

**AGENCY FOR INTERNATIONAL DEVELOPMENT
PROJECT IDENTIFICATION DOCUMENT
FACESHEET (PID)**

1. TRANSACTION CODE
 A = Add
 C = Change
 D = Delete
Revision No. _____
DOCUMENT CODE 1

2. COUNTRY/ENTITY
Africa Regional

3. PROJECT NUMBER
698-0522

4. BUREAU/OFFICE
AFR/DP

5. PROJECT TITLE (maximum 40 characters)
Financial Sector Research Project

6. ESTIMATED FY OF AUTHORIZATION/OBLIGATION/COMPLETION

A. Initial FY 9 | 0

B. Final FY 9 | 4

C. PACD 9 | 5

7. ESTIMATED COSTS (\$000 OR EQUIVALENT, \$1 =)

FUNDING SOURCE		LIFE OF PROJECT
A. AID		10,000
B. Other U.S.	1.	
	2.	
C. Host Country		
D. Other Donor(s)		10,000
TOTAL		

8. PROPOSED BUDGET AID FUNDS (\$000)

A. APPROPRIATION	B. PRIMARY PURPOSE CODE	C. PRIMARY TECH. CODE		D. 1ST FY 90		E. LIFE OF PROJECT	
		1. Grant	2. Loan	1. Grant	2. Loan	1. Grant	2. Loan
(1)	792	810		500		10,000	
(2)							
(3)							
(4)							
TOTALS				500		10,000	

9. SECONDARY TECHNICAL CODES (maximum 6 codes of 3 positions each)
970 950

10. SECONDARY PURPOSE CODE
797

11. SPECIAL CONCERNS CODES (maximum 7 codes of 4 positions each)

A. Code _____

B. Amount _____

12. PROJECT PURPOSE (maximum 480 characters)

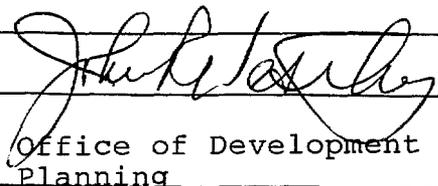
To increase host country and donor understanding of the operations of the financial sector in Sub-Saharan African countries and to facilitate the application of this understanding to appropriate development policies and programs.

13. RESOURCES REQUIRED FOR PROJECT DEVELOPMENT

Staff: Program Economist (AFR/DP/PAR); Project Development Officer (AFR/PD/SWAP).

Funds N/A

14. ORIGINATING OFFICE CLEARANCE

Signature: 

Title: AAA, Office of Development Planning

Date Signed: MM DD YY
01/11/90

15. DATE DOCUMENT RECEIVED IN AID/W, OR FOR AID/W DOCUMENTS, DATE OF DISTRIBUTION

MM DD YY

16. PROJECT DOCUMENT ACTION TAKEN

S = Suspended CA = Conditionally Approved

A = Approved DD = Decision Deferred

D = Disapproved

17. COMMENTS

18. ACTION APPROVED BY

Signature _____

Title _____

19. ACTION REFERENCE

20. ACTION DATE

MM DD YY

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Executive Summary

The proposed financial sector research project represents a \$10 million, five year effort to better comprehend how the financial sector functions in Africa and to facilitate application of this understanding to appropriate development policies and regions.

By clarifying how it is that Africa's financial systems function, this project will contribute both to the DFA goal of market oriented, broad based economic growth and the A.I.D. policy of promoting efficient financial markets as well as competition between viable financial institutions. Healthy financial markets and institutions must be established in order to develop and sustain a private sector-led growth effort. The need for this type of research was a major conclusion of the jointly sponsored (IMF, IBRD and A.I.D.) 3-day conference on "Policy Reform and Financial Sector Research in Africa" held in June, 1989. The research will be empirical and will seek to identify the primary factors blocking the development of liberalized financial markets. The project will be considered a success if the issues and concerns addressed aid in the design and implementation of future liberalization programs. Some issues studied may not result in operational outcomes within the five year life of project funding, while others may give birth to new issues not currently conceived. Integral to the project are successful training and network building components aimed at enhancing both the abilities of African policy-makers, researchers and financial sector practitioners and the level of contact between A.I.D., American institutions and Africa's financial sector.

The research program as currently envisaged will follow one or a combination of the country case study approach and the functional or subject study approach methods. The country study approach will examine, to the extent it is used, the financial sector of a selected group of countries, analyzing the sector in accordance with a set of hypotheses that will be tested. This will allow for subsequent comparison and examination of cross-cutting issues. The functional approach, to the extent it is used, will look at a broad category of issues, selecting specific countries to test hypotheses related to these subject areas; e.g., rural finance, monetary policy and financial innovation.issues.

The time is ripe for this type of analysis. Many African countries are in their third decade of independence and have each attempted a number of development strategies. It is now possible to look at the financial sectors in African countries over time and possibly develop relevant models explaining not only how they actually work but methods for increasing their efficiency and equity.

I. PROGRAM FACTORS

A. Conformity with Development Fund for Africa (DFA) Guidance¹

The first three strategic objectives of the DFA Action Plan are: 1) improving management of African economies by redefining and reducing the role of the public sector and increasing its efficiency; 2) strengthening competitive markets so as to provide a healthy environment for private sector-led growth, and 3) developing the potential for long-term increases in productivity. While contributing to all three objectives, the thrust of the proposed financial sector research project is directed primarily toward objective two. The better understanding of the operations of the financial sector in Sub Sahara African(SSA) countries and the relationship of macro-economic policy reforms and other sectoral adjustment policies to the financial sector and the testing of various hypotheses and questions outlined below in section II C (1) (Research Agenda) will substantially strengthen the capacity of host governments (and donors) to expedite the movement toward liberalized financial systems capable of mobilizing savings and allocating such savings to investments with positive returns. This anticipated outcome should contribute meaningfully to the ultimate goal of the DFA - economic growth that is market oriented, broad based and sustainable.

B. Conformity with A.I.D. Policy on Financial Markets Development²

A.I.D. policy on financial markets complements the DFA Action Plan, supporting developing country efforts to: (a) design, adapt and implement policies conducive to the development of efficient financial markets and (b) build and promote competition between viable private, profit-making financial institutions. A.I.D. has been actively engaged in encouraging financial liberalization through both policy dialogue and project and non-project assistance. Under these guidelines A.I.D. supports policy reforms and institutional development to create and monitor strong, free and competitive markets. Future financial sector projects should profitably be able to incorporate the knowledge gained from this research program in the design and implementation of these projects.

II. PROJECT DESCRIPTION

A. Perceived Problem

The economic experiences of the 1980's have led many Sub-Saharan African (SSA) countries to reconsider their approach to development. Misdirected domestic policies, substantial budget deficits, excessive external indebtedness, increasing trade deficits and drought have all caused major revisions in development philosophy. Most SSA governments now rely increasingly on market signals to allocate resources. However, the development of efficient financial systems necessary to fully realize the potential of the free market lags behind.

1. U.S. Assistance for Africa, the Development Fund for Africa (DFA), An Action Plan for FY 1989-91, May 1989.

2. Financial Markets Development, A.I.D. Policy Paper, PPC, August 1988.

The importance of efficient financial systems cannot be stressed enough. For instance, a stable, widely accepted currency reduces the cost of transactions and facilitates trade specialization in production. Financial assets with attractive yields, liquidity, and risk characteristics encourage savings. A variety of investment opportunities increases the efficiency of resource use. Access to a variety of financial instruments enables the pooling of price and trade risk. These four activities - trade, the efficient use of resources, saving, and risk taking - are the cornerstones of a growing economy.

In the past, governments' efforts to promote economic development by controlling interest rates, directing credit to priority sectors, and securing inexpensive funding for pet activities, have undermined sound financial market development. Recently, many borrowers in Sub-Saharan Africa have been unable to service their loans. This has forced governments to restructure insolvent financial institutions and begin rethinking on how to prevent future collapses in their financial systems.

In recent years, the Bureau for Africa has also sought to increase its knowledge and understanding of the financial systems in Sub-Saharan Africa and the relationship of the financial sector both to private sector development and to the policy reform process. AID/W has thus far financed several studies. In 1987, a report was prepared by Wharton Econometrics entitled, "The Role of the African Financial Sector in Development," covering a profile and analysis (based on a desk study) of eleven African countries with suggestions for financial sector reform. In 1988, Prof Jo Ann Paulson, University of Minnesota, completed a paper entitled, "African Financial Systems During Policy Reforms, Overview of the Issues" which concluded that, "There are still many unresolved theoretical issues on financial and economic reforms in small open economies and almost no empirical work on financial reforms in Africa." Prof. Paulson's paper did not cover franc zone countries. The following paragraph from her Executive Summary provides a brief overview and sketch of many of the African financial systems included in her paper:

"This survey focuses on financial sector problems common to many SSA countries. These problems include very thin financial markets with significant market power for the larger banks and no organized equity markets, perverse government regulations and intervention in the financial sector, and the broader structural characteristics of the economy, such as costly information, imperfect and missing markets, uncertain property rights, which inhibit intermediation. Most countries have inefficient high-cost systems of intermediation with low levels of resource mobilization and obvious problems in credit allocation and collection. These problems have led to national financial structures biased towards short-term debt financing and vulnerable to changes in interest rates, credit contraction, and credit quality problems in financial institutions. Past inappropriate macroeconomic policies and concentrated lending to inefficient import-substitution ventures left the formal financial systems vulnerable to the economic problems of the 1980s which are now manifest in poorly performing portfolios and rising bad debt. Since many countries are facing financial instability, interest has focused on financial reforms, particularly liberalization of the financial system."

In mid-1989, the Bureau for Africa in conjunction with PPC, the IBRD and the IMF sponsored a 3-day conference on "Policy Reform and Financial Sector Research in Africa." Conference participants included not only financial specialists from the sponsoring agencies but also academics from U.S. and European universities, African central bankers, financial research specialists and commercial bankers. Eight formal papers were presented and discussed, covering both the formal and informal financial sectors. The results confirmed Prof. Paulson's statement on the lack of empirical research on African financial systems and the unresolved theoretical issues and emphasized the urgent need for additional research. Although the final conference paper outlined major areas for further research (included in research agenda on page 4), a precise, definitive, priority-ordered agenda was not established.

In late FY 1989, the Bureau approved an unsolicited research proposal from the University of Minnesota. This research proposal (and cooperative agreement) will provide a two-country case study covering the general issues of: (a) interaction of macroeconomic and financial reform; (b) financial sector regulation; (c) efficiency of intermediation; and (d) financial innovation. Final details on the hypotheses to be tested and selection of the second country to be included remain to be determined (Malawi has already been selected as the first country). We anticipate that these details will be discussed and reviewed with the recipient in early 1990. Field work will begin during the summer of 1990 and the study will be coordinated with the larger-scale research effort proposed in this document. The total cost of this research effort is \$325,000 with a three to four year research time frame.

B. Project Goal and Purpose

1. The Project Goal is to promote broad based and sustainable economic growth by increasing the efficiency and accessibility of financial services to productive private sector activities. Attainment of these goals may be verified by improved economic performance and the broadening and deepening of financial services available to the private sector. Major assumptions underlying these goals are that conditions of macro-economic stability either exist in the economy or a policy reform program is in process which will establish those conditions expeditiously, and that their exists adequate and sustained commitment by the host country to implement a substantive financial policy reform program.

2. The Project Purpose is to increase host country and donor understanding of the operations of the financial sector in SSA and to facilitate the application of this increased knowledge to appropriate development policies and programs. In order to increase the relevance and quality of the research program, the integration of the results into host country financial systems, collaborative research arrangements and relevant training will be an intrinsic aspect of the project.

C. Expected Achievements/Accomplishments

This is an empirical research project. In large part, the accomplishments can be outlined in terms of the issues and concerns that will be addressed and the usefulness of those results in the design and implementation of future financial liberalization programs. As a research project, some of the issues to be studied may not be soluble within the time period of the project plan.

At the same time, the research on some issues may give birth to new issues not yet conceived. In addition, the proposed project will have both training and networking components that will sustain and generate additional research activities in SSA after this project has been completed.

1. Research Agenda

The proposed research agenda is divided into several major subject areas with a listing of questions that highlight appropriate issues. This is not an exhaustive list and will probably be revised or expanded during both the final project design stage and the implementation of the research work program.

a. Coordination of Macroeconomic and Financial Reforms: Experience in Asia and Latin America showed that it is extremely difficult (nearly impossible) to manage financial reforms and liberalization of the economy without macrostability. Even accepting this presumption tells us little as to the appropriate timing of financial reforms during the policy reform or structural adjustment process. Is there an optimal timing (or at least second best) for moving toward financial sector reform as other macro or sector policies are being put in place and implemented? What strategies have been adopted? What were the analytical bases, if any, for the adoption of these strategies? What were the results? For example, were attempts made to change monetary control regimes, establish interbank markets, Treasury Bill auctions or new money market institutions to supplement or support macro-economic policy reforms? What alternative strategies for financial liberalization were implemented during macro-economic policy reforms? Is there any theoretical basis or model to provide general guidance?

b. Imperfections in Financial Markets: Thin markets with inadequate competition often jeopardizes efforts to liberalize financial systems. For example, interest rate liberalization (deposits and loans) may not result in more efficient allocation of savings and investment if commercial bank mergers overwhelms the positive impact of this action. Will interest rate liberalization stimulate competition? In most African financial markets, the variety of financial instruments is extremely limited. In order to overcome this, should governments establish equity markets or allow the commercial banks to take equity positions? Are unit trusts or universal banks viable options? What do missing equity and insurance markets mean for operation and regulation of other parts of the system? What does market power in banking mean for regulation and macroeconomic policy? Can the government stimulate competitive behavior by lowering barriers to entry, changing the institutional mix, or reducing restrictions on allowable activities among financial institutions? Will this be adequate to stimulate competition and efficiency? If the banking (or financial sector) does not develop more competitive behavior within a reasonable period of time, what options are available and what agency (the Central Bank?) is available to utilize these options? Is the regulatory power of the Central Bank adequate or necessary to make needed changes?

c. System Stability and Credibility: Financial liberalization and new entry in most instances will increase the risk factor to existing financial institutions. Stronger regulations and supervision are

essential but will not eliminate the risk. What alternative government policies are available to deal with potential instability during liberalization? Does depositor insurance stabilize systems? Is it feasible to allow individual institutions to fail without depositor recourse? Are there various types of insurance schemes, partial and risk-oriented, that should be given serious consideration? Is market discipline consistent with depositor insurance schemes? Are risk-based capital standards with limited depositor insurance a sensible alternative?

d. Welfare and Development Objectives: Even within a completely liberalized and competitive financial market there may be instances in which welfare objectives rather than purely economic optimization may be legitimate. Increasing access to financial services by the poorer groups in a society may generate positive welfare benefits, but the economic and financial transaction costs may also be unduly high. What methods or techniques have been utilized and/or available to minimize costs and encourage accessibility? How have they worked? Formal financial systems are practically non-existent. Should priority be given to expanding financial services to the rural economy?

Development finance institutions (DFI) are possibly another instance of special demands that may not fit the liberalization mold. Can a government institution, for example, be held accountable to commercial standards and maintain autonomy in management and enforcement procedures? Can subsidies be limited and made transparent? Or is the only issue the method of privatizing the DFI?

e. Institutional Design and Financial Innovation: The limited research undertaken has indicated that financial innovation in Sub-Saharan Africa has been minimal. A major contribution in limiting financial innovation has been the assurance problem, that is the range of uncertainty as to the rules of the game governing exchange, cooperation and competition among individuals. The macroeconomic approach of institutional economics might be helpful in dealing with this problem. Finance is an institution, and the primary function of any social institution is to define the expectations of behavior for individuals operating in the system.

Two other dimensions (other than lack of competition, interest rate ceiling, etc) that have compounded the assurance problem and lowered incentives to innovate are the expensive and unreliable information and uncertain enforcement mechanisms on financial contracts. It should be noted that informal markets usually have an advantage in significantly lower information, transactions, monitoring and enforcement costs to develop contracts suitable for the structures of the local economy. It's problematic but certainly worth a significant investment in research resources to review informal financial arrangements, possible linkages with the formal financial sector and transferable experiences. Induced financial innovation is a necessary link between liberalization and development of the markets with new instruments and contracts and expanding clientele. To what extent, aside from legal aspects, does government have a role to play in encouraging financial innovation? Are there any worthwhile non-SSA models that provide useful guidance in the design of financial innovations?

2. Training

This research project will support short-term training for a cross section of policy-makers, researchers, central bank staff and other financial sector operations personnel. Recipients will undertake workshops and seminars as part of their training function. In view of the probable data limitations, training in data generation, collection and analysis will also be required, as well as training in computers, statistics and survey methodology.

3. Networking in the US and SSA

The project will promote development of formal and informal networks between US and SSA researchers, practitioners and policy-makers. Networking is an important element in the objectives of the project, and the selected recipient, possibly a US academic institution or research institute with university affiliations, will be responsible for actively implementing this objective. In many (if not most) instances, research activities will require collaborative relationships with African institutions (Central Banks, government ministries and/or academic institutions). Although this is primarily a research project and not an institutional development project, these types of collaborative relationships are likely to be necessary in order to generate a quality product. The research output generated by this project should be considered as the beginning of a process that will continue, not only in the US, but in the SSA long after project completion.

D. Project Outline and How it Will Work

The PP design team will endeavor to formulate a suggested research program. Currently, two general approaches are being considered. They are the country case study and the functional or subject study. One or a mixture of these two approaches may prove most suitable. Rather than specify the preferred option in the PP, an alternative strategy is to request bidders to provide a research strategy as an element in the selection process.

The country or case study approach examines the financial sector of a selected group of countries. It analyses the operations and functioning of the sector in each country using the general framework of questions posed above. Each case study will be unique and the scope of work and analysis tailored to the specific country conditions. A comparative or integrative study will then provide general lessons learned from the various country case studies and examine cross-cutting issues that may have more general application.

The functional method looks at a broad category of issues and then selects countries in which to test hypotheses related to these issues. A few illustrative topics include: monetary management, rural credit and financial sector innovation.

A combination of the two approaches is feasible. The advantage of the functional method is the feasibility of including more analytical country examples for SSA than may be feasible in adopting the country case study method. The country case study method deals more closely with the total financial sector environment and may have more validity and specificity than the functional approach. It's likely to be more attractive to USAID Missions

since it is specifically tailored to a country situation and potentially useful in the design and implementation of financial sector reform programs.

III. FACTORS AFFECTING PROJECT SELECTION AND FURTHER DEVELOPMENT

A. Social Considerations

As outlined above in section II. A., many of the financial sectors in SSA countries are seriously deficient. Thin financial markets, directed credit, subsidized or negative interest rates, etc. are prevalent. The financial sector has not had the opportunity to adequately support the process of sustainable economic development and growth based on increasing incentives and encouragement of the private sector. In many instances, political decisions by centralized government economic planners have dominated and sublimated the proper functioning of the financial system to the financing requirements of parastatal organizations and budget deficit financing. This has been to the detriment of all segments of African societies, especially those relegated to subsistence livelihoods.

A major purpose of this empirical research project is to provide a sound analytical framework that can facilitate the movement toward a liberalized financial sector that can meet the needs of a growing economy; e.g., financing the development from micro- to small enterprises, increasing trade and increasing savings and risk-taking opportunities. The establishment of a sound, credible and stable financial sector will benefit most segments of society in the short run and all in the long run. It will provide savers with the opportunity to invest in financial assets and earn a reasonable, competitive return on deposits or other financial instruments. More efficient competitive financial intermediation is likely to increase the quantity and quality of investments, generate additional employment and sustain the growth process. Investors, savers and the labor force will benefit from a financial system that responds to private sector decisions and operates within a regulatory framework that generates confidence in both the saving and investing public.

A financial sector that is given the opportunity to operate within a liberalized, competitive framework with adequate prudential regulation and supervision has a far greater probability of generating confidence and stability and providing increasing accessibility to financial services for major (and eventually all) segments of the population. The extent of the accessibility that is consistent with sound financial development remains to be determined and will be explored in the research project.

B. Financial and Economic Considerations

Financial liberalization, given certain conditions of prudential regulation and supervision, will result in a more efficient financial system when compared to the current situation in many SSA countries, which will in turn lead to stronger economic growth that is more likely to be self-sustaining. That is the motivating factor underlying this research project. Efficient financial systems are needed to support the private sector, which the entire economy depends upon for future growth. Without the

development of adequate financial systems, the private sector will be unable to provide its optimal contribution to the growth of income and welfare. The lessons learned from this research project, whether economic, financial or institutional, will be useful in the design and implementation of future financial sector liberalization or financial sector adjustment programs. It will provide a knowledge base for restructuring or revising financial systems so as to optimize the outputs and operations of the most productive sectors of economies. Increased access by all segments of society to financial institutions, increased domestic savings, stability, credibility, more efficient allocation of resources to promote more profitable returns on investment and hence increased economic development for all is the primary economic justification for proceeding with this research project.

C. Relevant Experience with Similar Projects

Official A.I.D. policy on the financial sector is to promote integrated and undistorted financial markets based on competitive financial institutions and on policies that facilitate competition. Increasingly in recent years, A.I.D. and other donors have promoted policies aimed at liberalizing the financial sector in African countries and fostering private entrepreneurship. Many efforts along these lines are ongoing and will be described below.

However, these ongoing efforts base the need for liberalization and institutional reform on existing models developed primarily in the context of what works in the developed world and how these conceptual frameworks were then applied to Asia and Latin America. Most existing projects have specific targets, such as the benefits of simplifying tax codes, privatizing banks and incorporating the informal sector. The proposed research project will endeavor to generate a better understanding of how the financial sector functions in the African context as distinct from Asia, Latin America and the developed world. To what extent the models derived from non-African economies are applicable to SSA remains to be determined.

The time is ripe for this type of analysis. Many African countries are in their third decade of independence and have each attempted a number of development strategies. It is now possible to look at the financial sectors in African countries over time and possibly develop relevant models explaining not only how they actually work but methods for increasing their efficiency and equity.

This financial sector research project seeks to complement and strengthen both AID and multilateral efforts by providing an African financial sector framework within which current and future projects can be designed and modified.

Several other financial sector activities are briefly described below. The other AFR/DP research effort (ref. page 3) will be coordinated with the current project proposal and may be useful in providing information as to the most appropriate analytical framework for the proposed more expansive AFR/DP research effort. The S&T FIRM project dealing with rural and informal finance will be, in good part, complementary to the AFR/DP project proposal insofar as African case studies are included. The PRE contract with Price Waterhouse has a small research component and the AFR/MDI evaluation program does not include

any long-term research efforts. The preparation of this PID, as well as the AFR/DP program in financial sector research has included meetings with all these groups and discussions as to the probable contents of the respective research programs. Continued regular communications between these groups should generate information and analyses that will be mutually beneficial to the parties concerned and minimize redundancy in the research activities. The plan is to include a representative of some of the AID units mentioned above in the PP design team. Moreover, project implementation arrangements will call for an appropriate degree of coordination to avoid any potential overlap among those activities.

Science and Technology Bureau (S&T)

S&T is undertaking a \$21 million (\$6 million S&T finances: \$15 million Mission buy-ins), 10 year, financial resources management (FIRM) project aimed at increasing the knowledge base on factors that affect the performance of rural and informal financial markets. FIRM follows on the heels of the Experimental Approaches to Rural Savings (EARS) project with the goal of promoting broad based, participatory and sustainable economic growth by expanding access to financial services to the general populations of the project countries. Specific African countries to be looked at are not yet determined. S&T is also embarked on the GEMINI project aimed at enhancing the position of microenterprises in competitive markets and improving their access to credit.

Bureau for Program and Policy Coordination (PPC/PDPR)

PPC has in the past and is currently sponsoring a variety of research activities in the area of financial markets. Primarily operational and instructional in nature, current efforts include studies on "Liberalization and Privatization of the Financial Sector in LDC's," and "Forging Greater Integration and Internationalization of Financial Markets." The first study seeks to outline the rules of the public sector in LDC financial systems with the aim of developing policies and plans to privatize state-owned financial institutions and the methods of liberalizing LDC financial systems. The second study seeks to explore policy approaches that will forge stronger linkages between the financial markets of developed and developing countries. Past studies have looked at taxation, privatization, interest rates, alternative financial instruments and equity markets in a variety of ways to promote policies of liberalization and privatization in LDC's. As stated, these studies are primarily operational in nature and less concerned with the overall macroeconomic framework in which LDC economies operate, much less the discrete characteristics of African economies. PPC has also contracted for the development of three books during FY 1990. These books will discuss capital markets and taxation in the developing world generally, and financial sector policy reform and research in Africa as a bi-product of the June 20-22, 1989 conference (see p. 3).

Bureau for Resources and Private Enterprise (PRE)

PRE, in conjunction with a Price Waterhouse led consortium, is on the verge of implementing a project aimed at working with Missions to determine what type of financial sector interventions are appropriate in the relevant

host country settings. In preparation, a complete literature review on financial liberalization will be undertaken and based on the results of this review, two country case studies will be performed with the aim of making policy recommendations. Subsequently, Price Waterhouse will work with individual missions to determine what country specific financial interventions would be appropriate to promote a free market economy.

PRE is also developing a worldwide project in 5-6 countries aimed at institutional reform and the informal sector. Based on the experiences of Hernando de Soto who found that businesses operating outside of the formal sector in Peru were by and large forced to do so because of institutional inadequacies, this project seeks to investigate in a number of countries the types of institutional burdens that are forcing businesses to operate outside the formal sector. Additionally, the project will develop a network of US and LDC academics and other experts on institutional analysis and strategy development.

Bureau for Africa - Office of Market Development and Investment (AFR/MDI)

MDI has supported a number of financial sector initiatives in Africa aimed at privatizing state owned enterprises, formal and informal finance, micro- and small enterprises, trade, and natural resource exploitation. None of the MDI activities are research oriented. MDI promotes the general movement in Africa to relieve constraints on private sector expansion by changing the regulatory structure to facilitate private sector exports, liberalizing the banking system to encourage local investors, and reducing competition from government-owned industries by privatization. Considerable A.I.D. funding is now being directed to private sector technical assistance to provide expert knowledge in planning reforms such as tax and investment codes, privatization, and capital market development. MDI has worked to enhance the position of private sector offices at A.I.D. missions in Africa, coached host country nationals in private sector operation and management, worked with OPIC for the establishment of Enterprise Zones in two African countries, implemented a Manual for Action in the Private Sector (MAPS) in a number of African countries and supplied technical assistance to Uganda and Malawi aimed at returning industrial and agricultural operations to the private sector. MDI also cooperates with other US agencies and donor organizations to coordinate private sector activities.

The World Bank and IMF

The World Bank Development Report of 1989 represents a comprehensive global analysis of financial institutions with various theories of what is currently occurring in the developing world compared to the experience of the "developed" countries. However, even to the extent that these analyses make use of data over time, they are very operational and not research oriented. World Bank and IMF staff and researchers all agreed at the jointly sponsored Conference on Policy Reform and Financial Sector Research in Africa (June 20-22, 1989) that the available empirical research on SSA financial sector operations was sparse and needs to be greatly expanded. It was clear and agreed to at that meeting that the joint sponsors (AID, the World Bank and the IMF) of the conference will continue an effective working relationship to substantially expand the African financial sector knowledge base. In another effort, the World Bank, USAID, UN and a number of other donors have been

contributing to a UNDP effort to reconcile and standardize Africa's statistical database. This project began in 1986, and efforts are underway to extend it through 1991. The improved statistical data could be useful to the proposed research effort.

Conformity with Mission Strategies

In recent years, the African Bureau has increasingly recognized the importance of the financial sector in Africa and, where appropriate, supported the efforts of African countries to better develop and liberalize their financial institutions. In Senegal, AID recently approved a \$32 million Sector Program grant tied to policy reforms in the banking industry. These reforms will include better inspection and supervision of banks, bank privatization and restructuring, better bank management and improved systems for pursuing bad debts. In FY 1989, A.I.D. approved a \$40 million program for Zaire that will concentrate on reforms affecting the private banking sector under the Private Sector Support Project. This project is conditioned on Zaire's continuation of measures to improve the economic environment and on long-term policy dialogue on measures to increase banks' resource mobilization and credit to private enterprises. In the Gambia, AID is planning to assist in the second phase of the highly successful Economic Recovery Program (ERP) with a \$5 million sector program grant aimed at policy changes in the allocation of bank credit ceilings, improvements in reserve control techniques, promoting prudent and efficient regulation and supervision of financial institutions, and privatization of the country's largest commercial bank. In addition, the Agency plans to include a \$1.5 million grant for studies and technical assistance. In Burundi, AID recently sponsored a major study of the financial sector over the past five years. This study looked at the financial establishment as a whole, banking regulations, credit operations, lending practices and credit to small- and medium-size enterprises. The proposed research effort will complement these and future financial sector projects by providing a clearer framework within which the financial institutions in Africa operate.

On September 8, a telegram (State 287993) was sent to all African missions soliciting feedback on the proposed research project. The 10 responses to the cable were mixed. Although there was general consensus of the need for financial sector research, there was also the strong feeling that this research should be applied or operational and on a case study basis. As part of the PP design, a follow-up telegram will be transmitted to USAID Missions outlining the results of the PID review and requesting more current views and opinions. In addition, a copy of the PID, if approved, will also be pouched or faxed to Missions as additional background to the telegram.

D. Proposed Implementing Agency

An American university or research affiliate with financial sector research experience in Africa are logical candidates to be the primary implementors of this research program. A number of such universities - Ohio State, Cornell, Harvard and others - have undertaken these types of research activities for A.I.D. in the past, and have demonstrated the type of long term commitment, access to researchers with varied skills and interests and adequate research facilities necessary to undertake this type of major research effort.

E. AID Support Requirements and Capability

The Financial Sector Research Project will be centered within the offices of the selected recipient and will be managed by a full time professional of that organization. Close monitoring and coordination will be maintained by an officer in the Policy Analyses and Research Division of the Office of Development and Planning in the Bureau for Africa (AFR/DP/PAR). The AFR/DP/PAR officer will also be responsible for ensuring that project activities are being coordinated with other A.I.D. bureaus undertaking related activities in order to both avoid unnecessary duplication and to coordinate programs in a way that will generate mutually beneficial outputs.

AFR/DP/PAR is currently project manager for the Policy Reform and Poverty Project (698-0519), a \$9.5 million cooperative agreement with Cornell University to estimate the impact of policy reform programs on lower income groups in selected countries in Sub Saharan Africa. This research is similar in scope and life of project to the activity outlined in this PID. It began in FY 1987 and will conclude in FY 1994. The Division is also managing two shorter-term research activities on: 1) traditional exports and 2) managing the policy reform process. No additional staff will be required in order to handle the new project management responsibilities.

F. Estimated Costs and Methods of Financing

Inputs to the FSR project will be funded by the Africa Bureau from the DFA and through financial contributions from USAID Missions in Africa. The project, under current planning guidelines, is estimated to cost about \$10 million. The Bureau has budgeted \$5 million over the FY 1990-94 period as core funding. Based on the experience of the Policy Reform and Poverty Project (698-0519), a 50-50 Bureau/Missions distribution appears to be a sensible first approximation. Under that project, Cornell Cooperative Agreement No. AFR-0000-a-00-8045-00, USAID Mission financial contributions will be \$4.6 million and AID Washington core funding, \$4.9 million. Under this proposed project (698-0522), the Bureau will commence funding in FY 1990 with a \$0.5 million obligation; \$1.5 million in FY 1991 and \$ 1 million in each of fiscal years 1992, 1993 and 1994.

G. Design Strategy

The PP design strategy will be formulated and developed by AID/W with the assistance of the USAID Missions. In respect to USAID Mission inputs, the Bureau decision on the PID will be telegraphed and a copy of the final PID panifaxed or pouched, requesting Mission comments and views. That request will include both Mission interest in participating in the research program and suggestions as to the structure of the program and major issues that should be included in the activity.

The AID/W PP design team will consist of representatives of AFR/DP, AFR/PD, AFR/MD, PRE, S&T and PPC. Various alternatives will be discussed. For example, as mentioned previously, it may be appropriate to request the bidders on this research project to provide outlines of their research strategies to meet the objectives of the project. Various parameters would presumably be established with requests for bids.

The PP design team should also include within its terms of reference the recommended legal relationship between the successful bidder and A.I.D.: e.g., grant, cooperative agreement or contract.

It is anticipated that a PP for Bureau review will be completed by April 1990.

Appendix A

PROGRAM DESIGN SUMMARY

PRELIMINARY LOGICAL FRAMEWORK

Life of Project
 From FY 1990 to FY 1994
 Total US Funding: \$10 million
 Date Prepared: 1/8/90

Program Title & Number: Financial Sector Research Project (698-0522)

<u>Narrative Summary</u>	<u>Objectively Verifiable Indicators</u>	<u>Means of Verification</u>	<u>Important Assumptions</u>
<p>A. <u>Program or Sector Goal: The broader objective to which this project contributes:</u></p> <p>-To promote broad based and sustainable economic growth by increasing the efficiency and accessibility of financial services to productive private sector activities</p>	<p><u>Measures of Goal Achievement:</u></p> <p>-Growth rate of GDPs -Share of private sector contributions to GDPs of respective countries</p>	<p>-National Income Accounts, and IMF/IBRD estimates -Host governments financial sector statistics -Host government central bank reports</p>	<p><u>Assumptions for achieving goal targets:</u></p> <p>-Continued performance by African governments under IMF Extended Structural Adjustment Programs</p>
<p>B. <u>Project Purpose</u></p> <p>-To increase host country and donor understanding of the operations of the financial sector in SSA countries and to facilitate the application of this understanding to appropriate development policies and programs</p>	<p>-Donors and host countries use research data to improve performance of financial systems in SSA countries</p>	<p>-Project monitoring and evaluation</p>	<p>-Conclusions of the research have sufficient credibility to warrant adoption and implementation by donor community and host countries</p>
<p>C. <u>Outputs</u></p> <p>1. Case studies examining the financial sectors of selected SSA countries</p> <p>2. Functional or subject studies examining sub-sector topics (e.g., rural credit or monetary management) across a broad range of SSA countries</p>	<p>___ number of case studies completed</p> <p>___ number of functional studies completed</p>	<p>-Project monitoring -Project evaluation</p>	<p>-Host countries agree to cooperate in the execution of these studies.</p> <p>-Data is available and adequate to undertake meaningful studies</p>

D. Inputs

Project funding of up to \$10 million will finance the provision of technical services to carry out the studies in question over a five year period.

Appendix B

Initial Environmental Examination

COUNTRY: Africa Regional
PROJECT TITLE: Financial Sector Research Project (FSRP) (698-0522)
FUNDING: Proposed Funding (LOP) - \$10,000,000 (DFA)
PERIOD OF PROJECT: FY 1990 - FY 1994

Activity Description: The program is an empirical research project aimed at determining the best way to move toward efficient liberalized financial systems, compared to the current unsatisfactory financial systems that exist in most Sub Sahara African countries. Most likely the contractor will be an American University that will undertake various studies of selected African economies using post independence data to determine how financial systems function in Africa as compared to the developed world and the development experiences in Asia and Latin America. Individual missions will have the opportunity to effect a country buy-in for a targeted host-country study.

Environmental Action Recommended: Categorical Exclusion in accordance with 216.2 (c)(2)(xiv).

RCX

IIE Prepared by: Bob Kerr, Project Development Officer, AID/Washington

Bureau Environmental Officer's Recommendation:

Approved: *P. Boyd, AFR/TR/ANR*
Bureau Environmental Officer, AFR/TR

Disapproved: _____

Date: DEC 15 1989

Clearances: GC/AFR: PJohnson _____