareholders, e.g. employees, general public, or foreign investors.

The magazine includes a section on project finance and the section entitled Practitioners Column offers a more theoretical view of the issues of privatization, e.g. how to sell a share offer or the process of change undergone by management in a newly privatized company.

The initial cost for a one year subscription is $545; the cost is $650 for a yearly subscription in all subsequent years. For subscription information, please contact:

Privatisation International
P.O. Box 863
London SE5 8JG UK

Tel: 44-71-274-3869
Fax: 44-71-274-8752

The Privatisation Review

The Review is published quarterly by the Privatization Council Inc. The Review deals with the theoretical concepts and relevant issues associated with privatization. Articles in previous issues have dealt with the "Economics of Privatizing, Wastewater Treatment Facilities," "Determining Privatization Feasibility," "Privatization and Economic Reform in Socialist Countries," and "Certificates of Participation: An Emerging Public Financing Technique."

The cost for a one year subscription for Public/Nonprofit Organizations is $120, $200 for Private Firms. For subscription information please contact:

MAXCO Publications Inc
1130 McBride Avenue
P.O. Box 748
Little Falls, NJ 07424
Tel: (201) 785-0764
Fax: (201) 785-0447

South

This monthly devotes itself entirely to being "the business magazine of the developing world." The magazine focuses on the economic, financial, and trade and investment issues important for developing countries as a whole as well as for individual countries. A highlight of some timely articles includes: investment in Hungary; privatization in Egypt; country surveys on Indonesia and other developing countries; development aid; and the changes taking place in foreign investment.

The price for a one year subscription is $36, for two years, $65. For subscription information, please contact:

South Media & Communications
128 East 37th St.
No. 4R
New York, NY 10016

Tel: (212) 685-7959
Fax: (212) 213-1249

Swaps: A Newsletter of Financial Instruments

Swaps is published quarterly by the Intrados Group. It monitors innovation in international financial markets. It aims to provide business leaders and government officials with the insight and commentary of financial experts, in order to help them in their day-to-day decision making activities. The Intrados Index, a weighted indicator that measures the average value of the debt of ten selected nations is published in each issue.

The price for a one year subscription is $175, overseas airmail additional. For subscription information contact:

Intrados Group
2020 Connecticut Avenue, NW
Washington, D.C. 20008

Tel: (202) 667-8270
Fax: (202) 223-8791

The Wall Street Journal

The WSJ published daily by Dow Jones is a well known source of pertinent business and financial information. The Journal is organized into three separate sections. The first contains economic, legal, and international information. The Journal also publishes Federal Reserve and Bureau of Labor Statistics. The second section, entitled "Marketplace" carries subjects of interest in the areas of Media & Marketing, Law, and Technology. This section also contains an index of businesses listed. The third section, "Money & Investing" contains the previous day's financial market activities for the U.S. and selected foreign markets.

The price for a one year subscription is $109. For subscription information, please contact:

The Wall Street Journal
200 Burnett Road
Chicopee, MA 01021

Tel: (800) 628-9329

* This listing includes a sample of relatively specialized business periodicals of particular interest to AID projects officers (another finance magazine of possible interest is Institutional Investor). It does not include other widely known magazines, many of which (e.g. The Economist, Far Eastern Economic Review, Barrons) contain excellent articles on international finance.

E. Graduate Level Text Books

Cook, Timothy Q, and Timothy D. Rowe, ed. Instruments of the Money Market. Richmond: Federal Reserve Bank of Richmond, 1986.

Compiled by the Federal Reserve Bank of Richmond, this text explains in a qualitative matter the instruments which comprise the money market. Chapter 2 provides a solid background of the role of the Federal Funds rate. Chapters 4 - 10 define and explain the uses of the various short and long debt instruments such as Treasury Bills Commercial Paper and the like. The book provides a framework of the functioning of these instruments in a developed financial system.

The first copy of the book is issued gratis, and the charge is $1 per copy thereafter. For information on ordering, please contact:

Ms. Claudine Darden
Public Services Department
Federal Reserve Bank of Richmond
P.O. Box 27471
Richmond, VA 23261

Tel: (804) 697-8109

Aliber, Robert Z. The Handbook of International Financial Management. Homewood, IL: Dow-Jones Irwin, 1989.

This text is divided into four distinct parts, each containing the issues, players, and theories of importance. The chapters most apropos to AID are numbers five through eight and twenty-seven concerning the Structure of the International Banking Industry; International Competition in Banking and Financial Services; Investment and Merchant Banks; the Regulation of Financial Markets; and Debt Problems of Developing Countries.

This book may be purchased for $59.95 plus tax at:

Sidney Kramer Books
1825 I St. NW,
Washington, D.C. 20006

Tel: (202) 293-2685

Adams Dale and Del Fitchett, ed. Informal Finance in Low Income Countries. Westview Press. 1991.

Why informal finance succeeds where formal finance often fails is the focus of this book. Traditional views about informal finance are evaluated, major types of informal finance are discussed, arguments about explanations in informal finance are analyzed, and major lessons that can be learned from their study of informal finance are discussed.

This book may be purchased for $52.50 plus tax at:

Sidney Kramer Books
1825 I St. NW,
Washington, D.C. 20006

Tel: (202) 293-2685

Livingston, Miles. Money and Capital Markets. Englewood Cliffs, NJ: Prentice Hall, 1990.

Chapters 3, 5, 6, 7, dealing with the Federal Reserve; Financial Intermediaries; Bank Regulation & Management; and Efficient Markets, respectively, are of interest to AID Mission officers. These chapters give a solid qualitative overview of the operations of the Fed, the various financial intermediaries in the marketplace, how and why they are regulated, and the concept of the efficient market which is necessary for functioning capital markets.

This book may be purchased for $42.00 plus tax at:

Sidney Kramer Books
1825 I St. NW,
Washington, D.C. 20006
Tel: (202) 293-2685

Other highly recommended textbooks:

On functioning of international capital markets:

Solnik, International Investing, Addison Weasley, 2nd ed, 1990

On basic Finance:

Brealey and Myers, Corporate Finance, McGraw-Hill

F. Television Programs

Adam Smith's Money World* (PBS)

Host Adam Smith discusses information pertinent to the economy, often with relevance to financial markets. He assembles a panel of experts, frequently with opposing views, to discuss the issues of interest. Panelists have backgrounds in economics, politics, and other fields relevant to the topic of discussion.

Growing a Business*

Paul Hawken, a California merchandiser, developed this "how-to" series to nourish the entrepreneurial spirit. This 18-part series documents the successes of a variety of businesses, begun with little more than a great idea. Specific topics such as cash-flow analysis and other accounting procedures are covered as part of the series.

CNBC

CNBC broadcasts without interruption during the hours of the New York Stock Exchange (9:30am - 4:00pm) with supplemental broadcasts during key morning and evening hours. The broadcasts feature market analysts and other expert opinions on the direction of the stock market. Additionally, CNBC has features on specific industries and their market performance.

Wall Street Week in Review (PBS)

Hosted by Louis Rukeyser, Wall Street Week in Review, focuses on the pasts week's stock market activities and future trends. Prominent Wall Street and business personalities are interviewed for their opinions and prognostications. The program also deals with specific aspects of the economy and the market, e.g. micro-enterprise aspects of particular industries, and the performance of small company vs. large company stocks.

Worldnet

The United States Information Agency Television and Film Service's WORLDNET satellite television network was created in 1983. In the area of Business and Economics WORLDNET broadcasts the following programs: Adam Smith's Money World, The Business File, Economics U$A, First Business, and Growing a Business. For information concerning broadcast times and video tapes, Mission personnel should contact a USIS public affairs officer.

*Available through Worldnet

G. Training Videos

Euromoney, Financial Training Videos

Euromoney offers a collection of financial training videos accompanied by workbooks and computer-based training programs. The present library contains forty films covering sixteen different disciplines. Video prices range from $425 to $1685 per tape. Sample tape titles are: the U.S. Money Market; An Introduction to Futures; and Introduction to Foreign Exchange. Many tapes are available in French, German, Japanese, and Spanish.

For further information, please contact:

Mr. Colin G. Sullivan
Financial Training
Euromoney Publications Plc
Nestor House
Playhouse Yard
London EC4V 5EX, UK

Tel: 44-71-779-8888
Fax: 44-71-779-8623

GLOSSARY OF KEY FINANCIAL TERMS

American depository receipt: A negotiable certificate, usually issued by a U.S. bank, denominated in shares, certifying that a stated number of securities of a foreign issuer has been deposited with a depositary (a U.S. bank or its foreign affiliate).

Amortization: The gradual reduction of a debt or obligation by making periodic principal and interest payments. Includes such practices as depreciation, depletion, write off of intangibles, prepaid expenses and deferred charges.

Arbitrage: The simultaneous sale and purchase, or lending and borrowing, of equivalent assets in order to profit from price disparity.

Asset: Anything that is owned by, or due to, an individual or business that has commercial or exchange value. Assets of banks and other financial institutions include loans of all types made by that institution to its borrowers, and all investments made by the institution in any type of financial instruments (stocks, bonds, money market investments), since such loans and investments "belong to" (are owed by) the bank or financial institution.

Balance sheet: An itemized financial statement showing the nature and amount of a company's assets, liabilities and capital on a given date.

Bank: An establishment which accepts deposits and extends credit; banks also typically also provide other financial services such as custody and management of financial assets, foreign exchange, letter of credit and guarantees, and financial advisory services.

Banker's acceptances: Promissory notes representing short-term loans by a bank to tan importer or an exporter, which are endorsed (guaranteed) by the bank and thereby become negotiable money-market debt securities for short-term investment purposes.

Basis point: 1/100 of 1 percent. For example, 40 basis points equals .40 percentage point.

Bid: The price at which a person is ready to buy.

Bond: A promissory note of a corporation, municipality, state or nation, obliging payments of interest periodically and repayment the loan upon expiration to bondholders. In every case a bond represents debt.

Broker: A party who acts as an agent or intermediary in buying and selling securities but does not take a position in the asset to be exchanged.

Capital gain or loss: Profit or loss from the sale of a capital asset.

Capital market: A market in which long term savings are channeled to investors in both debt and equity forms.

Capital stock: All shares representing ownership of a business, including preferred and common.

Capitalization: Total amount of the various securities issued by a corporation. Capitalization may include bonds, debentures, preferred and common stock and surplus.

Closed-ended mutual fund: Investment funds that issue only a limited number of shares, which therefore must be purchased only from current owners.

Collateral: Marketable assets (cash, securities, real estate) pledged by a borrower in favor of a lender which can be processed and sold by the lender in event of non-payment of the loan.

Commercial bank: An institution which accepts deposits and finances the short-term credit needs of corporations, individuals, medium, and sometimes long-term loans, foreign exchange, trust services.

Commercial paper: Short-term obligations (bonds) of major credit-worthy corporations representing borrowing by that corporation, issued in negotiable form for placement with investors by investment bankers and brokers; this form of borrowing by major corporations has replaced borrowing from banks, but it is only workable for the strongest, least-risky borrowers.

Common stock: Securities representing an ownership interest in a corporation. The payment of common stock dividends follows payments on bonds debentures, and preferred stocks Voting rights are usually accorded holders of common stock.

Contractual Savings Institution: An institution that collects savings on the basis of long-term contracts such as life insurance plans, employer-sponsored pension funds and government-sponsored social security funds.

Convertibles: Securities (generally bonds or preferred stocks) that are exchangeable at the option of the holder into other securities of the issuing firm.

Credit controls: Quantitative and qualitative controls exercised by the monetary authorities over the volume and nature of credit and over interest rates. These controls can effect the quantity and cost of credit available to domestic and foreign borrowers in the country's capital markets, and can strongly influence the direction of the national economy.

Credit union: A private not-for-profit financial institution offering a variety of services to its members such as savings and checking, payroll deduction plans, money orders, credit and debit cards, and Individual Retirement Accounts.

Currency swap: Agreement between two counterparts to exchange specific amounts of one currency for another and to re-exchange the currencies at a specific time in the future.

Current assets: Those assets of a company that are reasonably expected to be realized in cash, or sold or consumed during one year. These include cash, government bonds, receivables and money due within one year.

Current liabilities: Amounts owed and payable by an individual, company or financial institution within the current period of not more than one year.

Dealer: A party who purchases securities and then resells them from their own portfolio at a mark-up price.

Debenture: A classification for all forms of unsecured, long-term debt, usually applied to a certificate of debt issued by a corporation.

Derivatives: Financial futures, options, and swaps.

Discount: Distribution of a company's profits to its share holders pro rata among the shares outstanding. Typically a company's Board of Directors will decide how much of the company's net profits will be reinvested in the company versus how much will be distributed to shareholders in the form of dividends (which are usually paid in cash but sometimes in new issues of company shares).

Discount rate: The interest rate of federal monetary authorities charged to member banks for loans.

Disintermediation: The investing of funds that would normally have been placed with a bank or other financial intermediary directly into debt securities issued by ultimate borrowers; e.g., into bills or bonds.

Dividend: The payment designated by the board of directors of a firm to be distributed pro rata among the shares outstanding.

Equity: The net worth of a business, consisting of capital stock (preferred and common), additional paid-in capital, retained earnings and occasionally, certain net worth reserves and/or adjustments. When used in a financial sense, equity means the value of property beyond the amount of all claims and liens against it.

Eurobond: A debt security issued multinationally through an international syndicate of banks or securities firms in a currency other than that of the country in which the bond is issued.

Eurocurrency market: The market for foreign currency-denominated deposits held at banks located outside the currency's home-country.

Eurodollars: Dollars owned by non-residents of the United States which are held in bank accounts outside the United States.

Face value: The value of a bond that appears on the face of the certificate, unless the value is otherwise specified by the issuing entity. Face value is not an indication of market value, but rather the amount the issuing entity promises to pay upon the bond's maturity.

Financial markets: The markets for short-, medium-, and long-term securities and loans, forward and swap contracts, financial futures, and foreign currencies.

Foreign exchange market: The market in which the currencies of different nations are bought and sold with respect to each other. Most trading takes place with respect to the U.S. dollar.

Forward contract: Individualizes contracts requiring delivery at a future date of an agreed amount of one currency for another.

Futures contract: Standardized contracts to buy or sell a "basket" of financial assets at a specified price and date in the future. Financial Futures are usually traded on an exchange , and settlement is usually made by net cash transfers rather than actual delivery of the financial assets.

Institutional Investor: An organization whose primary purpose is to invest its own assets or those held in trust by it for others. Includes pension funds, investment companies, insurance companies, universities and banks.

Interest: The "price" of money when it is borrowed or lent, expressed as a percent (the "interest rate") per year ("per annum") of the amount borrowed or lent (the "principal"). In any given currency, the interest rate is a function of the supply and demand for money in that market, unless government fix interest rates by regulation. (The "real" interest rate is the interest rate less the rate of inflation in a given country; real interest rates can be positive--when nominal interest rates are higher than the rate of inflation--or they can be negative when nominal interest rates are lower than the rate of inflation.

Intermediation: The process by which savers and investors place funds in financial institutions in the form of savings accounts and the financial institutions in turn use these funds to make loans and other investments.

Investment banks: Banks that engage in the financing of capital requirements of an enterprise by buying and selling corporate and government securities in large blocks and selling them to investors. They finance the long-term credit requirements of business organizations for new buildings, new equipment, and plant expansion.

Isusu: An indigenous savings and credit association that provides informal loans to its members. Also known as a "tontine" in Francophone West Africa and a "chilenba" in parts of East Africa.

Lease: A contract whereby one party, known as the lessor, grants to another party, known as the lessee, the rights of use, tenancy, or occupation by the lessor. The property may be land, buildings, equipment, etc. The property leased reverts to the owner at the expiration of the lease agreement.

Letter of credit: An instrument by which a bank substitutes its own credit for that of an individual, firm, or corporation, to the end that domestic and foreign trade may be more safely, economically, and expeditiously conducted.

Leveraged Buy-Out (LBO): A transaction where: (1) the stock or substantially all of the assets of a company or a subsidiary or division is acquired; (2) a significant amount of debt and a limited amount of equity is used to complete the purchase, and (3) the lender relies substantially on the value of the assets and/or cash flow of the acquired company for repayment.

Liabilities: All claims by outside parties (debts owed) against an individual, corporation or financial institution. Depositors' funds placed with a bank or other financial institution are liabilities of that institution since such deposits represent amounts owed by that institution to the depositors.

Liquidity: The ability of a market for any commodity (financial securities, real estate, raw materials) to convert that commodity into cash at relatively stable prices. Liquidity is one of the most important characteristics of a good market for any commodity.

London Inter-bank Offer Rate (LIBOR): The deposit rate offered for interbank loans within London. LIBID, or the London Interbank Bid Rate is the interest rate at which bids for interbank loans are made. The midpoint of the spread between LIBOR and LIBID is commonly referred to as LIMID.

Loan: A business transaction between two legal entities whereby the lender agrees to rent funds to the borrower, generally to be repaid with interest.

Merchant bank: A financial institution that engages in a combination of commercial and investment banking functions.

Money market: The market for short-term debt instruments such as Treasury Bills, commercial paper, bankers acceptances, negotiable certificates of deposit, loans to securities dealers, repurchase agreements, and federal funds.

Net worth: The owner's equity in a given business, represented by the excess of the total assets over total liabilities.

Offer: The price at which a person is ready to sell.

Open-end mutual fund: A fund that redeems shares at net asset value and sets no limit on the number of shares available for public sale, usually selling as many shares as possible.

Option: A right to buy or sell a fixed amount of a given asset (stock, currency, commodity, etc.) at a specified price within a limited period of time.

Open market operations: A function of the Federal Reserve System whereby it buys or sells government obligations in the open market. The Federal Reserve acts in the open market as an instrument to help control the expansion and contraction of money.

Over-the-Counter Market (OTC): A market for securities not listed or traded on any of the regular exchanges. The OTC market is conducted over the telephone and through computer terminals and is the principal market in the U.S. for bonds of all types.

Preferred stock: Corporate stock whose owners have claims on the company's earnings before payment may be made on the common stock if the company liquidates. Usually entitled to dividends at a specified rate before payment of a dividend on the common stock.

Price-Earnings ratio: A popular way to compare stocks selling at various price levels. The PE ratio is the price of a share of stock divided by earnings per share for a twelve month period.

Principal: For any money or capital market debt instrument(bank deposit or loan, commercial paper, bond) the principal is the amount deposited, invested, lent or borrowed, and is due to be repaid at the agreed time. Interest rates payable by the borrower to the lender are calculated as a percent (typically a percent per-year--"per annum") of the principal amount.

Primary market: The market for new securities issues.

Provident Fund: Social security fund.

Risk: The possibility of loss; specifically, the chance of non-repayment of debt.

Secondary market: The market in which primary instruments are traded (stocks, debt) after they have been issued by companies or countries in the primary market.

Securitization: Capital financing through securities issuance, floating rate notes, and commercial paper, rather than bank financing. This often entails disintermediation of the banking system.

Special Drawing Rights (SDR): A basket currency created by the International Monetary Fund in 1967 to enhance international liquidity.

Stock exchange: An organized marketplace for securities whereby the prices are determined by supply and demand and the transaction of orders by member brokers or institutional and individual investors.

Subordination: Acknowledgement by a creditor, in writing, that the debt due from a specified debtor shall have a status inferior or subordinate to the debt which the debtor owes another creditor.

Term loan: A loan provided for an extended period of time, generally with a maturity greater than one year and for such purposes as an increase in working capital or the purchase of equipment or other fixed assets.

Trade finance: The financing of international trade (import or export) transactions. Such financing can take many forms: short-term financing based on commercial bank letters of credit issued in favor of the seller of goods; or longer-term export credits, often provided by government "Eximbank" entities.

Tontine: An indigenous savings and credit association in Francophone West Africa that provides informal loans to its members. Also known as an "isusu" in Anglophonie West Africa and a "chilenba" in parts of East Africa".

Underwriting: The designing, preparing, bringing forth, and guaranteeing of the sale of a new issue of securities.

Universal banks: Financial institutions such as those found in Germany and France which generally do not separate the investment and commercial banking functions.

Venture capital: Capital for start-up situations ("seed capital") or for existing high-risk small businesses having high profit potential as emerging growth companies.

Yield: The rate of return from one's investment in a specific security or specific piece of property.

USAID/MADAGASCAR
FINANCIAL MARKET DEVELOPMENT PROGRAM

I. Program Description

The Financial Market Development (FMD) Program marks USAID/Madagascar's entry into the financial sector in Madagascar. It follows from the Country Program Strategic Plan (CPSP) approved by USAID/Washington in September, 1992. Specifically, one of the targets of the CPSP is "Financial Market Reforms Increase Domestic Resources for the Private Sector". FMD will be the Mission's principal vehicle to achieve this target. The goal of FMD is to increase investment and employment in the private sector. The purpose is to increase the level of domestic financial savings and the share of savings going to the private sector. The FMD program addresses this goal and purpose both at the national level of monetary policy and at the grass roots level of the urban and rural poor. The program will have two collaborators; the Central Bank of Madagascar (BCRM), and the Caisse d'Epargne de Madagascar (CEM - the national postal savings bank). In order to encourage a national financial environment conducive to the growth of private savings, FMD will work with BCRM to improve the capacity of the Bank to implement stable, non-inflationary monetary policies consistent with free market principles. To encourage and enable the rural and urban poor to build financial savings, FMD will work with CEM to improve the access, user-friendliness and interest rate incentives for savers at CEM.

The FMD program will consist of both project assistance and non-project assistance (NPA). The NPA component is essential in order to put into place the institutional framework required for the effective functioning of the two collaborating organizations. The NPA component will include cash transfers to help the Government of Madagascar (GOM) cope with its external debt service problem. The project component will furnish technical assistance, training and equipment to the collaborating institutions.

II. Program and Project Activities

Central Bank The Central Bank component of the Project has been designed in parallel with the World Bank FINDEP Project (Financial Institutions Development Technical Assistance Project). As part of this multi-donor program to strengthen the Central Bank, FMD will take the lead in two areas: establishment of a Research Department and human resource development.

With the requirement for the Central Bank to have access to macroeconomic, research and policy-related data on a systematic basis so that it can fulfill its monetary and supervisory roles, the Strategic Development Plan (SDP) provides for the creation of a Research Department and specific data collection and research functions. Within the framework of the SDP the FMD Program will: (i) recruit an expatriate research advisor who will report to the Director General of the Bank, (ii) strengthen the bank's capacity to formulate monetary policy as well as act as advisor to the government on economic policies through training and technical assistance, and (iii) improve the bank's ability to keep the public informed through the regular publication of statistical policy and research information.

FMD's second contribution to strengthen the Central Bank will be in the area of human resource development. While the quality of staff in the Central Bank is quite high on average, there appears to be a lack of broad-based understanding of the functions of central banking in a market economy. There is virtually no systematic planning for staff rotation or long-term training. Central Bank senior management has also expressed the need for review of the present system for classifying personnel to improve incentives and prospects for horizontal and vertical mobility. The SDP will contain a human resource development plan which will insure that the skill requirements of the restructured and strengthened Central Bank departments, and more generally the evolving personnel needs of the Central Bank, are met. FMD will support this effort in four ways: first, undertaking a comprehensive human resource study focusing on staff classification, rotation, promotion and training; second, assisting in the development of the personnel management functions; third, providing both expatriate and local training experts and specialized training abroad for key personnel; and fourth, setting up an English language training program for bank staff.

Caisse d'Epargne de Madagascar CEM operates as a traditional postal savings institution although it was legally transformed into a savings bank in 1985. CEM already attracts the business of one-in-four inhabitants in Antananarivo and hence, has a good foundation from which to grow further. Apart from its own outlets in the capital, CEM operates 220 windows in post offices in 208 towns throughout Madagascar, giving it the widest financial network in the country. The vast majority of its accounts are held by individuals; the rest are held by a handful of enterprises, local governments, educational institutions, and religious as well as other associations. Individual accounts, however, average only about 40,000 FMG (about US $21.00)[1] and the minimum to deposit open an account is 100 FMG (about 5 cents), much lower than the minimum deposit required by commercial banks for a savings account. Thanks to its widespread network, the CEM could form an excellent base for establishing the necessary link between informal and formal institutions. The CEM is the most promising candidate in the near-term to provide linkages between small-scale, informal and formal segments of the financial system. To enable the CEM to play such a role, a broad revitalization program for CEM will be undertaken. This program will strengthen its organization and management, marketing, financial and personnel policies. An essential step will be for the GOM to revise the legal status of the CEM in accordance with its new goals and objectives.

The CEM has institutional, organizational and human resource strengths that will enable it to take on a larger role in Madagascar's financial sector. Analysis by the project design team and by outside consultants indicates three policy changes are needed as part of a CEM revitalization plan. The first policy change is the legal status of CEM. Currently, CEM is

[1]This calculation is based on an exchange rate of US $1 = 1,900 FMG.

an Enterprise Publique d'Intérêt Commercial (EPIC). A revised status of the CEM based on the recommendations of the Malagasy legal advisors will be a performance criteria. The second policy change relates to the interest rate paid on CEM assets deposited at the Treasury. Currently the interest rate is set annually by the Ministry of Finance and is well below market-determined interest rates. A policy determination that will result in the CEM interest rate being pegged to an observable market rate will be a performance criteria. The third policy change will require a payment by the GOM to the CEM in the approximate amount of 2.9 billion FMG about ($1.5 million) to compensate the CEM for interest not received on its deposits at the Central Bank during the period 1975-1985. This payment will eliminate the CEM's current negative net worth position.

The project elements of the CEM component will provide technical assistance, training and commodities to enable the CEM to implement its Strategic Development Plan (SDP). The elements of the SDP will include a human resource development plan, an organizational plan, a marketing plan, a financial plan and an information system plan.

III. Program Conditionality

The Program Conditionality of FMD will provide two collaborating institutions with basic frameworks (legal statutes and operating decrees) that ensure operating autonomy sufficient to carry out their core functions. Conditions Precedent (CP) regarding the BCRM are consistent with but not identical to the conditions for effectiveness of FINDEP. CPs regarding CEM will ensure that the negative net worth on the balance sheet of CEM is eliminated, that CEM receives a competitive market-determined interest rate on money it lends to the Treasury and its new statutes make it a more commercial operation and less an appendage of the postal system.

Satisfaction of the CPs will trigger the release of $6 million in two equal tranches as described below. The dollar sources will be used for external debt service (on debt owned to eligible multilateral financial institutions). GOM accepted all of the conditions during the negotiating meeting except repaying the interest CEM did not receive. The Minister of Finance presented our proposed conditions concerning the repayment of CEM interest to the Council of Ministers with the proposed 2.9 billion FMG figure and it was accepted. This condition, along with the agreement that the CEM will get the Treasury bill rate on its deposits, goes a long way to redress the balance sheet problems of CEM and means the FMD project will start with a "viable" financial institution.

Program Conditionality

First Tranche: $3 million

1. The Government of Madagascar deposits into the account of the Caisse d'Epargne de Madagascar held by the Caisse de Dépôts et Consignations the amount of 2,900,000,000 FMG.

2. The Minister of Finance publishes a decree fixing the rate of interest on the deposits of the Caisse d'Epargne at the Caisse de Dépôts et Consignations equal to the rate applicable on Bons du Trésor par Adjudication or "BTA" (twelve month Treasury Bills). The rate of interest on CEM deposits at CDC will be adjusted every three months. The interest rate for each three month period will be equal to a weighted average of the BTA rate for the previous three months. In the event the BTA market is not functioning, the last published rate will apply.

3. The Government of the Republic of Madagascar adopts a new governing statute for the Central Bank. The statutes will specify: (1) the objective of the Central Bank, (2) the fixed terms for Governor and Board members and grounds for dismissal, and (3) limitations on advances from the Central Bank to the Treasury.

4. The Board of Directors of the Central Bank adopts the Strategic Development Plan drafted by the staff of the Central Bank. The Strategic Development Plan will specify the responsibilities of each Department and will contain a three-year action plan for each Department.

Second Tranche: $3 million

1. The Government of the Republic of Madagascar adopts new statutes for the CEM in a form acceptable to USAID/Madagascar. The new statutes will: (1) reduce the size of the Board of Directors, (2) provide for autonomous Board management of the assets of CEM, (3) establish a personnel system independent of the civil service, and (4) replace the current accounting system with the Plan Comptable National.

2. The Direction of the Central Bank approves the Research Strategy and a one-year research work plan.

3. The Central Bank publishes an annual report, which includes an externally-audited balance sheet and income statement.

USAID/Madagascar anticipates a $10 million budget for the three year FMD Project which is to start in September 1993 as shown below.

Illustrative Budget

Budget Support for External Debt Service	$ 6 million
Technical Assistance/Support to the Central Bank	$ 3 million
Technical Assistance/Support to CEM	$ 1 million
Total	$10 million

USAID/BANJUL
FINANCIAL SECTOR REFORM

The following presents some insights into the financial sector reform programs underway in The Gambia and describes the technical assistance provided by USAID/Banjul through the Financial Sector Development Project.

I. Background

After gaining independence in 1965, the Government of The Gambia pursued an increasingly interventionist economic development policy. Major features included price controls on commodities, government-owned monopolies for marketing of export crops, subsidized parastatal companies for utilities and public transport, and subsidized investment in the productive sectors, primarily through preferential credit mechanisms. These policies produced large fiscal deficits. The rapid expansion of foreign and domestic credit used to finance the deficits resulted in serious inflation and declining per capita real income, particularly among rural and poor families.

In 1985, the deteriorating economic situation led the Government to undertake a major Economic Recovery Program (ERP), financed largely by and coordinated with lending agencies and various external donor organizations, including USAID/Banjul. The objectives of this Program include the elimination of government monopolies and price controls; the liberalization of exchange rate controls; the gradual reduction of the fiscal deficit through decreased government employment and improvements in tax policy and administration; the sale of some state enterprises and the elimination of operating deficits of those remaining under government ownership; and the imposition of tight credit controls on the public and private sectors.

A series of structural and financial reforms successfully implemented in recent years has led to an average annual GDP growth of 3.5 percent, a reduction in inflation from 70% to 14%, and a major strengthening in both the internal and external position of the national currency. These policy reforms ranged from broadly-based macroeconomic incentives to the unification of the exchange rates and the imposition of a free market pricing mechanism.

The Program for Sustained Development (PSD), implemented in 1990 as a continuing phase of the ERP, has consolidated and reinforced earlier economic policy achievements and accelerated an increase in living standards. The PSD has focused on strengthening financial institutions, preparing public expenditure programs for priority sectors and reducing the role of the public sector within the economy. Financial sector reform was significantly enhanced by the sale of the Gambian Commercial and Development Bank, a government-owned institution, in June 1992. This effectively eliminated the last direct public participation in the country's commercial banking sector.

II. USAID/Banjul Financial Sector Assistance

The Financial Sector Development Project was requested by USAID/Banjul to conduct three technical assistance engagements from 1989 to 1993. These activities included a.) Determining the feasibility of establishing a stock market in The Gambia; b.) Recommending an action plan for the central bank of The Gambia; and c.) Providing technical assistance to the Asset Management Recovery Company. These activities were intended to support the Government's reform program and to complement other technical assistance activities and reforms supported by the World Bank and other donor agencies. Each of these activities is described below.

a. Feasibility of Establishing a Stock Market in The Gambia

The Financial Sector Development Project first provided assistance in 1989 to study the feasibility of establishing a facility for active trading in securities, stocks, bonds, and shares and to identify the legal, regulatory, institutional, and manpower requirements for such a facility.

Based upon their assessment of the existing economic and political situation in The Gambia, the FSDP team advised against developing a stock market. Certain preconditions such as a sizable market, a fairly strong industrial base, and the existence of some high-quality industrial companies were found to be lacking. In addition, The Gambia did not maintain an appropriate economic securities market infrastructure, including investment banks, brokers, dealers, and development finance institutions. The commercial bankers in The Gambia were found to be uninterested in the development of a stock market, indicating that the floating supply of equities and the demand for equity investments were too small to support a formal market. Moreover, The Gambia lacked necessary regulatory guidelines for a stock market and the current taxation levels were found to be high in comparison to other emerging stock market countries.

Alternative recommendations to the development of an organized equities trading exchange and other improvements in the financial sector were made. These included:

- Completing the restructuring of the Gambian Commercial and Development Bank
- Encouraging investment
- Establishing a legal, fiscal and regulatory framework capable of attracting foreign banks and investors
- Providing training to improve management and accounting skills.

These recommendations indicate the types of developments that needed to be addressed in order to achieve the objectives of the Program for Sustained Development and the Economic Recovery Program. The subsequent engagements performed by FSDP specifically address reforms in regulation and in commercial banking that are intended to continue to strengthen the financial institution and assist in pushing ahead with economic achievements.

b. Reforms of the Central Bank of the Gambia Action Plan

Technical assistance was provided to the Central Bank of The Gambia in 1992. The recommendations outlined were to assist the Banking Supervision Department (BSD) of the Central Bank in developing an implementation plan building on recent activities and to facilitate the effective supervision of the commercial banking system in The Gambia. More stringent supervision of banking activities is central to increasing solvency and liquidity. This technical assistance contributed toward the Central Bank meeting part of the requirements for receiving the second tranche disbursement under the USAID Financial Sector Restructuring (FSR) program. The overall objective of the FSR is to improve the efficiency of financial intermediation in promoting savings and investment and in allocating savings to their most productive uses.

FSDP consultants outlined phases of the implementation plan to be followed by the central management to ensure that regulatory issues are addressed and to accelerate the process of restructuring the Central Bank. Recommendations presented to the Banking Supervision Department addressed the following issues:

- Adequacy of staffing (number and training and organizational structure)
- Adequacy of accounting standards and auditing resources
- Adequacy of regulatory powers including the current practices regarding examinations of banks
- Adequacy of revised legislation and required regulations
- Adequacy of bank examination procedures and written guidelines.

USAID/Banjul intends to provide further technical assistance to the Central Bank in the form of off-site and on-site examinations in the upcoming months.

Assistance was supported by the International Monetary Fund to rewrite the Financial Institutions Act and the Central Bank Act, which were passed by Parliament in December 1992. The IMF will be holding a workshop in October 1993 to explain the new legislation and new reporting requirements that are being written by a long-term technical advisor in the BSD of the Central Bank.

c. Assistance to the Asset Management Recovery Company - Phases I and II

In Phase I of this engagement FSDP provided technical assistance in designing the management, structure, and operation of the Asset Management Recovery Company. This organization was established in 1992 to administer and collect non-performing credit assets of the now privatized GCDB deemed to be unsatisfactory through negotiated settlements and/or legal action. The creation of this organization, now a corporation, is an integral part of the process of strengthening the commercial banking system, which, as stated above, is a major goal of the Government of The Gambia's financial sector liberalization program.

The most significant effect of the AMRC should have is to reduce the heavy financial cost of privatization of the GCDB. A total of US$ 26.2 million in non-performing assets and an outstanding US$ 9.9 million in other unsatisfactory assets of the banking system were transferred to the AMRC. The FSDP team made specific recommendations regarding the functioning of the AMRC, including the of number of gross direct credit assets, the transitional tasks to be established, and the liquidation period to be established. In addition, the organizational structure was outlined and the importance of governmental support for this organization was stressed. FSDP recommended collection targets and the creation of a Board of Overseers to supervise the AMRC's performance, with respect to internal controls and meeting its recovery targets.

In Phase II of the above engagement, the FSDP team provided an explicit recovery strategy for the AMRC. Realistic recovery targets and general and specific negotiating guidelines relating to resolution of non-performing credits were outlined. The team met with members of the transitional Task Force and representatives of the Ministry of Finance and Economic Affairs and the Solicitor General in November 1992 to present recommendations. General operating guidelines for successfully resolving credit problems were emphasized.

The sale of selected GCDB assets and deposits to the Meridien Banking Group raises the total number of privately-owned banks in The Gambia to four, and is expected to stimulate a greater degree of market competition resulting in a gradual reduction in the structure of interest rates. The high levels of profitability currently enjoyed by the private commercial banking sector reflect a continuing need for reduced intermediation costs through lower spreads and a more aggressive approach to financing the requirements of the country's emerging non-traditional sectors.

To date (July 1993) the AMRC has recovered one percent of the outstanding loans. The books of GCDB were officially closed March 1993, and AMRC's opened. Recruitment of staff is underway and the Ministry of Justice (MOJ) has budgeted for a dedicated court and judge to deal exclusively with AMRC cases. The MOJ is also recruiting additional bailiffs who will assist in enforcing judgements in AMRC cases.

AID/WASHINGTON SUPPORT FOR FINANCIAL MARKETS DEVELOPMENT

While A.I.D. field Missions have accumulated significant experience in financial market development, A.I.D./Washington has also provided considerable technical and financial support. The following text is divided into three sections: (a) activities of the Private Enterprise Bureau, the locus of most of the Agency's central support for financial market development; and (b) activities of the Africa Bureau, which has launched many innovative projects in financial market development (including sponsorship of this guidebook); and (c) other activities held by A.I.D./Washington supporting financial markets development.

I. Activities of the Private Enterprise Bureau (PRE)

A. A.I.D.'S Financial Sector Development Project (FSDP) and Financial Markets Project (FMP)

Since 1985, A.I.D.'s Bureau for Private Enterprise (PRE) has sponsored two five-year projects targeted directly at promoting the development of financial markets in LDCs. Following is a brief description of PRE's Financial Markets Project (FMP) and Financial Sector Development Project (FSDP).

1. The Financial Markets Project (FMP)

PRE created the Financial Markets Project in 1985 to help promote the development of financial market institutions and to mobilize domestic capital for productive activities in developing countries. The project (based on contract consulting assistance through Ernst and Young) provided a variety of support activities to A.I.D. Missions, host governments and indigenous private enterprises in over twenty countries. For example, FMP prepared financial markets surveys of seven countries between 1986 and 1988 and provided technical assistance related to venture capital, legal and regulatory reform, the commercialization of technology and capital market development.

According to the project's final evaluation, FMP was successful in heightening awareness among numerous A.I.D. Missions as to the importance of financial markets in overall private sector growth and made substantial contributions in a number of countries towards regulatory reform and the institutionalization of free markets. The evaluation also concluded that "it is not only imperative that a follow-on program continue to operate within A.I.D., but that it be infused with vitality and innovations borrowed from the entire international business community."[1] Therefore, building upon the largely positive experience of FMP, A.I.D. instituted the Financial Sector Development Project.

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[1] Agency for International Development, "Evaluation of Bureau for Private Enterprise Financial Markets Project", by Donald Shay and Marta Oyhenart, June 21, 1988. Washington, D.C.

2. The Financial Sector Development Project (FSDP)

The Financial Sector Development Project is the successor project, started by PRE in 1989 to build upon FMP's success. FSDP has Core and Buy-In components. Buy-ins from USAID Missions and Bureaus fund financial sector assessments, technical assistance and research activities. The core component supports the project's home office contract management efforts and makes limited contributions towards the project's technical assistance activities, described below.

a. Financial Sector Assessments

A financial sector assessment (FSA) is a tool for characterizing a country's stage of development; identifying areas of financial sector need or weakness; determining the priorities of the host country government and private sector; and defining action programs for financial sector intervention. Following are brief descriptions of FSDP's experiences with FSAs in Thailand and Nicaragua.

i. Thailand

USAID/Thailand requested an FSDP team to conduct a "reconnaissance," (a less than comprehensive assessment) of the Thai financial sector in March, 1990, with the aim of assisting USAID/Thailand in developing a long-term financial markets strategy. After discussions with private and public sector individuals (representatives of the Ministry of Finance, the Central Bank, commercial banks, the Stock Exchange of Thailand and others), the FSDP team developed a set of preliminary recommendations on areas suited for A.I.D. interventions. The FSDP team recommended that USAID/Thailand concentrate its efforts in assisting the Government of Thailand on legal and regulatory reform, improvements in the quality of financial information and training Thai banking officers and financial analysts in financial management. On a follow-up assignment, the team's leader met with Thai officials and representatives of the private sector at a USIS-sponsored conference to further explore areas where USAID assistance would make the greatest impact.

ii. Nicaragua

In the Summer of 1990, USAID/Nicaragua asked a four-member FSDP team to devise a strategic plan for Nicaraguan financial sector reform. The team met with officials from Nicaraguan ministries, the central bank, the World Bank, the International Monetary Fund, the Inter-American Development Bank, the four nationalized banks in Nicaragua, and the private sector. In addition, the team met with members of the Nicaraguan banking community residing in Miami to assess the community's willingness to participate in Nicaragua's economic reform. The team found that among the problems that needed to be addressed, the most pressing were: macroeconomic stabilization, assistance to the Central Bank in building its accounting and auditing capabilities, restructuring of the financial regulatory framework, and allowance for the formation of non-bank intermediaries. The

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team acknowledged that additional technical assistance would be needed to resolve the aforementioned problems. Upon its return to Washington, the team met with officials at AID/Washington to discuss the possibility of financial sector reform. The assessment resulted in follow-on assistance to refine areas for USAID intervention and to begin the process of donor coordination in rebuilding the Nicaraguan financial sector.

b. Technical Assistance

FSDP also provides specialized technical assistance to Missions. FSDP consultants have performed numerous technical assistance assignments, including reviews of banking and credit facilities, capital markets, bond and debt markets and venture capital activity. The following are several examples.

i. Banking and Credit

FSDP has conducted several banking and credit projects in developing countries. In an effort to strengthen the Honduran banking sector, a multidisciplinary FSDP team worked with senior management of the Central Bank and commercial banks and representatives of the Honduran Banking Association (AHIBA) to design and develop a long-term strategy for bank strengthening.

The program has several components, the largest of which are training and information systems. The training program will provide courses and seminars for all levels of bank employees, from entry level to senior management. By conducting an extensive skills and education inventory of bank employees throughout the country and analyzing the results with human resource personnel of the commercial banks, the team identified courses and designed a curriculum. The FSDP team also recommended potential providers of training including institutions within Honduras and Central America and those outside the region.

The information component consists primarily of the organization and linking of libraries of the Central Bank of Honduras, AHIBA, and the branch offices of both. In addition a publications program will be developed to issue and circulate periodicals related to banking, development, and Central Bank policies.

ii. Stock Markets

FSDP has worked on projects involving most aspects of stock market reform. In Indonesia, FSDP worked with the government to strengthen stock market supervision, regulation and operations in order to accommodate significantly increased stock market activity. FSDP advisors recommended a new regulatory regime for the stock market, the brokerage industry, underwriters, and other supporting professions. The recommendations touched upon a broad range of key issues, including fair play and disclosure requirements in registration statements, codes of practice and conduct, and new accounting rules to ensure accuracy in reporting. FSDP worked closely with the Mission and the GOI to assist in drafting a capital markets regulatory decree which was issued in December 1990; in making the stock exchange a private body, and in reviewing the training needs of the capital market executive agency.

At the request of USAID/Rabat, an FSDP team was engaged to assist Morocco in developing the legal, regulatory, fiscal and institutional environment needed for an effectively functioning equity market. The Government of Morocco was interested in strengthening the role of the stock exchange and has proposed amendments to current legislation regarding financial disclosure, taxation of capital gains and dividends, and the regulation of the Stock Exchange. The Casablanca Stock Exchange had not been operating at full capacity and privatization was identified as key to the growth and development of the Exchange. The team recommended that government control over the operation be transferred to the private sector and that the government limit its role to a regulatory capacity. The team further suggested that the proposed draft laws and regulations be strengthened to more effectively support information disclosure and discourage fraudulent behavior. Specific comments were presented to the Ministry of Finance. As of this writing, this legislation is pending before the Moroccan Congress and is expected to pass.

FSDP was contracted by USAID/The Gambia to analyze the feasibility of establishing a stock market in the Gambia. The absence of an equity market was viewed in official circles as a potential obstacle to privatization. The FSDP consultants concluded that a stock market is presently not feasible for a number of reasons, including the small size of the country's economy, a lack of investor demand for securities, and the limited number of enterprises that would be likely candidates for a public offering of securities. The FSDP team recommended alternatives to the establishment of an organized trading exchange, and offered strategies aimed at creating the necessary pre-conditions for equities trading at a future date. (Please see Annex B for further information on The Gambia.)

iii. Bond and Debt Markets

Bond and debt markets are an integral part of developed financial markets. FSDP teams have participated in a number of bond and debt market development projects in several A.I.D. countries.

In Chile, an FSDP team recently concluded a pre-feasibility study of A.I.D.-guaranteed local currency bond issues. The team noted a large and growing pool of long-term domestic savings in the Chilean financial markets. The potential for success for local currency bond issues is further enhanced by the country's relatively balanced legal and regulatory framework. The team noted that a culture of responsible financial and economic management has been successfully implanted in Chile, including low and stable inflation rates, high levels of growth, and growing levels of both domestic and foreign investment. The team concluded that the experience in Chile could provide the model for other countries where A.I.D. is assisting in developing financial markets.

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In Thailand, an FSDP team recently conducted a study which analyzed the feasibility of raising long-term local currency debt to finance public infrastructure projects and private corporate investment. The report concluded that with the appropriate policy, legal and regulatory changes, a medium- to long-term debt market could be developed in Thailand over the next three to five years and that the opportunity exists to utilize A.I.D. local currency guarantees as an instrument to support the mobilization and use of local currency borrowing for development.

c. Applied Research and Information Dissemination

Applied research and information dissemination projects aim to investigate new avenues for financial sector development and to transfer practical, relevant information to government and private sector officials of host countries and the United States. Research has been conducted at the request of several Bureaus and Missions. Country experiences in the areas of financial sector liberalization have been assessed in numerous countries including Chile and Pakistan. Moreover, issues at the forefront of financial sector development theory have been explored, as in the case of Pakistan where an FSDP team investigated the relationship between the provision of private power and capital market development. Information dissemination efforts are currently underway include the design and implementation of financial sector development conferences and the production of FSDP's newsletter, FSDP Update.

B. The Private Sector Revolving Fund

The Office of Investment of the Bureau Private Enterprise is charged with managing the Private Sector Revolving Fund (PSRF), now called the Private Sector Investment Program. The PSRF was created by Congress in 1983 to promote private sector development in developing countries primarily through the strengthening of small private sector enterprises. The Fund was designed to (1) promote economic development primarily by strengthening small private enterprises, (2) create innovative financing mechanisms, (3) strengthen local private financial institutions, and (4) involve the United States in private sector development.

A key obstacle to growth of small enterprises in developing countries is difficulty in obtaining adequate financing. Intermediary financial institutions are often reluctant to extend credit to small businesses because the costs of transacting and the perceived risks of lending are both high. The Investment Program provides a vehicle to assist these lending institutions in reducing their risk and in gaining experience in small business lending. Thus, the Investment Program aims both to mobilize credit for small enterprises in developing countries and to have a demonstration effect.

The primary investment vehicles used during the Investment Program's early years were direct loans. In 1988, however, Congress added loan guarantee authority to the existing dollar lending authority, signalling its intent to make loan guarantees backed by the full faith and credit of the U.S. Government the primary instrument used by the Program to meet its legislatively-mandated objectives.

Under i's Guarantee Authority, the Program offers a variety of financial mechanisms for increasing credit for small enterprises. Some of the principal ones include the following:

- Loan Portfolio Guarantee (LPG) Program: The LPG Program emphasizes a standardized approach, utilizing partial guarantees to assist IFIs in expanding credit to small businesses. Under the LPG facility, A.I.D. provides 50% guarantee coverage on a portfolio of loans to small businesses.

- Forfaiting: The purpose of this facility is to promote U.S. exports to LDCs by inducing forfait banks to accept LDC notes that they might deem too risky without a partial guarantee. A.I.D. offers guarantee coverage for up to 50% of the risk undertaken by the forfeit house.

- Leasing: This facility extends risk-sharing coverage to transactions involving the leasing of capital equipment by small businesses. This new program can be used to encourage IFIs to lend to leasing companies or to encourage leasing companies to lease equipment to small businesses.

The Private Sector Investment Program is seen as a "laboratory" for the development of innovative private sector programs. Thus, the Office of Investment continuously strives to create new financial vehicles, such as guarantees on subordinated bonds or other financial instruments. Currently, it is developing guarantee facilities to support privatization efforts in developing countries and to encourage the growth of franchises overseas.

C. Privatization and Development Project

The Privatization and Development Project is designed to closely align technical assistance in privatization with financial markets development. This project will be implemented by a consortium (the International Privatization Group) led by Price Waterhouse and including Morgan Stanley and Stanford Research Institute. Its objectives are two-fold: (i) to provide technical and financial advisory services with a focus on the design, preparation and implementation of privatization transactions; and (ii) to conduct practical, applied research and training on privatization issues.

To meet the first objective, the project will provide technical expertise to privatization units in the following areas:

- Technical training in areas such as valuation, financing techniques, and enterprise restructuring

- Strategic planning and management of privatization agencies
- Assessment of legal issues and industry-specific regulatory adjustment
- Design and implementation of public awareness campaigns.

At the enterprise level, the project provides assistance in the financial and operational appraisal of enterprises; the valuation of enterprises; investor identification, selection and negotiations; preparation of public share offers and solicitations; assessment of alternative financing techniques; and the design of employee share participation programs.

The second component of the project focuses on applied research, training and information dissemination. The aim of this component is to strengthen host-country capabilities to conduct research on privatization issues and to provide in-country technical training. The training focuses on building practical technical know-how in areas such as enterprise valuation and restructuring.

II. Activities of the Africa Bureau

The Africa Bureau has sponsored numerous field engagements to support the financial development of Africa. Several of these engagements have been conducted through the Financial Sector Development Project as well as other A.I.D.-funded projects. Engagements in Cote d'Ivoire, Lesotho, Uganda and the CFA regional zone are described below.

A.I.D., in conjunction with OPIC and the AFDB, sponsored a workshop on debt conversion techniques in Abidjan. The workshop focussed on presenting an overview of worldwide debt conversion trends and to provide an update on worldwide country debt conversion programs, Factors such as the current status of legislation and regulation, the types of debt conversion transactions executed, the volume of debt conversion transactions, and trading discounts were covered in the presentation.

In addition, AFR/MDI contracted technical assistance for an asset review of La Financiere Cote d'Ivoire and all its affiliated companies in order to facilitate the pricing of future share certificates. For the first phase of the project, the consultant assembled and made adjustments to unaudited financial statements as of September 30, 1989, as well as performed an evaluation of the financial statements incorporating those up through September 30, 1990.

A La Financiere review was undertaken during the second quarter of 1992. The consultant met with the President of La Financiere in Washington to review progress and plan the next steps to be taken. In January 1992, two consultants visited the project site to verify whether recommendations were being implemented or not. Observations made during this visit served as a basis for determining future A.I.D. technical assistance. In July 1992, a financial

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management expert assisted La Financiere to implement recommendations made by the previous teams.

USAID/Lesotho sponsored an analysis of the country's markets and financial markets structure as part of a multi-disciplinary project that studied agricultural sector development. The report focussed on constraints caused by the dependence of Lesotho's economy on that of the Republic of South Africa, as this dependence affects the formulation and execution of Lesotho's monetary policies. The report made a number of recommendations that Lesotho's monetary authorities could undertake to facilitate the provision of credit for agricultural activities.

In Uganda, USAID sponsored a securities market project to assist the Kampala Stock Exchange in establishing a local group that targets areas of possible assistance to promote the stock exchange. This group would include the Governor of the Central Bank and have the approval of the President of Uganda. The primary area of emphasis recommended was securities industry education adapted to local needs and conditions.

In 1992, USAID provided technical assistance to the Bank of Uganda to conduct examinations of the Uganda Commercial Bank and the Cooperative Bank. This was part of Uganda's financial sector reform program calling for a strengthened banking sector through improved systems for prudential regulation and supervision. The examination entailed portfolio analyses of assets and evaluations of potential risks.

Finally, in cooperation with the French Ministry of Cooperation, the World Bank and A.I.D. undertook efforts to promote financial market development in the West Africa region. An FSDP team conducted a feasibility study concerning the establishment of a regional financial market, including an assessment of the laws, the regulations, the judicial system, and the operating infrastructure capabilities of the financial markets in the region. Recommendations were made on the formulation of a regional financial market within the context of the current legal and regulatory environment.

III. Other A.I.D./Washington Activities

Several other engagements held by A.I.D./Washington concerned financial sector development in developing countries around the world, including Africa.

Early in the Financial Sector Development Project, a seminar called "A.I.D. and the Debt Crisis" was held. Distinguished bankers and economists attended and exchanged ideas with the A.I.D. Administrator and selected senior staff about the appropriate role for A.I.D. in contributing to the planning and execution of U.S. Government strategies to deal with the LDC debt crisis. This seminar affected future A.I.D. financial sector development policies. Among the program initiatives identified were debt-for-development swap programs and technical assistance and training in financial sector development.

Under the FSDP, AID sponsored two Algerian central bankers to attend an INTRADOS seminar entitled "Building Effective Financial Markets". Their attendance at this seminar was important for the Algerian government's current program of reforming the Algerian economy.

In collaboration with several A.I.D. Bureaus, Missions and the Massachusetts Institute of Technology, FSDP designed and delivered a three day conference examining several important issues related to financial markets and development. Discussions were held regarding innovations and emerging trends in international financial markets and their implications for developing countries and for A.I.D.'s strategic policy and programmatic agenda. The workshop was conducted in August 1991.

Additional FSDP projects related to financial sector development included bank analyses for the Loan Guarantee Program (LPG) funded by the PRE Investment Office. The consultants performed quantitative and qualitative analyses of applications submitted by private banks in Africa participating in the A.I.D. LPG program.

BRIEF OVERVIEW OF U.S. FINANCIAL MARKETS

This section provides a brief description of U.S. financial markets with an emphasis on those characteristics that distinguish the U.S. from other financial markets. It is a topical review intended to orient the reader to certain key features of U.S. financial markets and major developments, such as the collapse of the junk bond market, the S&L crisis and the Bush Administration's proposal to reform the banking sector. It is by no means a thorough examination of the subject given the dynamic nature of U.S. financial markets during the 1980's and 1990's. This current section was prepared in March 1991.

I. Characteristics of U.S. Financial Markets

A. Central Bank Independence

One of the key distinguishing characteristics of the U.S. financial system is the autonomy of its central bank, the Federal Reserve. The Federal Reserve is considered an independent entity which is supposed to make its decisions free of political influence. Governors are appointed for terms of 14 years, which further assures their independence. Perhaps the greatest incentive to pursue politically acceptable policies is the understanding that Congress could one day vote to reduce its independence. In other countries, central banks are directly subject to the government in power. The most notable exception is the Bundesbank in Germany, which was patterned on the American model during post-war reconstruction.

B. Glass-Steagall Act

Another key characteristic of the U.S. financial system is the separation of commercial banking from investment banking activities as a result of the 1933 Banking Act, also known as Glass-Steagall. In contrast, most major European countries allow "universal banks" to conduct a full range of commercial and investment banking activities and, in some cases, insurance activities on an integrated basis. For years, many U.S. commercial banks have argued that this puts them at a competitive disadvantage with foreign banks, both at home and overseas. They have been testing the limits of Glass-Steagall and gradually breaking into the investment banks' arena. The new banking reform package, proposed to Congress in February 1991, could effectively abolish Glass-Steagall, allowing well-capitalized banks to operate a securities subsidiary and securities firms' parent companies to acquire banks.

C. Role of Self-Regulation

A third key characteristic of the U.S. system is the blend of government and private or self-regulation of the securities markets. The Securities and Exchange Commission (SEC) is the government body that enforces the securities markets laws and regulations. However, self-regulatory organizations (SROs) are the principal means envisioned by the federal securities laws for enforcing fair, ethical and efficient practices in the securities industry. The SROs include all national securities exchanges (such as the New York Stock Exchange and the American Stock Exchange) as well as the National Association of Securities Dealers (NASD) which represents all firms operating in the over-the-counter market. Each of these organization is expected to mount strong, formal programs of self-regulation which can in turn be monitored by the SEC.

II. Changes in U.S. Financial Markets

A. Deposit-taking Institutions

The United States has a wide variety of deposit-taking institutions, including the commercial banks, savings banks, savings and loans associations ("S&Ls") and credit unions. Until recently, deposit-taking institutions were permitted to have offices in only one state. However, during the course of the 1980's, the majority of states relaxed restrictions on interstate operations, prompting many institutions to expand beyond their home state. Many institutions have merged, particularly savings banks and S&Ls in areas of the country where regional problems or overexpansion have created financial difficulties. Despite these changes, the U.S. continues to have many more deposit-taking institutions than any other country in the world.

B. Competition

While the essence of banking - borrowing and lending money - remains essentially the same, the nature of the business in the United States has undergone dramatic change in recent years. The broad dissemination of market information and technological developments have permitted large investors to borrow directly in the money and capital markets. Increasingly, large corporations issue commercial paper to meet their working capital needs instead of activating bank lines of credit. More recently, bank affiliates have begun to underwrite commercial paper and even equity securities in competition with securities firms as a result of the expanded authority granted to them by the Federal Reserve. The increased competition among financial intermediaries has lowered costs in the system and provided better service to savers and investors.

C. Varying Bank Strategies

Faced with heavy competition from non-traditional sources, many banks are attempting to specialize or to diversify into potential growth areas. Some banks have withdrawn entirely from retail or branch banking to concentrate on corporate clients. Others have sought to expand their consumer business. Some have pulled back from international operations, while others have expanded abroad. Because the U.S. banking community was adversely affected by the LDC crisis, many banks continue to be wary of new lending commitments to developing countries. Some banks have made new commitments on a very selective basis or have agreed to make loans as part of rescheduling agreements. In 1991, Citicorp, the largest U.S. bank, ranked twenty-ninth globally in terms of assets and continues to be the dominant U.S. bank with worldwide activities and a presence in most developing countries.

D. Capital Adequacy

In 1988, U.S. bank regulators established risk-based capital assessment procedures in order to comply with an international agreement among the Group of Ten (G-10) countries. The risk-based capital standards differentiate among risk categories of assets, establish capital requirements for each category and require capital to be held against off-balance sheet exposures. The new procedure also assign values to each element of a bank's capital according to its degree of risk. For example, cash would be assigned a value of 100% of face value, whereas a junk bond would be assigned only a fraction of face value. These new measures of capital assessment require higher levels of capital (i.e., 8% of assets), and are designed to ensure the future soundness of the banking community.

E. Prudential Regulation

The Federal Reserve regulates state-chartered Federal Reserve-member banks; the Office of the Comptroller of the Currency (OCC) regulates nationally-chartered banks; the Federal Deposit Insurance Corporation (FDIC) regulates state-chartered banks that are not part of the Federal Reserve System, as well as runs the deposit insurance program and deals with failed banks; and the Office of Thrift Supervision regulates savings banks and S&Ls. Legislation has been introduced in the House of Representatives to consolidate this regulatory authority, however, no similar action has been taken by the Senate.

III. Recent Traumatic Events

A. Collapse of Junk Bond Market

The need to review the regulatory framework has been made even more acute in light of recent traumatic events which have rocked the international financial markets. Among these traumatic events has been the collapse of the junk bond market. This market for high yield, below-investment grade bonds was very attractive in the mid to late 1980s, but more recently demand has dried up. As the popularity of leveraged buyouts (LBO's), partially capitalized through issuing these bonds, diminished due to negative publicity and bankruptcies among early participants, prices plunged and investor confidence was shaken. At the same time, the regulatory authorities became increasingly alarmed at allegations of widespread "insider" trading - evidence of which was to topple the leader in the junk bond underwriting and investing field, Drexel Burnham Lambert, and its junk bond "guru", Michael Milken. The final nail in the coffin of the junk bond boom was the S&L crisis, which was partially linked to the S&Ls' heavy exposure to such risky investments.

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B. Savings and Loan Crisis

The S&L crisis, however, highlights issues broader than questionable investments. Laxity in regulation, softening of the economy in traditional S&L sectors, such as real estate and small business, together with mismanagement and alleged fraud at some institutions, created insolvencies at many thrifts. Forced mergers, restructurings and closings weakened the Federal Savings and Loan Insurance Corporation (FSLIC), bringing its own solvency into question, and it had to be restructured by the federal government.

C. Federal Deposit Insurance Corporation

These same red flags threaten the FDIC, the deposit insurance fund associated with the commercial banks. Bad real estate loans follow upon the Third World debt crisis as the latest threat to bank solvency. Moreover, the growing rate and size of bank failures such as the Bank of New England and the recent fiasco with the Bank of Rhode Island that precipitated the failure of that state's deposit insurance fund raise the specter of another imminent taxpayer bailout. The regulators are more sanguine. At least for now, officials do not foresee widespread failures among the nation's largest banks.

D. Stock Market Crash and Mini-Crash

In 1987 the crash in stock prices brought back fears of a global economic and financial collapse. The Federal Reserve, however, took forceful actions to make credit temporarily available to the banking system until the crisis had clearly passed. The aftermath stood in sharp contrast to the unfortunate events that followed the 1929 stock market crash. The "mini-crash" of 1989 is widely thought to have been precipitated by the failure of United Air Lines to launch an employee-led LBO, which in turn is said to have been the result of Japanese investor skittishness. The short-lived, but significant crisis in 1989 has also been linked to technology, and the glitches computer trading can cause, but more significantly, it was a signal that capital is a worldwide asset that cannot be contained within political boundaries, but will seek to flow to those investments which, within a given risk profile, offer the greatest return.

IV. Influence of U.S. Financial Markets

The United States remains a powerful model for financial markets in developing countries, and the Agency for International Development has generated a broad array of experience in financial markets activities. The influence of U.S. financial markets on other markets continues to be substantial for a number of reasons. Although the market capitalization of most other markets has been growing faster than the U.S. market, the U.S. still has one of the world's largest equity market capitalizations, surpassed only by Japan. Moreover, the U.S. has by far the largest bond market in the world in terms of par value outstanding.

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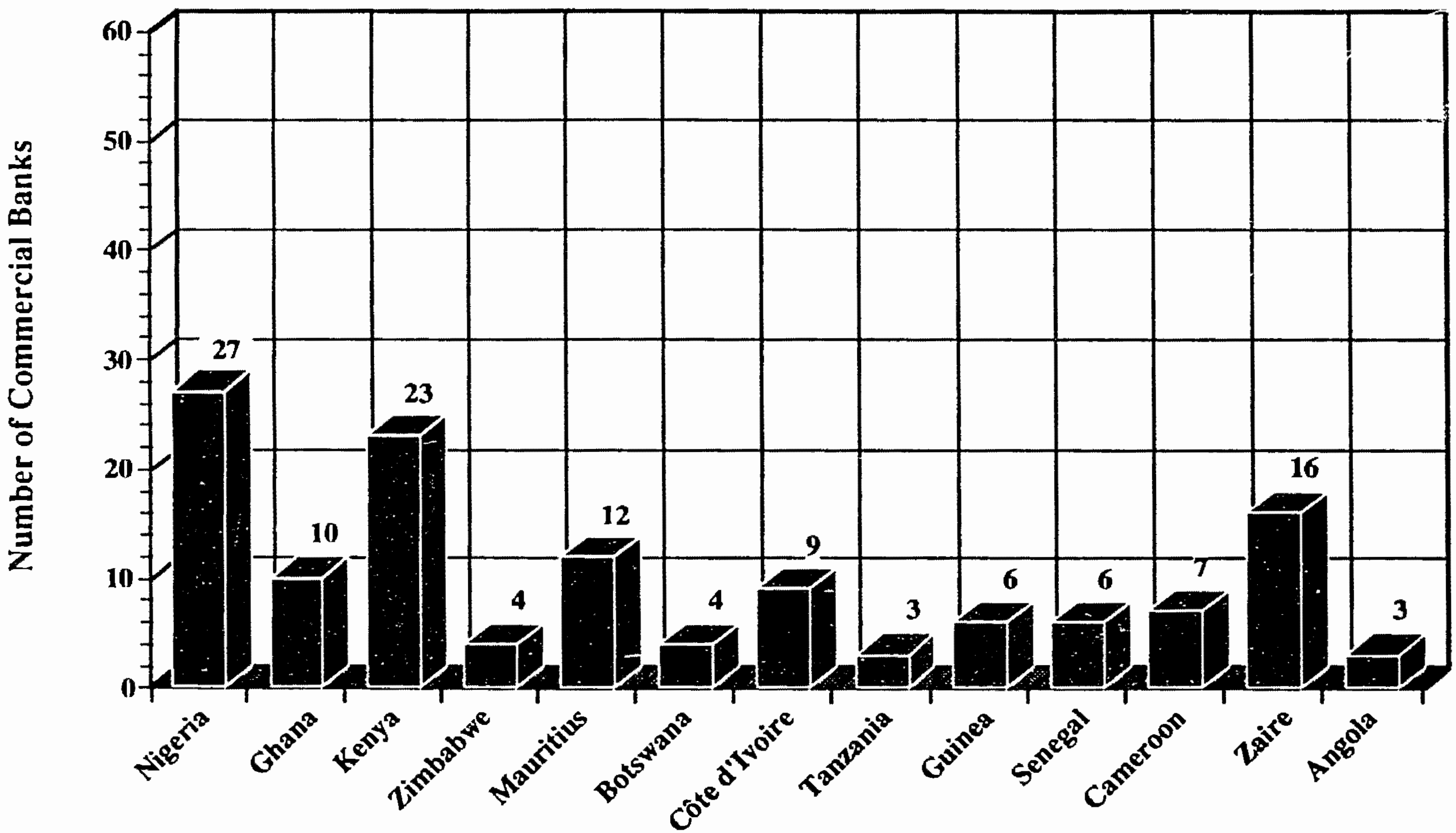
The U.S. continues to be the world's most innovative market in terms of developing new financial instruments. The regulatory climate in the U.S. has permitted our securities markets to introduce new financial instruments with great frequency. Trading in options and mortgage-backed securities, for example, began in the U.S. The U.S. has also been the pioneer in such areas as mutual funds, venture capital, employee stock option plans (ESOPs) and leasing. In addition, the U.S. is the most advanced in terms of the regulations governing disclosure, insider trading and market intermediaries. Moreover, foreign securities firms participate in a full range of investment banking and securities activities.

For these reasons, developing countries continue to seek U.S. expertise on many matters related to financial market development. Over the past years, A.I.D., through such mechanisms as PRE's Financial Sector Development Project, has provided highly-targeted assistance to developing country governments in support of financial markets reform. As developing countries confront the remaining challenges in the area of financial markets reform, A.I.D. is in a unique position to offer them support.

Highlights of the Banking Sector in Sub-Saharan Africa

Number of Commercial Banks*



* *Includes nationalized, private and foreign commercial banks*

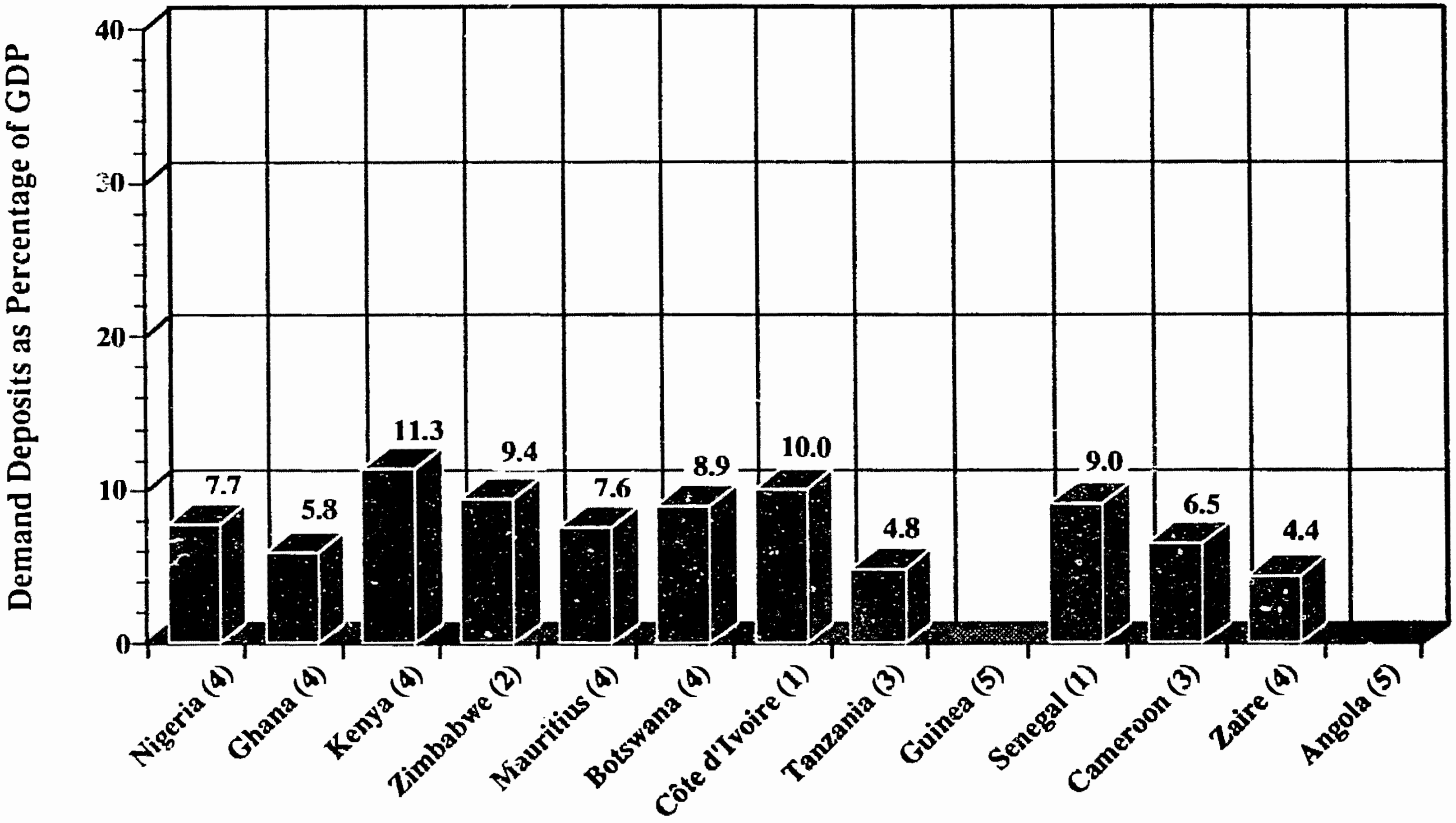
Data were taken from <u>*Africa, South of the Sahara, 1993,*</u> *Europa Publications Ltd.*

USAID African Charts 7/93
Int'l IPG (USAID Africa)

Table 1

Highlights of the Banking Sector in Sub-Saharan Africa

Demand Deposits at Commercial Banks as Percentage of GDP



Data were taken from Africa, South of the Sahara, 1993, Europa Publications Ltd.

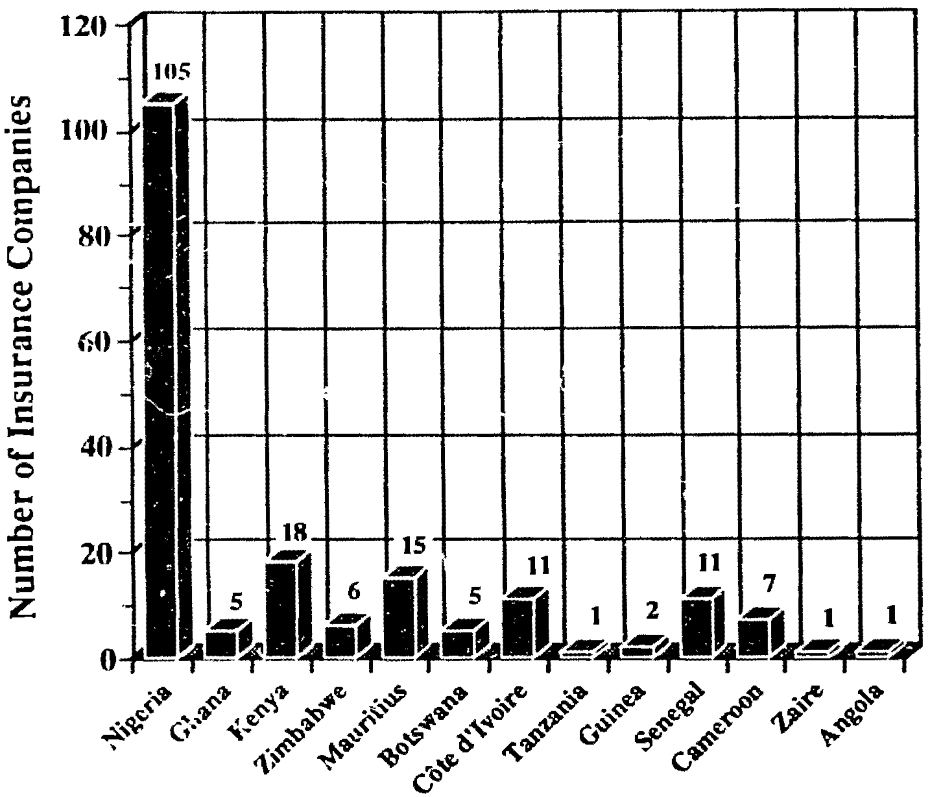
(1) 1986 data, (2) 1987 data, (3) 1988 data, (4) 1991 data, (5) Not available.

USAID African Charts 7/93

Table

Highlights of the Banking Sector in Sub-Saharan Africa

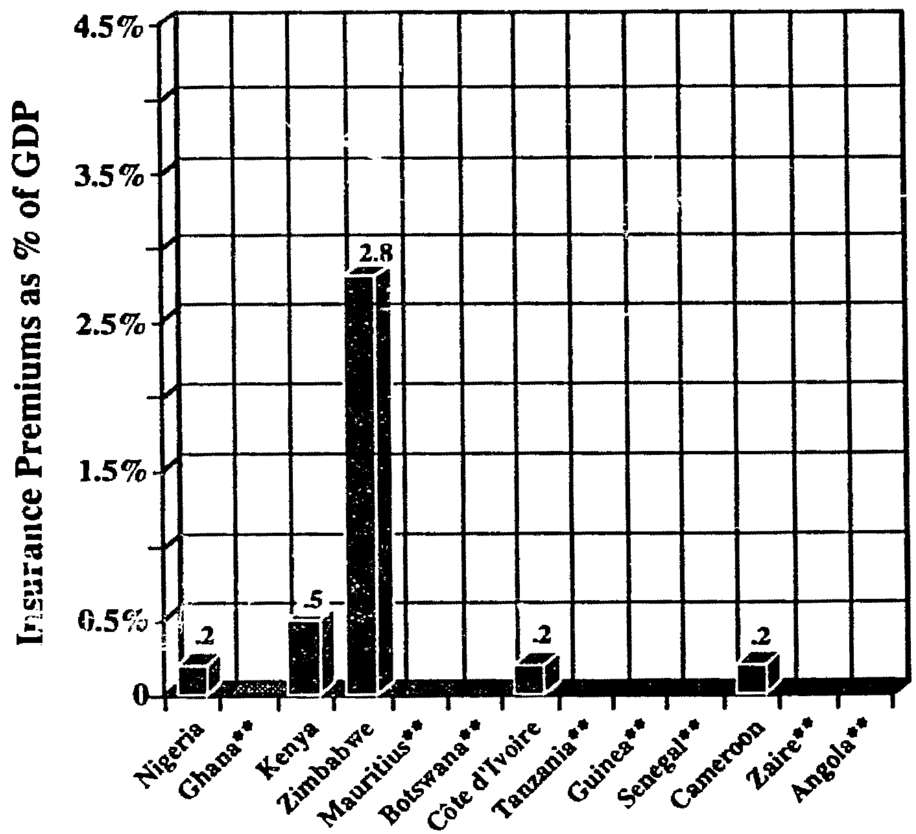
Number of Insurance Companies*



* *Includes domestic and foreign insurance companies*

Data were taken from *__Africa, South of the Sahara, 1993,__* *Europa Publications Ltd.*

Total Insurance Premiums as Percentage of GDP*



*** Not available*

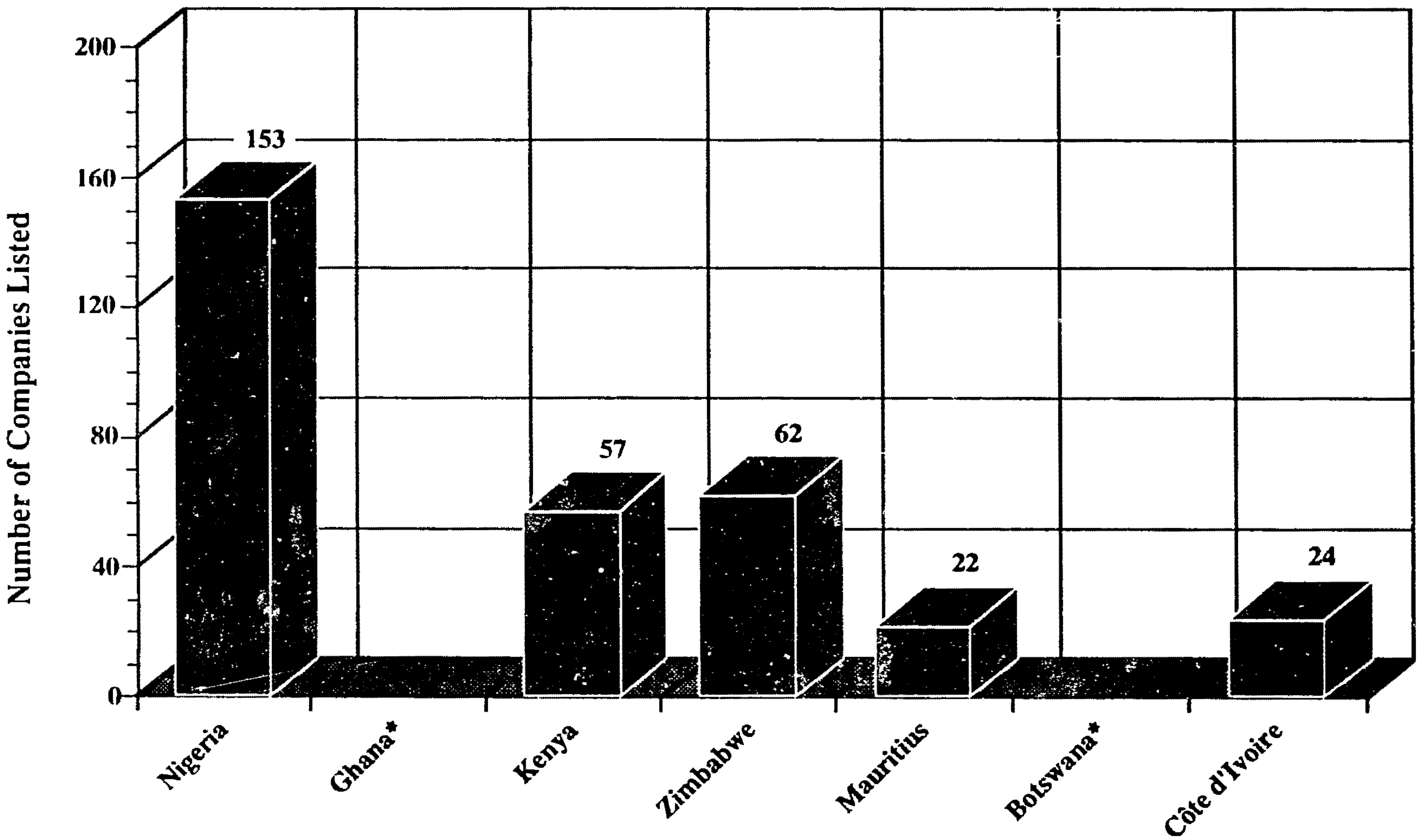
Data were taken from "Overview of Contractual Savings Institutions," Dimitri Vittas and Michael Skully, 1991.

USAID African Charts 7/93
Inf IPG (USAID Africa)

Table 3

Overview of Emerging Stock Markets

Number of Companies Listed, Year-End 1992



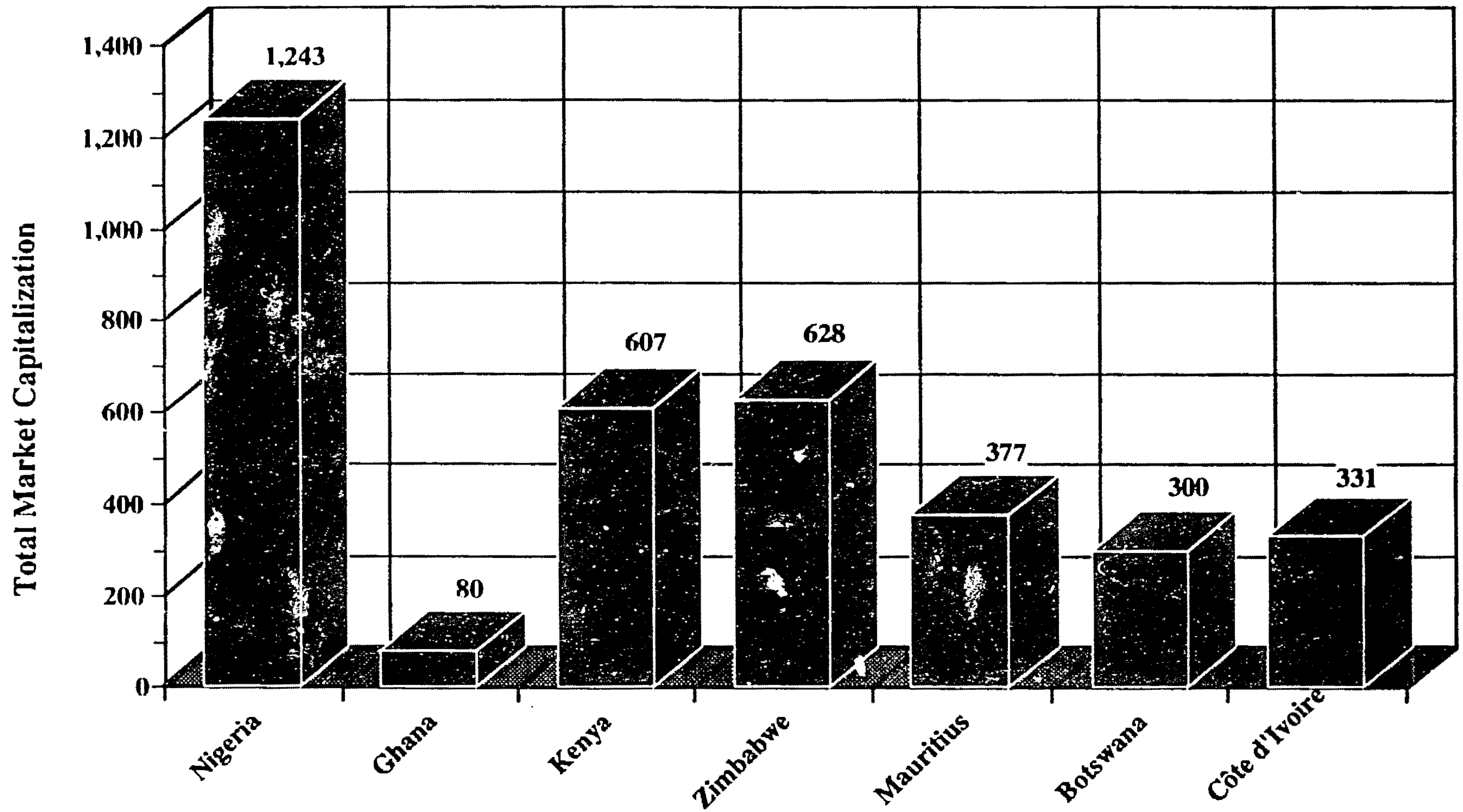
Number of Countries Listed is an indicator of the breadth of a country's stock market.

* *Not available*

Data taken from the IFC Emerging Stock Markets Factbook, 1993, *Europa Publications Ltd.*

Overview of Emerging Stock Markets

Market Capitalization (US$ Millions), Year-End 1992



Market Capitalization is equal to the total value of all shares listed (share price for each issue times the number of shares outstanding) and shows the size of a country's market.

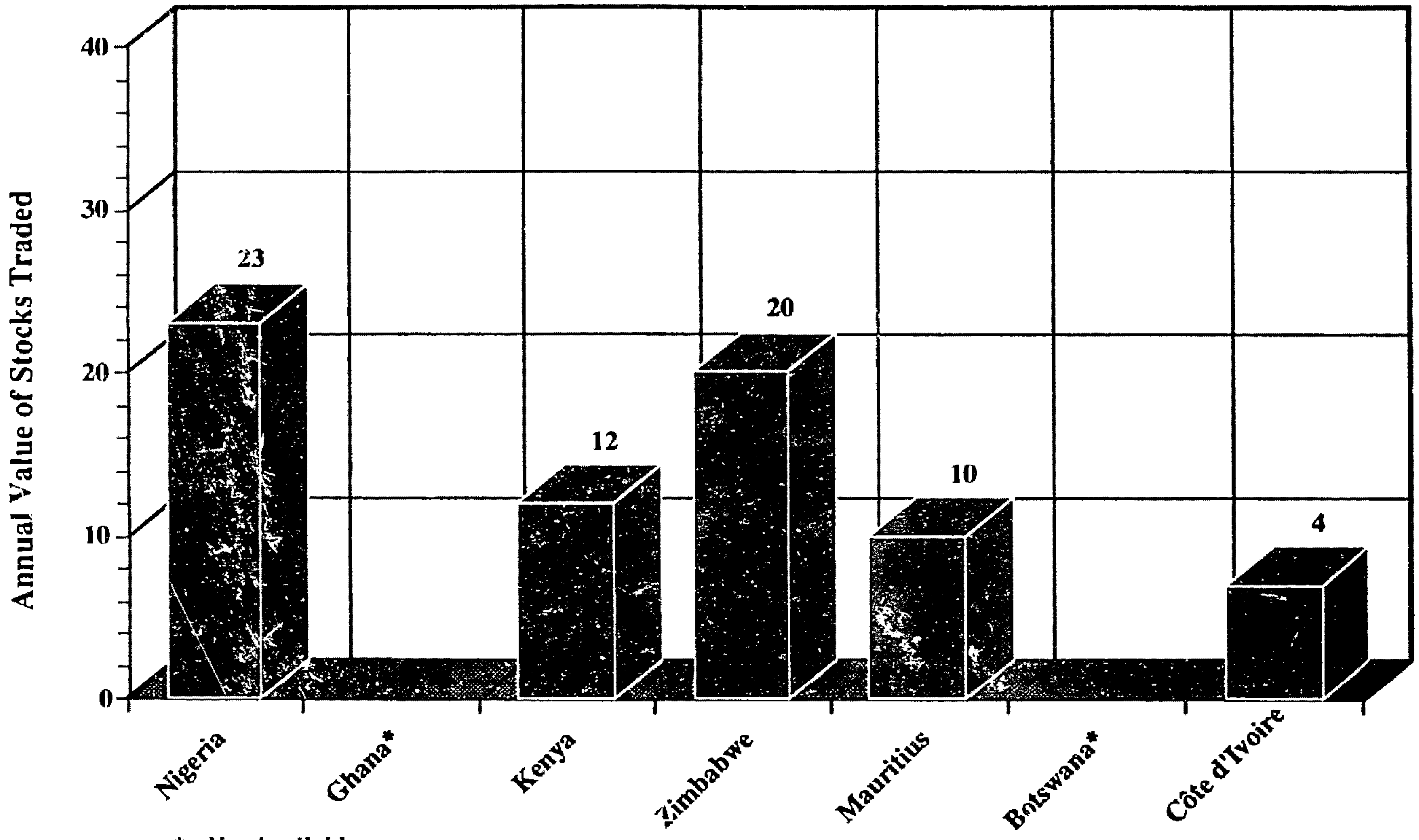
Data taken from the IFC Emerging Stock Markets Factbook, 1993, *Europa Publications Ltd.*

USAID African Charts 7/93
Inf IPG (USAID Africa)

Table 5

Overview of Emerging Stock Markets

Annual Value of Stocks Traded (US$ Millions), Year-End 1992

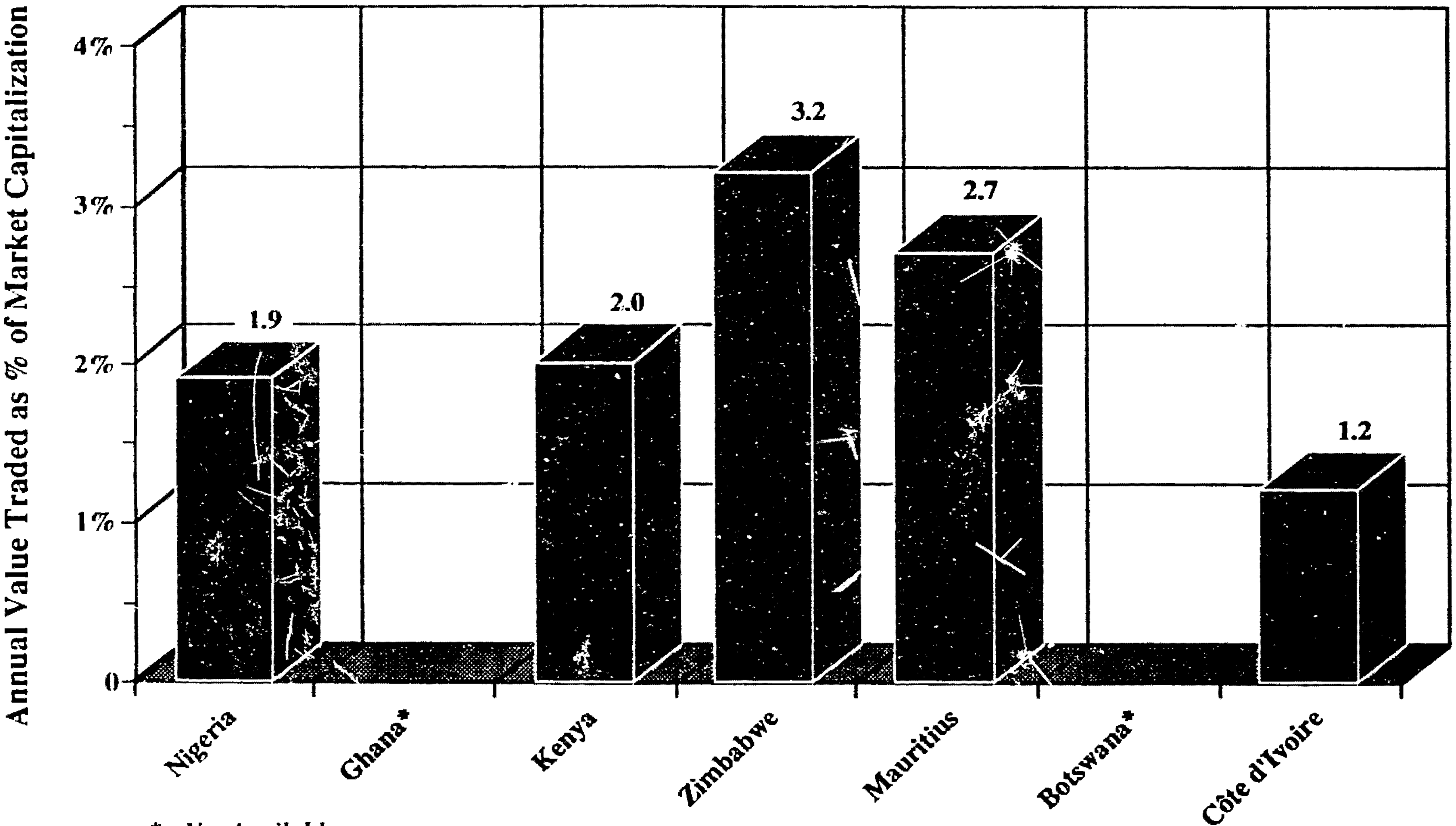


* *Not Available.*

Annual Value Traded indicates the level of activity of a country's stock market.

Overview of Emerging Stock Markets

Market Liquidity, Year-End 1992



* *Not Available.*

Annual Value Traded as a percentage of market capitalization is an indication of the level of activity or "liquidity" of a country's stock market.

Data taken from the <u>IFC Emerging Stock Markets Factbook, 1993,</u> *Europa Publications Ltd.*

USAID African Charts 7/93
Intl IFC (USAID Africa)

Table 7

A.I.D. Policy Paper

Financial Markets Development

Bureau for Program and Policy Coordination
U.S. Agency for International Development
Washington, D.C. 20523

August 1988 226

FINANCIAL MARKETS DEVELOPMENT POLICY PAPER

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FINANCIAL MARKETS DEVELOPMENT POLICY PAPER

EXECUTIVE SUMMARY

The purposes of this policy paper are to (a) describe A.I.D.'s policy on financial markets development, and (b) provide guidance on the development of A.I.D.'s programs and projects in financial markets.

Effective financial markets are indispensible to the pursuit of sustained, broad-based economic growth. Unfortunately, financial markets development is one of the most complex areas in the development field. Whether financial systems are relatively simple or highly complex, they perform the same broad functions and share the same key characteristics.

—The primary role of the financial system in any economy is to mobilize resources for productive investment. An efficient financial system channels resources to activities that will provide the highest rate of return for the use of the funds. These resources stimulate economic growth; they provide enterprises with the ability to produce more goods and services and to generate jobs.

—Governments in developing countries can and should facilitate financial markets development and provide a policy and regulatory environment that encourages the appearance of competitive forces, encourages the use of a variety of debt and equity instruments, promotes the growth of different kinds of institutions offering a wide range of financial instruments and services to potential savers and investors, and protects the interests of savers by reducing their risks.

—Efficient financial markets promote more widespread ownership of assets in a society. A larger number of citizens in a developing country will thereby have an opportunity to participate in, and enjoy the benefits derived from, the growth of their country's economy.

A.I.D. should promote a system of financial markets that is integrated and relatively undistorted, one that relies heavily on competitive financial institutions, and on policies to facilitate competition. This system should be capable of effectively mobilizing private savings, allocating that savings to investments yielding maximum returns, and maximizing the participation of the general populace. A.I.D. supports developing countries' efforts to (a) design, adopt, and implement policies conducive to the development of efficient, deep, and integrated financial markets relying primarily on market rates of interest and other terms for the efficient mobilization of private savings and allocation of credit, and (b) build and promote competition between viable private, profit-making financial institutions. A.I.D. can be a catalyst for financial liberalization in developing countries through both the policy dialogue process and project assistance.

A.I.D. can draw upon a broad range of resources to help developing countries build more effective financial markets. Different countries, depending on their stages of economic and financial markets development, may require different kinds of assistance. The primary policy approaches discussed in the policy paper are summarized below.

—A.I.D. too often has designed and implemented projects without adequately taking into account broader issues involving the financial systems in developing countries. In addition, many Missions manage a variety of "credit" projects and other financial markets activities simultaneously. Missions contemplating, or maintaining a continued presence in, financial markets activities should prepare a comprehensive financial markets development strategy paper before or in conjunction with pursuing additional financial markets activities.

—Failure to consider the macroeconomic setting may obscure the forces behind financial developments and lead to inappropriate policy recommendations. Improvements in policies affecting financial markets is an important objective for Missions that are active in the financial markets arena. In those countries in which the macroeconomic policy environment is not conducive to efficient performance of private financial institutions, A.I.D. should (a) urge the host government to adopt more appropriate policies and (b) consider postponing initiation or replenishment of financial markets activities until evidence exists that the host government is prepared to improve the policy environment.

—Domestic private savings should provide the major source of loan resources for financial institutions. Inappropriate policies inhibit prospective savers from relying on the formal financial system. A.I.D. should help developing countries develop and implement policies to encourage, mobilize, and monetize domestic savings.

—Over-reliance on directed credit results in often severe misallocations of scarce investment resources that undermines the strength and viability of financial institutions and retards the growth of financial assets. A.I.D. discourages developing countries from relying excessively on directed credit. A.I.D. should encourage developing countries to rely on market mechanisms to allocate capital to its most productive uses.

—In many developing countries, governments hold nominal interest rates constant. During periods of inflation, real interest rates fluctuate with inflation, and will become negative if the inflation rate exceeds the nominal rate. When the outright removal of all statutory ceilings to deposit and lending interest rates is not feasible, A.I.D. should encourage the host government to adopt specific reforms that permit interest rates to adjust (within an acceptable timeframe) to market levels in a deliberate and timely way.

—In many cases, the existing legal and regulatory framework restricts the growth of financial techniques and limits the ability of financial institutions to maximize their profits by seeking higher yield investments elsewhere. A.I.D. should engage in policy discussions and offer technical assistance, as appropriate, to reduce imprudent, and strengthen prudent, legal and administrative controls on financial institutions, and streamline and simplify the regulatory and supervisory responsibilities of government agencies.

—Strong institutions are essential parts of effective formal financial systems. Improvements in the institutional framework are a means of attaining the objective of broad-based economic growth. The most effective place for A.I.D. to concentrate its resources, after policy reform, is in assistance to promote the institutional development of financial intermediaries that operate in a free competitive market and other institutions that operate in the financial system.

—A.I.D. has been active in helping developing countries improve their financial systems through the provision of credit. A.I.D. will not take an equity position in a private enterprise. The interest rate to be charged on A.I.D. resources to ultimate borrowers (a) shall, at a minimum, be at or near the prevailing interest rate paid on U.S. Treasury obligations of similar maturity at the time of obligating such funds, to the maximum extent practicable, and (b) should not be less than terms prevailing locally or a rate that approximates the opportunity cost of capital in that country. At a minimum, the interest rate to ultimate private borrowers should be significantly positive in real terms, i.e., when adjusted for inflation. A.I.D. funds provided to financial institutions should carry an interest rate that (a) is at least equal to the cost of local, nonconcessional sources of capital; (b) approximates the cost of lendable resources of comparable maturities from the local private capital market (if such resources exist); and (c) is based on the appropriate rate to the ultimate borrowers.

I. INTRODUCTION

Effective financial markets are indispensible to the pursuit of sustained, broad-based economic growth.* Unfortunately, financial markets development is one of the most complex areas in the development field. Policy perspectives differ, often sharply, and the costs of establishing and implementing poor policies are high.

The purposes of this policy paper are to (1) describe A.I.D.'s policy on financial markets development, and (2) provide guidance on the development of A.I.D.'s programs and projects in financial markets.** 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.

II. THE FUNCTIONS AND KEY CHARACTERISTICS OF FINANCIAL MARKETS

The nature and performance of financial systems in developing countries must be judged in relation to an individual country's level of development. Whether these financial systems are relatively simple or highly complex, they perform the same broad functions and share the same key characteristics. These functions and characteristics are discussed below.

*A financial system is composed of many financial markets, each offering different types of financial services, serving different sets of customers, and operating in particular geographic areas. Markets can be classified as involving debt instruments, equity instruments, or foreign exchange (or some hybrid involving more than one of these, e.g., letters of credit). The policy approaches and principles described in this policy paper are applicable to the development of all financial markets.

**The policy guidance presented in this paper apply to the use of all A.I.D. resources (DA, ESF, PL 480, U.S.-owned local currency) and, when practicable, host country-owned local currency. References to forms of A.I.D. activities (such as "project" and "program") are used interchangeably in this policy paper. The policies presented in this document should be applied in concert with those in the A.I.D. policy papers on Private Enterprise Development (revised March 1985) and Pricing, Subsidies, and Related Policies in Food and Agriculture (November 1982); the Guidelines on Terms of Aid (revised October 1985); and the guidance contained in cables 1986 STATE 259310 and 259314 on the private enterprise local currency lending program described in sections 106 and 108 of the Food Security Act of 1985. Additional guidance on the Housing Guaranty Program is provided in the Shelter Policy Paper (February 1985).

A. Mobilizing Domestic Resources

The primary role of the financial system in any economy is to mobilize resources for productive investment. The financial system provides the principal means to transfer savings from individuals and companies to private enterprises, farmers, individuals, and others in need of capital for productive investment. An efficient financial system channels resources to activities that will provide the highest rate of return for the use of the funds. These resources stimulate economic growth; they provide enterprises with the ability to produce more goods and services and to generate jobs.*

Well-functioning and well-developed financial systems encourage savings and allocate resources to higher-yielding investments. Savers can make their surpluses available to investors by, in effect, purchasing financial assets (from a variety of debt and equity claims including entries in a savings passbook from a commercial bank). The financial system mobilizes savings and increases liquidity by providing asset holders with attractive (in terms of yield, risk, and liquidity) financial claims. In the absence of developed financial systems, only investments financed by individual savers or closely-knit groups of individuals would be possible. Many high-yielding investments would not be undertaken and some capital would be invested in activities yielding low returns.

Well-developed formal financial markets offer to savers and investors a variety of short- and long-term savings and investment instruments (often, but not always) through qualified financial intermediaries that enable individuals to make reasonable judgments about the risk and rewards of saving or investing their funds. These instruments effectively package risk and returns so that individuals who wish to participate in appropriate markets can do so, taking into account their own perceived capacity to accept risk. Individuals are able to borrow funds on terms commensurate with the expected risk and return of the investments they wish to make.

* Private enterprises are defined as privately-owned, for-profit business entities. They should be distinguished from private voluntary organizations (PVOs) that are private, nonprofit entities.

Financial systems transform the size, maturity, and risk characteristics of assets. For example, to reduce their risk, investors who wish to finance the acquisition of long-lived capital prefer to borrow at long term. For similar reasons (to reduce their risk), savers seldom are willing to tie up their funds for the long term. Financial systems mediate, *inter alia*, between the short-term perspectives of these savers and the long-term perspectives of these investors. They do so through (1) direct term transformation of maturities by borrowing short and lending long, and (2) indirect term transformation by buying and selling long-term instruments prior to maturity in secondary markets.

Another way to mobilize domestic resources is through the development of the equity or securities market. Equity financing provides an alternative to debt financing; it also offers new opportunities for investors and for broadening the ownership of economic assets. Expanding popular participation is essential to accompishing the aims of A.I.D.'s policies.

B. The Role of Government

The growing inadequacy of financial systems as countries develop often leads to government intervention in the financial system. To the extent that government involvement in financial systems is misdirected, the development of efficient financial markets will be inhibited and the costs of financial intermediation will be increased. Monetary and financial regulatory policies that stifle financial intermediation, creating "financial repression," are the policies primarily responsible for poorly functioning domestic monetary systems and capital markets, and thus for poor rates of growth. Interest rate ceilings on deposits and loans, combined with inflationary rates of monetary expansion, are the most important policies creating financial repression. Other policies adding to this repression are exchange controls, taxation, credit allocation, and heavy reserve requirements.

Government restrictions on freedom of entry almost always reduce the quantity and quality of financial services available to the economy, and thus hinder or distort economic growth. In contrast, competition in banking and financial intermediation tends to limit the spreads between the interest paid by borrowers and that received by depositors. This serves as an incentive for increasing saving and provides more funds, more cheaply, to investors. This competition, when combined with the adoption of liberalized financial sector reforms, enhances the efficiency with which intermediation is carried out.

At the same time, government plays a key role in assuring that financial markets operate effectively. Governments in developing countries can and should facilitate financial markets development and provide a policy and regulatory environment that encourages the appearance of competitive forces, encourages the use of a variety of debt and equity instruments, promotes the growth of different kinds of institutions offering a wide range of financial instruments and services to potential savers and investors, and protects the interests of savers by reducing their risks. Such actions would serve to decrease the transactions costs associated with financial intermediation.

Government should play an important role in the area of private ownership and property rights. Private ownership and property rights arrangements are important elements in determining the extent of an individual's participation in financial markets. When private property rights exist, an individual has exclusive right to use and derive the income from assets, to transfer the assets voluntarily to others, and to be assured that contracts of exchange are enforceable. The absence of these rights makes it difficult for private enterprises and individuals to participate in the financial system.

The proper role of government is heavily conditioned by one key characteristic of financial markets. Unlike markets in goods and most services (in which there is a simultaneous exchange of value), financial markets involve sale and purchase transactions that are separated in time. In a financial market, the product is exchanged for a commitment (for example, in the savings market, a promise to repay savings deposits plus interest), that is, for a promise to act in the future. Although a certain amount of risk is part of any economic transaction (witness the admonition "caveat emptor"), assessing and coping with risk is the essential component of every financial market transaction. The nature of the product involved is in large part determined by the personal characteristics of the actors involved in the transaction. In the early stages of financial markets development, personal judgments of creditworthiness lie at the core of all financial transactions.

The types of policy approaches available could generally be classified in four categories:

(1) purely competitive, where government policy is to rely on market forces with limited government involvement even in matters related to supervising, and establishing solvency requirements for, key participating institutions;
(2) competitive but heavily regulated for soundness through extensive use of supervision and solvency rules;
(3) administered market, where government intervenes by allocating finance and structuring institutions, but lets markets set prices within these parameters; and
(4) managed, where government decisions replace market relationships and the enforcement of supervision and solvency policies is minimal.

The mix or balance of policy approaches could differ in a given market through time and among different markets in a given country. Government policies now generally favor administered or managed systems in many of the developing countries in which A.I.D. operates. Recently, however, several developing countries have liberalized their financial markets. They have implemented reforms to reduce the extent of government intervention through *inter alia* state ownership of banks, directed credit programs, and subsidized interest rates. As a result, financial markets in these countries are less distorted and more integrated; they respond more readily to market signals rather than administrative directives.

C. Efficiency and Depth

Financial markets can be effective to the extent that they are efficient and deep. Governments regulate financial markets to promote efficiency and to avoid volatility.

Efficient financial markets (1) mobilize funds from savings with, at the margin, the lowest opportunity cost (adjusted for perceptions of risk) and (2) distribute those funds to investments that offer, at the margin, the highest potential returns (adjusted for perceptions of risk). Taken together, these are the two characteristics of allocational efficiency. Efficient financial markets also mobilize and allocate funds at minimal cost. This is the characteristic of operational efficiency. It is also important to keep in mind that if there are inefficiencies in the market, then prices or costs would not reflect the real information relevant for financial decision-making (price discovery efficiency).

The depth of financial markets is a measure of their strength; deep financial markets are inherently less fragile than shallow financial markets. A commonly used indicator of formal sector financial depth is the ratio of broadly defined money (currency plus demand deposits) to gross domestic product. A low ratio suggests that the formal financial system is a poor mobilizer of funds; combined with strong demand for funds by the public sector, a low ratio makes credit to the private sector very scarce. In many developing countries, formal financial markets are shallow; relatively few people have access to these markets, and the range of available financial instruments is limited.

Friends, relatives, and moneylenders are the primary sources of external finance in a very shallow system. Savings tend to be placed in real assets such as gold or cattle as a store of value. As the system develops, more options are available for yields, maturities, and risks, leading to higher household welfare.

As the system financial develops, prospective investors increasingly can turn to local financial institutions, national financial organizations and, ultimately, international banks and securities markets for additional funds. Each step leads to a more efficient allocation of capital. The resulting increase in the availability of equity and debt funding will enable developing economies to move towards more balanced capital structures of enterprises.

Shallow, formal financial markets do not adjust well to external shocks without collapsing or displaying excessive fluctuations; they are markets in which, *inter alia*, severe market gyrations are fairly common, institutions too often collapse, and "secure" instruments are not, in fact, safe havens for savings. Shallow financial markets also are rather easily subject to manipulation. Low-income developing countries, with their shallow financial markets, have been found to rely relatively more heavily on administrative allocation systems than high-income developing countries.

However, in most of the developing countries in which A.I.D. operates, government policies now appear overly concerned with curbing volatility and inadequately concerned with promoting operational and allocational efficiency. The quest for greater efficiency in the financial markets of developing countries typically means relying more heavily on

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market forces rather than on administrative controls

There is a risk—due to heightened market volatility—involved in the timing and sequencing of introducing liberal reforms. The recent experience of the Southern Cone countries of Latin America is instructive. The main lessons of that experience are:

- financial liberalization should be accompanied by effective supervision of both public and private institutions to avoid fraud, circumvention of sound financial practices, and misuse of funds;
- financial authorities should devalue an overvalued currency before attempting to reform domestic financial markets. Failing to do so will lead to "excessive" borrowing in anticipation of a real devaluation;
- financial authorities should consider carefully the likely effects of rapid reductions in existing interest rate subsidies. Depending on the context, a sudden shift to high real rates may trigger widespread defaults and lead to a collapse of the banking system; and
- financial authorities should pay particular attention to the sequence—the timing—of reforms. For example, authorities may wish to liberalize the international current (trade) account before liberalizing the capital account. Otherwise, depending on the context, the result may be destabilizing short-term capital inflows that could stimulate rapid unwarranted appreciation of the domestic currency.

D. Integration

Effective financial markets are integrated in two dimensions. First, integration can be "vertical." Vertically integrated financial systems are those in which the three principal market clusters (formal domestic markets, informal markets, and international markets) are closely linked. Second, integration can be "horizontal." Horizontally integrated financial markets are those in which market interest rates typically array themselves around a basic reference rate.

Vertically integrated financial systems incorporate informal and international financial markets with formal domestic financial markets. Informal financial markets are especially important in A.I.D.-recipient countries because these markets provide the credit and savings mobilization functions for a major portion of A.I.D.'s target groups (see section IV.B.6.).

Informal financial markets are highly segmented: moneylenders generally exercise spatial monopoly power. Informal financial markets clearly are "interlinked" markets, in that informal financial transactions spill over into transactions in the local land and labor markets (for example, local money lenders often are members of the landed elite and often hire labor at differential rates depending on the indebtedness of that labor). Although assessing the degree to which these interlinked informal financial markets are integrated with formal domestic financial markets is difficult, linkages between the two markets are greater than may be readily apparent. Informal financial markets have links with formal credit through their lines of credit with commerical and development financial institutions. In addition to serving microenterprises and informal sector enterprises, informal financial intermediaries supply those credit requirements of formal sector enterprises that cannot be met by formal financial institutions.

An effective financial market system also should connect domestic financial markets to international financial markets (and to the related commodity trading systems). The presence of effective financial markets in developing countries will encourage foreign investors to consider providing capital (in the form of both debt and equity) for productive investment. Over time, integration with international financial markets will (1) narrow the differences in the cost of funds between markets in different countries and between different instruments, and (2) spread the risks associated with exchange rate and interest rate fluctuations among a larger number of market participants.

In horizontally integrated and efficient formal financial markets, the reference rate, typically the inter-bank rate, is the market rate of a short-term, low-risk financial instrument. Such an instrument is easily available to financial institutions. It typically provides the basic liquidity for the formal financial system, and central banks often use it to gauge the tightness of monetary policies.

Two markets sometimes are closely integrated because intermediaries operate simultaneously in both, for example, commercial banks operate in both the savings (deposit) and the loan markets. On the other hand, in most developing countries, the government bond market and the market for housing loans probably will not be very tightly integrated.

E. Promoting Widespread Ownership

Efficient financial markets promote more widespread ownership of assets in a society. A larger number of citizens in a developing country will thereby have an opportunity to participate in, and enjoy the benefits derived from, the growth of their country's economy. Development of the equity securities market, for example, provides a means of distributing the ownership of securities more widely among the public, which increases the probability that business ownership will not be confined to a small number of wealthy families or to big industrial-financial conglomerates. Another way to build up widespread ownership is the establishment of contractual savings arrangements through pension funds.

III. STATEMENT OF A.I.D. POLICY AND OBJECTIVES FOR FINANCIAL MARKETS DEVELOPMENT

A.I.D. supports developing countries' efforts to develop financial markets. A.I.D. will encourage these countries to (1) 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 (2) build and promote competition between viable private, profit-making financial institutions. The primary source of capital for economic growth should be private domestic resource mobilization. A.I.D. can be a catalyst for financial liberalization in developing countries through both the policy dialogue process and project assistance.

IV. COMPONENTS OF THE A.I.D. POLICY

A.I.D. can draw upon a broad range of resources to help developing countries build more effective financial markets. Different countries, depending on their stages of economic and financial markets development, may require different kinds of assistance. If that assistance is needed to overcome existing constraints in the policy environment, then that assistance should be designed to help resolve, and not compensate for, those constraints. The policy described in this policy paper is Mission-directed, flexible, and closely guided by detailed and comprehensive country studies. It is expected that Missions will concentrate on policy reforms that emphasize greater reliance on competitive, market-based allocation systems and on project assistance to and through private sector institutions. AID/W will help Missions with technical assistance and other assistance mechanisms where it can.

A. Financial Markets Development Strategy

Missions contemplating, or maintaining a continued presence in, financial markets activities should prepare a comprehensive financial markets development strategy paper before or in conjunction with pursuing additional financial markets activities. This strategy paper should (1) develop a framework for financial markets activities based upon host country conditions and the policy and institutional issues raised in this policy paper, and (2) discuss how existing and proposed A.I.D.-supported financial markets interventions in a country interrelate under this framework.

A review of A.I.D.'s credit projects suggest that A.I.D. too often has designed and implemented projects without adequately taking into account broader issues involving the financial systems in developing countries. For example, A.I.D. often provided credit through public and private development banks, credit unions, and PVOs without exploring the need to mobilize domestic financial resources. A.I.D. projects often implicitly accept interest rate ceilings and administratively determined credit allocation mechanisms as incidental constraints on specific projects. In particular, too little attention may have been paid to the reasons why formal credit was not available.

Many Missions manage a variety of "credit" projects and other financial markets activities simultaneously (involving, e.g., microenterprise loans, agricultural credit, mortgage credit, and exchange rate reform efforts). These projects are often channelled through an uncoordinated subset of financial institutions, at a variety of interest rates and conditions. Such efforts may promote a more fragmented domestic financial market than might exist without A.I.D.'s assistance.

B. Policy Dialogue

Improvements in policies affecting financial markets is an important objective for Missions that are active in the financial

markets arena. Missions must assess realistically the influence they have in encouraging host country governments to adopt sensitive reform packages. It may be difficult to leverage significant financial policy reforms with sharply limited resources or through a single project affecting only a vary narrow part of the financial system.

Missions should solicit a broad range of local private sector views to ensure that suggested policy changes are responsive to the broader needs of the private sector as well as to the requirements of economic efficiency, and encourage a continuing dialogue between government and the private sector. In a number of developing countries, important elements of the business community believe that their governments do not adequately understand their needs and their roles in the development process. Missions may wish to encourage host governments to publicly develop a strategy to promote their financial markets through an appropriate set of policies. Such a commitment, as well as a continuing dialogue on matters relating to financial markets development, may improve saver and investor confidence.

Missions should coordinate their efforts in financial markets development with multilateral agencies and other bilateral donors. Multilateral agencies and other bilateral donors are working with many developing countries to help improve their financial systems. Multilateral agencies in particular often are especially well-positioned to advocate politically sensitive policy reforms.

1. Macroeconomic Policies

In those countries in which the macroeconomic policy environment is not conducive to efficient performance of private financial institutions, A.I.D. should (a) urge the host government to adopt more appropriate policies and (b) consider postponing initiation or replenishment of financial markets activities until evidence exists that the host government is prepared to improve the policy environment. If a Mission wishes to initiate or replenish a financial markets activity when the macroeconomic policy framework is inadequate, suitable documentation should clearly demonstrate that the Mission has analyzed the effect of the existing policies on the activity's ability to achieve its purpose. Failure to consider the macroeconomic setting may obscure the forces behind financial developments and lead to inappropriate policy recommendations. Among the policies that may need attention are monetary policy, fiscal policy, exchange rate policy, import and export barriers, credit controls, and access to foreign exchange. The reform of a particular policy should be undertaken carefully and in concert with other actions.

Missions should encourage developing countries to adopt investment policies that attract foreign investors and increase the contribution of foreign and local investment to economic growth. Opening markets to foreign direct investment provides ways for these countries to diversify their economies and increase their capital inflows. Efforts to attract foreign investment will, if properly conceived, also mobilize local investment. A.I.D.'s policies on foreign investment are presented in the Trade Development Policy Paper (July 1986).

2. Encouraging and Mobilizing Domestic Private Savings

A.I.D. should help developing countries develop and implement policies to encourage, mobilize, and monetize domestic savings. A.I.D. should encourage developing countries to eliminate interest rate ceilings, which inhibit capital formation and individual savings and encourage capital outflow, and adopt policies that allow interest rates to fluctuate in response to market forces.

Domestic private savings should provide the major source of loan resources for financial institutions. Inappropriate policies inhibit prospective savers from relying on the formal financial system. Instead, they hold more traditional forms of wealth such as land, animals, jewelry, or gold. The result is an aggregate level of savings less than that which could be achieved given improved financial markets policies. Inadequate information, distrust of large and centralized institutions, and various cultural considerations are other important factors that inhibit savers from relying more fully on formal financial markets.

Empirical evidence strongly supports the assertion that the poor in developing countries save. The poor often rely on informal institutions such as investment clubs, savings societies, and rotating credit associations for saving. The informal institutions involved frequently are effective mechanisms for channelling those mobilized savings to productive uses. Mobilization of domestic private savings is dependent on efficient financial markets and profitable uses of the mobilized funds.

Several actions are needed if a savings mobilization effort is to be successful. Two are particularly important. First, effective interest rates paid to savers should be sufficient (normally positive in real terms, that is, adjusted for inflation) to attract an increasing inflow of funds from private savers; artificially low interest rates produce a bias in favor of current consumption and therefore reduce the incentive to save. Second, the services offered by financial institutions must be easily accessible and otherwise attractive to savers.

Combining savings and lending activities of financial intermediaries offers many benefits, and demonstrates the importance of savings to institutional viability. It reduces some costs, including those of establishing creditworthiness, since financial intermediaries will have better information on and be better acquainted with borrowers through their role as savers. Saver-dominated financial institutions also tend to show steady growth in assets and liabilities, lower loan delinquency, and greater efficiency and financial viability. Borrower-dominated financial institutions tend to show higher rates of loan delinquency, poor rates of growth, perennial liquidity problems, and other weaknesses associated with dependence on external sources of funds.

3. Credit Allocation Policies

a. Directed Credit

A.I.D. discourages excessive reliance on directed credit. A.I.D. should encourage developing countries to rely on market mechanisms to allocate capital to its most productive uses.*

Administrative allocation mechanisms are particularly appealing to governments of very low income countries where money markets are typically very shallow and highly fragmented (between geographic regions, urban and rural borrowers, different loan purposes, large and small enterprises and classes of borrowers). Governments generally pursue these mechanisms because of political, social, or distributional considerations.

Over-reliance on directed credit results in often severe misallocations of scarce investment resources that undermines the strength and viability of financial institutions and retards the growth of financial assets. Persistent and usually subsidized directed credit programs typically do not adequately reach their intended beneficiaries, limit the access to (and make more costly) credit of firms not in government-designated "priority" sectors, create "moral hazard" on the part of private investors who operate under the expectation that government support will ward off failure, reward inefficient capital-intensive patterns of investment, require administrative burdens that most developing countries are particularly ill-equipped to handle, and discourage savings intermediation. In addition, the allocation of credit may often be compensating for deliberate or accidental inadequacies in the host government's own policy actions.

b. Government-controlled Interest Rates

When the outright removal of all statutory ceilings to deposit and lending interest rates is not feasible, A.I.D. should encourage the host government to adopt specific reforms that permit interest rates to adjust (within an acceptable timeframe) to market levels in a deliberate and timely way.

In many developing countries, governments hold nominal interest rates constant. During periods of inflation, real interest rates fluctuate with inflation, and will become negative if the inflation rate exceeds the nominal rate.

Countries that have consistently maintained positive interest rates and have an adequate number of institutions that issue attractive financial instruments show a higher rate of growth in their financial assets and have deeper financial intermediary systems than countries that have low and/or widely fluctuating levels of real interest on deposits. Positive market-determined real interest rates generally are associated with the development of sound and self-sustaining financial systems.

Interest rate ceilings often are imposed by governments to protect the borrower from "unscrupulous" lending practices. Yet, lending to large numbers of small and widely

*The "market-determined" or "market-clearing" rate for credit is used throughout this paper, even though its common meaning (the rate at which the supply and demand for credit are in balance with a minimum of government interference) is often not applicable in developing countries where governments exert a great deal of control over financial and related markets.

dispersed borrowers (e.g., small, rural entrepreneurs) normally involves relatively high administrative costs per loan that cannot be passed on to the end-borrower because of the interest rate ceiling. Consequently, it becomes unprofitable for financial institutions to lend to these borrowers.

Imposing interest rate ceilings, no matter how well-intentioned, often results in reductions—not increases—in the availability of formal credit for specific target groups. Local financial institutions handling the subsidized credit can be expected to allocate the credit in accordance with their appraisal of risk and profitability for themselves and thereby improve the quality, but not expand the dispersion, of their loans. Subsidized interest rates also encourage greater use of capital-intensive production techniques by making loans for capital equipment less costly, and, consequently, decrease employment per unit of capital employed.

c. Credit Collateral Requirements

A.I.D. should encourage financial institutions to seek alternatives to fixed and high collateral requirements (such as adopting flexible collateral requirements, charging higher interest rates, lending to groups of borrowers, or establishing special small loan windows).

Formal lending institutions (e.g., banks, credit unions, savings and loans, and finance companies) frequently establish loan collateral requirements that effectively direct credit to favored groups of individuals or enterprises. Collateral requirements often are very high (ranging from 150% to 200% in most developing countries) and may be limited to certain types of collateral (e.g., land). Where interest rates are artificially low, collateral acts as a screening mechanism to discriminate among prospective borrowers. High collateral requirements also may be derived from lender concern about political and economic uncertainty and a lack of familiarity with certain potential borrower groups.

4. Legal and Regulatory Constraints

A.I.D. encourages host country governments to review the legal and regulatory framework affecting their financial systems. A.I.D. should engage in policy discussions and offer technical assistance, as appropriate, to (a) reduce imprudent, and strengthen prudent, legal and administrative controls on financial institutions; (b) streamline and simplify the regulatory and supervisory responsibilities of government agencies; and (c) improve the capabilities of regulatory bodies to enforce appropriate laws and regulations.

In many cases, the existing legal and regulatory framework is designed to ensure proper banking practices. However, some controls often restrict or repress the growth of financial techniques and limit the ability of financial institutions to maximize their profits by seeking higher yield investments elsewhere. These controls include, *inter alia*, time limits on deposits; maximum amounts for certain deposits; restrictions on the types of institutions that can receive certain types of deposits; and entry requirements in the banking sector. Some of these measures manifest themselves as implicit taxes on financial intermediaries (see section IV.B.5).

Legal codes and regulations of developing countries are often inadequate on such issues as security of assets, title to property, property transfer, taking possession of collateral on loans in default, and sharing ownership of assets. The result is that under existing laws (a) it is often difficult to broaden the range of financial instruments and securities available in the market; (b) there are limits on when and at what price companies can issue securities in public offers (inhibiting public offerings), and interest that can be paid (discouraging savings); (c) securities cannot be easily transferred among holders, and often a company has the power to refuse transfer; and (d) investors have inadequate rights and protections.

Proper government regulation is beneficial to lenders, borrowers, and investors. For example, regulation of securities may increase investor confidence in equity shares. Reasonable standards of investor protection, such as adequate accounting standards and rules of financial disclosure, protect securities investors and are critical to the successful functioning of a capital market. Fair enforcement of contracts protects investors, lenders, and borrowers. Deposit insurance encourages individuals to save and deposit their funds. The removal of market entry barriers and the resulting increased competition in providing financial services generally increases the quantity and quality of financial services available to savers and investors. Responsible regulation of private banking and other financial institutions may remove some of the host government's excuses for nationalization of financial institutions and resistance to privatization of state-owned financial institutions

It should be recognized also that the judicial and enforcement systems are weak and inadequate to settle disputes. Enforcement of rules and regulations can be just only with a fairly administered adjudicatory mechanism including means of appeal.

5. Tax Policies

As part of their financial markets development strategy, Missions should review their host country's tax structures to assess their roles in the development of the financial system. Missions should encourage host governments to change restrictive tax laws and adopt tax policies that provide a suitable tax environment for financial markets development.

In some countries, tax measures inhibit financial markets development and restrict capital formation by increasing the cost of financial intermediation and reducing the financial system's flexibility due to the reduced amount of funds available for lending and, in turn, for investing. Financial intermediation is subject to explicit and implicit tax measures that are not applied to other sectors of the economy. For example, some governments impose an explicit transactions tax on the value of each financial transaction undertaken by a financial institution. Implicit taxes consist primarily of requirements for the maintenance of high reserve levels and forced portfolio investments on low yielding government securities.

In addition, special tax preferences for certain forms of investment discourage savers from investing in those that are not so favored.

A number of tax measures may improve financial intermediation and capital formation. These include, *inter alia*, lowering the explicit and implicit taxes levels imposed on financial intermediaries, and adopting lower marginal tax rates for corporations (which promotes economic efficiency and equity investment, and may reduce capital outflows), and for individuals (which encourages savings rather than consumption). In the absence of lower tax rates, numerous measures can be explored that could encourage greater savings and investment. These efforts will involve substantial policy debate, as financial markets development may conflict with other host government goals, such as raising short-term tax revenue.

6. Informal Financial Markets*

A.I.D. should encourage the host government to adopt specific reforms that increase access to formal sources of credit. A.I.D. should sponsor studies on the nature and functions of informal financial markets. As appropriate, those lessons should inform the design of projects and programs involving formal financial markets.

In many developing countries, the common requirements and practices of formal financial institutions make access to credit and other financial services difficult and expensive. As a result, there remain in place often sizeable informal financial markets. Typically, informal financial markets comprise professional and nonprofessional money lenders (often relatives and friends), local bankers-cum-merchant middlemen, private pawnshops and finance firms, personal and business fixed fund and rotating savings and credit associations, landlords, and the more prosperous agriculturalists. Although heterogenous in composition, these intermediaries share some typical economic characteristics including the predominance of cash transactions, freedom from official registration and regulation, ease of entry or exit, small scale of operations, and the multiple-interest relationship (financial and socio-cultural) between lenders and borrowers. They are found in both rural and urban areas, and can be national in scope, such as the curb market in South Korea, or international in scope, such as the Hundi system prevalant throughout South Asia.

Informal financial markets transactions generally take place in an unregulated environment. Some elements of these transactions may be very efficient. They have at best limited connections with monetary authorities (for example, they are not subject to reserve requirements and governments exercise no direct fiscal controls over their activities). However, information of the nature and functions of informal financial markets is woefully inadequate. Important lessons may be derived from careful study of their behavior.

The activities of moneylenders in informal financial markets are often abhorred since interest rates charged in the informal financial markets often are higher and for shorter

*The informal sector refers to those business entities that operate outside formal economic and governmental structures and range in size from the small and labor-intensive enterprise to relatively large and capital-intensive enterprises. Women are widely represented in the informal sector, particularly at the small-scale range of the spectrum terms than in the formal markets. Yet, growing evidence suggests that the implicit and explicit costs and difficulties associated with formal credit sources often are higher than are the nominally higher costs for funds obtained in the informal markets.

A.I.D.'s assistance to the informal sector has historically been in the form of project-based credit and technical assistance. Although many A.I.D. programs directed at micro-enterprises and informal sector enterprises have demonstrated that these enterprises are reliable borrowers and can be reached cost-effectively, studies have shown that providing credit alone to microenterprises only rarely produced self-sustaining gains; increases in income were short-lived.

Informal sector enterprises often face a policy and administrative environment that contains serious market access and entry barriers. Some macroeconomic policies have a negative impact on informal enterprises and serve as entry barriers to the formal sector. These issues should be addressed within the framework of A.I.D.'s assistance to the informal sector.

A.I.D. should also continue to encourage formal financial institutions to serve the same clientele served by the informal financial markets. In the process, the more efficient formal markets gradually displace less effective informal markets. The best examples are those involving the extension of formal financial systems to better serve the growing financial demands of small farmers and small-scale entrepreneurs. This approach depends for its success on the truth of an assumption that formal financial markets are more effective than informal institutions under appropriate circumstances. Although this assumption is generally borne out over the long run, it may not be correct in some markets in the short run.

To facilitate graduation to commercial borrowing, A.I.D. should foster the involvement of formal financial institutions in the informal system. For example, it may be useful to have a representative from a local private bank involved in an A.I.D.-sponsored informal sector lending program conducted through a PVO. This might facilitate an informal enterprise's graduation from the A.I.D. program to commercial banks by increasing the bank's familiarity with the borrower (and much of that segment of borrowers) while establishing a credit history in which the bank has confidence.

C. Institutional Strengthening and Development

Strong institutions are essential parts of effective formal financial systems. The most effective place for A.I.D. to concentrate its resources, after policy reform, is in assistance to promote the institutional development of financial intermediaries that operate in a free competitive market and other institutions that operate in the financial system. It should be kept in mind that improvements in the institutional framework are not ends by themselves, but only a means of attaining the objective of broad-based economic growth.

Although particular country situations differ, private sector financial institutions are generally more efficient than public institutions for channelling assistance to individual private enterprises and for mobilizing domestic resources in support of financial markets because they:

- have to depend to a greater extent on their capacity to attract nonconcessionary savings and to engage in new financial activities because of their more limited access to concessionary resources;
- are more innovative in reducing transaction costs and spreading the costs of bearing risks; and
- have been able to better avoid projects of dubious profitability (although sometimes to an imprudent extreme).

A.I.D. should give priority attention to strengthening the private financial system (through which A.I.D. resources should be channelled) and those private institutions that have a reasonable prospect of being self-sustaining. It is preferable to expand the capabilities of existing private financial institutions rather than establish new institutions. A.I.D. should encourage well-run, existing financial institutions to add new types of financial activities to their traditional operations rather than create new institutions to accomplish particular development objectives. Diversification allows institutions to overcome the problems of scale associated with over-specialization, especially in low-income countries with small financial markets.

Greater attention should be directed to structuring assistance to financial institutions to improve their (1) prospects for viability after A.I.D.'s assistance has been terminated, and (2) operations in ways that would enhance their own financial strength, growth prospects, and contribution to savings mobilization and credit allocation performance. Examples of measures meriting close attention include cost controls, loan application appraisal techniques, reasonable collateral and other safeguards to protect loan contracts, good collection records, business services, and deposit-taking functions. For self-sustaining viability, financial institutions in developing countries should move toward mobilizing their funds from the domestic economy.

Missions should be alert to the risks of over-emphasizing the supervision of the uses of credit, as this sometimes results in the neglect of potentially more important objectives of credit projects. External assistance, in the form of technical assistance or staff training (rather than capital for making loans) may help these institutions develop their own capabilities.

In a free market, financial institutions generally organize themselves according to the opportunities they see to meet the different needs of savers and users of funds as well as the changing patterns of savings, fiscal conditions, and institutional arrangements. A.I.D.'s programs and projects should be sufficiently flexible to allow for the disbanding of inefficient entities, restructuring, or the merger of institutions as appropriate. For example, institutions may properly merge or go out of business when there is insufficient market demand to support many separate institutions.

On a case-by-case basis, A.I.D. may help to establish new financial institutions (including special purpose institutions) in areas where private institutions have not been established despite a favorable policy environment and other supporting factors. However, A.I.D. should carefully study each situation and weigh available alternatives prior to proceeding with the new entity. Where existing private financial institutions are capable of performing the desired activity, the establishment of a new trust or trust fund to serve as a financial intermediary for on-lending or equity investment should be avoided.

An unwarranted increase in the number of financial institutions can reduce the success of institutional development. Since financial systems in most developing countries are shallow, special purpose institutions could affect adversely the ability of commerical institutions to attract natural clients. The creation of parallel and costly institutional structures should, therefore, be discouraged, particularly in smaller countries.

Before establishing new financial institutions A.I.D. should review the existing financial system to determine whether (1) financial intermediation is being provided at a reasonable cost; (2) financial institutions are providing an appropriate mix of services for market demands; (3) the level of competition among various institutions is adequate; (4) the financial stability and structure of the various institutions is appropriate for their types of financial activities; and (5) experienced management is available.

D. A.I.D. Credit Policy

A.I.D. has been active in helping developing countries improve their financial systems through technical assistance, training, studies, policy dialogue, and the provision of credit. A.I.D.'s credit programs and projects (1) support new development finance institutions; (2) help existing banks expand their traditional short-term lending operations to add medium- and long-term lending; (3) increase the credit resources available for financing priority development activities; (4) eliminate impediments to capital movement among regions or sectors; and (5) open up access to formal credit to disadvantaged borrowers.

1. The Provision of Equity and Grants by A.I.D.

As established in section 635(g) (3) of the Foreign Assistance Act of 1961, as amended, and section V.D. of the Private Enterprise Development Policy Paper, A.I.D. will not take an equity position in any private enterprise.* Grants to private enterprises in developing countries are permitted to finance direct training and technical assistance, although such assistance should be programmed in a way that provides competitive access for many enterprises rather than one enterprise.**

Owners' equity is important during the start-up phase of an intermediate financial institution (IFI) or other private enterprise as it

* Section 635(g) (3) of the FAA restricts A.I.D. from directly purchasing equity securities, although A.I.D. does have limited authority to purchase convertible debt securities and may convert them or otherwise obtain equity securities through such means as the enforcement of liens and pledges. Legislative guidance on this subject extends back to the Mutual Security Act of 1954, as amended, and the Development Loan Fund, one of A.I.D.'s predecessor agencies.

** This language refers to private enterprises that are not IFIs. A permitted use for grants to IFIs is discussed in section IV.D.3.a. below.

provides permanent finance with no contractual payments. Owners' equity is the financial stake put at risk by each of the owners, originating from each owner's desire to earn a return on his share of equity higher than alternatives for which he could have used the funds.*

A number of reports have characterized A.I.D.'s involvement in IFIs as providing "quasi-equity." The quasi-equity instruments usually referred to, such as debentures, are debt instruments. Any confusion between equity and quasi-equity may have arisen because A.I.D., in the short run, may perform like an owner of equity by insisting that a portion of an IFI's on-lending portfolio (generally the capital available from A.I.D.) contain loans to an A.I.D. target group.

2. Interest Rates to Private Enterprises and Other Ultimate Borrowers

The interest rate to be charged on A.I.D. resources to ultimate borrowers (a) shall, at a minimum, be at or near the prevailing interest rate paid on U.S. Treasury obligations of similar maturity at the time of obligating such funds, to the maximum extent practicable (it should be borne in mind that use of the U.S. Treasury rate is moderately concessional); and (b) should not be less than terms prevailing locally or a rate that approximates the opportunity cost of capital in that country. If interest rates, collateral requirements, or repayment periods are administratively imposed by the government, the terms agreed to in A.I.D.-supported activities will be part of a planned effort to encourage governments to move progressively toward market terms. At a minimum, the interest rate to ultimate private borrowers should be significantly positive in real terms, i.e., when adjusted for inflation.**

Where practicable, the interest rates and associated fees charged to the sub-borrower by an IFI should cover all of the IFI's costs of lending, such as the costs of funds mobilized or borrowed, the normal premiums for the higher risks of term loans or devaluation risks for loans denominated in foreign currency; a loan loss reserve; the administrative costs of providing loans to end borrowers (which usually are high as A.I.D. generally tries to service the credit demands of a large number of small borrowers); any extraordinary costs of non-bank services furnished the sub-borrowers or of supervising the sub-loans, and a reasonable profit margin for the IFI. Interest rates to be charged on A.I.D.'s direct loans to private enterprises should be set within the context of this effort.

Special circumstances for concessional assistance are discussed the Private Enterprise Development Policy Paper (section V.D.); however, concessional rates should not be used to encourage private enterprises to undertake activities that are not commercially feasible at market rates. If there is little expectation that a needed product or activity is not commercially viable, then Missions should consider the use of a contracting mechanism to one or several firms to undertake the particular activity, rather than introduce new distortions into the financial market.

Experience shows that in countries in which private business is overshadowed by subsidized state-owned enterprises (SOEs), the financial market is severely handicapped and limited. SOEs often consume much of the total domestic credit available. When A.I.D. extends credit to SOEs, loans to SOEs will be at the same rate charged to private enterprises, and are to be provided in the context of the privatization guidance contained in the Private Enterprise Development Policy Paper (section V.F.).

3. The Relationship between Donor Funds and the Cost of Capital to Financial Intermediaries

a. Interest Rates

A.I.D. funds provided to financial institutions should carry an interest rate that (1) is at least equal to the cost of local, nonconcessional sources of capital; (2) approximates the cost of lendable resources of comparable maturities from the local private capital market (if such resources exist); and (3) is based on the appropriate rate to the ultimate borrowers. All IFIs (regardless of whether the owners are public or private, joint public/private, or PVOs) should be treated as private enterprises for

* A donor, such as A.I.D., has two immediate problems in trying to use its funds as equity. First, a donor's principal motive is not to earn more than an average return on its funds. Second, a donor sees itself as a catalyst to an IFI or a private enterprise, not a long-term member of the board. A.I.D. cannot act as an owner of equity unless it internalizes market-based, entrepreneurial behavior in its involvement in the business entity. A.I.D. would then have to direct its funds to the business entity that offers A.I.D. the best prospects for the highest return.

**The opportunity cost of capital represents the value of the best alternative use of the capital, or the opportunity that is sacrificed for a particular use of the capital.

the purpose of determining interest rates on loans to them because they are selling services in commercial markets and are capable of earning revenue.

Market-based interest rates on loans to IFIs are an essential component of financial markets development. Historically, A.I.D projects that provided low interest (or interest-free) loans to IFIs have developed maintenance of capital value problems in later years. These relatively low nominal interest rates were often combined with moderate to high level of inflation and resulted in negative real rates of interest. Consequently, these projects have built-in automatic financial drains. Interest rate subsidies lead to substantial recurrent cost problems. It is difficult to wean IFIs from subsidies.

A financial institution's usual sources of capital for on-lending are equity capital, debt instruments, borrowings from the Central Bank, and retained earnings. The provision of donor funds provides three initial benefits. First, donor funds provide additional capital to a financial system that has little or no access to external funds and cannot meet capital demand with its domestic resources. Second, the addition of donor funds to the capital base decreases the aggregate cost of funds in the economy. Third, donor funding to the financial sector provides new foreign exchange to the Central Bank.

When a donor provides capital to an IFI at terms below that which the IFI must pay to attract depositors, the IFI may deemphasize its acquisition of deposits from local sources and seek to increase its access to additional donor resources as deposits become relatively more expensive. At the same time, a relatively large spread between A.I.D.'s loan terms to the IFI and the on-lending terms may enable IFIs to operate profitably with a significant percentage of their loan portfolio in arrears or default, and will reduce the pressure on the institution to expand volume and services. This large spread may reduce the IFI's overall market effectiveness and efficiency, and discourage its aggressiveness in other financial activities. A.I.D. needs to balance this cost against the goal of wanting these IFIs to develop a more aggressive risk profile in their loan portfolios.

A.I.D. needs to make more realistic determinations of the costs of carrying out A.I.D.-required activities when developing credit projects. If it is necessary to make adjustments (concessional assistance) in the terms of A.I.D.'s assistance to the IFI to hedge agreed-upon risk (although not necessarily the total risk) or cover the costs arising from meeting A.I.D.'s programmatic objectives, then the value of the adjustments shall be equal to, but not greater than, the actual costs incurred by the IFI.* This will enable the IFI to cover the costs of A.I.D.-sponsored activities and earn a return that, since it is comparable to other returns earned by the IFI, will not discourage the IFI from pursuing its non-A.I.D. activities (such as deposit-taking).

If the cost of the institution-building activities (such as training IFI employees) occurs primarily in the early stage of an IFI project, it may make sense to identify such costs as separate components of a project and to finance these with grant funds, rather than have such costs spread over the term of loan repayment. This approach may be preferred if it is desired that the institution-building activities should proceed before the on-lending activities can generate revenues. Another approach is to provide technical assistance to reduce loan transaction costs in the credit delivery system. A concessional loan would not be appropriate for handling long-term differences in transaction costs between loans to different types of end-borrowers.

If the A.I.D. loan to the IFI is to be concessional, then the grant component of the loan should be identified, analyzed, and its value fully reflected in program or project documents. A.I.D. must justify fully, on a case-by-case basis, the use of loan subsidies (and, as appropriate, grants) to IFIs (including PVOs that act as IFIs).

If the spread between the cost of the funds from A.I.D. and the IFI's on-lending rate is too large, then the IFI receives a windfall profit. If the spread is too small, then the IFI will not disburse the funds, or will not disburse them to the clientele targeted by A.I.D. Thus, the interest spread is a critical financial

*These costs generally include the costs of analyzing and monitoring loans and maintaining a loan loss reserve. The adjustments to A.I.D.'s assistance generally include grants, reduced interest rates, or extended grace periods. Programmatic objectives may include making credit available to private enterprises that would not be able to obtain formal financing in the absence of A.I.D. support (additionality), encouraging an IFI to provide term loans, or providing services to a borrower that are not normally part of a loan agreement (such as business advisory services). Determining these costs may be a difficult task; Missions may wish to obtain expert assistance to conduct the appropriate analyses.

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parameter in an IFI project. Missions may wish to consider lending their funds to an IFI at a floating interest rate if A.I.D.'s funds are to be disbursed over a long period of time

b. Foreign Exchange Risk

The issue of foreign exchange risk presents a special problem. There are certain situations in which private financial institutions are unwilling to accept dollar loans because of the risk of devaluation. They are also afraid that they will be unable to convert their local currency repayments into dollars because of foreign exchange limitations. There are several ways to deal with this problem.

A.I.D. often utilizes a two-step loan that passes its financing through a host country's government entity (e.g. Central Bank) before the funds are on-lent to ultimate borrowers. The dollar loan is made directly to the government which assumes responsibility for its ultimate repayment and the dollars or the local currency equivalents are then on-lent through the IFI to the ultimate borrowers. This procedure allows internal on-lending arrangements to be structured so that the government can continue to bear all the risk of devaluation, or can pass all or a part of the risk to the IFI and then to the ultimate borrowers. In this two-step process, the interest rate charged to the IFI by the government entity could reflect the real cost of loanable capital to the IFI within that developing country, including the foreign exchange risk. Alternatively, the foreign exchange risk can be shared in varying proportions between two or all three of the participants. It should be noted, however, that in some instances the involvement of the host government in the transaction may discourage private IFIs from participating in the A.I.D.-sponsored activity.

The A.I.D. dollar loan also may be made directly to the IFI. The loan arrangement should be structured to adequately protect the IFI from the high risk of future currency devaluation and to insure the IFI's solvency. Therefore, the credit program should be structured so that all or most of the risk is shifted forward to the sub-borrowers. In high-risk situations this could restrict on-lending to export activities that would earn the foreign exchange needed for repayment.

In both the two-step or direct loan approach, the charges to the end borrower of a loan denominated in local currency may include a contribution to a reserve fund held by the IFI that could be used to offset any deficiency in the local currency loan service receipts in the event of devaluation. Also, in both approaches, the on-lending rate to the ultimate borrower should still be determined by the guidance in section IV.D.2.

Many ultimate borrowers do not require dollars. In these instances, they are unwilling to accept the foreign exchange risk associated with dollars. A.I.D. should utilize local currency financing wherever possible in credit projects.

c. Parastatal Financial Institutions

Many governments own or control many of the suppliers of finance in their respective countries. Missions should refer to the Private Enterprise Development Policy Paper (sections V.D. and V.F.) for additional guidance on dealing with parastatal financial institutions. The guidance in section V.D. states that "A.I.D. funds provided to financial institutions should avoid introducing government ministries or parastatals into the on-lending approval process where such involvement does not now exist. Furthermore, such projects should seek to extract government ministries and parastatals from the process if they are now so involved."

4. Targetting and Guarantying Loans

Targetted credit projects typically enlarge the role of government in financial markets and further distort, or continue to displace, market allocation of capital. Missions should consider such projects (a) after they have determined that there are no policy, institutional, or cultural constraints discouraging the extension of credit to the target group, or (b) as a way of encouraging host governments to correct policy and other constraints where they exist and helping private financial institutions develop some expertise and experience with delivering financial resources to intended target groups (possibly with the concomitant provision of training and technical assistance).

Directed credit projects appear to be attractive mechanisms for assisting A.I.D.'s target groups. However, there is some skepticism over whether targetting of A.I.D. loan resources actually accomplishes its intended purpose.

The fungibility of money makes it difficult, if not impossible, to attribute measurable increases in the output or incomes of targeted borrowers to A.I.D. credit activities. In addition, directed credit activities may contravene efforts designed to improve the market behavior and performance of the financial system and mitigate the likelihood that, over time, A.I.D.'s directed assistance will be replaced by the capability and interest of the indigenous financial system itself to service the needs of the target group. Great care must be exerted to ensure that A.I.D.'s assistance is designed in a way that does not discourage or preempt private sector initiative in this area (especially where this initiative has developed without A.I.D. assistance). Studies have also found that the costs associated with the administration of targetted loans through rural finance institutions, for example, are many times larger than the estimated private lender costs for the simpler task of establishing creditworthiness of borrowers. Finally, the time associated with monitoring and recordkeeping for the donor diverts the time and skills of the financial institution's staff away from profit-generating activities.

A.I.D.-sponsored guaranty activities also risk distortions of market forces and the efficient allocation of capital. For instance, A.I.D.'s objective in a guaranty project designed to redirect credit to rural enterprises (covering the extra risks of lending to the target group), usually requires that credit be redirected away from urban enterprises and towards rural activities. This may reduce much-needed investment funds in urban areas where unemployment rates are extremely high.

Yet, guaranties may be appropriate when the general policy and institutional environment is supportive and lenders retain their traditional inhibitions in developmentally important areas (such as encouraging new, higher-risk, longer-term lending, or lowering or changing collateral requirements). Since guaranty programs should facilitate breakthroughs in new lending patterns and are not meant to substitute for unaddressed structural inadequacies in financial markets, the case for their introduction must be well-justified and the size and duration of such programs should be limited.

5. Lending through PVOs and Nonprofit Entities

A.I.D. should rely upon PVOs and non- or not-for-profit groups for lending only when private, for-profit financial intermediaries capable of performing the desired activity do not exist, or when PVOs are used as part of a Mission's financial markets strategy to involve the private financial banking system in on-lending to the target group (in a way that does not discourage or preempt private sector initiative in this area). PVOs or other non- or not-for-profit groups are not to be utilized for making equity investments. PVOs should lend at rates consistent with the guidance stated in section IV.D.2.

Some private voluntary organizations (PVOs) have special advantages in working with micro and small-scale enterprises because the PVOs are flexible and in touch with the poor and their problems. Some PVOs can offer financial assistance to enterprises or individuals not reached by formal sector credit markets and can collaborate with banks and local financial institutions to establish credit systems for those needing small or short-term loans. The use of PVOs and a combination of technical assistance and credit are often effective in reaching A.I.D. target groups such as rural enterprises and women.

Establishing financially autonomous institutions to manage credit, training, and technical assistance programs and projects often is an important component of a good financial markets development project. To the extent that PVOs act as IFIs, they should follow lending and repayment collection practices based on market-oriented and capital preservation principles. In situations where there has been no experience with lending to micro and small-scale enterprises, PVOs can demonstrate to financial institutions how lending to the poor may be profitable. Where feasible, A.I.D.-financed projects should include mechanisms to graduate beneficiary enterprises from utilization of resources provided from PVOs to borrowing from formal sector institutions.

E. Financial Training and Standards Development

A.I.D. should emphasize to a developing country's public and private sectors the importance of (1) adopting adequate training requirements for accountants and auditors; (2) establishing generally accepted accounting principles and auditing standards, and comprehensive uniform financial reporting and public disclosure requirements; and (3) maintaining a proper balance between self-regulation and public regulation of these matters. A.I.D. also should support efforts to train accountants, auditors, and others involved in finance. Adequate accounting, financial analysis and reporting, and auditing are critical to a properly functioning market-based financial system. Without these skills, it is not possible to determine the true position and profitability of enterprises. Accounting and auditing principles should be standardized and widely accepted.

F. New Financial Instruments and Institutions

As economies develop, credit demands become more complex and the expanding demand for physical capital requires credit that varies by the length of time required (short-, mid- or long-term) as well as the end-use (consumer, investment, risk capital, venture capital, mortgage, etc.). Where delivery and marketing systems and government policies are satisfactory, formal financial institutions generally evolve to satisfy these more complex needs. However, in most developing countries the strength of demand for different types of credit exceeds the financial sector's capacity to diversify and develop the institutions needed to respond.

As appropriate, Missions should develop and pursue a policy dialogue agenda with host governments that encourages development of capital markets and associated intermediaries in, for example, equity securities. In most poor developing countries, securities markets are effectively absent and their development is not a high priority. Capital market intermediaries (primarily primary and secondary securities markets) are often inadequate for the development of new equity instruments and the transfer of equity shares and bond instruments. Even in some relatively sophisticated countries securities markets are extremely thin: transactions in stocks are negligible; medium and long term bond markets are shallow; and institutional investors are not a major presence. Therefore, capital markets have little opportunity to contribute to savings mobilization and economic growth and enhance the country's participation in international capital or equity transfers. A sustained effort to develop securities markets may be warranted in many A.I.D.-assisted developing countries. Some preliminary work to promote the concept of securities markets development may be useful in the poorer developing countries.

A.I.D. encourages developing countries to develop and utilize new debt and equity instruments for directing scarce capital resources into productive investments. Among the instruments and techniques for mobilizing capital for productive investments that should be explored are commercial paper and bonds, term lending,* debentures, government securities, trade or supplier credit, debt-equity swaps, mortgage bonds, agricultural production contracts, variable interest rate structures, and deposit insurance. These and other financial instruments enable the financial market to spread risk among a variety of instruments, thereby reducing exposure to market volatility, and to be more flexible and responsive to the users of financial instruments.

Missions should ensure that the proper policy conditions exist for venture capital activities prior to, or in concert with, the provision of any support to venture capital firms. Funds lent to venture capital firms should be at market rates; grants or equity contributions are not permitted.

In some A.I.D.-assisted developing countries, A.I.D. may wish to explore activities involving venture capital. These activities may wish to emphasize the policy environment. Among the impediments that should be addressed in support of venture capital activities are: (1) the lengthy government approvals process required for the start of new ventures; (2) unfavorable tax laws; (3) failure to give adequate legal recognition to venture capital firms; (4) requirements for court or government approval to merge or sell out the company when successful; (5) absence of an adequately organized or liquid securities market into which the venture capitalist may sell his shares; (6) government control of when public offerings may be conducted and at what price; and, for foreigners, (7) restrictions on repatriation of profits.

An alternative to fixed-rate loans for venture capital activities may be variable-rate loans based on the internal rate of return or equivalent financial performance of the venture capital enterprise. This arrangement would reflect the relatively high degree of risk and uncertainty attendant in venture capital

*Private lending institutions in many developing countries avoid making long-term loans because they lack access to resources with the longer maturities appropriate for supporting term lending. They also consider such lending to be less profitable or more risky than alternative investment opportunities, and often face an uncertain policy environment. Other major factors that limit the ability of these financial institutions to undertake long-term financing are the institutions' own shallow resource bases; preferences for fast recovery of funds; inexperience with term loan instruments; and limited local markets for large, long-term financial assets. Furthermore, the unreliable accounting practices commonly followed by many private enterprises contribute to the reluctance of commercial financial institutions to extend credit to new and unfamiliar enterpreneurs.

approaches in developing nations, and would avoid burdening the venture with a large fixed obligation that might inhibit risk taking.

A.I.D. supports the use of debt equity conversion programs as an important financial markets instrument.

Debt equity conversions, or the capitalization of foreign obligations, are gaining considerable momentum in business and policy circles. A debt/equity conversion (commonly referred to as a debt/equity swap) is essentially, through a series of complex and interrelated steps, the conversion of an external debt obligation into an equity stake in a company.

Debt-equity conversion programs contribute to economic growth in several ways, including the promotion of policy reforms that support growth and investment and the reduction or containment of immediate foreign exchange debt servicing burdens. Use of debt equity swaps also has the effect of increasing levels of private investment in productive enterprises, facilitating financial arrangements for privatization, encouraging the return of flight capital, and rebuilding confidence between commercial banks and debtor countries.

The cumulative impact of debt equity swaps depends on available opportunities for investment in developing countries, the depth of their capital markets, and the ability of the local economy to absorb additional credit.

ANNEX

GLOSSARY OF FINANCIAL MARKETS TERMS

Asset—Anything that is owned by an individual or business that has commercial or exchange value. Assets may consist of specific property or claims against others, in contrast to obligations due others. The principal asset categories are: *current assets*, the sum of cash and short term investments, accounts receivable (trade and other), merchandise inventories, advances on merchandise, and listed securities not in excess of market value; *fixed assets*, permanent assets required for the normal conduct of a business (furniture, land, buildings) and generally referred to as illiquid or capital assets: and *deferred assets*, assets that are not, in the ordinary course of business, readily convertible into cash, subject to current settlement.

Assets may also be classified as tangible and intangible. *Tangible assets* include physical or material assets, e.g., real estate, buildings, machinery, and cash, as distinguishable from *intangible assets* that represent rights or economic benefits that are not physical in nature, e.g., goodwill, patents, franchises, and copyrights.

Bankers' acceptance—A bill of exchange drawn on or accepted by a bank to pay specific bills for one of its customers when the bill becomes due.

Collateral—Security given by a borrower to a lender as a pledge for payment of a loan. Principal kinds of collateral are real estate, bonds, stocks, and chattels. Although any kind of property that has a ready and stable market may be employed as collateral, the collateral value of different kinds of property is subject to wide fluctuation depending upon the readiness and steadiness of the market and the ease of title transfer.

Commercial paper—All classes of short-term negotiable instruments (notes, bills, drafts, checks, deposit certificates, and acceptances) that arise out of a commercial transaction.

Common Stock—Securities that represent an ownership interest in a corporation. That part of the capital stock of a corporation that represents the last claim upon assets and dividends.

Convertibles—Securities (generally bonds or preferred stocks) that are exchangeable at the option of the holder into other securities of the issuing firm.

Credit controls—Quantitative and qualitative control exercised by the monetary authorities over the volume and nature of credit and over interest rates. These controls can affect the quantity and cost of credit available to domestic and foreign borrowers in the country's capital markets, and can strongly influence the direction of the national economy.

Debenture—A classification for all forms of unsecured, long-term debt whether for corporate or civil obligations, although it is usually applied to a certificate of debt issued by a corporation.

Equity—The net worth of a business, consisting of capital stock (preferred and common), additional paid-in capital, retained earnings, and, occasionally, certain net worth reserves, and/or adjustments. When used in a

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financial sense, equity means the value of property beyond the amount of all claims and liens against it.

Financial markets—The money and capital markets of the economy. Money markets buy and sell short-term credit instruments generally for working capital to enterprises that require funds to manage their current affairs. Capital markets buy and sell long-term credit and equity instruments generally for fixed or permanent capital formation that enables businesses to be established or to expand their operations.

Foreign exchange rate—The price of one currency in relation to that of another, or the number of units of one currency needed to purchase one unit or another.

Intermediation—The investment process in which savers and investors place funds in financial institutions in the form of savings accounts and the financial institutions in turn use the funds to make loans or other investments.

International financial markets—An all-encompassing term that refers to all international or multinational markets for short-, medium-, and long-term securities and loans, forward and swap contracts, financial futures, and foreign currencies.

Letter of credit—Instrument by which a bank substitutes its own credit for than of an individual, firm, or corporation, to the end that domestic and foreign trade may be more safely, economically, and expeditiously conducted.

Loan—A business transaction between two legal entities whereby the lender agrees to "rent" funds to the borrower, to be repaid with or without interest.

Net worth—The owner's equity in a given business, represented by the excess of the total assets over the total amounts owing to outside creditors at a given moment of time.

Preferred stock—Corporate stock whose owners have some preference as to assets, earnings, etc. not granted to the owners of common stock of the corporation.

Primary markets—The market in which financial assets (i.e. stocks) are originally issued.

Risk—The possibility of loss, specifically the chance of nonrepayment of debt.

Secondary market—The "market" in which primary market instruments (e.g., stocks) are traded after they have been issued by corporations in the primary market.

Securitization—The broad process whereby capital financing occurs through securities issuance rather than bank financing.

Subordination—Acknowledgement by a creditor, in writing, that the debt due him from a specified debtor shall have a status inferior or subordinate to the debt which the debtor owes another creditor.

Term loan—A loan provided for an extended period of time, generally with a maturity greater than one year and for such purposes as an increase in working capital or the purchase of equipment or other fixed assets.

Trade credit—Credit on goods purchased by a company from its supplier (also called supplier credit or accounts receivable credit). The use of trade credit brings different types of companies, including many nonfinancial companies, into the credit system and may, in fact, increase a firm's sophistication in the uses of credit.

Trade finance—The financing, usually characterized as short-term, of import-export trade transactions.

Venture capital—Capital to provide funds for start-up situations ("seed capital") or for existing high-risk small businesses suffering from capital deficiencies but having high profit potential as emerging growth companies.

Yield—The rate of return from one's investment in a specific security or specific piece of property.

D. Financial Markets and the Informal Sector

1. What is Informal Sector Finance?

a. Definition

For the purposes of this discussion, informal sector finance (ISF) will refer to all unregulated, unrecorded but otherwise legal financial activities, including lending, borrowing, leasing, and remittance. Informal sector finance comprises professional and non-professional money lenders, indigenous bankers, brokers, commission agents, private finance firms, pawnshops, savings and credit associations, merchant-middlemen, and households. Informal sector finance also includes parallel and unofficial markets, such as those for foreign exchange.

b. Characteristics of Informal Sector Finance

Despite the diversity of agents and transactions, ISF typically has the following characteristics:

- Relative freedom from official regulation (except for licensing of professional money lenders and pawn brokers)
- Small scale of operations
- Ease of entry and exit
- Linkage of land, credit, commodity and labor contracts
- Informality and secrecy of transactions often based on implicit contracts
- Limited recourse to documentary credit
- Minimal or no paperwork; short processing time
- Flexibility of working hours, collateral, maturity, interest and repayment
- Appraisal of credit proposals based on firsthand knowledge of clients
- Effective enforcement through peer group monitoring
- Lower delinquency rates.

The prevalence of ISF, even with its higher and variant interest rates, indicates that it offers certain advantages and suggests that the access and availability of credit are often more important than its cost to small-scale borrowers whose needs have not been satisfied by formal financial markets. In many Asian countries, the variety of formal sector financial instruments and institutions is limited - both because government regulation has forbidden innovation and because of insufficient entrepreneurial activity in the formal financial sector. As financial development experts would say, the formal financial markets are "shallow," not "deep." Consequently, a large number of potentially creditworthy borrowers and savers with funds are not served. In many African countries, this problem is further compounded by a population that is largely rural and dispersed, which makes the cost of transactions much more expensive, both for lenders and borrowers.

Fortunately, informal financial instruments and institutions exist and serve many of these clients. Unfortunately, this results in financial dualism (the existence of separate formal and informal financial sectors) and a lack of integration of markets. Those with access to the formal sector get cheaper money to support lower yielding activities for which they pay rents to those who run formal sector institutions. Those without access to the formal sector abandon relatively productive activities because of the high cost or unavailability of capital due to the limitations of informal financial markets.

Informal finance provides working capital for consumption credit to small, marginal, or poor borrowers (i.e. traders, hawkers, artisans, microentrepreneurs, and farmers) and spillover credit for the formal sector. A distinction, however, needs to be made between "autonomous" informal finance, which historically pre-dates formal finance (i.e., indigenous bankers, pawnbrokers) and "reactive" informal finance which develops primarily in response to controls over and deficiencies in formal finance (i.e., private finance companies, curb markets). The latter component expands and contracts in response to repression and liberalization of the formal sector.

c. Other Important Financial Services Provided by the Informal Sector

Given the shortage of formal banking institutions outside of African cities and major towns, one encounters a wide range of informal mechanisms to supply financial services other than credit, especially savings and money changing and transfer. Clubs or other arrangements for saving money are often deeply ingrained in the culture. Sometimes they consist of simple arrangements whereby a group of savers make pre-arranged, weekly contributions. The arrangement continues until everyone in the group has had a turn at receiving the weekly pot of savings once.[16] At other times, the arrangements for saving or accumulating capital are more elaborate, and may include a broker who comes every day for a month to colect an individual's savings. At the end of the month, the saver receives his or her accumulated capital minus one day's savings which is a fee to the broker. Informal savings arrangements are much appreciated in market places, villages, and even among formal sector traders as ways to accumulate capital.

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[16] This is called a "tontine" in Francophone Africa, an "isusu" in Anglophonie West Africa and a "merry-go-round" in East African countries such as Kenya.

2. Linkages Between the Informal and Formal Sectors

A growing consensus has emerged regarding the need to foster and strengthen the linkages between the formal and informal sector, to maximize the comparative cost advantages of informal finance, and to overcome the constraints of small scale by promoting access to the resources and expertise of the formal sector. In this guidebook, and throughout the growing body of theoretical literature and practical research on informal financial markets, the term "linkage" refers to two types of links, which depend on the sector of origin. "Indigenous" linkages, arising from the informal sector, are transactions between formal and informal financing agents, either institutional or individual, that facilitate the flow of funds between the two sectors. The presence of these linkages is especially important to policy makers because they allow monetary policy to be transmitted to informal financial markets. The other types of linkages, often called "copying" in the informal sector, are initiatives that tie the informal sector borrowers and savers to formal financial institutions. Such linkages tend to compete directly with informal lenders since they replace ties to informal intermediaries.

The various linkages between the informal sector clients and formal sector institutions are classified below according to their institutional affiliation and nature of linkage.

a. Indigenous Linkages Between the Formal and Informal Sectors

The typical linkage between the informal and formal sectors consists of lenders in the informal sector holding accounts with public or commercial banks and borrowing from them to onlend to their customers in the informal sector. Credit and savings associations or Private Voluntary Organizations (PVOs) working in development may approach formal sector banks for loans to on-lend to their members or beneficiaries. Although there is increasing interest among formal sector banks to do this, most local development organizations have not yet learned how to operate with borrowed funds. Both in Mali and in Burkina Faso village bank movements are forming headed by local PVOs that organize some of the poorest women into community-based credit and savings groups. In addition to grants, these village bank movements are accessing borrowed funds from public sector banks.

Cooperatives have been the mechanism in Africa that have served as the most prevalent linkage between the formal and informal financial sectors. Agricultural cooperatives obtain production credit based on bulking, storing and marketing the crops of members. Large movements of credit and savings cooperatives exist in Cameroon and Togo, both with thousands of members. The credit and savings cooperatives, however, have mainly served those with formal employment who have the steady income to make regular savings. Most of the resources mobilized by credit and savings cooperatives are employed for such things as housing, education, the purchase of consumer durables, etc. rather than production.

b. Linkages of Banks through Brokers, Bank Staff, and Parallel Services

In contrast to linkages initiated by informal sector participants that aim to generate a greater pool of financial resources, there are infrequent examples of linkages sponsored by the formal sector to attract small traders, artisans, farmers, savers, and other informal sector clients. Some banks such as Barclays Ltd. in East Africa use mobile units to serve towns and villages where they do not operate branches. In Ghana, the World Bank, in collaboration with the Government of Ghana, has capitalized and upgraded the skills of a series of small rural banks. Each of these has a local board and staff with knowledge of local borrowers and projects. Although approximately a third of the rural banks have failed in Ghana, the ones that remained solvent definitely contributed to distributing resources into secondary towns and the countryside.

While these innovations have allowed some credit to flow toward informal sector producers, African countries by and large lack the large-scale lending arrangements that have attracted so much international attention in Asia and Latin America. Such high-profile examples include the Grameen Bank in Bangladesh with over a million borrowers; the Bank Bakyat Indonesia that serves 1.8 million borrowers and 6.7 million savers; Banco Sol which makes non-collateralized loans to over 100,000 microentrepreneurs in Bolivia; and a fast-growing village banking program in El Salvador managed by the Centro de Apoyo a la Microempresa. In two years time, this program in El Salvador has established branches nationwide and organized 25,000 low income women borrowers and savers.

A natural question is why such highly innovative examples of mass-scale loan extension and credit mobilization programs targeted to the informal sector are not present in Africa. Part of the explanation is contextual: the incredible population densities of Bangladesh or Indonesia do not exist in this region of the world, nor is there as much organizational infrastructure among workers, farmers, petty traders, etc. With few exceptions, the public sector banks or parastatal organizations charged with extending credit to the informal sector have dismal records of recouping loans, usually because they organize borrower groups poorly and have such distant relationships with them. (The exceptions are frequently parastatal agencies that promote cash crops and can recover credit by marketing crops.) the commercial banks in Africa are too conservative; they demand titles to property or guarantors with formal sector jobs rather than accept the non-formal type of collateral[17] that has opened access to credit for small producers elsewhere. African PVOs and cooperatives that do accept these non-formal types of collateral and do organize borrowers well face higher transaction costs than in other regions. These African private development agencies also lack the vision and the management training to successfully adopt the national coverage models of the high-profile organizations mentioned above.

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[17] Non-formal type of collateral include peer group guarantees or small possessions that the poor may own such as a bicycle, a radio, jewelry, grain, animals, etc. Savings of 10-15% of loan value is also accepted in programs that mobilize savings.

Although it is unrealistic to expect that African credit projects will equal the size of mass-scale microenterprise programs in population-dense Asia, efforts exist to replicate more cost effective credit extension systems. In Malawi, a loan scheme exists using Grameen Bank methods to organize women into small solidarity groups. It then combines these into "centers" of 100 borrowers and savers, and services many such centers. In South Africa, the Get Ahead Foundation makes 8,500 loans annually to the self-employed poor in low income townships surrounding Johannesburg.

c. Linkages Between Banks and PVOs or Self Help Groups (SHGs)

Instead of individuals acting as links between the two sectors, voluntary organizations sometimes assume the intermediary function between banks and informal clients. The initiative for such relationships originates from either organizations or banks, with the organization generally assuming the responsibility for monitoring and recovering the loans, and the bank providing deposit facilities. By participating in such arrangements, organizations can overcome possible regulatory restrictions on acceptance of deposits and can access larger financial resources, and a wider range of financial services for their members. Banks can reduce the risk and lower the cost of making small loans and start to mobilize savings among informal sector participants. There are many variations of the relationship, involving both PVOs and Self-Help Groups (SHGs).

The traditional linkage between PVOs and banks consists of banks lending to PVOs, which in turn lend to informal sector groups and individuals. Although the cost of credit is higher for the end-client than standard commercial bank lending rates (which are not available to informal customers), the interest rate is generally less than that of more traditional informal loans. PVOs oftentimes are more honest with the money of beneficiaries than local brokers or moneylenders. Also, loans from PVOs retain the flexibility, adaptability, and heterogenous characteristics found within informal sector loans without tying them to disadvantageous contracts (as is often the case in financing arrangements negotiated with traders or money lenders).

Other variants of the PVO-bank model include:

- Clients of the PVO borrow directly from the bank and the PVO gives its approval to the bank on loans, supervises the use of funds, assists in loan recovery by the bank, and addresses the full risks of lending.

- The bank uses its own criteria in extending credit, with the PVO providing guarantees to the bank - the existence of which is not always disclosed to the borrower.

Another institutional linkage between the formal and informal sector may be through informal or formal self-help groups among members. These resemble the peer groups or solidarity groups found in Africa and Latin America. Informal SHGs are not officially registered, and have no written rules, but are based on verbal understanding (i.e., mutual aid societies and unregistered community groups or credit and savings associations). Formal SHGs are officially registered, and have written rules and a prescribed structure (i.e. agricultural cooperatives). While either type of SHG may exist before the linkage, some are formed through bank guidance. Many SHG-bank linkages in Africa, especially in rural areas, seem to follow two broad patterns: (1) savings-oriented systems or (2) credit-oriented systems, especially agricultural credit. Occasionally, credit and savings functions are combined, as in the case of village bank programs that feature both production credit and mandatory savings.

Village bank programs now exist in several countries in Africa, including Mali, Senegal, Ghana, Burkina Faso, Benin and Uganda. Each village bank receives a collective loan every four months, which it distributes to its members. Members pay the loan and save every week, and the village bank then rotates this capital for further interest earnings. So long as external loans continue to be paid back every four months, this series of loans continues for 3-4 years, thus allowing individual members to develop economic activities and the group itself to develop a pool of member savings or other types of investments. Once the village bank's capital reaches $300 per member, it is graduated or linked to the formal banking system. Although these programs have not reached national coverage anywhere yet in Africa, most exhibit very high repayment rates due to high repayment rates due to careful grassroots management.

d. <u>Linkages of Mutual Banks and Informal Sector Groups</u>

The highly successful Grameen Bank in Bangladesh, now 17 years old, is a classic example of a large-scale mutual institution using informal financial technology to the maximum advantage of the institution. Today, it serves a million borrowers and many of the lowest income producers. Instead of collateral, it relies on peer pressure from small groups for timely repayment. The large and rapidly expanding clientele and low default rates of less than 2 percent attest to its success. Grameen Bank members not only save 5 percent of their loan amount, but also contribute to an emergency fund which a member can access for sickness or other urgent social reasons.

Although they are not of the same size, similar kinds of credit-led, multi-purpose development schemes are being repeated in Africa. The difference between these and other multi-purpose development schemes is that intensive training is given to local groups to manage credit and savings activities. PVOs and SHGs are also adding additional types of education such as mother-child health, family planning, and literacy training. Although these programs are subsidized, their major features are that they have methods to recover a substantial portion of their costs and they create means for beneficiaries to access other kinds of health, education and community development gains in a non-welfare approach. These credit-led programs using non-formal collateral, village-level management, and savings mobilization tend to be more cost effective than traditional credit programs that make costly individualized loans, or traditional social service programs that have no cost-recovery.

In Africa, the Kenya Rural Enterprise Program sponsored by USAID has assisted more than 30 Kenyan PVOs to improve their skills for financial intermediation, including credit extension, information systems, and formal management. More programs like this are needed in Africa, especially ones which can teach self-sustainable credit and savings operations to PVOs that already have organized large numbers for other purposes (health, agriculture, etc.)

e. Concluding Observations on Linkages

The diverse linkages available suggest a variety of possible combinations for intermediate financial arrangements. These combinations depend on replicability, the policy and regulatory environment and the legal framework of the country. The more successful linkages have certain features in common. These include:

- A policy climate favoring financial sector development
- Market-determined interest rates, reflecting supply and demand conditions
- Reciprocity of savings and credit, with a priority on savings as a precondition of credit
- Group liability or the promise of continued access credit to ensure timely repayment
- Minimalization of official subsidy.

Programs that build upon these features tend to fall into three groups:

- Formal financial institutions that employ informal financing arrangements through individual agents, with the intent of enlarging their market and client base, and competing directly for clients with the informal sector
- Specialized financial institutions that by-pass completely formal clients, and emphasize savings mobilization and group or character-based lending for individuals without access to any form of formal credit
- PVOs that link their knowledge of informal clients, technical assistance activities, and lending programs to commercial sources of funds.

All three are promising models in which donors such as A.I.D. could be involved, since they entail working either directly or indirectly with banking institutions and decrease opportunities for unsound lending practices, poor bookkeeping, and ineffective loan recovery activities. In addition, the models combine the comparative advantages of the informal and formal financial systems while increasing market integration and allowing funds to move more easily between sectors and to flow into high-yielding activities. Since this may involve increases in transaction costs of the banks, this puts a premium on there being strong, well-capitalized banks in the formal sector.

E. Expansion of Securities Markets

A securities market is a market for the exchange of instruments that signifies an ownership position in a corporation (a stock), a creditor relationship with a corporation or government body (a bond) or rights to convert to some underlying security such as a stock (e.g., an option or warrant). As explained in Chapter One, the securities market is normally divided into two components: the primary market and the secondary market. The primary market is the market for new issues of securities, as distinguished from the secondary market where previously issued securities are bought and sold. Primary market institutions include investment banks, brokers, dealers and venture capitalists. Secondary market institutions include stock exchanges and over-the-counter markets, as well as brokers, dealers, mutual fund companies and others who buy and sell securities subsequent to their original issuance.

Securities markets play a key role in fostering economic development. They enlarge the range of options available for more efficient savings mobilization and resource allocation, both in terms of financial instruments and funding mechanisms. Securities market institutions are no substitute for banks; and securities market instruments are no substitute for bank credits. Rather, they complement each other by offering the public greater diversity in meeting their individual needs, and in providing a variety of products to meet investors' varying risk and return preferences.

The contrary, however, is sometimes true: in some countries banks have substituted for capital (equity) markets by offering subsidized credit to already over-leveraged firms. This has been a cause not only of weak or insolvent banks, but also of the low state of development of the capital markets in countries which pursue such policies.

For companies seeking capital, the securities markets provide a permanent source of financing (stocks) with none of the contractual payment obligations associated with bank or debt financing. This results in a better balance between the debt and equity portions of company balance sheets, reducing their vulnerability to business and economic cycles, with their undesirable social and political consequences.

Securities markets help allocate capital more efficiently by establishing fair market prices for securities and by minimizing the cost of buying and selling them. They help to increase the total volume of domestic savings and investment, thereby promoting economic growth and employment. Securities markets, in an appropriate economic and business environment, encourage a wider distribution of ownership through the sale of equities, hence promoting democratic capitalism. A sound and efficient securities market also helps to promote the inflow of foreign capital for both portfolio and direct investment, an added source of long-term funding for economic growth.

Several countries in the Sub-Saharan Africa region would benefit from technical assistance in creating an effective legal and regulatory framework for the securities industry, strengthening securities exchanges and establishing securities markets institutions such as investment banks and mutual fund companies (depending upon the depth and liquidity of the securities markets). Other issues to be considered include the potential role of credit rating agencies, venture capital companies and contractual savings institutions in improving the flow of long-term capital to worthy investment projects. The following section presents an overview of each of these topics and describes the types of assistance that A.I.D. could provide to strengthen a country's securities markets.

1. Legal and Regulatory Reform

If securities markets are to be efficient and play an active role in developing economies, they must be set within a suitable legal and regulatory framework. The experience of many countries shows that prudential government regulation is necessary to ensure the proper operation of the securities markets. Regulations are needed to protect small investors, license securities market intermediaries, curtail improper activities in the market (such as the use of privileged information by company insiders for personal gain), and to provide for adequate disclosure of information so that investors can make informed decisions.

In the United States, the Securities and Exchange Commission administers federal securities laws that seek to provide protection for investors and to ensure that securities markets are fair and honest. Under **the Securities Act of 1933**, companies are required to provide investors with material information concerning securities offered for public sale and are prohibited from making false and misleading statements. Under **the Securities Exchange Act of 1934**, companies seeking to have their securities listed for public trading on an exchange are required to file an application with the exchange and the SEC and to file annual and other periodic reports to update information contained in the original filing. Provisions of this law also govern insider trading, the registration of brokers and dealers, the regulation of securities trading and sales practices, the registration of securities exchanges, transfer agents, clearing agencies and others. In addition to these Acts, activities of companies engaged primarily in investing and trading in securities and whose own securities are offered to the public (such as mutual fund companies) are subject to regulations of **the Investment Company Act of 1940.**

Securities markets in many developing countries have suffered from either underregulation or overregulation. Countries with underregulated securities markets have found that a free market has limitations. The "laissez faire" approach, without some degree of regulation, is ineffective. This is true for a number of reasons, including: (1) government policies affecting such things as interest rates and banking policies distort the incentives for raising capital in securities markets, (2) monopolies created by exchanges provide the opportunity for corrupt practices to occur, and (3) free markets often provide incentives and opportunities for abuse of uninformed investors. As a result, many developing countries that have adopted this approach suffer from both the perception and the reality of an unfair market.

Some developing countries have reacted to these problems with a paternalistic approach which provides a degree of overregulation. A common scenario where overregulation can lead to problems is when the government has broad regulatory power to order securities companies to rectify any problems in their operations deemed to be causing damage to the "public interest." In some developing countries, the government maintains strict control over the number of licenses for securities companies and approves in advance the hiring of any director, manager or broker. This approach to regulation, in which the government makes judgments as to the "merit" of securities market participants and gets directly involved in the workings of the system is known as "merit-based" regulation; it indirectly encourages monopolistic tendencies and decreases competition. It is distinct from "disclosure-based" regulation where the role of the government is to assure that disclosure of information is adequate for securities market participants to make their own assessments of merit.

A complicating factor in the regulatory structures of many developing countries is the use of securities markets to achieve goals of redistributing ownership of companies. The theory behind using capital markets to achieve redistribution goals is that ownership of shares enables the public to participate in the profits of a capitalist society beyond what can be earned through direct labor. Unfortunately, developing country capital markets generally are not efficient enough to provide an incentive for the redistribution process to take place on its own.

Some countries have used regulatory means to attempt to accomplish the goal by requiring that: 1) companies of a certain size list their securities on local stock exchanges, 2) a certain percentage of a company's securities be sold to the public, or 3) these sales be made at prices that are advantageous to the public. Free market principles have been dispensed with entirely in some countries where governments have been allowed to fix the price of an initial offering. In general, all of these attempts to substitute government fiat in place of openly competitive markets have served to delay the development of efficient capital markets.

While each securities market and regulatory structure governing it is different, there are a few important principles that are universal:

- A single regulatory body that is separate from stock exchanges should govern all aspects of the securities market. To the extent possible, this regulatory body should be independent, in the same manner as central banks are independent.

- Securities market participants must be permitted to price securities offerings without governmental interference.

- Companies should not be required to list their securities.

- There should be free entry into all aspects of the market. Objective standards should be established for participation in the marketplace and if the standards are met, the government should not be permitted to restrict participation.

- The integrity of financial information should be assured, as it is fundamental to decision making by the marketplace.

- The government should not assume an overly protective role over new offerings. Accurate disclosures made to a market are preferable to governmental judgments about the merit of a company and its securities.

- Laws should prohibit fraud, misleading statements, insider trading and similar undesirable acts. Civil remedies, enforcement powers and an adequate forum are essential. While insider trading is largely prohibited in the U.S. and can harm public confidence in the market, it is difficult to enforce and is allowed in many European countries.

- The laws, rules and regulations should be as concise and straightforward as possible.

Developed countries have struggled for many years to attain an appropriate degree of regulation over their securities markets. Even in developed countries, unfairness is present to a significant degree. Regulatory problems facing developing countries are compounded by inefficient capital markets and legal systems and by a significant degree of corruption. Yet, overregulation can stifle a market. As with many aspects of an economy, balance in regulating a securities market is difficult to achieve.

Potential A.I.D. Activities:

As described below, A.I.D. could provide technical assistance in developing countries to: 1.) rationalize and strengthen securities markets laws and regulations; 2.) improve enforcement through the establishment or strengthening of a securities market regulatory agency; and 3.) arrange visitation programs for securities market officials to overseas regulatory agencies.

1.) A.I.D. could provide technical assistance to review existing securities markets laws and regulations, recommend revisions and draft model legislation. Depending on the country, these might be designed to reduce the fragmentation of securities markets laws, strengthen existing provisions or encourage the development of new financial instruments. The following areas might receive close attention:

- Regulations related to underwriting, brokering and trading
- Regulations related to investment and investment advisory companies (including investment restrictions relating to insurance companies, pension funds and mutual funds)
- Regulations related to mergers and acquisitions
- Regulations related to public issues of new equity shares, rights issues, preferred equity shares, and straight and convertible debentures, warrants, asset-backed securities and other financial instruments
- Regulations relating to private placements of the above
- Tax laws providing incentives that would favorably impact the supply of and demand for various securities market instruments.

It should be noted that programs targeted at legal and regulatory reform often require persistent, long-term technical assistance, given the need for consensus building and the long lead times required for passing legislation.

2.) A.I.D. could provide assistance in establishing a securities market regulatory agency. A.I.D. could evaluate the existing regulatory organization and make recommendations on the following areas:

- Organizational structure
- Responsibilities, qualifications and training requirements of staff
- Procurement and installation of computer hardware and software
- Drafting operational manuals to support staff operations
- Developing in-house training programs for staff in the area of securities market monitoring and supervision.

3.) A.I.D. could make arrangements for appropriate officials to visit securities markets regulatory authorities to observe their operations. The International Institute for Securities Market Development of the U.S. Securities and Exchange Commission offers a program of intensive instruction in all facets of the operation and regulation of securities markets. In addition, the International Law Institute offers a workshop called "Capital Markets: Development and Regulation."

Sources of expertise for the above activities are many. They include: A.I.D.'s Financial Sector Development Project, the Emerging Markets Advisory Committee of the Securities and Exchange Commission, the International Law Institute, securities markets lawyers and regulatory agency/organizational experts, investment bankers and training experts.

2. Securities Exchanges

The term "securities exchange" refers to a market where orders to buy or sell tradable securities are brought together to compete with each other and therefore result in trades at the best achievable price. An exchange is not necessarily a special building or institution, but can be an informal meeting place or network of brokers, linked by phone or computer. Securities exchanges form a very important part of the infrastructure of a national economy. By offering their shares for sale to the public, companies are able to raise capital for a wide variety of purposes, including research and development, expansion, and the creation of jobs and new products. The shares of listed companies allow investors, both large and small, to invest in the nation's future and to participate in the growth of the economy. Additionally, securities exchanges contribute to economic development by mobilizing long-term debt finance for the government and corporate sector.

Liquidity, one of the most important characteristics of a good market, is the ease with which securities can be bought and sold under normal circumstances without wide price fluctuations. By definition, liquidity has two principal features: ease of converting securities into cash and the ability to do so without incurring a substantial discount. By providing liquidity to long-term investments, exchanges allow small and large investors to adjust their maturity and risk preferences. Securities markets also allow business ownership to be more widely dispersed and provide venture capital companies and privatized entities with a necessary outlet for their shares.

In Sub-Saharan Africa, there are seven active securities exchanges located in Nigeria, Ghana, Kenya, Zimbabwe, Mauritius, Botswana and the Cote d'Ivoire.[18] Their combined capitalization in 1992 was $3.6 billion, or 0.1% of the total U.S. market capitalization. The following table shows the capitalization levels of the SSA stock markets and the size of the markets as percentages of the countries' GDP.[19]

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[18] If the stock exchanges of South Africa, Swaziland, Namibia and Uganda are included, the total is eleven exchanges. The Johannesburg Stock Exchange has over 800 companies listed and lies outside the scope of this Guidebook; the other SSA exchanges have little activity.

[19] The information on the African stock markets are based on the *Emerging Stock Markets Factbook 1993*, published by the International Finance Corporation.

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Market Capitalization of SSA Stock Exchanges		
Country	Market Capitalization (US$ Millions)	% of GDP
Nigeria (1991)	1,882	6.4
Ghana (1991)	80	1.5
Kenya (1991)	638	7.9
Zimbabwe (1987)	718	15.5
Mauritius (1991)	324	11.2
Botswana (1991)	300	8.9
Cote d'Ivoire (1986)	332	0.01

Source: *Emerging Stock Markets Factbook 1993*, International Finance Corporation.

Of the seven markets, the Nigerian and Zimbabwe markets are the largest with capitalization levels of $1.2 billion and $0.6 billion respectively as of year end 1992. In 1992, the Nigerian Stock Exchange continued its upward trend in both market capitalization and the total value of shares traded in local currency terms. However, due to the 40% devaluation of the naira, share prices dropped significantly in dollar terms. Altogether, 153 stocks are listed on the Nigerian exchange with a trading volume of $23 million in 1992, a substantial increase from $9 million in 1991. During the same year, share prices on the Zimbabwe Stock Exchange fell dramatically in response to the worst drought in Zimbabwe's recent history and to high interest rates. Market capitalization fell from a record high of $2.4 billion in 1990 to $628 million in 1992. Even though the number of stocks listed on the Zimbabwe market increased from 60 to 62, the total value of shares traded was only $20 million, as compared to $77 million in 1991. To help Zimbabwe cope with the difficulties caused by the severe drought, a group of fifteen western nations agreed to provide $1.4 billion in grants, soft loans and commercial loans to support the country's ongoing economic reform program.

Compared to securities markets in the U.S., Europe and many parts of Asia, the African markets are still in the early stages of development. Further development of these markets is dependent on such factors as creating:

- A hospitable environment for investment, including a stable political and administrative structure, low inflation and stable interest rates

- An efficient and extensive financial network to expedite the flow of capital, which will ultimately improve long-term stability and growth of the market

- An adequate number of market intermediaries such as brokers, dealers and underwriters

- Sufficiently well developed accounting, auditing and disclosure standards, to ensure the availability of accurate financial information.

Over-the-Counter Market

An important option for LDCs seeking to enhance securities market trading is the development of an over-the-counter (OTC) market. An OTC market is a screen-based, geographically decentralized market in which trading is conducted over the telephone or through computer terminals. Such a system may be suitable for LDCs because of the reduced level of capital investment required vis-a-vis the development of a physical exchange.

In the United States, the OTC market is the second-largest (in terms of market capitalization) and fastest growing securities market. Trading occurs through a global computer and telecommunications system known as the National Association of Securities Dealers Automated Quotations System (NASDAQ). In 1993, over 4,300 companies listed their securities on NASDAQ, or more than the New York Stock Exchange and American Stock Exchange combined. The National Association of Securities Dealers (NASD) is the self-regulatory organization of the securities industry responsible for the regulation of NASDAQ and the over-the-counter securities market.

Potential A.I.D. Activities:

Areas in which A.I.D. could assist in promoting stock exchanges or over-the-counter markets are as follows:

Institutional

- Reform of legislation and rules regarding stock exchange/OTC structure and organization; membership fees; standards of conduct, (i.e., self regulation), discipline and the arbitration of disputes

- Assess adequacy of trading facilities and procedures for processing securities transactions - i.e., clearance and settlement systems

- Assess staff development and training needs

- Support the development of information systems: computerization of trading transactions; establishment of appropriate settlement systems.

Regulatory

- Formulate requirements for listing and regulations of new issues on a "disclosure" basis to replace "merit-based" systems of government regulation

- Establish regulatory basis for financial disclosure and shareholder rights and standards of corporate governance

- Support staff development and organization of a capital markets regulatory agency

- Design and implement appropriate accounting systems

- Analyze the adequacy of current brokering and underwriting of new issues

- Examine the status and regulation of institutional investors.

Policy

- Evaluate the tax structure with respect to returns on investments in listed securities and other financial assets (for example, treatment of capital gains) relative to taxation of other financial assets vis-a-vis stocks and bonds.

Sources of expertise for these activities include A.I.D.'s Financial Sector Development Project and former executives of U.S. stock exchanges or the NASD with managerial, financial and operational experience. Technical assistance for training could be provided by organizations such as the New York Institute of Finance which has conducted special courses for foreign securities professionals in New York for over 100 years and in foreign countries for about five years; former trainers of the New York Stock Exchange member firms or at universities; and the newly-formed African Stock Exchanges Association (ASEA) based in Nairobi which has training as one of its principal objectives.

Technical assistance for information systems components could be provided through the FSDP or contacts with a U.S. stock exchange; computer software companies providing turnkey systems and training to the securities industry; and diversified accounting firms with information technology and management consulting practices.

3. Mutual Funds

A mutual fund is a company that makes investments on behalf of individuals and institutions who share common financial goals. They offer investors a simple, convenient and less time-consuming method of investing in a portfolio of securities (like stocks and bonds) than trading them individually. Through mutual funds, investors can delegate decisions on which securities to buy, sell or hold to professional money managers. As a practical matter, investors in mutual funds can also reduce their investment risk by accessing a broader diversity of securities than they could by investing on their own.

Mutual fund investors select a fund with an investment objective that matches their own. For example, they might want to maximize their current income, maximize the long-term growth of their capital or pursue some combination of growth and income.

The fund pools the money with that of other shareholders who have similar objectives. Professional money managers then use the pool to buy a wide range of stocks, bonds or other instruments that, in the manager's judgment, will help the investors achieve their objectives. Together, these securities form the underlying portfolio of the fund.

An investor in mutual funds is buying shares of the fund. Each share represents partial ownership in all of the fund's underlying securities. Dividends and capital gains (earnings on securities sold for a profit) are paid out in proportion to the number of the fund shares owned. Thus, shareholders who invest a few hundred dollars get the same investment return per dollar as those who invest hundreds of thousands.

Over the past two decades, the mutual fund industry in the U.S. has grown from 426 to more than 4,150 funds and from $46 billion to over $1.6 trillion in assets. Mutual fund companies have become the third largest financial intermediary in the U.S. - behind commercial banks and life insurance companies. The amount of money invested in mutual funds is estimated to be $1 billion a day. About 40 million Americans directly own stocks or shares in stock mutual funds.

Mutual funds in the U.S. are regulated by the Securities and Exchange Commission. As part of this regulation, all funds must provide a prospectus to every investor. This document describes the fund, its shares, its investment objectives and all fees in detail. All funds are required to provide their shareholders with periodic reports on the status of their investments.

Investment companies managing funds may be classified as "closed-end" or "open-end" companies. A closed-end company issues a fixed number of shares to investors. Thereafter, shares of closed-end funds typically trade on stock exchanges and are not redeemed by the fund itself. "Open-end" companies continue to sell new shares to the public, as well as stand ready to buy back or redeem their shares from shareholders at the share's current value.

Consequently, these funds must rely heavily on a substantial liquidity of the underlying market for stocks.

While open-end funds are the most popular form in developed countries, many countries with emerging securities markets prefer the closed-end form. Some believe that the manager of a closed-end fund can pursue a longer term investment strategy more easily because he or she is not required to redeem shares throughout the year or to invest new funds from additional sales of shares (i.e., the pool is likely to be more stable). From a national perspective, the closed-end structure may be preferable in emerging securities markets because a fund that is forced to sell securities to meet redemption requests may create a sudden drop in securities prices. In addition, an open-end fund must have the ability to determine at any given time the current net asset value per share, in the event that investors seek to redeem their shares. Prompt and accurate valuation of the fund's portfolio may be particularly difficult if activity in the market is thin or unstable.

Mutual funds have the potential to play an important role in emerging markets. Their basic characteristics (pooling, diversification, professional management) enable them to attract smaller investors into the securities markets. Traditional "savers" who usually put their money into savings accounts might thus become "investors". By attracting savings from individuals and investing them in a diversified portfolio of securities, investment companies contribute to capital formation and economic expansion, while increasing the distribution of securities over a broader base of owners.

However, not all funds were created for the traditional "savers"; mutual funds also exist for sophisticated investors preferring higher risk portfolios. The Nigeria Emerging Market Fund is an example of such a fund. Founded in October 1992, it is an open-ended fund which invests in debt securities of private companies, debt obligations of the Nigerian government (including government-guaranteed debt), lease-related instruments and other securities. Other mutual funds in SSA include the Mauritius Fund and the First African Asset Fund.

Mutual funds also play a positive role in contributing to the development of viable securities markets. Not only do mutual funds create demand for stocks, but they do so for investment purposes. Without the presence of institutional investors, there is a risk of the market being dominated by individual speculators. As long-term investors, mutual funds may exert a stabilizing influence on securities markets. In addition to attracting domestic savers to an emerging securities market, mutual funds may be used to encourage foreign investment in the market. Foreign portfolio investment in an emerging market could benefit the host country in a number of ways. Foreign investors create a demand for better financial information, disclosure and securities analysis. This may strengthen standards in these areas, benefitting local investors in the process.

Potential A.I.D. Activities:

1.) A.I.D. could assist in preparing a feasibility study for the creation of mutual funds. **Such a study should be conducted only if the depth and liquidity of the securities markets are sufficient to warrant one.** Areas for examination could include creating an appropriate legal and regulatory framework for mutual funds, estimating the potential demand for mutual funds, identifying professional money managers and possible joint venture partners and analyzing the operating costs and earnings potential of the fund(s).

2.) If the feasibility study is positive, technical assistance could be provided in such areas as:

- Management structure and organization
- Portfolio management techniques
- Training and developing qualified staff
- Procurement and installation of computer hardware and software
- Marketing mutual funds and educating the public about them.

Sources of expertise in this area would be former executives of U.S. companies offering mutual funds. Among the largest of these companies are Merrill Lynch, Fidelity, Prudential Bache, Dreyfus and Vanguard. An additional source of expertise and information is the Securities Industry Association whose members include mutual fund companies throughout the U.S. and Canada.

4. Investment Banks

An investment bank is a financial institution which mobilizes funds mainly in the securities markets and invests these funds, either by extending loans directly to industry or indirectly by buying corporate securities. A well-organized securities industry includes a number of investment banks. These perform a range of activities essential to the functioning of securities markets, including acting as brokers, dealers and underwriters and providing investment management and financial advisory services.

A **broker** is an agent who buys and sells securities on behalf of customers without taking possession of the item traded. Brokers generate income by charging a commission. When you place an order with a broker to buy or sell a security, you are hiring the broker as your agent. When the trade is executed, you are charged a commission based on the quantity of shares or monetary value of the transaction.

A **dealer**, on the other hand, has an inventory of securities which he or she buys and sells for his or her own account. The dealer's profit is derived from being able to sell securities at a higher price than that at which they were purchased. Of course, dealers can also incur losses. The possibility of profits and losses makes the risks of a dealer higher than those of a broker.

Another function performed by investment banks is **underwriting**. As an underwriter, a firm's major function is to distribute new debt and equity securities issued by private or government entities. In what is termed "firm commitment" underwriting, the investment bank purchases all of the new securities issued by a corporate or government borrower. The investment bank then resells these securities in smaller units to individual and institutional investors. Thus, the investment bank assumes the risk of unfavorable price changes between the time they agree to buy the securities at a given price and the time they resell them. Under a "best effort" arrangement, the investment bank acts more as an agent, taking a commission for whatever amount of securities the banker succeeds in marketing. The top domestic and global underwriters of debt and equity in 1993 are Merrill Lynch, Goldman Sachs and Lehman Brothers, respectively.

In the U.S., the investment banking industry has undergone considerable restructuring since a peak in recent decades. Many firms have merged (for example, the Smith Barney, Harris Upham & Co. unit of Primerica Corporation with American Express Co.'s Shearson Lehman Brothers to become Smith Barney Shearson), become majority foreign-owned (Credit Suisse's stake in Credit Suisse First Boston) or have gone under (Drexel Burnham Lambert). With the gradual erosion of the Glass-Steagall Act, which traditionally separated investment banking from commercial banking activities, U.S. commercial banks such as Bankers Trust and J.P. Morgan have intensified the competition for securities underwriting and fee-generating business. Brokerage firms such as Merrill Lynch, meanwhile, are expanding their lending to major customers, thereby acting more and more like commercial banks.

The investment banking industry reached a peak (in terms of employment) in 1987. After a more than 500 point decline in the stock market that year and a subsequent weakening of the economy, many firms reassessed their aggressive pursuit of such risky mega-deals as the leveraged buyouts of Allied Department Stores and Interco. These corporate deals were financed primarily through the issuance of below-investment-grade "junk" bonds and involved minimal equity, exposing the bond holders to the risk of default in the case of an economic contraction and companies with excessive debt on the balance sheets more vulnerable in the ease of a down turn.

According to recent surveys, many U.S. investment banks are focusing increased attention on rebuilding traditional lines of business such as providing retail investment advice. To be sure, the investment banking industry will continue to experience its peaks and troughs. With an appetite for risk, unusually high overhead and enormous profit expectations, many investment banks will continue to restructure and regroup with each major turn in the market.

<u>**Potential A.I.D. Activities:**</u>

1.) A.I.D. could co-sponsor seminars and training programs for underwriters, brokers, dealers and other participants in the securities markets on subjects such as the following:

- Stockbroking and trading administration
- Financial analysis
- Valuation
- Issue underwriting (including preparing registration statements, pricing securities, forming and managing a selling group and stabilizing the price of the issue during the offering and distribution period)
- Assisting foreign companies in establishing joint ventures
- Project finance
- Mergers and acquisitions
- New financial instruments.

Such courses might be offered through the local stock exchange, chambers of commerce or business institutes. While A.I.D. might provide some seed money to get the courses started, a goal should be to encourage a well-respected institution to offer them on a continuing basis. The implementation of training programs would require specialists in the areas of investment banking, financial analysis, securities market regulation, financial instruments, and training.

2.) A.I.D. could support the development of a professional association of chartered financial analysts to improve skills in securities and investment analysis. The professional association could sponsor courses, conferences and lectures; refresher courses; examination and certificate programs; research and publication.

3.) In addition, A.I.D. could encourage the development of private investment banks and brokerage firms by (a) supporting the International Executive Service Corporation (I.E.S.C.) in matching start-up companies with retired U.S. business executives with investment banking and brokerage backgrounds; (b) encouraging the development of local consulting firms offering fee-based advisory services to investment banks and brokerage firms; (c) providing direct, short-term technical assistance to selected financial institutions for which local expertise is not available; or (d) use of A.I.D. credit guarantee facilities (or alternatively, work with IFC or other donors credit and equity facilities) to support the establishment or expansion of local investment banks. In many developing countries, local consulting firms would benefit from training and assistance in broadening their range of expertise. Support for the development of new institutions could include the preparation of feasibility studies, assistance in locating foreign partners/investors, assistance in formulating financial and operating policies, and the provisions of loans or loan guarantees.

Sources of expertise in this area include U.S. investment bankers, brokers, dealers and consultants to the securities industry. The Institute of Chartered Financial Analysts in Charlottesville, Virginia is a source of expertise in developing chartered financial analysts programs. Examples of investment banks in Sub-Saharan Africa that might be contacted are Merchant Bank of Central Africa Ltd. (Harare), Diamond Trust of Kenya Ltd. (Nairobi), Merchant Bank Ltd. (Accra), African Banking Consortium Merchant Bank (Lagos) and Tanzania Investment Bank (Dar es Salam).[20]

5. Credit Rating Agencies

Reluctance to invest in securities often stems from uncertainty regarding the risks associated with a particular company or financial instrument. Investor confidence rests to a large extent on the availability of clear, reliable information on the financial condition of the company concerned and the quality of the instrument offered. Without it, the public cannot make a proper risk assessment of investment opportunities.

A credit rating is an opinion of the ability and legal obligation of a company to make timely payments of principal and interest on a debt instrument until its maturity. A rating is also designed to rank, within a consistent framework, the relative risk of each debt issue and issuer. In determining a rating, both qualitative and quantitative analyses are used. In addition to its financial position, a company's management quality, environment (e.g., vulnerability to economic cycles, changes in technology or regulation), basic operating position (market share, cost structure, diversification) and strategies are all examined in the rating process.

In the United States, the two leading companies providing securities credit rating services are Standard & Poors and Moody's Investor Service. Standard & Poors and Moody's provide standard ratings for debt and debt-like instruments, such as corporate bonds, municipal bonds, certificates of deposit and preferred stock. The nine rating symbols used by Moody's -- from Aaa to C -- indicate the level of creditworthiness of a particular instrument. A triple A rating has long been synonymous with a "blue chip" investment. To be rated, a company must pay the rating agency a fee. The generation of fee income, along with revenues from publications and training and information services, provide the core earnings of a rating agency.

When a credit rating agency fills its proper role, it benefits investors, issuing companies and market efficiency. It serves investors by providing quick, comparative forecasts of the credit quality of each rated issue in the context of other rated issues in the marketplace. Institutional investors (eg., insurance companies and pension funds), traders and brokers and other participants in the markets look to credit ratings as an independent, professional source of opinions and up-to-date information to support their own internal analysis.

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[20] While these firms are known to provide investment banking services in Sub-Saharan Africa, the reader should make an independent assessment of their suitability as potential resources.

Ratings also give an indication of future liquidity should the investor decide to sell the instrument.

Credit ratings help issuing companies because investor confidence in the ratings translates into a greater ability for a company to sell its debt. Generally, credit ratings help issuing companies by broadening the market for their debt securities to new, untapped investor groups, enabling well-rated companies to improve the terms of their offering and stabilizing their access to the market in times of stress. Credit ratings also promote market efficiency by assuring that investors are being adequately rewarded for the risks they are taking.

Credibility is essential to the operation of a credit rating organization. This usually arises from the organization being independent of the business of any company that might seek a credit rating. In LDCs, a reputation for objectivity may be developed through an association with an international credit rating agency or partial government ownership. Credit rating agencies, to be sure, are keenly interested in the development and application of financial accounting, auditing and reporting standards in developing countries. Where such standards are found to be lacking, a greater burden is placed on the credit rating agency to question management on the standards and procedures used.

In the absence of a sizeable market in debt instruments in Sub-Saharan Africa, a private credit rating agency may not be sustainable. The ability to generate fee income would depend on the number of companies and the number and size of the issues to be rated. The agency's fee structure and profitability would also depend on the fees being charged for other financial services, such as banking and legal fees. Systems of prudential regulation for financial institutions should be in place as banks and finance companies are likely to be large issuers.

An example of an independent credit rating agency in a developing country is Crisil - Credit Rating Information Services of India. Crisil was set up in January 1988 by the state-owned Unit Trust of India, the country's main investment institution, and the Industrial Credit and Investment Corp of India (ICICI), a joint stock public lending company. Government-owned investment institutions and Indian and foreign banks have also acquired minor stakes in Crisil, a profit-making organization. Crisil was created after investors got a rude shock in 1986 when an established, reputable Indian manufacturer made a Rs 270 million debenture issue and then halted interest payments a year later. In the wake of that event, financial institutions supported moves to establish an organization that could provide professional risk assessment. Other developing countries with credit rating agencies include Mexico and Korea.

Potential A.I.D. Activities:

A.I.D. could assist in preparing a feasibility study for the development of a credit rating agency, arrange study or visitation programs to credit rating agencies in other countries or, at a later stage, assist in the institutional development (operating procedures, information processing requirements, personnel planning, etc.) of a rating agency.

The tasks involved in conducting a feasibility study might include:

- Estimates and projections of demand for the services of the rating agency by current and prospective investors, the likely level and frequency of requests for rating information and the expectations of customers for service levels

- Estimates and projections of the volume of securities likely to be issued and susceptible to being rated

- Analysis of the types and quality of information available and recommendations for meeting information needs

- Estimates and projections of the information processing requirements and related equipment needs

- Estimates and projections of total operating costs, including capital costs, financing alternatives, including possible assistance from A.I.D. and other donors, and alternatives for charging fees

- Recommendations for staff recruitment and training.

In addition, the feasibility study might consider options for creating linkages with U.S. firms (credit rating agencies computer firms) and identify potential local candidates for an international joint venture or fully domestic firm.

Credit rating agencies contribute greatly to market development but are rarely profitable in the early stages. As a result, a additional A.I.D. role might be to help finance start-up costs (loans, loan guarantees) and to provide assistance in institutional development. Until the securities markets are fully developed, the main beneficiaries of credit ratings are financial institutions; therefore, one role that A.I.D. can play is to encourage local financial institutions to jointly organize an independent credit rating agency (to which the beneficiaries pay fees). A.I.D. could provide technical assistance in launching such a service. A visitation program to credit rating agencies in the U.S. would allow the organizers to better understand how credit rating agencies operate in the U.S.

Sources of expertise on conducting feasibility studies and institutional development are industry leaders such as Standard & Poors (S&P) and Moody's. S&P, apart from its offices in major financial centers, has an equity stake in a new rating agency in Sweden and has created a fee-based consulting unit to operate in developing countries. Moody's has offices in four major financial centers (London, Paris, Tokyo and Sydney) that provide financial services to investors in nearby markets.

6. Venture Capital Companies

"Venture capital" is still a relatively new expression in developed and developing countries. Although the term is used increasingly, there remains some confusion about its meaning. Venture capital is often thought of as the early-stage financing of new companies seeking to grow rapidly. Others associate it exclusively with high technology enterprises, such as the genetic engineering and Silicon Valley enterprises of the United States. Although historically early-stage financing and high technology have been a main focus of venture capital investors, the industry covers today a broader spectrum of interests. Venture capitalists can also provide seed, start-up, development and expansion financing to companies which, having demonstrated the viability of their business, do not yet have access to public or credit-based institutional funding.

In Africa the term venture capital is often used very generally to mean almost any form of equity and "risk" capital for investment in private business as contrasted with debt or development financing. This reflects the paucity of equity financing alternatives available in most African countries in the present early stages of financial sector development. There is a great need to de-mystify the term venture capital, to understand that it refers to quite specific methods of mobilizing and investing capital, to understand its limitations and to position venture capital within the larger context of financial and private sector development.

Although the particular form, structure, investment focus and objectives can vary, the essence of venture capital involves certain core concepts and requirements.

- Venture capital is long-term equity or quasi equity (subordinated debt) financing provided to promising growth-oriented small or medium size companies - for the purpose of gaining a higher return associated with taking higher risks over what is typically a four to ten year period.

- At the core, venture capital is a partnership among investors who bring capital, entrepreneurs who bring business leadership and financial opportunity, and professional investment managers who bring the abilities to help grow and "add value" to target companies.

- Venture capital managers differ significantly from bankers or lenders in the high degree of business, financial, management, and other technical assistance they must provide in order to realize a higher return while protecting against the numerous risks involved.

- A financial return can only be generated if the investment is liquidated or sold to another investor at a significantly higher value (hopefully three to five times the original value) and this means developing an "exit" strategy via other corporate, private or institutional investors, the company's management, or the public securities market if and when it is mature enough.

In the U.S., an important step in the development of venture capital was the passage of the Small Business Investment Act in 1958. This provided the basis for the creation of Small Business Investment Companies (SBICs) which are eligible for loans from the Small Business Administration. By the late 1970s, venture capital was already a mature industry, and by the early 1990s it had a capital pool of over $40 billion. With pension funds, endowments and other institutions supplying capital to the venture capital industry, SBICs have largely been overshadowed by independent venture firms.

A venture capital fund is a formal investment vehicle in which investors pool their resources for management and investment by professional managers who know how to select and help develop promising companies over the long term. Venture capital funds, which number well over 1,000 in the U.S., vary greatly in their purpose and focus depending on the goals and strategies of their managers and their investors. Some focus on early-stage high tech ventures; others focus on providing seed capital to develop a process or concept; many others focus on expansion of already successful growth companies; and still others on buyouts of more mature or "turn-around" situations. Most VC funds specialize in various ways, e.g., industry, market size, stage of growth and financial goals.

Although venture capital appeared much later in Europe than in the U.S., by 1993 the total pool of venture capital within the European Community countries was around $15 billion. The major sources of venture capital in Europe appear to be banks and governments, while pension funds, foreign investors and individuals are the major contributors in the U.S.

Over the past few years many African countries, development agencies and private interests in Africa have begun an exploration of VC applications and opportunities in Africa - through assessments, feasibility studies, financial assistance, and limited attempts to create VC funds. As of mid-1993, there are a few dozen VC-related initiatives or experiments in Africa, many with government or quasi-government sponsorship, e.g., A.I.D., OPIC, various European agencies, development financing institutions such as the IFC, the World Bank, Commonwealth Development Corporation (CDC), Deutsche Investitios and Vertwieklungs Gesellschaft Gmbh, SWED Corporation, SMO of Holland, PROPARCO of France and participation by private companies such as the Equator Bank and Meridian Bank. The types of involvement range from direct company investments (IFC), to venture capital fund development (CDC in Ghana and Tanzania working with local and foreign investors with the A.I.D.-funding), to feasibility development assistance (A.I.D. through the African Venture Capital Project), to indigenous efforts (VCCZ, a government venture capital group in Zimbabwe), to participation by a combination of private and government entities (the Equator Bank, private U.S. corporate investors, OPIC and A.I.D. involvement and/or sponsorship of the Africa Growth Fund).

At this stage, the total number of formal investments made by these VC projects is quite small. The range of investments is estimated at 50 to 100, depending on how they are defined and counted.[21] It will take five to ten years for most of these investments to grow, mature and be liquidated or "cashed out" and before real assessments can be made of return on investment. Perhaps the farthest along is the African Growth Fund, which plans to be fully invested by 1994 with $25 million in a total of 11 or 12 companies, in Ghana, Cote d'Ivoire, Kenya, Botswana and a couple of other West African countries. However, the greatest challenges still lie ahead in managing the investments, confronting all of the risks and problems of expanding companies over several years, and being able to "cash out" and actually return funds to investors.

Creating a Suitable Climate for Venture Capital

Studies on venture capital in different countries suggest that local and national governments can play important roles in creating the right conditions for venture capital activities. Perhaps the most important areas requiring government attention are the policy and regulatory impediments to private enterprise, e.g., high wealth and income taxes, myriad licensing and permit requirements, entrance barriers protecting certain industries, and, worst of all, an overall negative attitude towards rapidly earned wealth.

Second, investors should be able to dispose easily of their equity. While public stock markets have been the most visible equity market for venture capital investors in the U.S., the "exit" has frequently been through other avenues: sales to private, corporate or institutional investors, acquisitions and mergers, management buyouts and purchase by other co-investors. In Europe these other routes have predominated as they must in Africa while nascent stock and OTC markets develop over the coming decade. This is in contrast to Asian venture capital funds which often exit through initial public offerings. This may be due to the large amount of savings and the propensity for equity investments.

Third, a supportive environment for small and medium-sized enterprises (SMEs) e.g., financial programs, infrastructure facilities and/or advisory services - should exist to encourage the growth and development of SMEs. Government-sponsored financial programs to assist SMEs can take several forms. They can include (1) direct lending to SMEs, usually through specially created agencies or through rediscount mechanisms in development banks and central banks; (2) loan guarantee schemes, whereby the government covers partially or entirely loans to SMEs made by banks (as in France, the U.K., Canada and the U.S.); (3) financial support to venture capital firms. Governments can also improve the environment for SMEs through the creation of industrial estates or of "small business incubators" providing a common site, shared support services and on-site management assistance (e.g., U.S. and Canada).

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[21]This estimated range refers to deals valued at $100,000 to $1-2 million and does not include micro-size investments or "informal" VCs.

Of course, all of the above enabling conditions should be in addition to, not as a substitute for, a good macroeconomic env:..onment with low inflation and stable interest rates.

The following is a general outline of factors that must be examined in order for venture capital investments to succees:

1. Identify the Potential Investment: The Venture Capital firm will define each business situation according to a set of creteria is uese to evaluate businesses. Venture capital firms differ in their preferences for the types of businesses they will finance. Traditionally, VC firms have sought to invest most of thier funds in high technology products. Additionally, most venture capitalists typically prefer innovative products or thoses can be categorized as substitution products, such a s fast food resturant that substitutes chicken to hamburgers.

2. Reviewing and Analyzing the Opportunity: Once the potential investment has been identified, the ·nture capital firm will analyze the opportunit along four basic areas: the quality of management, the uniqueness of the venture, projected returns and possible exit strategies.

3. Negotiating and Closing the Deal: One of the most difficult tasks in the investment cycle of the venture capitl firm is negotiating and closing the deal. Specific negotiation points include interest or dividend rates, collateral agreements, use of capital and payment terms, future borrowing constraints and ratio requirements or operating restrictions on the firm. Each requirement must be clearly stated and agreed to in order to move forward.

4. Monitoring and Managing the Investment: Once the deal is closed and the relationship has begun,the relationship between the company and the venture capital firm must be managed. The timing and amount of the firm's involvement will vary depending on the business.

5. Liquidating the Investment: The exit of the venture capital firms involves selling off its stock and/or receiving its final debt payment. The exit is very important because it determined the actual yield on investment and cash flow available to teh venture capital firm, which form the basis for the investment in the first place.

Venture Capital within the Broader Context of Economic, Financial Market, and Private Sector Development

From A.I.D.'s perspective, the first question might be: Why consider VC for Sub-Saharan Africa at all, and where does it fit into a broader economic development strategy?

It has come to be common knowledge that 1) formal equity and risk capital is scarce in African countries and unavailable to most who need it; 2) there are indications of promising enterprises and entrepreneurs with growth potential that would greatly benefit from equity capital rather than taking on too much high-cost debt which could restrict and even cripple company growth; 3) the small- and medium-sized business sector can and should be an engine of economic expansion, job development, savings and capital creations; and 4) there are few alternatives for investors who may want to achieve the higher rates of return associated with higher risks. Venture capital is one vehicle which has the potential to address these needs.

It is also important to understand certain limitations and realities of venture capital, namely that: 1) VC is narrow and specialized and will provide funds for a very small number of companies; 2) it takes a long and persistent effort to organize a fund and make investments and even longer to realize financial returns; 3) the pool of potential VC managers and investors is very small in Africa due to the unusual qualifications and requirements involved; 4) the long-term investment risks inherent in an emerging or transitional economy in Africa are manifold and go far beyond the business, technology and market risks in the West, i.e. the additional political, economic, legal, social and other risks; 5) government or public agency involvement in VC fund management and economic subsidy dilutes and undermines the private sector discipline and commitment required for success; and, 6) significant local participation by investors, management and/or entrepreneurs is critical to success.

Finally, given these characteristics and the needs venture capital can address, where does it fit into the broader context of financial and private sector development strategy? What are the reasons for considering it as an interrelated element?

- Formalized venture capital has most often represented the very upper point of the financial sector pyramid, offering a vehicle for: a.) mobilizing sophisticated, high-end investors; b.) adding rigorous management expertise; and c.) directing these funds into businesses with the most promise. Often funds exist which have been accumulated on or off shore but have little commercial opportunity to earn a return. Venture capital funds are also used to stimulate activity for capital investment purposes early in the financial sector development of a country.

- Second, though the VC target (or recipient) companies may be few in number, their quality and economic growth potential may be significant given sufficient capital to expand. The success of these businesses may create high profile role models that raise the sights and aspirations of others. This may attract other investors, managers, and entrepreneurs into the equity and risk capital sector. However, it is important to be cognizant of the time frames involved.

- Third, to the extent the venture capital process is successful it can a.) contribute to critical skills development in the financial sector, b.) help foster the development of financial sector activities in such areas as investment banking, the emergence of stock markets and brokers, a more market-oriented commercial banking sector, and selective financing of privatized companies, and c.) influence policy and regulatory change beneficial to private sector investment and growth.

- Fourth, history has shown that with higher risks also come the possibilities for higher returns. The venture capital process, properly executed, is flexible, selective, and disciplined in managing risks and opportunities.

- Fifth, it is important for investors, financial managers, and entrepreneurs to consider their shared objectives with respect to the purpose, type, and level of return on investment. Venture and equity capital investing itself is extremely entrepreneurial and pluralistic in its various forms and must be adapted to local realities. Increasingly, investors, managers and entrepreneurs, as well as development officials are exploring how to include development objectives as a compatible component of venture capital projects.

Although experience in developing countries is limited, it appears that venture capital can make a significant contribution to the economic environment for entrepreneurs. Furthermore, in the absence of true capital, expanding businesses and startups might otherwise be forced to take on imprudent levels of debt or to restrict their growth.

The A.I.D. Africa Bureau has initiated activities under its Africa Venture Capial Project. This Project is designed to increase the availability of and access to long-term risk capital for productive private enterprises. A number of international efforts, many of which are supported by A.I.D., are directly or indirectly involved in trying to assist theAfrican entrepreneur both with capital resources and technical assistance. The AVCP is intended to interact closely with these efforts in a complementary fashion.

Potential A.I.D. Activities:

A.I.D.'s orientation toward privatization, private sector and financial sector development opens up a range of possibilities for considering venture capital within a broad portfolio of financial sector initiatives. Venture capital activities can support A.I.D. objectives set out in the 1988 Policy Paper which "encourages the use of a variety of debt and equity investments [and] promotes the growth of different kinds of institutions offering a wide range of financial investment and services to potential savers and investors". The Policy Paper encourages the development of "capital markets and associated intermediaries" to help meet the capital requirements of developing economies. Moreover, the Africa Bureau views the fostering of market-oriented private sector activity as a key to achievement of sustainable growth in Sub-Saharan Africa.

A.I.D. could support the preparation of a feasibility study to assess the potential viability and utility of venture capital companies. First, a preliminary assessment should be made to determine whether the business environment for venture capital is appropriate and whether there are sufficient opportunities and entrepreneurial spirit in the financial and business community. Important to this assessment would be an inventory of all initiatives and sponsors (local and foreign), the attitudes of the government and private sector toward venture capital, conditions in the economy such as stock market development, business tax incentives/disincentives, the legal and regulatory framework and most importantly the specific possibilities for (and degree) of local participation and commitment.

If the results of this preliminary study are positive, A.I.D. could provide technical assistance to (1) assess the demand for a venture capital fund and the specific business investment opportunities, (2) identify potential collaborative groups, sources of support, and management for the fund (3) provide recommendations as to the focus, strategy and range of services, (4) offer guidelines with regard to its design, structure, development and operations, (5) assess the long-term sustainability of the fund, and (6) analyze the potential utility of such a fund in attracting local and foreign investors.

The next step could be to seek a seed money grant and/or technical assistance to the principals involved in the development stage of a particular VC fund. This might take the form of consulting and training by people experienced in the VC field in raising the funds, managing the investment process, and working with entrepreneurs to grow companies.
A.I.D. could also provide highly qualified technical assistance to assess all existing equity/venture activities to identify the issues being confronted, progress being made and lessons being learned for the purpose of defining and fostering next stages of financial and private sector development in which A.I.D., and other public and private entities may have mutual interests.

<u>Venture Capital as a Bridge Between Privatization and the Securities Market.</u>

A variant of venture capital which bears mentioning in the developing country context is that of venture capital in support of privatization of state-owned enterprises, and not only of new SMSE's. A specialized venture fund could be considered for the purpose of acquiring part or all of the shares of companies being privatized, managing these companies through a transition phase to profitability, and then selling such companies to private or corporate investors or listing them on the local stock exchange. This concept is a variant of the venture capital principle of marrying the entrepreneur with the investor: in this case the marriage is between the newly-privatized company and the investor, with the latter taking a strong role in managing the company but with the objective not of long-term ownership but of restructuring and growing the company until it is attractive to other investors. Many companies being privatized are too troubled to be listed immediately on the local stock exchange or for sale to a single buyer; a private venture capital fund could be practical "halfway house" for such companies, providing necessary management skills to improve the company's performance and seeking a profit on the future share listing and/or sale of the company.

USAID can help this process in several ways: it can provide technical assistance or funding for feasibility studies; locate investors, perhaps complemented by certain international agencies; afterward, it can then provide the capital for the entity; USAID could then assist with loan financing to the venture fund itself and/or to specific privatization projects in which the venture fund participates.

The venture capital and equity investing arena is a very sophisticated and challenging field. The issues are complicated, the skills needed and the commitments required are formidable., It is essential to access the expertise and counsel of others who have a first hand understanding of the "technology" and practical execution of venture capital. The greatest challenge over the 90's in Africa will be 1) to learn and develop, from on-the-ground experience, "appropriate models" and approaches to venture capital which work in emerging and transitional economies. 2) create structures and mechanisms that greatly expand the number of investors, managers and entrepreneurs successfully participating in formal equity investing, and 3) develop and involve major participation of indigenous investors, managers and entrepreneurs.

The following is a list of projects and resources, supported by A.I.D. and other organizations which represent extensive information, technical assistance and specific VC case examples in the field venture capital that are relevant to Africa and developing economies.

There is an increasing number of players from the international development community and the private sector participating in the evolution of VC in Africa. Collectively, they represent a wide-ranging pool of experience, approaches, expertise, as well as technical and financial resources. Among these are: A.I.D.'s Financial Sector Development Project (FSDP), Private Enterprise Development Support (PEDS) Project, the Africa Venture Capital Project (AVCP), the Africa Growth Fund (in which Equator Bank and OPIC are co-sponsors) and the Africa Management Services Company (AMSCO); the IFC's Division of Capital Markets and Sub-Saharan Africa/Small Business Development Unit and Africa Enterprise Fund; the African Development Bank's Private Sector Development Unit; the Association of African Venture Capital Companies (AAVCC); the Venture Network Association (Fairfield, Connecticut), and the International Venture Capital Institute (Fairfield, Connecticut).

Additionally, there are various private not-for-profit development groups. They are: Economic Development for Equatorial and Southern Africa (EDESSA), a Swiss company; the Société d'Investissement et de Développement Internationale (SIDI), a French company; and SIFIDA, a Swiss company.

7. Contractual Savings Institutions[22]

Contractual savings institutions (CSIs) such as insurance companies and pension funds (discussed below) have a common feature in that they raise the major portion of their funds through savings programs whereby participants regularly contribute an agreed amount over an extended period of time in order to attain a long-term savings goal. These payments may be voluntary, such as through a life insurance policy, or compulsory, such as to a pension fund or social security system (also called a national provident fund) required as a condition of employment.

Unlike many other forms of savings, these funds generally cannot be withdrawn until the end of the contract except in an emergency or with heavy penalties. The continuous commitment of the saver is ensured by penalties for late or missed payments.

While the compulsory nature of such savings programs might seem to be a disadvantage, from the saver's perspective it can be a major advantage. In developing countries where the extended family claims rights to members' property, such inaccessible savings provide one of the few avenues for individuals to accumulate personal financial assets. Even where such factors are not important, many households find they lack the financial discipline to save on an entirely voluntary basis and prefer a compulsory savings program. Arrangements can be made through employers to deduct payments automatically from salaries and so avoid the transaction costs and inconvenience of first receiving the cash and then making payments. With employment-related pension funds, the employer usually also makes a contribution. There are also opportunities for risk diversification by investing in securities through CSIs rather than directly as individuals. Finally, some savings programs, such as a life insurance policy's death coverage, serve an important social role in family financial planning.

From a national perspective, contractual savings plans offer the following benefits:

- Expands the number of regular savers which, in turn, should increase the level of national savings (see below)

- Offers an alternative to bank savings products, thereby promoting increased competition in the banking sector

- Produces a more predictable and constant flow of savings which can be used to finance long-term investment projects (especially important given the decline in long-term credit from abroad)

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[22] This section draws upon the research of Dimitri Vittas and Michael Skully of the World Bank, Zvi Bodie of Boston University and the Employee Benefits Research Institute (EBRI). See "Overview of Contractual Savings Institutions" by Vittas and Skully, January 1991, "Managing Pensions and Retirement Assets" by Zvi Bodie, June 1990, "Contractual Savings Institutions" by Michael Skully, March 1988 and the EBRI Databook 1990.

- Increases the pool of funds managed by professional investment managers, allowing small savers to diversify their risks and promoting capital market development.

Whether contractual savings programs mobilize new savings in an economy or simply attract old savings and find substitute uses for them depends on several conditions. If the funds raised through a contractual savings institution are used to finance loans for consumption activities or are used to purchase government securities issued to finance government or public enterprise deficits, then there is little if any savings benefit. Even worse, if tax concessions are used to attract funds into these contractual savings vehicles, the government deficit could become even greater than before. The relationship between government tax incentives, the funds raised and the investment of the resulting funds needs to be studied on a country-by-country basis.

Among the many types of contractual savings institutions that exist, the most important private sector institutions are generally insurance companies and pension funds. (In the public sector, the most important CSIs are usually social security programs and pension funds for government employees.) The following is a brief overview of private sector insurance companies and pension funds in the U.S. and the developing world.

Insurance Companies

While it is difficult to generalize about an industry that is rapidly diversifying into many new forms of business, a common way of viewing the insurance industry is to divide it into three segments: life insurance, non-life or property/casualty insurance and reinsurance. Traditionally, life insurance protects against two types of risk: the unexpected loss of family income due to the premature death of the principal breadwinner (or the loss of earnings due to sickness or disability) and the danger of insufficient income at retirement to cover one's cost of living. Non-life or property/casualty insurance breaks down into "personal risks," such as house and car insurance, and industrial and commercial "large risks" such as catastrophic damage and product or professional liability. Reinsurance is the insurance which insurers take out to defend themselves against large claims, odd risks or claims that they have little capital to support. About 80% of reinsurance premiums come from non-life risks (though countries differ) and less than one-tenth of direct insurance worldwide is reinsured.

Insurance in the U.S. has become so important that annual premium payments account for roughly 9% of GDP. The U.S. accounts for a little less than two-fifths of premium income worldwide making it the world's most important market. With assets of $1.8 trillion, most of it in long-term investments (unlike most bank loan portfolios which tend to concentrate on short- and medium-term lending), insurers have fueled industrial expansion in the U.S. for over a century. Insurance sometimes plays a such critical role in the U.S. that, being a litigious society, companies will often abandon certain activities or projects if they cannot insure them.

In the U.S., most insurance is provided by private insurers, the largest (in terms of total assets in 1989) being Prudential ($163 billion), Metropolitan ($98.7 billion) and Allstate ($87.1 billion). In developing countries, the smaller the economy, the more likely it will be served by only one insurer, typically government-owned. Alternatively, the country might be served by the agents of foreign companies. Locally-incorporated private insurance companies or formal branches of foreign insurers are generally found in larger markets. Joint ventures between the government and a foreign insurer might also exist. Examples of insurance companies in Sub-Saharan Africa are the National Insurance Company of Zimbabwe, the State Insurance Corporation of Ghana, the American International Insurance Company and the Taisho Monarch Insurance Company Ltd.

One frequently used indicator of the level of development of the domestic insurance industry is the ratio of annual premiums to GDP. In general, the higher the percentage of premiums, the greater the development of the local insurance industry. According to research on life insurance companies in developing countries conducted by Sigma, the Swiss reinsurance company, out of five countries studied in Sub-Saharan Africa, only one country, Zimbabwe, had annual life premiums in excess of 1 per cent of GDP in 1988 as shown in the table below:

Annual Life Insurance Premiums as a % of GDP in Five Sub-Saharan African Countries

Country	Annual Premiums
Zimbabwe	2.85%
Kenya	0.49%
Cameroon	0.19%
Nigeria	0.16%
Cote d'Ivoire	0.16%

Source: "Overview of Contractual Savings Institutions" by Vittas and Skully, January 1991

By comparison, five out of fourteen countries in Asia and the Near East had annual life insurance premiums in excess of one percent of GDP: Korea (7.48%), Taiwan (2.68%), Singapore (1.45%), Malaysia (1.23%) and the Philippines (1.11%). In interpreting these statistics, it is important to remember that a variety of domestic factors will affect the insurance industry's growth, such as the tax treatment of premiums, the level and distribution of income in a country, the industry's investment earnings and payouts to policy holders, and the country's social cultural and family structure. (For further statistics on the insurance industry in Sub-Saharan Africa, please see the Annexes.)

Insurance companies are usually heavily regulated in both developed and developing countries. In the U.S., state regulations set limits for such things as investment practices, reserve ratio requirements, and operating costs (for example, the commissions paid to agents). Other types of regulations concern pricing, policy terms and conditions, and audit and actuarial inspections. While federal deposit insurance exists for U.S. banks, no federal safety net exists for insurance companies. Through re-insurance and other means, insurers pool their risks with other companies.

In developing countries, insurance company regulations are often a matter of encouraging local ownership and employment, of controlling the outflow of reinsurance premiums and head office expenses, and of raising revenues via licensing fees or government securities holding requirements. In some countries, regulations exist simply to maintain a government monopoly or preserve a dominant market position. The industry has been regarded as too small to justify specific legislation or amendments to existing law. Prudential regulation, such as is required for the banking sector, seldom exists or is adequately enforced. Informal guidance is often used instead. The government should try to create an appropriate regulatory structure which protects holders' interests while encouraging private sector investment and the industry's development.

Private Pension Funds

A major development in the industrialized countries since the mid-twentieth century has been the rapid growth of employee retirement or pension funds. Employees increasingly view pension plans as an important part of their compensation package. The establishment of adequate retirement programs has become a key factor in companies' ability to attract and retain qualified personnel.

TO BE UPDATED In general, employer-sponsored pension plans are backed by pension funds. Contributions to the fund may be made by employers, employees or both. At the end of 1989, the total asset value of private trusteed pension funds in the U.S. reached $1.4 trillion. (If private insured pension reserves of $602 billion and public employer funds of $950 billion are included, total financial assets of all employer-sponsored pension plans reached $2.8 trillion at December 31, 1989.) From 1975, when the Employee Retirement Income Security Act (ERISA) became law, to 1987, the number of plans sponsored by private employers in the U.S. more than doubled from 340,000 to 872,000. Total participation in private plans grew from $44.5 million in 1975 to $78.2 million in 1987. (These figures do not adjust for double counting of employees participating in multiple plans).

Of the total assets held by private trusteed pension funds in 1989, 40% was invested directly in corporate equities, 16% in corporate and government bonds, 7% in cash and marketable securities, 19% in other directly-held assets and 17% in bank pooled funds.

There are basically two types of pension plans: **defined contribution** and **defined benefit** plans. With a defined contribution plan, the participant's benefits depend on the amount contributed over a number of years and the returns from the investment of these funds. With a defined benefit plan, the amount the participant receives is not directly related to his or her level of contribution - often it is based on the employee's level of earnings at the time of retirement and the number of years employed by the firm. If the benefits upon retirement are much higher than the total amount contributed by the employee, the employer will need to fund the difference.

The U.S. Department of Labor ensures that pension plans are managed and operated in accordance with the requirements of the Employee Retirement Income Security Act of 1974 (ERISA). The Internal Revenue Service is responsible for pension plan funding and vesting requirements, and for ensuring compliance with federal tax laws. A further element of pension fund regulation is to require most private sector, defined benefit pension plans to carry the equivalent of deposit insurance for pension plans. This insurance is provided by the Pension Benefit Guaranty Corporation. Coverage by the PBGC is mandatory for most employer pension funds in the U.S. and the premiums are deducted from the funds' earnings. In return, fund participants are assured of receiving at least a specified minimum monthly pension, even if the fund itself should run into financial problems.

In Sub-Saharan Africa, private pension funds are among the least developed and least regulated of the contractual savings institutions. Due to the lack of licensing requirements for private pension funds in many countries, it is difficult to determine how many funds exist or to comment on their investment policies or financial soundness. Little information on private pension funds in developing countries is readily available. According to Vittas and Skully (1991), company-based pension schemes are more likely to be found in countries such as Zimbabwe, Botswana, India and other former British colonies. They are also more developed in countries with small or non-existent social security systems and provident funds but where multinational corporations have a relatively strong presence, such as Brazil, Mexico and Indonesia.

According to one study, the lack of private pension funds in developing countries may be a reflection of the lack of, or ambiguities in, existing pension fund legislation rather than disinterest on the part of employers to provide them. The introduction of appropriate legislation would be a major step in facilitating the creation of private plans.

Potential A.I.D. Activities:

In developed countries, contractual savings institutions such as life insurance companies and pension funds play an important role in the mobilization and allocation of long-term investment capital. In developing countries, it is apparent that they have helped to increase the range and maturity of financial assets, sometimes in spite of government actions. If properly encouraged, the role of these institutions in expanding the supply of long-term finance could be greatly enhanced. The following are several areas in which A.I.D. could play an important role in supporting the development of contractual savings institutions.

1. Conduct studies as a basis for policy dialogue on such issues as:

    - Potential impact of contractual savings institutions on the national savings rate, the mobilization of long-term financial resources and capital market development

    - Integrated approaches to the development of contractual savings institutions - in particular, public schemes (such as social security systems and national provident funds) with private schemes

    - Implications of granting preferential tax treatment on contractual savings products.

2. Provide technical assistance in creating a legislative framework conducive to the establishment of contractual savings institutions. Such legislation should enable CSIs to compete successfully alongside other financial institutions with respect to their investment options and product lines.

3. Provide technical assistance/training in developing and enforcing prudential regulations that create a proper balance between safeguarding investor interests and allowing the institutions to operate competitively. These regulations might concern the following:

    - Licensing

    - Ownership and shareholder affiliation

    - Authorized investments

    - Related-party transactions

    - Premium levels and retention growth rates (insurance companies)

    - Underwriting results (insurance companies)

- Annual external audits and reporting to beneficiaries

4. Provide technical assistance on improving investment performance

5. Provide technical assistance in introducing new contractual savings products within the permitted legislative framework

6. Provide technical assistance to help improve the public's knowledge of contractual savings products, the benefits of appropriate insurance coverage, etc.

Sources of expertise include retired executives from major U.S. insurance companies and pension plans, and organizations such as the American Council of Life Insurance, the American Insurance Association (representing the big property/casualty firms) and the National Association of Insurance Commissioners (a voluntary association of state regulators).

F. Quality of Financial Information

The mobilization and efficient allocation of financial resources is contingent upon the availability of reliable, comparative financial information. High quality financial information facilitates the efficient distribution of capital through the financial markets to the entities that can best utilize it in generating economic growth. Investors must have access to useful, independently audited data on the financial performance of business entities before they will be willing to put their capital at risk.

Capital market participants in mature financial markets, such as in the United States, have traditionally looked to the accounting profession to provide them with useful financial information to be utilized for making investment decisions. The accounting profession defines useful financial information as data showing the financial results of operations of business entities that are reliable, comparable, and consistent. Accounting information is **reliable** if users can depend on it to be reasonably free from error and bias and to be a faithful representation of the economic conditions or events that it purports to represent. The essence of **comparability** is that information becomes much more useful when it can be related to a benchmark or standard. The comparison may be with data for other firms or it may be with similar information for the same firm, but for other equivalent periods of time.

The methods adopted by an enterprise should be employed with **consistency** if there is to be comparability in the financial statements.

1. Accounting Standards

Accounting standards are a set of policies and procedures that are formulated for measuring the true economic impact of business activities undertaken by business entities. Institution and enforcement of these standards ensure consistency and uniformity of reported financial information by business entities which, in turn, increases the usefulness of this information for making investment decisions.

In the United States, the Financial Accounting Standards Board (FASB) is responsible for formulating accounting and reporting standards. The FASB is a non-profit private organization whose mission is to establish and improve financial accounting and reporting standards. These accounting and reporting standards are formulated by the seven full-time members of the FASB and are kept under continuing review for changes that may be necessary as business conditions warrant. The Board's standard-setting process is designed to encourage participation of both the preparers and users of financial information. This is done through holding several hearings, which are open to the public, for discussion and evaluation of topics on the FASB's agenda. The results of the public hearings are evaluated, and once consensus is reached among the Board members, Statements of Financial Accounting Standards are issued.

The American Institute for Certified Public Accountants (AICPA) is a non-profit private organization that establishes educational, certification, and training requirements for its members who are professional accountants. The organization has been entrusted with the task of ensuring that all its members comply with the standards of financial accounting and reporting formulated by the FASB. Compliance with the AICPA's requirements is mandatory for all members who wish to perform audits and prepare financial statements for use by investors or regulators, and in cases where member accountants are found to have violated AICPA's professional requirements, their certifications may be revoked. Therefore, the accounting profession in the United States is self-regulatory in nature.

With the rapid increase in cross-border financial flows, the establishment of internationally accepted accounting standards has become extremely important. These standards are particularly important in promoting foreign investment in developing countries where accounting standards tend to be weak. In 1971, the International Coordination Committee for the Accountancy Profession founded the International Accounting Standards Committee (IASC). The aim of the IASC is to formulate basic standards to be observed in the presentation of audited accounts and financial statements and to promote their worldwide acceptance and compliance. The IASC has over 30 associate members who are enforcing adherence to the standards established by the IASC.

2. Auditing Standards

The purpose of an audit is to verify the reliability of financial information reported by business entities and to ascertain their compliance with financial accounting and reporting standards in reporting the results of their operations. To achieve this purpose, the auditing profession has established generally accepted auditing standards that must be adhered to in performing audits.

In the United States, the AICPA's Auditing Standards Board (ASB) is the designated technical body for setting generally accepted auditing standards. Professional auditors and accountants are certified by the AICPA and must comply with the professional and auditing standards established by the ASB. The ASB issues Statements on Auditing Standards (SAS) which address responsibilities, functions, and professional qualifications of auditors; delineation of generally accepted auditing standards; and the relationship of generally accepted auditing standards to quality control standards.

Although international auditing standards have not been developed by the IASC or any other international standard-setting body, the auditing profession has traditionally adhered to certain auditing conventions. International accounting firms have also made great contributions to the development and enforcement of generally accepted auditing principles and guidelines through their internal quality control programs. Further, the existence of multinational corporations has advanced adherence to a uniform set of generally accepted auditing conventions. For example, a U.S.-based multinational corporation would require that the financial results of its international operations be audited in accordance with U.S. auditing principles. Therefore, the absence of a rigid set of international auditing standards should not be misconstrued.

3. Accounting and Auditing Standards in Developing Countries

In most developing countries, the absence of quality financial information and formal accounting and auditing standards remains a significant obstacle to the development of money and capital markets. The absence of standards which meet the tests of reliability, comparability and consistency is also a significant factor crippling the ability of banks to play a proper role in financing growth. Investors in developing countries tend to be highly risk averse as a result of past periods of economic mismanagement and resulting instability. Banks are suspicious of any information presented by potential borrowers and often place more reliance on collateral coverage for this reason. The establishment of uniform accounting and auditing standards for preparation and verification of useful financial information can serve, to a limited extent, to strengthen investor trust and enhance the process of capital formation. Of course, such standards must be accompanied by other changes in the system, i.e, independent reviews and legal accountability for complying with standards.

Resistance to the establishment of sound standards for financial information may come from many sources, not the least of which will be company owners who do not want to disclose the financial state of their companies. In certain countries, companies maintain several sets of financial records to avoid paying taxes. This results in financial reporting complications; companies are hesitant to publicize the true results of their operations since it may result in additional tax liabilities to be assessed by the national governments.

In Madagascar the regulatory framework governing the accounting profession is obsolete and the quality and availability of records and information on companies is poor in general.

USAID/Madagascar is supporting a multi-donor development program that, in part, is intended to improve the quality of financial information. One component of this program, carried out under the Financial Sector Development Project, entailed assessing the adequacy and appropriateness of Malagasy audit practices and norms, particularly those of commercial banks. The FSDP team examined the current regulatory environment governing the auditing profession and financial reporting and disclosure practices and identified changes necessary for improving accounting standards. These upgrades in accounting and auditing standards will serve to increase the reliability of financial information in Madagascar, thus increasing investor confidence and the mobilization of savings to meet the investment financing needs of the private sector.

Potential A.I.D. Activities:

A.I.D. can play an important role in improving the quality of financial information in developing countries. A.I.D. could sponsor technical assistance projects in the following areas:

1. Comprehensive Needs Assessment Study. The purpose of a comprehensive needs assessment is to develop an understanding of the existing financial accounting and reporting environment in the country, including a review of accounting, auditing, and bookkeeping standards and conventions and an evaluation of professional associations, accounting educational requirements, and regulatory and tax reporting requirements. The results of this study will help to identify areas in which A.I.D. can provide additional technical assistance in improving the quality of financial information.

2. Assistance in Developing Accounting and Auditing Standards. A.I.D. can play an important role in providing technical assistance for developing formal accounting and auditing principles and standards where they do not exist. Technical assistance could be provided in formulating a conceptual framework upon which accounting, reporting, and auditing standards can be developed.

3. Creation of a Professional Association. A.I.D. can provide technical assistance in developing an organization that would be responsible for establishing and enforcing accounting and auditing standards on an ongoing basis, once an initial set of standards have been developed. In order to legitimize and give credence to the directives issued by this organization, professional membership and certification requirements should be established and implemented.

4. Educational Requirements Definition and Training. A.I.D. can provide technical assistance in identifying the appropriate educational requirements for accounting and auditing professionals. Moreover, assistance can be provided in creating a capacity to provide training programs on an ongoing basis, perhaps in conjunction with the standard-setting organizations and/or professional associations.

Sources of expertise in these areas include the American Institute of Certified Public Accountants (AICPA), the Financial Accounting Standards Board (FASB), the large international accounting firms and the Securities and Exchange Commission (SEC). Within the SEC, one of the objectives of the International Institute for Securities Market Development is to provide technical assistance in developing accounting and auditing standards and to provide formal training programs and internships in these disciplines.

G. Privatization

The very reforms which strengthen financial markets in Sub-Saharan Africa also contribute to the success of these countries' privatization programs. Moreover, privatization transactions can reinforce and enhance financial sector policy reforms in that financial reforms and privatization transactions are undertaken with a similar objective: the improvement of economic efficiency. The following section examines how the reforms and A.I.D. activities discussed in the previous sections of Chapter III support privatization activities and concludes with a discussion of how A.I.D. can assist in the design and implementation of developing country privatization programs in Sub-Saharan Africa and efforts to increase the private provision of public services.

1. Macroeconomic Policy

The key to a successful privatization program is the development of an attractive climate for private investment, characterized by macroeconomic stability and sound credit, monetary and fiscal policies. Indeed, a privatization program should be part of a broader macroeconomic reform program that is geared to promoting a free market environment. Privatization can make greater strides in contributing to economic growth and efficiency if accompanied by measures to:

- Eliminate administrative controls over prices, interest rates and credit allocation which distort free market signals in many Sub-Saharan Africa countries

- Control inflation and growth in the money supply

- Establish a realistic exchange rate and reduce foreign exchange controls to attract flight capital and foreign investment

- Reform the tax system to encourage greater private sector investment and entrepreneurship

- Promote greater competition by eliminating any government monopolies and liberalizing investment policies.

2. Commercial Banking

Governments undertaking privatization should focus on the early establishment of a competitive banking system. Economic growth and development requires savings mobilization so that savings can be channeled into productive investment. Newly privatized firms will require competitively-priced bank products and services in order to meet their needs for payment services, working capital, cash management and short and medium-term financing.[23]. In some SSA countries, a bank strengthening program may be necessary to attract savings "tucked under mattresses," channelled into the informal sector, or sent abroad.

The government or some other central institution may need to assume responsibility for a bank with liabilities that can no longer be serviced or with large portfolios of non-performing loans. A bank with these types of problems may need to be restructured.

For a banking system to fulfill its proper role in an economy undergoing privatization, it may be necessary to:

- Reform legislation relating to such matters as the transfer of property rights, the assignment of collateral, and bankruptcy

- Improve the capability of banks to assess risk through training in credit and financial analysis

- Establish a credit information bureau to provide banks access to a centralized source of credit information on potential borrowers

- Increase the competition between banks and non-bank financial institutions such as leasing companies, credit unions and cooperatives, both in terms of their product and service offerings and their use of money markets and, ultimately, capital markets as a tool of financial management.

- Privatize the banking system itself, or at least to remove the privileges, subsidies and monopolies enjoyed by the state-owned banking sector; the objectives should be to introduce competition into the banking system, and to eliminate political control of the credit allocation process.

Measures to increase competition in the banking sector should be accompanied by improvements in bank prudential regulation and supervision. Effective bank supervision is an important element in establishing and maintaining public trust and confidence in the

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[23]Capital markets are required to provide long-term financing, as commercial banks generally restrict their loans to the shorter end of the credit spectrum.

financial sector. The development of deposit insurance might also serve to enhance public confidence in the banking system.

3. Expansion of Securities Markets

The creation of efficient, liquid securities markets in SSA will expedite the process of privatization for a number of reasons. First, securities markets are indispensable for financing the restructuring and growth of newly privatized firms. By offering their shares for sale to the public, companies will be able to raise capital for a wide variety of purposes, including plant and equipment modernization, plant expansion, and research and development. Secondly, the shares of listed companies allow investors, both large and small, to invest and participate in the growth of their nation's economy. Additionally, a liquid market in which securities can be easily bought and sold helps attract capital to privatized assets by allowing investors to adjust their holdings without the risk of huge price fluctuations.

In countries with relatively shallow markets, privatization can be an important tool for stimulating the growth and development of local stock exchanges. By successfully privatizing a few large public enterprises, a country can dramatically increase stock market activity, while drawing new participants into the market. By pooling the resources of small investors into mutual funds, a large portion of the population can become shareholders in the newly privatized companies. This benefits both the companies, in terms of greater access to capital, and the investors, through the benefits of portfolio investment and professional fund management. Insurance companies, pension funds and other contractual savings institutions contribute to the accumulation of long-term savings and therefore represent important suppliers of capital in the securities markets for the newly privatized companies.

Participation in securities markets by individuals and institutional investors will be greatly enhanced if the markets are perceived to be fair. Laws against insider trading, market manipulation and other abuses of public confidence should be clearly defined and adequately enforced. Regulations governing securities exchanges and such matters as the licensing and capital requirements of brokers and investment banks should also be designed to strengthen the securities markets and their role in the privatization process.

4. Quality of Financial Information

The privatization process is bound to be more complicated in countries lacking generally accepted accounting and auditing standards. Accurate financial information is required for many privatization tasks including identifying privatization candidates, developing privatization strategies, conducting enterprise valuations and preparing public offering memoranda. Programs aimed at improving the quality and transparency of financial information should serve to bolster investor confidence with respect to purchasing the shares of the formerly state-owned enterprises by allowing them to make informed investment decisions.

Successful privatization programs must be part of a broader program of reform that creates an enabling environment for the private sector. Crucial elements usually include: the development of sound macroeconomic policies; legal and regulatory reforms; the creation of a competitive banking system, the development of efficient securities markets; and procedures for the improving the quality and relevancy of financial information. A.I.D. can play an important role in providing technical assistance to developing countries in the area of financial sector reform. A.I.D. can also support SSA countries in the design and implementation of privatization programs.

Potential A.I.D. Activities:

Experience in both developed and developing countries suggests that there are certain key components to a successful privatization program. A.I.D. can provide technical assistance tailored to the needs of a particular country in each of the following areas, depending on an assessment of the potential strategic impact of the assistance:

- Assist in the development of a database/information system on state-owned enterprises that would provide useful inputs in designing the country's privatization strategy
- Facilitate the design of a privatization strategy based on a policy dialogue with the host government and a determination of its goals and objectives
- Support the development of a public information campaign to address the concerns of potential opposition groups such as labor unions and civil servants
- Conduct a policy dialogue to explore the policies and legislation necessary to facilitate privatization
- Assist in identifying criteria that might be used in targeting firms for short, medium or long-term privatization
- Conduct financial and operational appraisals of firms, and industry or firm-specific legal, regulatory, economic and environmental analyses
- Define alternative strategies for transferring ownership, such as widespread share offers, negotiated private sales, management buyouts and employee stock ownership plans
- Aid in the implementation of privatization strategies; depending on the method of transfer, help to prepare the prospectus, coordinate publicity, arrange the underwriting, negotiate with investors, advise on legal and regulatory matters, etc.

- Assist in establishing a capability to monitor the privatization process on an ongoing basis.

USAID/Zambia, through the Privatization and Development (PAD) Project, is providing technical assistance to the Government of Zambia (GOZ) in the implementation of its privatization program. The GOZ has initiated a five-year privatization program targeting more than 150 state-owned enterprises, including manufacturers, farms, newspapers and transportation concerns, notably Zambia Airways. The Zambia Privatization Agency (ZPA) plans to privatize the companies in 12 tranches.

Price Waterhouse, prime contractor under the PAD Project, is advising the Zambia Privatization Agency (ZPA) in privatizing the 19 companies in Tranche One. As of May 1993, two companies were on the verge of being sold, five companies were in the final stage of negotiations and nine were still in the negotiation stage. The sale of the remaining three enterprises had yet to be negotiated.

Also scheduled for privatization is the Zambian Consolidated Copper Mines (ZCCM), Zambia's largest commercial enterprise which brings in almost 90% of the country's foreign exchange earnings. ZCCM and the other countries to be privatized represent nearly 80% of Zambia's economy.

Related to privatization are programs designed to finance and commercialize the private provision of public services such as water, gas and electricity, ports and transportation, telecommunications and waste disposal. The benefits should include an increased capacity for economic growth through enhanced infrastructure capacity and efficiency and through the greater scope for competition with public services. Alternative investment arrangements include:

- Direct investment

- A contractor relationship, such as production sharing, contract mining or a management contract

- Build, Operate and Transfer (BOT) - A method of financing public sector projects by a private party, or consortium of private parties. In exchange for financing and building a project, the government grants the financing party(ies) an operating concession or franchise to operate the facility for a limited duration. The revenues from operations constitute the principal source by which the investor recovers his or her investment and earns a return. At the end of the period, ownership of the project is transferred to the government. This arrangement is also called FBOOT (Finance, Build, Own, Operate and Transfer).

- Build, Own and Operate (BOO) - Same as BOT, except the duration of the operating concession or franchise is unlimited.

- Build and Transfer (BT) - Also a method of financing public sector projects by a private party, or consortium of private parties. The parties finance and build a project and turn title over to the government. Compensation to the investor comes in the form of an agreed share of the revenues derived by the government from facility operations.

A.I.D. could assist governments in analyzing the need for and potential benefits of private investment in public services and in defining the criteria for evaluating alternative investment arrangements (financial, legal, commercial and other). A.I.D. could further assist in identifying possible contractors, soliciting bids and negotiating contractual arrangements. There may also be an appropriate role for A.I.D. to either use its credit or credit guarantee facilities (or work with complementary resources of such other donors as the IFC or IBRD) to facilitate specific privatization transactions.

Expertise for these activities is available through the Privatization and Development Project and the Financial Sector Development Project, Price Waterhouse, Washington, D.C., as well as through other sources of expertise (some of which are listed in Chapter X).