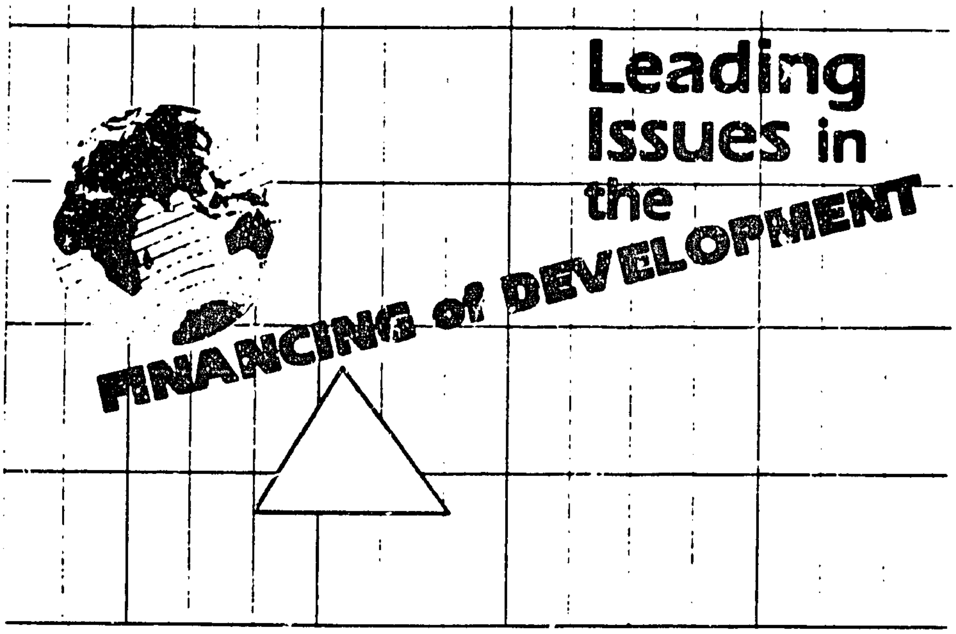
THE FINANCIAL SECTOR IN DEVELOPING COUNTRIES:

LEADING ISSUES IN THE FINANCING OF DEVELOPMENT

Washington, D.C. August 18-21, 1991

REPORT OF THE PROCEEDINGS



U.S. Agency for International Development

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FOREWORD

The rapid changes affecting developing countries in politics, economics and technology in the 1990s are no where more evident than in the realm of finance. We indeed are experiencing a global financial revolution in the speed and versatility with which we fund economic growth. These changes have tremendous implications for how the U.S. Agency for International Development and other donors might best interact with the public and private sectors in supporting financial market development in developing countries and the new emerging markets of Eastern, Central Europe and the Commonwealth of Independent States.

During August 18-21, 1991 it was my pleasure to open and then participate in an Agency-wide workshop which grappled with these issues and their programmatic implications for U.S.A.I.D. This workshop was extremely informative for all participants in a variety of technical areas, ranging from institutional innovations to democratize capital, to building and regulating financial markets. In addition, the workshop was a useful forum to receive feedback from field AID Mission personnel on how this might affect future AID programs in technical assistance, training and credit/credit guarantees. Following the workshop, an Agency-wide Financial Markets Working Group has been formed to continue to share information (both in and outside the Agency) and to identify areas for future U.S.A.I.D. programmatic intervention in this area.

I wish to congratulate Donald Lessard for his excellent work in designing and organizing the workshop, as well as Richard Breen and his staff at Price Waterhouse for both their substantive and logistical contribution to the workshop. As co-chairmen of the Agency-wide steering committee which coordinated the overall organization and funding of the workshop, Lance Marston, Senior Business Advisor of the Europe and Near East Bureau, and Michael Unger, Chief Financial Economist of the Private Enterprise Bureau, also did an outstanding job. Finally, I would like to acknowledge the contribution which Gary Vaughan, Private Sector Officer with the Europe and Near East Bureau, made to the success of the workshop, particularly in designing and coordinating the production of a Regional Guidebook on Financial Markets which was presented at the workshop.

As one of the new "emerging sectors of development" under the Agency's Business and Development Partnership Initiative, financial markets present a number of interesting policy and programmatic possibilities. In the weeks and months ahead, I will monitor with interest the actions and next steps which flow from this important workshop.

John E. Mullen
Interim Assistant Administrator
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PREFACE AND ACKNOWLEDGMENTS

APRE and ENE Bureaus, in cooperation with other regional bureaus, recently sponsored an A.I.D.-wide workshop on "Leading Issues in the Financing of Development." The workshop took place August 18-21 in the Washington area and involved some 55 participants representing 11 A.I.D. fild missions, several AID/Washington offices, and a variety of academic, public and private sector experts in the field of finance. Keynoted by AA/PRE's John Mullen, the workshop also involved the participation of John Blackton of A/AID, Henrietta Holsman-Fore, AA for the Asia Bureau, and several Mission or deputy Mission Directors from throughout the Agency. Key topics in the workshop included the global financial revolution and its implications for the financing of development; increasing equity participation; structured financing and securitization; institutional innovations to democratize capital; swaps, options and guarantees; building and regulating financial markets; and policy and programmatic implications for A.I.D.

The purpose of this workshop was threefold: first, to inform U.S.A.I.D. regarding a variety of innovative techniques of international finance; second, to assess their relevance for the financing of development; and third, and most importantly, to conduct an Agency-wide strategic assessment of future A.I.D. programming and policy directions.

As communicated previously to all AID field Missions in State 307467, the key conclusions reached at the workshop can be summarized as follows:

-- General Economic and political Rationale: A properly regulated financial system has an enormously important role to play in supporting sustainable economic growth in developing countries, and many A.I.D.-assisted countries' financial systems need help. We need to perceive them as dynamic systems, and not as passive channels for directed credit. Moreover, expanded A.I.D. work in this area does not aim to favor the rich or exacerbate "crony capitalism" in such countries, but rather quite the opposite. By broadening and deepening the financial system, donor programs should strengthen the forces of competitive capitalism, and lead to more open and pluralistic societies.

-- U.S.A.I.D.'s Capabilities: The workshop made clear that the Agency has more to learn regarding many of the modern techniques of international finance, and how they might be appropriately applied in LDCs. However, while many A.I.D. officers may need to update their skills in order to more effectively manage programs in this area, this does not imply a requirement for widespread long-term, M.B.A.-type training for A.I.D. officers. Rather, we can meet the requirements for these skills through a mix of general short-term training for most A.I.D. staff, more intensive training for a few in-house specialists, and appropriate contracting of outside technical experts. Participants also noted that greater availability of AID/W central contract resources in finance would also help strengthen missions' ability to respond appropriately in this area.

-- U.S.A.I.D.'s Comparative Advantage: While A.I.D. may need to update some of its technical skills in financial markets, workshop participants agreed that we already have a comparative advantage (vis-avis many other donors) in this programming area due to our on-the-ground knowledge and network of local contacts in both the public and private sectors.

-- Policy Reform vs. Transaction Support: Participants were unanimous that the Agency can and should work with host governments to develop a conducive business environment required for financial market development and to strengthen the legal/enforcement infrastructure for prudent surveillance. Without appropriate policies, economic and financial market development may be badly handicapped. However, policy reform alone will not guarantee adequate financial system growth. Actual A.I.D. involvement in and support for the use of new financial instruments may be appropriate in many country contexts. Andres Velasco from Chile's Ministry of Finance emphasized that especially in poor countries, economies do not work unless they are prodded into "virtuous circles." The importance of A.I.D. involvement in important financial transactions which have a potential demonstration effect was cited repeatedly by participants and speakers alike. Both John Mullen and Henrietta Holsman-Fore emphasized the importance of transactions, "to make things happen."

-- Collaboration with other Agencies: It was noted that many other donors and U.S. government agencies have both additional resources and specialized expertise which U.S.A.I.D. should tap as we expand our programmatic activity in this area. Such agencies include not only traditional donor partners such as the World Bank, but often less familiar actors such as the International Finance Corporation (IFC), the Securities and Exchange Commission (SEC) and the Federal Reserve System.

-- A.I.D. Policy Context: AA/PRE John Mullen noted in both his opening and closing remarks that our work in finance should not be viewed in insolation, but rather as complementing our expanded work in other private sector programming areas. Such areas include trade and investment, privatization, capital projects and our broader political objective of promoting more pluralistic and democratic societies in the developing world and emerging democracies.

While the above provides the key general conclusions reached by participants during the workshop, the following proceedings provide greater detail. The first section of the proceedings is organized under the eight topical areas covered during the conference, with subsections attributed to a specific speaker or panelist marked by highlighting that individual's name. The second section summarizes participants' feedback during the workshop, mostly conveyed in the context of small breakout groups. Finally, the third section amplifies some the conclusions and next steps for the Agency as specified by various A.I.D. officers during the last day of the workshop.

The appendix includes two groups of materials distributed during the workshop. The first is a copy of the programmatic agenda as well as a list of workshop participants. The second contains excerpts from key resource materials handed out at the workshop. These include selections from the Agency's Regional Financial Markets Guidebook, the A.I.D. Policy Paper on Financial Market Development, the Center for Development Information and Evaluation's (CDIE) discussion paper on directed credit, an excerpt from the World Bank's World Development Report 1989: Financial Systems and Development, a current edition of the Private Enterprise Bureau's Financial Sector Development Project's (FSDP) Update bulletin, plus a listing of recent Price Waterhouse technical assignments around the world under this project.

We wish to thank all those who assisted in carrying out this important workshop, whether through their participation or presentations at the event itself, or their involvement in funding and organizational support. Donald Lessard did an excellent job in both structuring the overall design of the workshop and in making key presentations during the event. We also appreciated the fine contributions of the many technical presenters during the workshop as well as selected A.I.D. mission representatives. Their names are detailed in the program agenda in the appendix. Richard Breen of Price Waterhouse was also helpful in providing input for the workshop's design and technical presentations, and his staff (especially Barbara Friday, Patricia Parera and Priscilla Schroy) made an invaluable contribution in assuring final preparations and logistical arrangements for the workshop. Finally, we would like to thank Karim Solh for serving as a rapporteur and for writing and compiling this report.

This workshop was particularly noteworthy in that all of A.I.D.'s regional bureaus, as well as the Private Enterprise Bureau, contributed both time and funding toward the eventual realization of the workshop. As co-chairman of the Agency-wide steering committee which designed and organized this workshop, Lance Marston's assistance was particularly appreciated. Members of the A.I.D. Working Group who were especially helpful in shaping the workshop agenda and in identifying supporting funding and other resources included Warren Weinstein of AFR/ONI, Jim Fox and Clarence Zuvekas of LAC/DP, Laurie Landy of PPC, and Sandra Frydman of PRE/EM. Finally, we would like to express our appreciation to Henrietta Holsman-Fore, Assistant Administrator for Asia, and John Mullen, Interim Administrator of the Private Enterprise Bureau, and John Blackton, Executive Assistant to the Administrator, for their early support for this activity and for their able participation in the workshop.

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Chapter 1

PROCEEDINGS

1.1 The Global Financial Revolution and its Implications for the Financing of Development

The lead speaker, **Dr. Donald Lessard,** introduced the main theme of the conference: "financial innovations and their applications in developing countries in the context of radically increased global integration of real and financial activities." Participants, he stated, will examine the range of financial tools available, consider which ones are most relevant in particular development contexts, and assess the institutional preconditions for their successful implementation. Through this process, participants will sharpen their views on the role of A.I.D. in finance, identifying its leverage points and how it can apply these advantages in the development scene.

Dr. Lessard noted that while the outlines of the "new development finance" are not complete, it is possible to identify those elements of the "old development finance" that have not worked as a general rule. These include directed credits and credit-granting Direct Foreign Investments within countries, and general obligation government borrowing as the primary mode of cross-border finance. These, in turn, are part of an "import substitution" model of development finance, where the attempt was to replicate within individual developing countries the financial institutions and instruments of more advanced economies, with few international linkages.

In order to assess the potential contribution of particular innovations in financing development, it is important to develop a common vision of the functions of financial systems. Financial systems are often viewed as the "plumbing of the economy", capturing, aggregating, and channeling resources to various uses. In the context of open, plural societies, a more appropriate metaphor is that of the nervous system that signals resource availability and requirements, creates incentives, monitors performance, and imposes sanctions in the case of non-performance. In pursuing financial market development, A.I.D. must define and design this nervous system, taking into account its increasing openness and interconnection.

Changing Global Economic Context

The past 20 years have seen major shifts in the world economy and world financial markets, changes which have affected both the developed and the developing world.

Major changes in trade and investment include:

• Globalization of competition. The increased international integration of markets for goods and services. This greater interconnection of economies has resulted from a continuing decrease in costs of transportation and communication as well as barriers to trade, a convergence of customer preferences and requirements, an increase in the proportion of product costs represented by investments in intangibles such as product and process technology, and an increased sophistication of business firms in spreading their value-added activities around the globe.

• Regionalization. The integration of trade and investment and the underlying corporate activities is even more intense within specific regions, especially Europe, North America, and to a lesser extent Asia. Even areas such as Latin America are increasingly being treated as regions rather than as a collection of nations.

• Marginalization. Many developing countries do not affect the world economy in any major way. World financial markets, therefore, largely, ignore them.

• Marketization. A shift from state leadership to market incentives is taking place through privatization and deregulation. Privatization in countries such as Chile and Mexico has reduced public deficits, created new incentives for efficiency, and served as a strong signal regarding future growth prospects. Eastern Europe is beginning its massive transformation as well. Even in the OECD countries, deregulation and, in some cases, privatization is increasing the role of markets.

• Changing government role in international competition. Given the globalization and regionalization of competition, industries no longer operate within the limits set by national policies. Rather, such policies are now elements of competition within industries. Governments, regardless of their ideology, have become major players in the international competition through their fiscal, monetary, commercial and industrial policies. This, of course, substantially limits their degrees of freedom in tailoring policies to meet local needs.

The emergence of global competition has coincided with, and to some extent, given rise to major changes in the financial environment.

• The world economy continues to display a high degree of turbulence that has plagued it since the early 1970s. Divergences in macroeconomic policies and massive structural pressures have led to violent shifts of interest rates, exchange rates, and relative prices of commodities.

• Increased integration of national financial markets into a single global market has resulted both from deregulation and an increase in the market power and financial skills of corporate and institutional users of financial services vis a vis the traditional providers of these services.

This trend toward greater integration of financial markets is not universal, though. Many less-developed countries, in response to foreign exchange crises brought about by their own external borrowing coupled with variations in world economic activity and interest rates, have seen their financial systems cut off from the world by debt overhang. Thus the financial map of the world includes an increasingly integrated core and a large periphery that is dependent on but only loosely linked to the core international market.

• Increased securitization of finance, implying a reduced role of financial intermediaries both within and across national boundaries. A greater proportion of finance takes place directly between users of funds (both governments and corporations) and large suppliers of funds (usually institutional investors). In the past, to play in the large scale finance required a large branch network to amass funds. Today, such funds can be "bought" in the wholesale market. Vertical integration, therefore, is much less important than it once was.

• Financial innovation, not only in new instruments and transactions, but also in the information, trading, and document processing systems and analytical technologies that underpin them. New markets have been created for many specific risks, and there are more alternative ways to participate in projects and enterprises. While many of these innovations are relevant to developing countries, it should be noted that most are undertaken to meet the needs of borrowers and lenders from developed countries and LDCs will have to identify and adapt innovations appropriate for their own use.

• Given the degree of volatility and institutional flux, credit risks at the firm and country level will continue for the foreseeable future. There will be many shaky customers in world financial markets, with the resulting failures, bailouts, and workouts. This is likely to lead to an emphasis in financial markets on quality, which will further disadvantage less developed countries (LDCs) in their quest for resources.

The Changing Nature of Finance in Developing Countries

This changing external context, as well as major shifts in prevailing views of the efficacy of state leadership versus market incentives in guiding development, have resulted in major shifts in the nature of development finance as well. These include:

• Increased micro-level emphasis. In the 1970s and 1980s, LDC external financing was dealt with primarily on a macro level, with Ministers of Finance, the IMF, and Central Banks as the main players. In the 1990s, there will be a shift back to micro-level basics, finance at the project and enterprise level. The main players in this finance will be foreign direct investors, local entrepreneurs and foreign and domestic financial intermediaries. This is good news for A.I.D. because these micro-level players are its main constituencies, especially given its mission to promote open, plural societies through widespread ownership of capital and participation in capital markets.

• Disappearance of captive domestic savings in LDCs. To a large extent, these have already disappeared as local investors have transformed themselves into world investors through capital flight. For them to have remained at home would have been pure speculation. In this new environment, countries must compete internationally for capital, whether it comes from residents or foreign investors. When things are working well, capital flows both ways, with foreign direct and institutional investors investing in LDCs as local investors diversify internationally.

• New modes of finance. Rather than relying primarily on a combination of local short-term credit and external general obligation bank lending and direct investment, a variety of modes will be employed. These modes differ in terms of key characteristics such as the degree to which they involve risk sharing and managerial participation, and in many cases, a blurring of the distinction between domestic and international finance.

• Financial costs as a competitive factor. As LDCs open their economies and seek to compete globally, disadvantages in financing costs due to country risk and/or inefficient internal financial structures will become competitive disadvantages for locally-based firms, potentially offsetting low costs of natural and human resources and skewing the ownership and control of local operations toward foreign firms that can obtain financing at competitive world terms.

Implications for Financial Systems Development Policies

• Focus on financial services, not institutions. Traditionally, the focus of development finance has been on the development of financial infrastructure, particularly the establishment and strengthening of specialized institutions, within national boundaries. As a result, those individuals charged with defining policies for very small or poor countries conclude that little in the way of financial innovation and modern financial practices are relevant in their countries, since only the core financial functions can meaningfully be performed there.

An alternative view focuses on the financial needs of the various actors in the national economy including the central government, various government enterprises, large, medium, and small private enterprises, whether foreign or domestically-owned, and households, ranging from wealthy, internationally-mobile ones to poor totally localized ones. Farmers in an extremely poor country, with low per capita GNP and minimal internal financial capabilities, may nevertheless require risk shifting to reduce their exposures to fluctuations in the prices of a key export crop. Similarly, medium, and large enterprises in even the poorest countries that seek to compete externally typically require more advanced financial services than can be provided locally.

• Emphasize the financial core. Placing the emphasis on the needs of specific national actors does not imply ignoring the development of a local financial system. All transactions involving local actors ultimately rely on the core of the system -- the basic payments system, including short-term deposit taking and lending. This core, typically embedded in the commercial banking system, underlies virtually all other financial activities including transactions with the rest of the world. Therefore, special attention must be given to ensure that the core is efficient, that transactions are settled rapidly without error, and that the core activities cannot easily be manipulated for gain by any of the parties in the system.

• Recognize complementarity of domestic financial deepening and international financial integration. Financial deepening can be characterized along many dimensions including: extending maturity, increasing risk shifting, and increasing the degree of participation by investors in the management and control of the underlying activities. The possibilities for deepening along each of these dimensions within a particular national market will depend upon the stability of the macroeconomic context, the development of the legal system that underpins financial contracts, the sophistication of domestic entrepreneurs and corporations, the distribution of risk exposures, and the potential size of the market, not only in monetary terms, but also in terms of the number of potential independent market participants.

• Develop "upwardly compatible" regulation. In many smaller, less developed countries only a fraction of the total financial intermediation required by domestic economic actors can be expected to take place within the national boundaries. This implies that many of these needs will have to be met by institutions operating in other markets and will be effectively regulated by those markets. This creates the potential for conflicts in regulation as well as situations where specific transactions fall between domestic and offshore regulation and therefore become totally unregulated.

What is required is a "nested" approach to financial regulation in less developed countries, whereby local regulation fits into an over-arching international framework. Domestic law must regulate the core financial system, but it need not encompass all of the variations and derivatives that will based on these core activities. It should be possible to either apply the laws of specific foreign countries or at least refer to the principles those laws in the national legislation, shifting the burden for regulatory innovation towards the more advanced countries where the pace of innovation is faster and the resources to deal with it are more ample. Developing countries might enter into an international convention to adapt their local financial market regulations to this common framework, in return for some voice in the setting of international standards. Alternatively, they might require that sophisticated financial transactions by local firms take place through a major world exchange, thereby implicitly requiring that they meet the regulatory standards of that country.

• Recognize the benefits of privatization. Privatization reduces the organizational scope of government, allowing it to focus on those things that were more closely related to general population needs. Further, by shedding deficit-making public enterprises and financing new infrastructure on a self-supporting basis, Mexico, for example, found that even in a period of austerity it could obtain funding for local community self-help projects.

• Recognize that big finance also can serve basic needs. For agencies such as A.I.D. that are particularly concerned with meeting the needs of the mass of households and small businesses, at first glance it would appear that financial innovations such as pre-financing of receivables, commodity swaps, interest rate hedges, project finance, public sector carve-outs, outright privatization and so on are irrelevant. "Stick to your knitting", it might be argued, and concentrate on local deposit and credit facilities, localized risk transfer mechanisms, etc. This perspective, however, misses the point that the ability of governments to meet basic needs is limited by the extent to which their financial and administrative capacity is tied up in activities that could be financed on a market basis.

In his concluding remarks, Dr. Lessard stressed the need for A.I.D. to frame a vision of its future policies regarding financial markets, recognizing that they will be much more open, with greater interpenetration and also recognizing that they are the key nervous system of a market economy.

In his comments on Dr. Lessard's presentation, **Dr. Andres Velasco** pointed out that modern finance can be very helpful in the strengthening of developing economies. Financial engineering can help overcome market failures which concerns all LDCs. Dr. Velasco described some examples of market failures:

- Public facilities in developing countries are in very bad condition. Since no tax is charged, they are excessively used and there is a lack of funds for required maintenance. Charging for the use of these facilities would be a simple yet effective solution.
- Inadequate management incentives and a lack of owner involvement are common problems in LDCs. The owners are mostly absent and rarely get involved in the management of their companies. One effective solution would be to provide financing that is directly related to performance (e.g. indexed bonds). This type of financing will exert continuous pressure on the owner and will surely increase his involvement.

As the above examples illustrate, modern finance can be instrumental in the overcoming of market failures.

Another role of finance is to enable the governments "to get out of things." In the past, governments have given many bad loans to inefficient companies and ignored the good ones. As a result, uncollectibles are big on government balance sheets. Today, small firms must be financed without government intervention. Governments must get out of guaranteeing loans (the third largest source of government spending). The risk must be passed onto the people who are able to bear it best: bankers, owners, etc. If the government won't finance companies, new sources must be found; companies can go to the stock market and/or to venture capital firms or issue vouchers.

Dr. Velasco recognized that modern finance has a key role in the development of third world countries. However, he cautioned against a new round of borrowing by such countries as Mexico, Venezuela and Brazil. These countries are discovering new financing mechanisms and sources. This round of new financing may lead to an explosion in borrowing which would put the developing world back into square one.

1.2 Building and Regulating Financial Markets

Prof. Philip A. Wellons of Harvard University said that a very important step in financial development is the establishment of congenial substantive laws and legal processes. A country's success in getting these laws depends on (1) finding good models, which in turn requires understanding the effect of the laws on the environment of developing countries; (2) creating a comprehensive legal system, not just isolated rules; and (3) managing competing or hostile bureaucratic and political groups over time.

A common view has been that law is often an impediment to an efficient financial sector and that the appropriate prescription is to remove the repressive laws. Simple deregulation will not work, however, even if prudential rules are in place. A.I.D. is now getting a much broader view of the role the legal system plays in financial development. Law, in its widest sense as encompassing the whole legislative, regulatory and institutional framework, can act as a supportive structure and mechanism for developmental activities.

Legal development can be a very difficult process. A very basic problem is that legal reform advisers cannot honestly say they understand the likely effects of the reforms they propose. Too little is known about the way substantive laws and legal processes affect financial development. Legal advisers must catch up with advisers about other parts of the financial sector.

Countries' legal needs for financial development vary widely. Four very rough categories are countries with essentially no legal system, with outmoded legal systems, with perhaps deliberately inefficient legal systems, and with legal systems that are close to neutral in their impact on financial markets. Countries in each of these four categories need different kinds of help to build or reform their law. Political and bureaucratic obstacles to reform vary in type and intensity across the four categories.

Legal reformers must concentrate more on the process of reform than they have up to now. The management of legislative drafting, implementation, and enforcement is crucial to the success of legal reform for financial development. Drafting must take place in a way that resolves basic policy issues. Implementation must accommodate "the two-steps-forward, one-step-back" evolution of financial policy found in many countries. Enforcement must address existing bureaucratic structures. It is not enough to write a good law and supporting regulations, then leave.

In these circumstances, how can A.I.D. contribute to legal development in developing countries? At least three activities are possible:

- A.I.D. could promote analysis and reform of specific laws and processes in groups of countries, allowing for comparison and development at the same time;
- A.I.D. could try to build a systemic perspective into its work on individual laws for financial (and other) reform, coordinating to the same end with others that provide technical assistance in order to avoid duplication and maximize the return on the aid dollar; and
- A.I.D. could take a longer view of reform by allowing more resources for implementation and enforcement, but break up the work into shorter discrete tasks with observable output to reflect the availability of resources and to assure quality.

In short, A.I.D. can play a valuable role in law and institution building for financial sector development.

In his comments on Dr. Wellons' presentation, Mr. **Douglas Tinsler** expressed his satisfaction at seeing lawyers thrust into a line position, helping the Agency move forward in its work. There is an important role to be played by the legal profession in development, particularly in the financial system development where there is a need to build both the legal process and the legal institutions. All too often, A.I.D. has tended to consider the judiciary and the legislative systems as political institutions, rather than technical institutions and, therefore, beyond our technical and institutional development efforts. This characterization is wrong; A.I.D. needs to change this perspective. A.I.D. can make as much an impact in building legal systems in developing countries as it has made when building health and educational systems. As an institution, A.I.D. should not shy away from legal system improvement projects because the host government and A.I.D. perceive them to be in the political domain. To the contrary, it should consider, on a priority basis, support for legal system development, perhaps, in inverse relation to the status of development of that country.

Dr. Wellons' four point categorization provides a useful framework when considering whether or not to support legal system development:

1) No legal systems
2) Outmoded legal systems
3) Deliberately inefficient legal systems
4) Neutral legal systems

As an example, Costa Rica was somewhere between the deliberately inefficient and the outmoded legal system. The Supreme Court in Costa Rica had to consider every case because there is no system of precedence. This can be quite difficult especially when considering that all activities of the parties involved in a case must cease until a verdict is reached. USAID/San Jose was asked to improve and bring order to the legal system. So with our technical support, we hired and trained twenty law clerks to help the judges write the cases. We also installed a computerized case load system to speed the process. Today, Costa Rica has one of the more advanced legal systems in Latin America.

A.I.D. needs to improve the education of the people in the judiciary, in the assembly, in the legislature and within the bureaucracy. It is currently working on a major educational effort in LDCs and are trying to build a consensus on the writing of some laws. In conclusion, more attention should be given to the legal process. A.I.D. needs to make a better effort in the education and training of the legal staff in both the judiciary and the legislative spectrum.

At the same time that LDCs are struggling to establish minimal legal systems required for the effective functioning of a modern financial core, the requirements placed on the legal framework are escalating due to the international interconnection of financial markets, including those of LDCs. The next speaker, **Dr. Ghon Rhee**, described stock market volatility in world financial markets and specifically in the six Dynamic Asian Economies (DAEs), namely Hong Kong, Korea, Malaysia, Singapore, Taiwan and Thailand. He began by describing the systemic risks in the securities markets of the DAEs. Systemic crisis is defined as a disturbance impairing the working of the system which is composed of market participants, trading mechanisms, clearing and settlement arrangements, regulatory arrangements, etc. Systemic risks are those risks with the potential to cause such a crisis and, in extreme cases, a breakdown in the system.

Empirical evidence indicates that a large decline in one major market could trigger a serious disruption in another market and, eventually, in the global financial system through volatility transmission or the spillover effect. The reported results are documented on the basis of advanced securities markets in New York, London, and Tokyo. This conclusion raises an interesting challenge for regulators of securities markets because the interdependence of national securities markets will place strains on global supervisory efforts.

However, very little spillover effect is found between the advanced securities markets in New York, London, and Tokyo and DAEs' securities markets. Cross-border equity investment is an important factor in explaining the transmission of market volatility from one national market to another. Studies have concluded that there is no volatility spillover from the U.S. market to Korea and Taiwan which are effectively closed to cross-border investment. Volatility spillover from the U.S. market to Japan occurred mostly after U.S. securities firms were allowed to become members of the Tokyo Stock Exchange (TSE) in February, 1986.

Of the six DAEs, Korea, Taiwan, and Thailand are in the process of liberalizing and/or internationalizing their securities markets. In contrast, securities markets in Hong Kong, Malaysia, and Singapore have provided foreign investors access for direct investment. As a result, inter-market volatility transmission will soon be a reality in the region.

As the globalization of the DAEs' securities markets progresses, potential risks of contagion are also increasing. The failure of individual securities companies in one country may lead to chain reactions that could be detrimental to the achievement of systemic stability in the region. Hence, supervision and deregulation on a national level would not be sufficient unless international coordination is undertaken. Harmonization of national supervisory activities emerges as an important task. The establishment of a framework for coordinating supervisory activities and for exchanging necessary information is needed more than ever.

1.3 Increasing Equity Participation

As an illustration of the privatization process in developing countries, **Dr. Roger Leeds**, Director of the International Privatization Group at Price Waterhouse, described two privatization transactions in Jamaica and reflected on the potential lessons learned from them.

In December 1986, the Jamaican government sold 51 percent of the National Commercial Bank (NCB), the country's largest bank. The $J 90.6 million (U.S. $16.5 million) public offering, by far the largest of its kind in the nation's history, was 170 percent oversubscribed and attracted more than 30,000 individual citizens and institutional investors, including 98 percent of the bank's own employees. On the first day the stock traded on the Jamaican Stock Exchange, it rose to a 67 percent premium. Prime Minister Edward Seaga described the offering as "a spectacular success [that] marks a milestone in the government's privatization program."

Six months later, the government sold a second offering, the Caribbean Cement Company (CCC). The CCC divestiture was a far larger transaction, raising almost $J 200 million, partly because 100 percent of the company's equity was sold, compared to only 51 percent as was the case with NCB. Also, this sale involved a major foreign investor. Another significant difference was the result: the offering was considerably undersubscribed. When the shares opened for trading, the price dropped well below what it had been on the offering date.

These two transactions hold important lessons for other developing nations that envisage privatization as an important component of their development strategies. Contrary to conventional wisdom, a developing country with a relatively low level of per capita GNP (US $940) had been able to mobilize domestic savings from a broad spectrum of the populace, channel those funds through a small, undeveloped stock market, and shift control of two major state-owned enterprises (SOEs) to the share-holding public. The offerings were politically popular and even enjoyed the support of the management and staff of the two companies, who benefitted from generous employee purchase schemes.

The NCB transaction did not maximize the government's revenues since by most standards the NCB shares were underpriced. The change in ownership did not precipitate major changes in the bank that would justify a conclusion that privatization enhanced NCB's efficiency. Furthermore, no serious attempt was made to measure the impact of the transaction on the fiscal deficit

On the other hand, despite indications that the CCC transaction results were not optimal, many of the government's privatization objectives were achieved. With 78 million shares trading on the Jamaican Stock Exchange and thousands of new participants, the offering did contribute to capital market development. Share ownership had been broadened and "democratized", as the Prime Minister had hoped. There was one less state-owned enterprise for the government to administer and monitor and the public treasury was enriched by about $J 182 million, less the expenses incurred in executing the transaction.

The two transactions provide some useful insights that are applicable beyond Jamaica. Doubt should be cast, for example, in the minds of those who view the execution of a privatization transaction as simply another form of technical analysis leading to the correct valuation, pricing and sale of assets. These cases illustrate that decisions must be made along the way that also require a high quotient of vision and judgment, selecting technical advisers, determining the optimal timing of the transaction, designing and implementing a marketing campaign, ensuring employee support for the privatization, defusing political opposition, and so forth.

The most striking conclusion about privatization in countries such as Jamaica is that many of the key decisions that determine success or failure are based on calculated subjective judgments. No amount of quantitative analysis, for example, can identify the "right" price. No market survey can measure with precision the effective demand, or the likely effect of adding warrants. Lastly, no formula exists that can establish the correct tone for an advertising campaign. Instead, these are matters that depend on experience, judgment and good fortune. The Jamaican program benefitted from each of these elements, and the government established a solid foundation for future privatization initiatives.

In his presentation, **Dr. Aaron Tornell**, Advisor to the Minister of Finance in Mexico, reflected on the Mexican experience in privatization and on some of the lessons learned. From 1982 to 1991, Mexico privatized 1000 out of the 1200 existing public enterprises. The lessons to be learned from this extraordinary process are twofold:

1) Privatize the Private Sector.

When privatizing a company, the government has to reduce by two-thirds the number of employees, restructure the company, insure it is ecologically sound, and last but not least, make capital investments in it. This very difficult process will face tremendous resistance. So before starting the privatization process, the Mexican government allowed one company, Aero Mexico, to go bankrupt due to financial problems. This was the first bankruptcy in sixty years. Next, it allowed the bankruptcy of a steel mill in Monterrey with 30,000 employees. These actions sent the message about the government's changing attitude and its adoption of a free market approach. By "privatizing the private sector," the government forced the private sector to be more responsive to such market place disciplines as competitive pricing and made it clear that failed firms would be allowed to go bankrupt.

Dr. Tornell claimed that privatization does not make sense macro-economically. The government would want to keep the good and profitable companies and would not want to privatize the bad ones because it would have to bail them out later on. The only reason the Mexican government is privatizing its companies is because it can not control all of them. In 1982, there were four ministers sitting on the board of 1200 public companies. Evidently, those ministers didn't have time to manage and supervise these companies; inefficiencies and corruption was rampant. Only the private sector could efficiently manage and control these companies. This is the main factor that led to today's privatization program.

2) Proceed Slowly

The Mexican government did not launch the privatization process immediately. First, it made sure it had the necessary prerequisites for privatization: a stable economy, low interest rates, a strong stock market and transparency. Once these necessary ingredients are present, the government started the privatization process with small companies and learned from these transactions. The first public enterprises privatized were a cabaret and a bicycle factory; afterwards, the government moved onto bigger enterprises such as banks and steel mills.

In his comments on Dr. Tornell's presentation, **Mr. John Blackton**, Deputy Assistant Administrator for Policy, agreed with Dr. Tornell on the need to "privatize the private sector" and stated that A.I.D. has been following this strategy for the last ten years.

He also emphasized that A.I.D. needs to continue to support competitive environments.

In his presentation on Venture Capital in Africa, **Mr. Kenneth Locklin** began by defining the exact nature of venture capital. Venture capital activity is not commercial lending; it has a much higher risk and return. Venture capital is the early stage financing of new companies seeking to grow rapidly. Venture capitalists 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.

Venture capital is very important to developing countries. A successful intervention by a venture capital firm brings to a local project two elements that are traditionally in short of supply in developing countries:

- Risk capital which, almost by definition, is largely unavailable in developing countries
- Good management with an entrepreneurial style

International venture capital funds are very active today. Some of these funds focus only on a region or a country (e.g. the East Europe fund, the North Africa/Middle East fund, and the Kenya Equity fund). The MPI and Africa bureau support the initiatives of these funds because they help develop and strengthen the private sector.

Venture capital firms are starting to consider participating in the capitalization of privatization. This seems like a good area because the needs of a privatizing company are directly in line with the resources of the venture capital firm. Privatizing companies need capital injections - especially with risk capital - and also entrepreneurial management style. However, at this stage, privatization is more intriguing than applicable for a venture capital firm since privatization deals are intended to generate money for the government only.

Where local capital markets are not sophisticated, the venture capital concept is sound. Venture capital does not require highly developed or even functional financial markets to operate. Venture capitalists rarely go to the stock market to raise funds (only one quarter of all venture capital projects result in initial public offerings. Sales to other institutions, original investors and third parties are the most common exit forms for venture capitalists.

Venture capital, when used properly, can be a good development tool.

1.4 Structured Financing and Securitization

Dr. Donald Lessard reported on the contribution of a range of financial innovations to the development of capital markets in less developed countries and through these markets to the economic development of those countries. These financial innovations can be broken into two parts:

- Structured financing: financing whose terms are directly linked to the cash flows of some underlying project or enterprise; and,
- Securitized financing: financing which is obtained by packaging underlying securities into standard instruments that are more readily acceptable and tradeable in financial markets.

Financial mechanisms used in developed countries cannot be simply applied to developing countries because financial markets in these countries differ in several ways:

- Country risk
- Fuzzy boundaries between public and private activities
- Fuzzy boundaries between the wealth of individuals/families and corporations and among corporations within family-based groups
- Concentrated risk exposure at a national level
- Hollow financial markets

Clearly, financial innovations must be adapted to the needs and sophistication of each respective market.

Comparative Advantage in Risk Bearing

Just as ideal patterns of specialization and trade among countries, and among firms within countries, can be defined in terms of comparative advantage, ideal patterns of financing within and across countries can be defined in terms of financial comparative advantage. Dr. Lessard illustrated this concept with a hypothetical example on chicken farming. A chicken farmer is exposed to two types of risks: risks that are within his control (choice risks), such as the health of the chicken, and risks that are outside of his control (chance risks) such as the price of chicken feed. The farmer should manage the choice risks while delegating the chance risks to investors in his farm. The logic behind this is that the farmer can actually reduce the choice risk by taking good care of his chickens. However, the chance risks would be best handled by the investors because they are able to diversify these risks and/or have a high risk tolerance. After all, financial investors have access to a wide range of investments and should be able to diversify across multiple risks. This example demonstrates that financial comparative advantages are directly related to the ability of the economic agent to bear risks. Those agents able to bear the greatest amount of risks have the greatest comparative advantage.

Potential Role of Financial Innovations in Financial Market Development

There are many characteristics of LDC financial markets which represent obstacles to efficient resource allocation, risk sharing and agency. While these problems must be addressed primarily at their core through macroeconomic stabilization, restructuring and reduction of external obligations, shrinking the role of the state, and improving the legal infrastructure for finance, certain innovative financing techniques can move these markets closer to the ideal before these fundamental changes are complete. The key financial technologies that can be used include:

- New types of claims which provide for limited or formula participation in particular activities
- Price-level or commodity price-linked securities
- Financial instruments that separate debiting and payment streams
- Securitization of either existing or new assets.

Many of these mechanisms, although largely based in private markets and involving primarily private actors, require substantial institutional support either in the form of the legwork to put them together, to create the required legal context and, in some cases, partial guarantees. Nevertheless, once properly implemented, the contribution of these financial mechanisms to the economy can be very valuable.

Mr. Richard Breen, Director of the Financial Sector Development Project (FSDP) at Price Waterhouse, agreed with Mr Lessard that there is much to be gained in trying to apply structured finance in developing countries. As an example, he spoke of FSDP's recent activities in Portugal. FSDP performed a study to determine the feasibility of establishing a secondary mortgage market in order to enhance the prospects of the housing finance system to meet the huge demand for home financing.

At the completion of the study, it was found that there are several deficiencies in the Portuguese financial system, which made the immediate launch of true mortgage backed securities unlikely. On the other hand, there were sufficient positive factors to allow the virtual immediate launch of a variation of this type of security which would introduce the concept to the market and pave the way for its future development and sophistication.

There were five main impediments to the development of true mortgage-backed securities in Portugal because of increased risk and uncertainty to the investor:

- Absence of standardized mortgage loan contract.
- Inconsistencies in the government interest rate subsidy programs.
- Interest capitalization features of existing mortgage contracts reduced the cash flows of the great majority of mortgages in the system to below that required to make the periodic payments to the investors.
- Absence of certain legal institutions, such as trusts.
- Absence of standardized underwriting procedures.

Despite these and other shortcomings in the existing system, the recently introduced mortgage bond law provided a good basis to create a new security. This security would adapt well understood concepts of debt instruments, add features of mortgage collateralization, and introduce them to the market with appropriate guarantees to gain acceptance. A pool of mortgages, serving as a collateral and structured to provide the cash flow necessary to pay off the investor in a credible fashion, would allow the development of a secondary mortgage market in the future.

The message here seems to be a positive, even encouraging one. It is possible to develop new financial products such as a mortgage backed security. They will demand a high level of discipline in the economy and appropriate rules as a precondition; but isn't this the direction these countries must move in if they are to develop the savings needed for their own development? For countries that have already taken steps to develop sources of savings in the insurance and pension fund industry, these investment products should receive serious consideration. The advantages to both investor and borrower and the efficiency of the system seem at this stage to be powerful.

1.5 Institutional Innovations to Democratize Capital

In his presentation on Country Funds, **Mr. Antoine Van Agtmael** described how financial markets are being rediscovered as a tool for development. Previously viewed as insignificant "casinos", today the financial markets are beginning to gain more respect from economists and policy makers. This change in perception can be attributed to a shift of emphasis from government intervention to the private sector. In addition, the debt crisis has shown the need to rely on domestic savings and international sharing of risks and returns.

Although financial markets are becoming more popular, there remain numerous obstacles to their development:

- Unrealistically low cost of debt
- Overvalued exchange rates

- Entrepreneurial parochialism
- Tax discrimination and evasion
- Uneducated speculation
- Lack of accounting and auditing
- Investment restrictions on pension funds and insurance companies
- "Pay as you go" social safety net

Despite these obstacles, the global trend toward financial market development and liberalization cannot be ignored. Major companies in newly industrialized countries are joining the "international blue chips" and are being listed, owned, and traded internationally. Access to and cost of finance is becoming an increasingly important part of competitiveness. If domestic risk capital is not available, entrepreneurs are " selling out" or forming alliances with multinationals or set up holding companies abroad. Local markets today have two options: either become competitive or face extinction.

Mr. Van Agtmael asserted that foreign portfolio investment is the safest remedy against protectionism. International shareholders are a natural lobby and ally against protectionism by having a stake in the success (and failure) of firms. In addition, foreign institutional investors improve the quality of information (disclosure, stock reports, market information) thereby helping local investors.

For most investors, emerging markets are of growing interest. Emerging markets provide risk diversification and a potential for higher returns. In addition, the inefficiency of markets opens unusual gain opportunities. Finally, some of the stocks could be future bluechips. These investors allocate their assets through many investment vehicles: country funds, diversified funds, regional funds, American Depository Receipts (ADRs) and international equity. With Asia booming and Latin America recovering, emerging markets are bound to increase in importance in the world financial market.

As part of the "capital democratization" theme, **Mr. Dimitri Vittas** of the World Bank, described the objectives of contractual savings institutions.

Whether they are compulsory or voluntary, the main objective of contractual savings institutions is to provide for the future. This implies that their investment policies must be guided by two principles: safety and profitability.

The provision of economic security to retired and disabled people and their dependents is the main objective of all pension systems, whether they are funded or not. In fact, one would have no objections against unfunded pay-as-you-go systems if they could deliver adequate pensions in an equitable and stable manner.

The main criticism of unfunded systems is that, in the face of changing demographics and deteriorating dependency ratios, they cannot achieve financial equilibrium without one of three actions:

- an increase in contribution rates, which would discriminate against the current generation of active contributors;
- a reduction in benefits, which would discriminate against the current generation of pensioners and retiring workers;
- an increase in the operating deficit that is financed from general tax revenues. The latter option makes unfunded systems unsustainable in the long run since there is a clear limit in all countries on the contribution that general tax revenues can make to the pension system.

Impact on Savings and the Promotion of Long-Term Savings

There is a vast and inconclusive literature on the impact of funded and unfunded pension systems on the rate of national savings. Funded systems that are young and lack credibility may involve an increase in overall savings because consumers will be less inclined to adjust their saving behavior with regard to their discretionary income. But as systems mature and gain credibility, the greater efficiency of savings through contractual savings institutions may lead to changes in consumer behavior that may compensate, and even overcompensate, for the increased availability of future pension incomes. Thus, the effect on overall saving may then be negative.

Role in Securities Markets

By providing an effective demand for marketable securities and a mechanism for professional fund management, contractual savings institutions can stimulate the development of capital markets. Institutional investors can exert pressure for better accounting and auditing standards as well as disclosure of information to investors. They can also encourage improved brokerage and trading arrangements and help establish more efficient and reliable clearing and settlement facilities.

The impact of contractual savings will depend on the regulations that governments impose on their investment policies. Tight restrictions may cause distortions and may also undermine the principle of private management, but complete freedom may also be unjustified given the tendency of financial institutions to adopt imprudent policies, assume excessive risks and make big mistakes.

The government has a clear responsibility, especially if participation in a funded pension system is compulsory, to ensure the safety of invested funds and the payment of adequate pensions. Thus, a comprehensive system of investment and prudential regulations is necessary.

Following Mr. Vittas, **Dr. Mario Abuhadba** spoke of the regulatory considerations of pension fund management firms in Chile. Mr. Abuhadba described the ten-year-old pension fund system as a very successful method of accumulating savings in Chile. This system could be used as a model for other countries around the world. The Chilean pension funds are called "Administradoras de Fondos de Pensiones" (AFP). AFPs are private institutions in charge of collecting salary deductions (10% of income) from the working force and distributing benefits to retired workers. The government supervises these AFPs; its role is to regulate and control them.

The pension fund system was created in 1980. It comprises 13 AFPs who managed to gather 3 million workers out of the 4 million labor force. Indeed, the rate of accumulation has been very fast. From 1981 to 1990, the AFPs collected almost 8 billion dollars in funds, approximately 30% of GDP. This is an incredible amount for such a short period of time.

The AFPs hold a large percentage of the total supply of instruments in the country. In 1990, the AFPs held 20% of all investment instruments in Chile. In some instruments, the percentage is much higher. For example, AFPs own 55% of all bond supplies and 96% of all Treasury papers. These numbers give a feeling of the magnitude of this new AFP system. All these securities are tradeable and in demand on the market.

The success of this system is partially credited to the strong government participation. The government is actively engaged in the surveillance and control of the management of the fund. In addition, any AFP that wants to enter the market has to go through a vigorous screening by the government. In its evaluation, the government looks mainly at the quality of the management and the minimum capital requirements. This screening is not an impediment to the establishment of AFPs but rather a control mechanism to protect the savings of the population. The government requires all instruments to be kept in the Central Bank. Last but not least, a minimum level of return is required from the AFPs to prevent harm and discredibility to future pension funds. The requirements are stringent but necessary; the government has to ensure that the system is well run and managed to give confidence to local savers.

AFPs compete among each other on the basis of return to the workers. They have to guarantee a minimum rate of return to the workers. In case an AFP's return is below the minimum requirements, the difference will be extracted from the AFP's reserves.

Pension funds are very important players in the Chilean capital market. Three AFPs dominate in particular, controlling 70% of the 8 billion dollar pension fund industry. With this money, the AFPs can control many corporations. This is a disturbing issue that will have to be dealt with in the future.

1.6 Swaps, Options, and Guarantees

Dr. Nalin Kulatilaka of Boston University discussed the role of derivative securities in the development of financial markets.

Futures, options, and other derivative securities are often associated with advanced capital markets. As a result, their use in emerging markets has often been understated. Dr. Kulatilaka used an example to illustrate how derivative securities can play an increasingly important role in the development of capital markets even during their infant stages.

In recent years, developing economies have embarked on ambitious programs to privatize firms and even entire sectors that have long been under government ownership and control. Developing country capital markets, however, are in infant stages of development and are unable to provide the necessary liquidity to float such large issues of new capital. Therefore, an infusion of foreign capital has become essential to this process of privatization. However, debt-to-equity swaps and other schemes have come under strong criticism, creating a growing political fear of privatization programs becoming "foreignization" programs. On the part of domestic interests, the fear stems from the fact that transferring control to foreign firms will create incentives for those firms to act in self interest without regard to the national interest. What is needed is a credible privatization scheme that creates pluralized local and foreign stakeholdership and avoids concentration of power, prevents collusion and fosters development of stable institutions with local interests.

One feasible solution is to set up a mechanism that allows both the foreign firms and the domestic investors to share in the up-side benefits of the success of domestic projects. In particular, the government might sell equity shares of the privatized firms to foreign investors via debt-equity swaps or private placement of equity. In return, in order to enable domestic investors to participate in the gains from local projects, long-dated out-of-the-money call options on the foreign firms that purchase the equity would be created and sold to the local investors. A call option provides the investor with a levered right to participate in the up-side benefits of a firm. Due to the high leverage provided by out-the-money options, local investors will be able to invest a small amount of wealth and, in effect, purchase a claim on the equity of the privatized firms. Thus, they are able to share in the potential profitability of the privatized firms even if the foreign owners transfer some of the profits out of the local economy.

A potential problem is that a foreign firm's asset base will include other assets than merely those of the small country project. Hence, small country investors following this strategy will be exposed to the risks inherent in those assets as well. Viewing this from an international portfolio diversification point of view, purchasing contingent claims on the foreign firm amounts to the local investor holding a world-diversified portfolio, which is quite desirable. In choosing portfolio weights, local investors must take into account this effect as well.

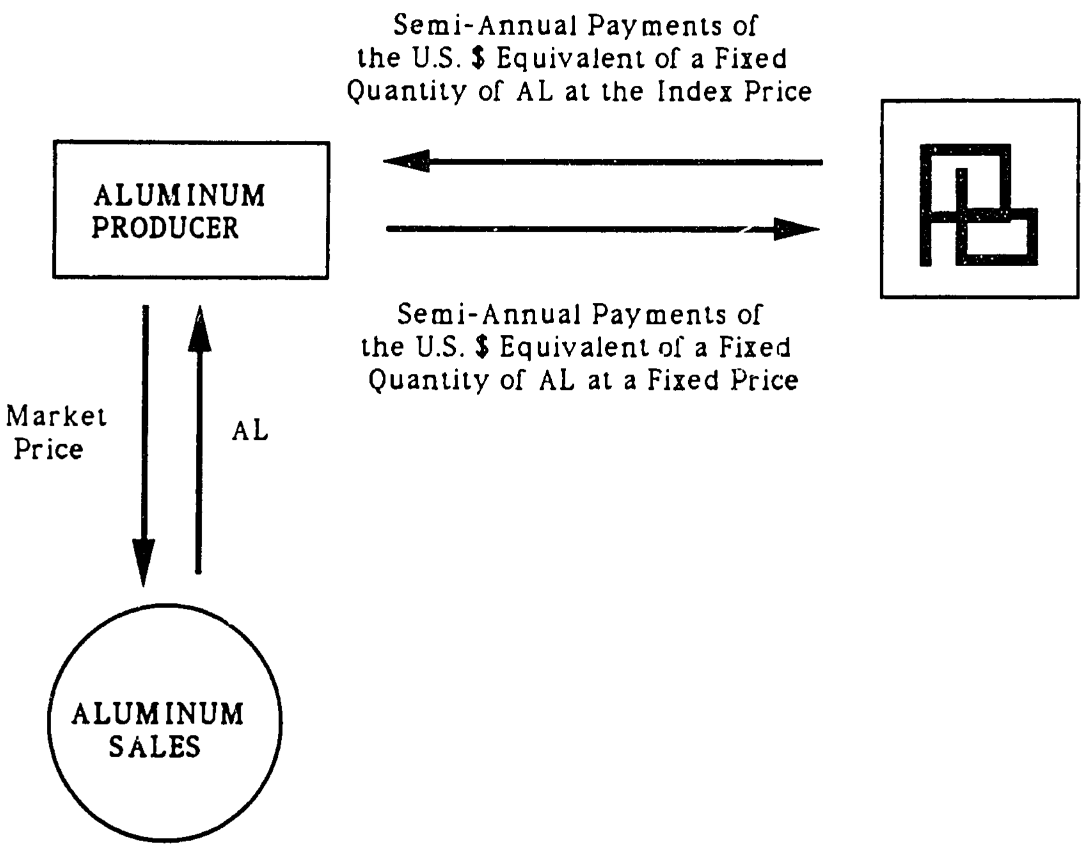
While a scheme developed along these lines may overcome some of the "agency" problems, other issues pertaining to corporate governance are much harder to solve. Nevertheless, this analysis hints at the very wide scope of possible applications of derivatives and their potential impact on developing economies. Policy makers should take a closer look at these new instruments in designing capital market development and risk management strategies in developing economies.

Dr. Gaylen Byker, the Managing Director of the Commodity-Indexed Transactions Group at Banque Paribas, described today's global business environment as being characterized by many kinds of volatility: volatility of supply, volatility of demand, political volatility, interest rate volatility, and volatility of energy costs. These factors make the business environment riskier than ever. Strategies for managing the volatile factors that affect the business world are increasingly important. The need for such hedging strategies applies equally to companies and countries.

Several financial institutions such as Banque Paribas have developed an array of strategic hedging tools that enable users of commodities to manage long-term price risks. Banque Paribas has adapted techniques from financial markets to manage commodity-price risks for period as long as ten years. This is far longer than traditional hedging methods permit. To exemplify a strategic hedging tool, a commodity price swap involving an aluminium producer is described below.

On the left hand side of Exhibit 1, we have an aluminium producer selling aluminium into the market on a regular basis and receiving the market price. In swaps jargon, this is called the "floating price." The producer receives whatever the market is paying at the time. If the market is paying $3,000 per ton, that's what he receives. It's in this type of volatile price environment that the bank (on the right side) approaches the producer and proposes to pay a fixed price for a given quantity of aluminium for a fixed period of time.

FIXED-FOR-FLOATING ALUMINUM PRICE SWAP



In this illustration, we will assume that the swap is for three years and that the bank offers to pay the producer $1,600 a ton for 10,000 tons every six months. The producer agrees to pay the bank 10,000 tons times whatever the price of aluminium turns out to be in that six-month period. For example, if the price of aluminum in the first six months of our three-year swap turns out to be $2,000 per ton, the bank owes the producer $16 million; that is, $1,600, the fixed price in the swap, times 10,000 metric tons. The producer owes the bank $20 million; that is, the average price of aluminium, $2,000, times 10,000 metric tons. So the producer sends the bank a "difference check" for $4 million. Now, what has happened to the aluminium producer is that he has received $2,000 a ton from the market, and he has paid $400 of that to the bank, leaving him with a net of $1,600 a ton. If, in the second six months of the swap, the price of aluminium averages $1,200 a ton, the bank still owes the producer a "difference check" for $400 a ton or $4 million. The market has paid the producer $1,200 a ton, the bank has paid him $400 a ton, so his net is again $1,600 - his fixed price in the swap. The bank is not at all involved in the physical aluminium business in this transaction. It is merely entering into a financial agreement to hedge the price risk.

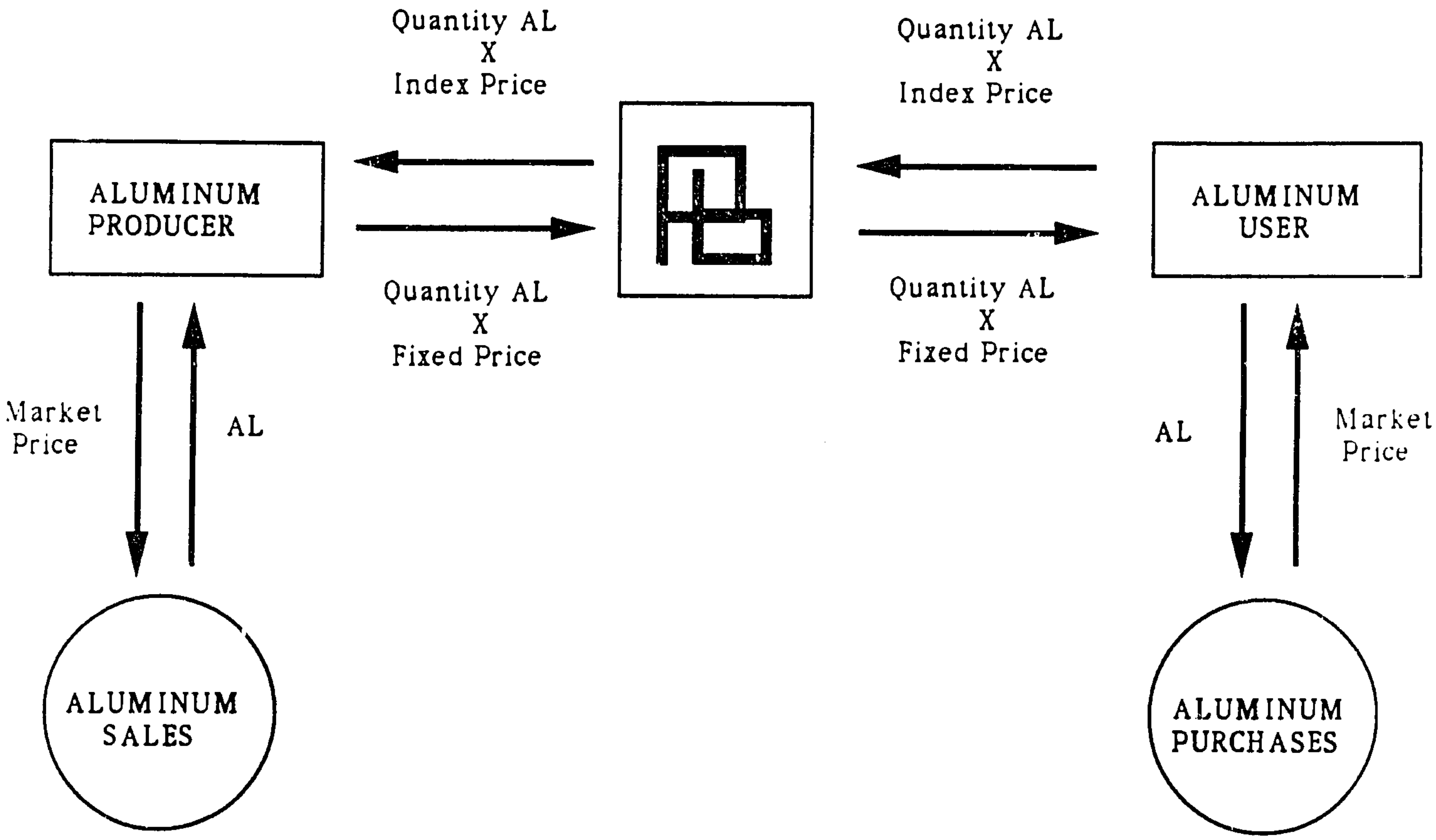
Exhibit 2 shows the entire swap transaction. The bank is not in the business of taking open exposure to aluminium prices, but instead finds an aluminium user who has the opposite price/profitability profile of the producer. That is, if aluminium prices go up, the profits of the user go down. The user is worried about exactly the opposite scenario that concerns the producer. That is, it is worried that aluminum prices will go back to $3,000 a ton. This mirror image swap transaction with the user provides the user with the financial equivalent of a long-term fixed price contract. If the price is above $1,600 a ton, the user pays a "difference check" to offset the excess. If the price is below $1,600 a ton, the user pays a "difference check", giving up the benefit of lower prices. In academic terminology, the swap is an "unbundling" of the risk involved in this transaction and the financial mediation of pure price risk.

These transactions can be done for 3, 4, or 5 years and beyond. They involve no direct cost to the parties other than the spread the bank receives for taking the credit risk.

Developing countries are starting to get involved actively in financial engineering. For example, Venezuela is securitizing its export receivables, Puerto Rico is actively involved in the balance of payment risk management and Algeria is considering the use of oil-indexed financing. Continuing volatility makes long-term price risk management an essential element of a strategy for the stable growth of developing countries in the coming decade. Mechanisms such as swaps, long-dated options and indexed financing are now available, and more applications are being created every year. Creative long-term price risk management cannot eliminate the risks of

Exhibit 2

FIXED-FOR-FLOATING ALUMINUM PRICE SWAP



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volatility, but it certainly allows for the management of those risks to achieve the objectives of stable growth and improved earnings.

1.7 Country Presentations

In the first country presentation, **Mr. Mark Kraczkiewicz** described the conditions of the financial markets in Morocco. He noted that many new developments have occurred in Morocco lately, including the freeing up of interest rates, the considerable increase in long-term deposits of savings, and an increase in short-term interest rates. In addition, the Moroccan credit system is being liberalized. The IMF and the World Bank have persuaded the government to begin borrowing at market rates. Credit by private commercial banks shot up 19.9% in the first month of 1991. All these developments are strong indicators of the degree of suppression in the previous financial system. The only signs of monetary austerity still present are the reserve requirements and the central bank advances to the commercial banks.

This was the environment in which A.I.D. operated last year. A.I.D. worked on two projects: the secondary debt market development and the stock market development.

In the secondary debt market, A.I.D. tried to increase the liquidity of the market, broaden the market for T-bills, open up market operations and establish a market-based reference rate. Some of A.I.D.'s recommendations to the Moroccan government were to reduce the number of maturities and establish a primary dealer system.

As for the stock market, which is government controlled and opens for half an hour per day, A.I.D. recommended that it become self-regulating and autonomous instead of government controlled. In addition, A.I.D. recommended that the main stock market be broadened to regional stock markets. Finally, limits on the participation of insurance companies have to be lifted. The rate of the stock market development will depend on the pace of privatization and the public education.

In the future, A.I.D will continue to provide technical assistance and training geared to improving the Moroccan financial markets.

In the second country presentation, **Mr. Ulrich Ernst** described the conditions of the financial sector in Sri Lanka. For illustration purposes, he used two examples within the Sri Lankan financial context: the finance companies and unconventional initiatives to expand the range of banking services to segments of the population whose needs are not being met by the existing structure.

Regulating New Institutions: the Finance Companies

The 1977 reforms created new opportunities for finance companies, either through direct lending or through lease-purchase arrangements. These reforms in effect allowed anyone to set up a finance company, to start accepting deposits and finance equipment purchases. The new policies made few provisions to ensure the financial soundness of the new institution, leaving decisions on such factors as capitalization and management procedures largely to the companies themselves.

The resulting expansion of the finance company sector was a factor in the country's rapid economic growth in the late 1970' and early 1980's. But the failure to provide regulatory guidance and oversight also opened the door to incompetent and sometimes fraudulent operators. As economic growth slowed down in the mid-1980's, many finance companies encountered difficulties. The Central Bank worked closely with the finance companies themselves to find solutions for troubled companies (restructuring, closure, merger, or the takeover of management by other companies) and provided funds to honor the claims of depositors.

Improving the Performance of Rural Financial Markets

All the work that has been done on rural financial markets in Sri Lanka points to the overwhelming importance of the informal financial system. The formal financial sector in rural areas lurches along without significant impact on production, employment and income. The formal sector has succeeded in mobilizing rural financial resources but has tended to allocate them primarily to urban areas.

Thrift and Credit Cooperative Societies (TCCSs) play a major role in the rural financial system. TCCSs participated very effectively in the expansion of the country's housing finance system, one of the more progressive elements of the financial sector.

In an attempt to bridge the gap between formal and informal institutions in rural financial markets, the Central Bank has sponsored a number of Regional Rural Development Banks (RRDBs). The RRDBs are designed to experiment with and demonstrate innovations in lending practices, in order to spur commercial banks into greater efforts. As a result, virtually all of the major banks are exploring and experimenting with different mechanisms to strengthen linkages between formal and informal institutions.

In general, much of the work on rural financial markets in Sri Lanka has favored the supply side of credit (banks and other financial intermediaries).

1.8 The Policy Triad

The final speaker, **Dr. Stanley Fisher**, presented an overview of the effect of domestic policies on the internationalization and integration of individual developing economies. The main priority today for developing countries is to design and implement the necessary domestic financial policies that would allow them to take advantage of changing global possibilities To argue this point, Dr. Fisher discussed the following three issues: international trade and the Uruguay Round, increasing integration of global capital markets and the implications of these trends for individual economies.

International Trade

The politicians and economists who created the post-World War II economy aimed to restore the global economy that existed in 1913 which was destroyed by two world wars and the Great Depression. They created a framework for international integration to stimulate economic growth. They succeeded beyond any sober expectation. International trade has grown at a faster rate than overall gross national product has throughout the post-World War II period. Major national money, bond and stock markets are now as integrated as they were prior to World War I when capital controls were uncommon.

There are many examples demonstrating that the trend of increasing international financial and economic integration will continue in the last decade of the century: Eastern Europe and the Soviet Union are, hesitatingly, rejoining the international economy; European integration proceeds rapidly; and the Uruguay Round could open up trade in services and perhaps even agriculture and textiles.

On the other hand, fully integrated economies are not guaranteed. U.S. financial institutions, for instance, are in distress. The structural transformation of Eastern Europe and the Soviet Union will be lengthier and more difficult than expected, and the success of the Uruguay Round negotiations is uncertain.

A potential failure of the Uruguay Round raises concerns that, at least, trade growth would cease serving as an engine of growth, and, at worst, that trade restrictions would serve as an engine of destruction.

If the Round fails we can expect increasing non-tariff protection and the further development of regional trading blocs. However, the development of three major exclusive trading blocks in the relevant future looks very unlikely. The complementarities and mutual dependence between East Asia and the United States are too great in the near term for either Japan or the United States to want to reduce their trading links significantly. If a two-bloc world (Europe and the rest of the world) is created this would create larger costs for the developing countries that would have to choose sides, and that might be excluded from one or the other large market. Some appear ready to turn their backs on the liberal international economic order just as the developing countries are trying to join it.

International finance is strongly linked to international trade: the integration of the real sides of the economies is the background against which global financial integration is taking place. A failure in the Uruguay round could seriously dampen the current globalization trend in finance.

Current Global Status of International Financial Markets

International financial markets have become more integrated at both the short and the long ends. At the short end, we live in a global financial market. The internationalization of financial markets is reflected in the possibility of twenty-four hour a day trading, and the essentially instantaneous transmission of shocks, such as the October 1987 stock market crash, among major markets. Speculators, investors, and financial economists have all gone international. These advancements in the international marketplace owes much to the trends in financial deregulation in the industrialized economies and the lifting of capital controls in Great Britain, Japan, and other European countries.

At the long end of the market, investors in the United States, Europe, and Japan directly and indirectly (through pension funds) now have larger shares of foreign securities -- often in the form of mutual fund shares -- in their portfolios than they did a decade ago. Foreign direct investment and the internationalization of production are also results of the mobility of long term capital.

The International Debt Crisis

The international debt crisis of the past decade, however, has cast a shadow on the benefits of international financial market integration. Moderation is now in vogue and it has become clear that while countries and firms can make use of the international capital markets to increase their growth, such activity should be tempered by lessons from the past decade. The debt crisis has taught us that developing countries should:

- Borrow only to finance productive investments. Developing countries must be careful to borrow only to finance projects which are likely to generate the resources needed to service the debt.
- Take advantage of risk-sharing forms of foreign investment. Risk-sharing forms of foreign capital inflow, such as foreign direct investment and portfolio investment, offer many advantages because

they loosely relate the interest rate to the growth rate. Innovative forms of financing, for instance commodity bonds, can also help share the risk between the borrower and the lender.

- Understand that real interest rates can change rapidly. The sharp increase in the real rate in the early eighties, which has more or less been sustained until now, was one of the causes of the debt crisis. High real interest rates make successful borrowing more difficult because projects must generate higher income streams and investment returns than would be required otherwise to be attractive.
- Limit access to foreign borrowing. In Chile and Argentina, the lenders pressured the government to assume the debt of failing private borrowers. The rationale for the debt transfer was that a country's credit rating would be impaired if it did not stand behind its domestic firms. In reality, the debt transfer added to a growing debt burden in Chile and Argentina. The lesson gained from this experience is that domestic firms should not be given unrestricted access to foreign borrowing, particularly non-equity financing.

Policy Implications for Developing Countries

What do the lessons learned mean for developing countries? Specifically, what domestic financial policies can an individual developing country undertake to assure integration into world financial markets?

Integration into World Financial Markets

The liberalization of international capital flows poses potentially difficult problems for developing countries. The experience of the Southern Cone countries shows some of the difficulties. In the late 1970s The Southern Cone countries tried to tighten their money supplies to achieve economic stability, while simultaneously running large fiscal deficits. The result was currency overvaluation which exacerbated the effects of the debt crisis in the 1980s. The lesson to be drawn from this experience is that capital flows should not be liberalized until domestic stabilization has been achieved.

Despite the generally accepted argument that liberalization of international capital flows should come late in the adjustment process, some countries, such as Indonesia, liberalized foreign exchange transactions early and successfully by tightening fiscal policy to reduce domestic interest rates and thereby discourage capital inflows. Others, such as Mexico, have not been able to control capital flows, and have nonetheless adjusted successfully by exercising control over their fiscal deficits.

There is a credibility argument for early liberalization: governments that permit the free flow of capital internationally signal their confidence that their economy will be well-managed, and subject themselves to the discipline of the market's views of the likely course of the current account of the exchange rate. In addition, capital inflows enable the country to supplement the financing of investment. Nevertheless, a government that is not yet fully in charge brings unnecessary complications to its management of the economy by opening the capital account early.

Before liberalizing capital flows, you can get benefits from longer-term inflows, particularly through portfolio investment and foreign direct investment. Countries do not need a fully open capital account to be able to bring in portfolio investments, to set up regulations that allow foreign investors to move their portfolios in and out, and set up arrangements for repatriation of profits. Countries should be focusing on getting these regulations straight rather than opening the capital accounts immediately.

Foreign Direct Investment brings with it the added benefits of potential access to foreign management skills, technology, and markets. Countries that manage their economies well are likely to be able to attract increasing amounts of foreign capital in the form of direct investment.

There are also increasing opportunities for developing countries to hold reserves and borrow (both government and private sector) in innovative commodity-price related hedging instruments. Countries like Mexico, Venezuela, and Indonesia depend on one single commodity; their economies get hit by massive shocks when the price of this commodity moves. Fortunately, today, these risks can be laid off through the use of commodity-price related hedging tools. The issue is less short-term hedging, for which purpose countries can and do participate in the international commodity and futures markets, but is longer-term in nature, using financial instruments such as bonds. Mexico and Algeria now have oil bonds, others have cocoa or copper bonds. Chile has a copper stabilizing fund to control the impact of price fluctuation on the government budget. Venezuela ought to have a similar device because 90% of the government revenues come from oil. Ultimately, most of this hedging which has to be done by the governments will be handled by the capital markets. It doesn't make sense for a country like Chile to try to handle all the risks itself. The industrialized world can easily take this risk and lay it off the developing countries; this area will undoubtly be exploited by the capital markets in the future. These markets are alternatives to the commodity-price stabilization schemes that the LDCs have been trying to set up unsuccessfully for a long time.

Domestic financial policies

The financial sector has long been the source of the most spectacular examples of fraud and mismanagement in both industrialized and developing countries. Because of the crucial roles of deferred payments and therefore of information, and of economies of scale, this is not an industry where laissez faire works well. There is a strong need for a careful system of prudential regulation in financial intermediaries. The focus of the regulations has to be the banking system with the goal of producing a robust system, even at the cost of some sophistication. The banking sector, which won't be allowed to fail, should not be allowed to take financial speculative positions. It should only invest in very safe government obligations (both national and toreign). The rest of the financial system, which will not be bailed out, can invest in whatever pleases them.

Stock markets are not an important source of financing in the early stages of development. Even in industrialized economies, the bulk of financing comes from retained earnings and from borrowing from banks or other financial institutions. Thus the development of a stock market need not be a high priority; but there is no reason to oppose the development of the market, provided that the appropriate prudential regulations are put in place.

Concluding comments

Eastern Europe and the Soviet Union, Latin America and Africa, and now India too, are all moving in the direction of a global economic order. Nevertheless, progress is not inevitable and current events in the areas of international trade and finance may cause rifts in economic integration. Indeed, the Uruguay Round may finally break down, the international economy instead of becoming unified may split into trading blocs, and the volume of international trade may begin to fall.

Both Africa and Latin America have to revive growth after a lost decade. If the open-economy market-oriented strategies that are now so confidently advanced and adopted do not succeed, countries will turn elsewhere. They will study the East Asian examples carefully. They will ask why China, which is reforming in some directions but not others, is doing so well. Fortunately some countries, in particular Mexico and Chile, are seeing the fruits of greater participation in the international economy. But we should not exaggerate the impact of these policies on growth. Chile and Mexico each took several years to turn around in the same way.

We should not be over-optimistic, and we should certainly not over-promise. But with all due caution, recognizing the progress that has been made by countries that have participated fully in the international economy, and the collapse of centrally planned economies, we should be optimistic both about the potential gains from global integration of trade and finance, and the likelihood that many will realize them.

Chapter 2

PARTICIPANT FEEDBACK

At the end of each day, the workshop participants broke up into groups to discuss different topics. Listed below by topic are the feedback, comments, and recommendations of each group.

2.1 The Global Financial Revolution and its Implications for the Financing of Development

Participants opened the discussion by declaring that USAID's current goals are the encouragement of the export businesses with comparative advantage and the development and pluralization of the local private sector. The group also debated whether A.I.D. should operate at a policy or transactional level. It was agreed that the middle of the spectrum, with a demonstration effect, would be the most efficient path. Transactions with demonstration effects would facilitate considerably the implementation of policies.

With this in mind, the participants have recognized the following specific needs:

- A.I.D should start looking at financial instruments that allow pluralization and lessen governments' financial burden. It should encourage the private provision of the infrastructure and social services and develop opportunities in which the international investment community can assist for profit.
- A.I.D. should educate LDCs on risk management techniques. It should promote the concept that the correct allocation of risk can actually optimize returns and reduce risk. That countries are starting to recognize these benefits is evidenced by the growing markets for specific risk that are attracting many LDCs.
- There is a need to strip country risk from transactions. A.I.D. should work to liberalize foreign exchange movements in LDCs so that entrepreneurs are encouraged to thrive.
- The missions should work at lessening the risk exposure of A.I.D. itself.
- A.I.D. has to increase coordination with the other international agencies to increase harmonization. A.I.D.'s intervention should not conflict with the work of these organization and the global movement in general.

2.2 Building and Regulating Financial Markets.

The participants insisted on the need to push for free market reforms: remove direct control, interest rate control and credit control and continue to support prudential regulations. This can be accomplished through policy dialogue and technical assistance. A.I.D. should continue to work on the enabling environment: tax reform, legal reform, etc, mostly through technical assistance.

The participants also underlined the need to focus on market diversification. There must be an attempt to increase the number of agents and actors in the system. In addition, to improve the operation of the market, the quality of the institutions must improve and savings in the market must increase.

In summary, A.I.D. should continue what it is doing through its policy dialogue and technical assistance: removing market control, supporting prudential regulations, improving the enabling environment and diversifying the market.

2.3 Privatization

The participants recognized that privatization procedures should be tailored according to the country, the industry and the size of the enterprise. In addition, they emphasized that the enabling environment plays a crucial role in privatization.

Participants came up with a list of recommendations for A.I.D.:

- A.I.D. should continue to be transaction-oriented in privatization. For example, USAID/Cairo is dealing with transactions as well as policy.
- A.I.D. needs to establish a mechanism that assists and facilitates exchanges between countries undergoing privatization. The International Privatization Group at Price Waterhouse can play a big role in those country exchanges.
- The missions have to make sure that there is a competitive and open private sector before they engage completely in the privatization process. The "privatize the private sector" theme is an important one.
- Foreign assistance requires economies of scale. Small companies need to be grouped together in order to achieve these economies of scale. As a consortium, they may be more suitable recipients of foreign aid.
- Core investors should be found, when possible, in order to ensure that privatization is progressing and that the enterprise is efficiently run.

2.4 Structured Financing and Securitization

The participants stressed the importance of financial innovations in the development of LDCs. They recognized that risk-bearing techniques can be a very important development tool. As an illustration, they described three examples of private sector risk sharing techniques:

- Coffee Producers in Colombia accumulate retained earnings during the good years to finance the years when earnings are low. These retained earnings are transferred to offshore Investment holdings to avoid local negative interest rates.
- Guatemalan nontraditional agricultural producers write marketing contracts that include provision of technical assistance from the customer. As an example, producers of strawberries reduce risk by asking buyers to provide technical and monetary assistance in advance.
- Through commercially sound risk-sharing deals, parastatal intermediaries share the price risks of farmers in Sri Lanka.

The participants debated whether A.I.D. should be in the risk reduction business. Should A.I.D. promote individual deals ? Most of the participants had many question in this area; however, they recognized that there are certain sectors in the enabling environment that A.I.D. should be in. Some of the activities A.I.D. should be involved in include establishing stability in the macro environment, strengthening the enabling environment, developing a good legal environment to allow enforcement of contracts and enforcing transparency and disclosure. Once these goals have been accomplished, A.I.D. should start the securitization process.

2.5 "Avoiding marginalization as a means of globalization while ensuring pluralization of the market place."

The participants recognized that there is a need to increase the number and the variety of institutional investors in the financial system without causing anarchy.

They described future potential A.I.D. interventions:

- A.I.D. needs to (a) map institutional actors to identify required actions; (b) identify the incentives/constraints in the system; (c) evaluate the existing financial markets and assess the need for technical assistance; and (d) find out where the power lies.

- Participants recommended the selection of a set of countries for analysis. A.I.D. should establish a comparative framework and identify problems that constrain the development of financial systems.
- A.I.D. should avoid anarchy by increasing and promoting supervision, transparency and regulation. In addition, A.I.D. should strongly encourage the legal enforcement of these regulations and rules.

Finally, the participants identified possible specific areas where A.I.D. can help. These include providing long-term financing, increasing availability of risk capital, increasing risk sharing transfer opportunities, providing export financing, increasing surveillance, and enforcing regulations.

They also pointed out that A.I.D. has to coordinate its efforts with other international agencies and focus mainly its efforts in areas where it has a comparative advantage.

2.6 Instruments for Risk Management

The participants agreed that financial instruments are very important to the development of LDCs. Financial innovations must be researched and applied wherever necessary. Some of the required steps in the successful application of financial instruments are:

- A.I.D. needs to educate its staff on the use of the new financial innovations so they understand the benefits of these instruments and are able to apply them to their respective markets.
- The missions should undertake an extensive assessment of the financial system of each country before "jumping into action." Once the country assessment is done and the country risk is defined, A.I.D. has to prioritize the needs and act accordingly. It can close the gaps by delivering the required technical assistance (risk management, hedging, export finance, etc)
- There should be an internal assessment of A.I.D. in order to identify the current weaknesses.
- A.I.D. should establish good working relations with the Federal Reserve and the Security Exchange Commission and request their assistance when needed.
- The best way to demonstrate these new instruments is to adopt a transaction-oriented approach.

As an application of these financial mechanisms, one participant pointed out that some LDC corporations need to hedge their export receipts. This can be accomplished through A.I.D.'s export assistance program.

Another comment was that many developing countries are excluded from world finance. A good way to assist these countries is to grant them trade finance credit and/or provide them with offshore/inshore financing mechanisms.

Finally, the group recognized that it is the duty of the missions to find out the needs of each country in terms of financial mechanisms. Having people in the field is A.I.D.'s comparative advantage. A.I.D., through its missions, knows quite well the economic condition of each country (unlike other organizations, such as the "Fed" or SEC).

Chapter 3

WORKSHOP CONCLUSIONS AND NEXT STEPS

Mr. Warren Weinstein, Associate Assistant Administrator, AFR/MDI, summarized the main points of the conference:

1) A vigorous, pluralized private sector is impossible without a liberalized, open, working financial system that has a prudent surveillance mechanism built into the financial infrastructure.

2) Growth, whether led by the private or public sector, requires an expanding financial system and local actors who are comfortable with an ever increasing span of financial system instrumentalities and engineering.

3) A.I.D. has a comparative advantage due to the nature of its resources (grants for the most part) and its on-the-spot knowledge and network of contacts.

4) A.I.D. can help the private and public sectors to understand and use concepts and instruments available in the global financial system and identify ways to enhance domestic financial system infrastructure: legal and enforcement; number, kind and quality of agents; and sophistication in understanding instruments.

5) A.I.D. officers must overcome risk aversion and concerns about working directly with the private sector and supporting the private sector.

6) Financial system growth will not be achieved through policy reform alone; it will require training and, at initial stages, the use of new instruments and perfection of the legal/enforcement infrastructure for prudent surveillance.

7) In moving ahead, A.I.D. should pay careful attention to existing international standards and cooperate closely with other donors and actors, regulatory and agents, in the global financial market.

8) The financial system has developed ways to involve the global financial market to address a specific LDC country's risk and capitalization problems, whether this be based on receivables financing or structures which permit hard currency to be retained outside the domestic market, or use of options and futures.

9) In the Africa Bureau, A.I.D. has to identify one or two countries where the mission program is directed at "getting the market place moving" to:

- Identify the current role and constraints in the financial system.

- Identify the key agents and points of entry for interventions that could accelerate growth in market activity and expansion in the breadth of the market. The countries A.I.D. has in mind have export oriented projects as well as activities aimed at pluralizing the market place through improvements to the market infrastructure.

- Identify instruments, structures, aspects of financial engineering, and legal/enforcement requirements that are relevant and engage in test applications (with both the private and public sectors) to further refine "financial engineering" to country specific requirements.

Based on results in a few demonstration countries, the Africa Bureau will then explore using these experiences for their demonstration effect impact in other African countries.

In conjunction with the African Development Bank and OPIC, the Africa Bureau will hold a seminar for the top leadership in the Finance Ministry and Central Bank to educate it about new instruments and concepts in the global financial market. A second workshop will then be held for the key private sector agents.

10) A.I.D. needs to raise the comfort level in the Africa Bureau in dealing with financial markets/system. In carrying out this plan of action, the Africa Bureau should involve the African Development Bank and should work closely with other donors and with the global market regulatory bodies (e.g., the Basel group and others like it which may come into existence) as well as relevant U.S. government agencies.

Mr. Douglas Tinsler said that what is missing in financial sector development is a policy dialogue, a discussion at the regional level among the actors themselves. There is a real opportunity waiting to be captured in this field. Some of the relevant questions are: How do we get scale? How do we prevent redundancies in terms of getting work done? How can we mobilize the specific resources? How do we go about bringing the ideas talked about at this workshop to the field and get some tangible progress at the end of the day. This is not an easy task to do.

As such, Mr. Tinsler sees a third initiative emerging in Central America which could be called "Financial Sector Development". This third initiative would complement the other two initiatives already in place: the Enterprise for the Americas Initiative (EAI) and the Partnership for Democracy and Development (PDD). This new initiative, which is a derivative of this conference, will focus on a regional perspective of financial sector development and on the re-integration of Latin America into world financial markets. A.I.D. has to make sure that it structures this initiative with active Latin American participation from the beginning. The Group of Three, Mexico, Venezuela and Colombia, as well as Chile, must participate in these initiatives. The impact of these countries on the changing of ideas in Central America is more profound than anything A.I.D. can do by itself. The best role A.I.D. can have is to keep pushing these countries into the limelight. This process is going to be very costly. It is not a one-time event but rather a continuous process.

In turn, **Mr. Ulrich Ernst** gave his own recommendations for future directions. He underlined the need for drafting prudential regulation to increase stability. He also said asking the right question is critical: how much knowledge should we have? We don't need to be experts on financial engineering but we should know how to ask the right questions. He also encouraged an increase in surveillance and transparency, a reform of the financial sector, and the introduction of risk management tools and other financial instruments.

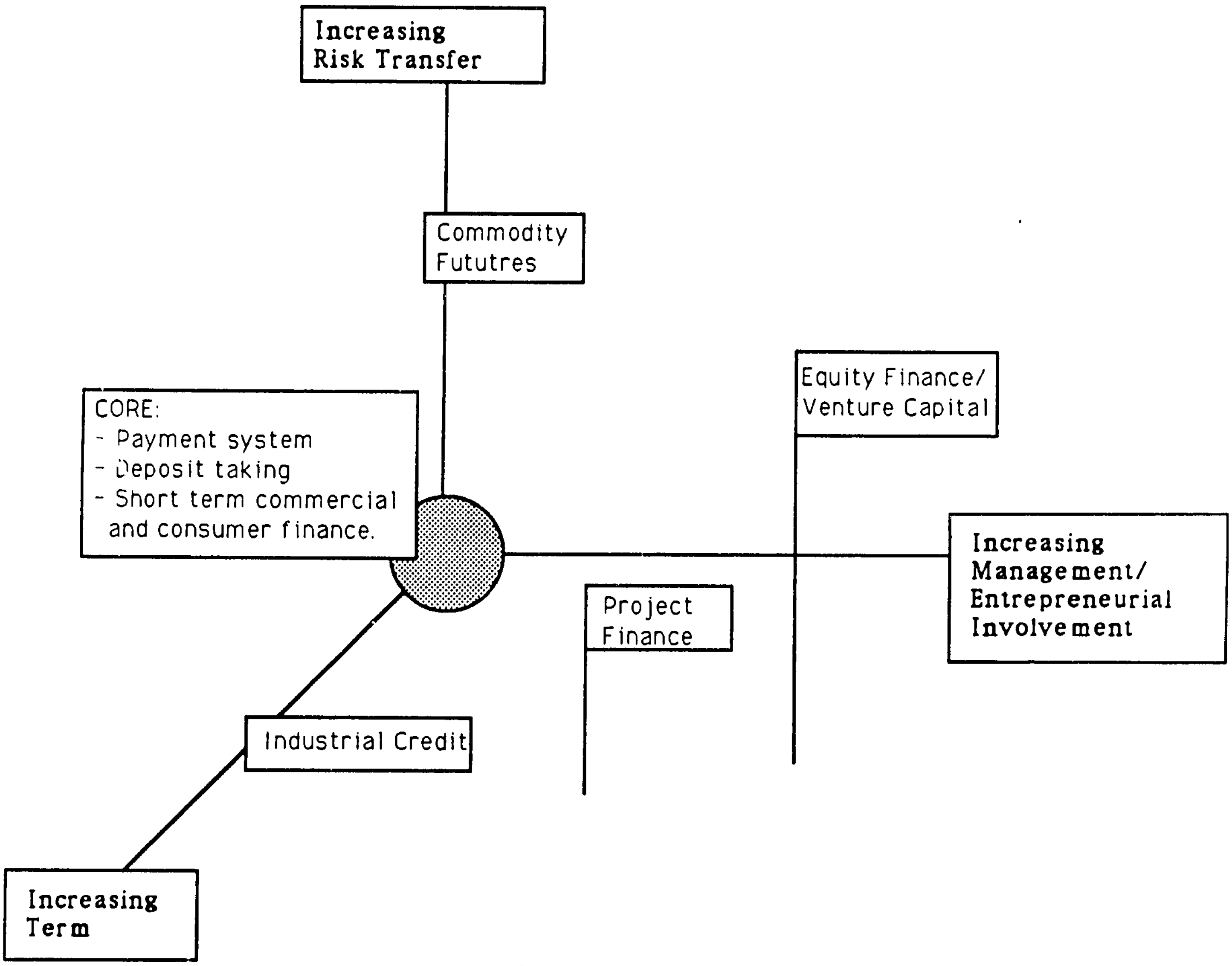
Mr. Ernst also questioned whether A.I.D. should package deals. Is that a proper role? How can A.I.D. participate and leverage its resources? What kind of risk positions could A.I.D. take as a donor agency? A.I.D. has to stop handling risk as a guarantor ("if it goes wrong, we pay you" - the standard guaranty price mechanism). Rather, it has to design mechanisms that share risks, and people can trade off these risks against certain income. This is an area that needs further study, at both the top level and the level of individual projects.

In his concluding remarks, **Dr. Lessard** said that risk is endemic since every economic activity, whether in developing or advanced economies, represents a bet on macroeconomic, technological, and management performance and, as a result, taxpayers, workers, managers and owners will all have exposures to certain key risks. However, one of the main points learned at this conference is that there are numerous ways to shift many of these risks.

In order to improve the ability of economic agent in developing countries, and especially local entrepreneurs, to make these bets, A.I.D.'s first task is to make sure that the core of the financial system -- including mechanisms for the settlement of payments, deposit taking, and the provision of short-term commercial and consumer finance -- works well. Once this is accomplished, it can turn its attention to financial deepening along the three dimensions illustrated in Exhibit (3): extending term, increasing risk shifting, and increasing private entrepreneurial involvement.

Exhibit 3

Dimensions of Financial Deepening



- A.I.D. needs to insure that short-term financing for local and international commerce is available at competitive spreads over the cost of funds relative to worldwide standards. This typically requires an improvement in the basic commercial banking system, including an increase in competition and a reduction in the implicit and explicit taxes levied on financial intermediation by the state.
- Public enterprises must make their payments and collect their fees. The payment system must work adequately.
- A.I.D. needs to identify areas of the economy where risk transfer is really required.
- Private sector involvement must be encouraged.
- Entrepreneurs with good ideas but with no money need to be encouraged.

In order to have strong financial systems, A.I.D. must consider ways to push out on these three dimensions simultaneously.

Dr. Lessard concluded by stating that while the economic problems of LDCs must be addressed primarily at their core through macroeconomic stabilization, restructuring and reduction of external obligations, shrinking the role of the state, and improving the legal infrastructure for finance, certain innovative financing techniques can move these markets closer to the ideal before these fundamental changes are complete.

Closing comments

In his closing remarks, **Mr. John Mullen**, Interim Assistant Administrator for the Private Enterprise Bureau, pointed out that most developing countries have realized that the way to economic prosperity is through free markets. Therefore, A.I.D's current task must gradually change from education to action. The next logical step is essentially to go ahead and adapt market techniques to the particular country setting, learn how to harness the financial techniques to developing countries, and most importantly, to advise wisely on the sequence of reform. Mr. Mullen emphasized that market economies and political democracy will not work without a rule of law in place. An underlying financial institutional infrastructure is required for the successful operation of the financial markets. He also noted that development problems differ from country to country, but financial sector techniques and legal systems can be studied and adopted in many countries. A.I.D. should study financial sectors and carry out country assessments that would point out where the country's weaknesses are. The agency should also complement its traditional policy-based activities with support for transactions.

Mr. Mullen underscored the importance of the demonstration effect. The successful turnarounds of Mexico and Chile, for example, provide lessons to other countries on both policy and transactional levels. A.I.D. must identify some demonstration projects which will serve as an example to all the missions.

Mr. Mullen's final words to the participants were to **go out and act**.

THE FINANCIAL SECTOR IN DEVELOPING COUNTRIES:

LEADING ISSUES IN THE FINANCING OF DEVELOPMENT

Workshop Information

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Andres Velasco	Ministerio de Hacienda, Chile
Dimitri Vittas	The World Bank
Warren Weinstein	Associate Assistant Administrator, AFR/MDI
Philip Wellons	Harvard University
Clarence Zuvekas	International Economist, LAC/DPP/EA

AGENDA

SUNDAY AUGUST 18

3:00 - 5:00 p.m. **REGISTRATION**

Patricia Parera
Priscilla Schroy

5:00 - 6:00 p.m. **RECEPTION**

6:30 p.m. Dinner

MONDAY, AUGUST 19

8:30 - 9:00 a.m. **WELCOME AND INTRODUCTORY REMARKS**

Michael Unger, Chief Financial Economist

SPEAKER: John Mullen, Assistant Administrator (Designate), Private Enterprise Bureau

9:00 - 10:00 a.m. **THE GLOBAL FINANCIAL REVOLUTION AND ITS IMPLICATIONS FOR THE FINANCING OF DEVELOPMENT**

MODERATOR:	Michael Unger	
SPEAKER:	Donald Lessard	The Global Financial Revolution
COMMENTATOR:	Andrés Velasco	The Global Financial Revolution and the Opening of LDCs Financial Markets

10:00 - 10:30 Coffee

10:30 - 12:30 a.m. **INCREASING EQUITY PARTICIPATION**

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Supply-side measures to increase, open and broaden entrepreneurial and investor participation in the private sector including privatization, management earnouts and venture capital.

MODERATOR:	Donald Lessard	
SPEAKER:	Roger Leeds	Increasing Equity Participation through privatization
COMMENTATORS:	Aaron Tornell	Privatization in Mexico
	Kenneth Locklin	Venture Capital in Africa

12:30 - 1:30 Lunch

1:30 - 3:30 p.m. STRUCTURED FINANCING AND SECURITIZATION

Financial innovations that increase the role of private investors in risk taking and management, and limit recourse to host governments, where traditional equity is not feasible.

MODERATOR:	Lance Marston, Senior Business Advisor	
SPEAKERS:	Donald Lessard	Structured Financing and Securitization
COMMENTATORS:	Richard Breen	Securitization in Housing, Portugal Case

3:30 - 4:00 Coffee

4:00 - 5:00 BREAK OUT GROUPS

GROUP LEADERS: Peter Benedict, Mark Kraczkiewicz, David Dodd

5:00 - 6:00 PLENARY

DISCUSSION LEADER: Donald Lessard

6:00 - 7:00	Reception
7:00	Dinner

TUESDAY, AUGUST 20

8:30 - 10:30 a.m. **INSTITUTIONAL INNOVATIONS TO DEMOCRATIZE CAPITAL**

Demand side innovations to deepen markets and broaden investor stakes in LDC private sector: contractual savings institutions and investment funds.

MODERATOR: Warren Weinstein, Associate Assistant Administrator

SPEAKERS:	Antoine van Agtmael	Country Funds and their Impact on the Development of the Local Capital Market
	Dimitri Vittas	Contractual Savings - Institutions and the Development of Financial Markets
	Mario Abuhadba	Regulatory Considerations of Pension Fund Management Firms in Chile

10:30 - 11:00 Coffee

11:00 - 12:30 **SWAPS, OPTIONS AND GUARANTEES**

Basic applications of fixed income derivatives within LDCs; distinction between derivatives linked to market risks and corporate equity.

MODERATOR: Michael Unger

SPEAKER:	Nalin Kulatilaka	Swaps, Options & Guarantees
COMMENTATOR:	Gaylen Byker	Applications of Innovative Financial Instruments in LDCs

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12:30 - 1:30	Lunch		
1:30 - 3:30 p.m.	**BUILDING AND REGULATING FINANCIAL MARKETS**		
	MODERATOR:	Richard Breen, Manager FSDP	
	SPEAKER:	Philip Wellons	Building and Regulating Financial Markets
	COMMENTATORS:	Douglas Tinsler, USAID/San José	
		Ghon Rhee	Regulation and Systemic Market Risk in Asian Securities Markets
3:00 - 3:30	Coffee		
3:30 - 4:15	**COUNTRY PRESENTATIONS ON THE DEVELOPMENT AND REGULATION OF FINANCIAL MARKETS**		
		Mark Kraczkiewicz, USAID/Rabat	
		Ulrich Ernst, USAID/Tegucigalpa	
4:15 - 5:30	**BREAK OUT GROUPS**		
	GROUP LEADERS:	Randy Peterson, Larry Brown, Ealine Grigsby	
5:30 - 6:30	**PLENARY**		
	DISCUSSION LEADER:	Donald Lessard	
6:30 - 7:30	Reception		
7:30	Dinner		

WEDNESDAY, AUGUST 21

8:30 - 9:45 **THE POLICY TRIAD**

COMMENTATOR & MODERATOR: John Blackton, USAID Mission Director

SPEAKER: Stanley Fischer The Policy Triad

9:45 - 10:00 Coffee

10:00 - 11:30 **WHERE DOES AID GO FROM HERE ?**

FACILITATOR: Philip Wellons

REPORT TO PLENARY: Warren Weinstein, Douglas Tinsler, Ulrich Ernst

11:30 **CLOSING COMMENTS**: John Mullen

THE FINANCIAL SECTOR IN DEVELOPING COUNTRIES:

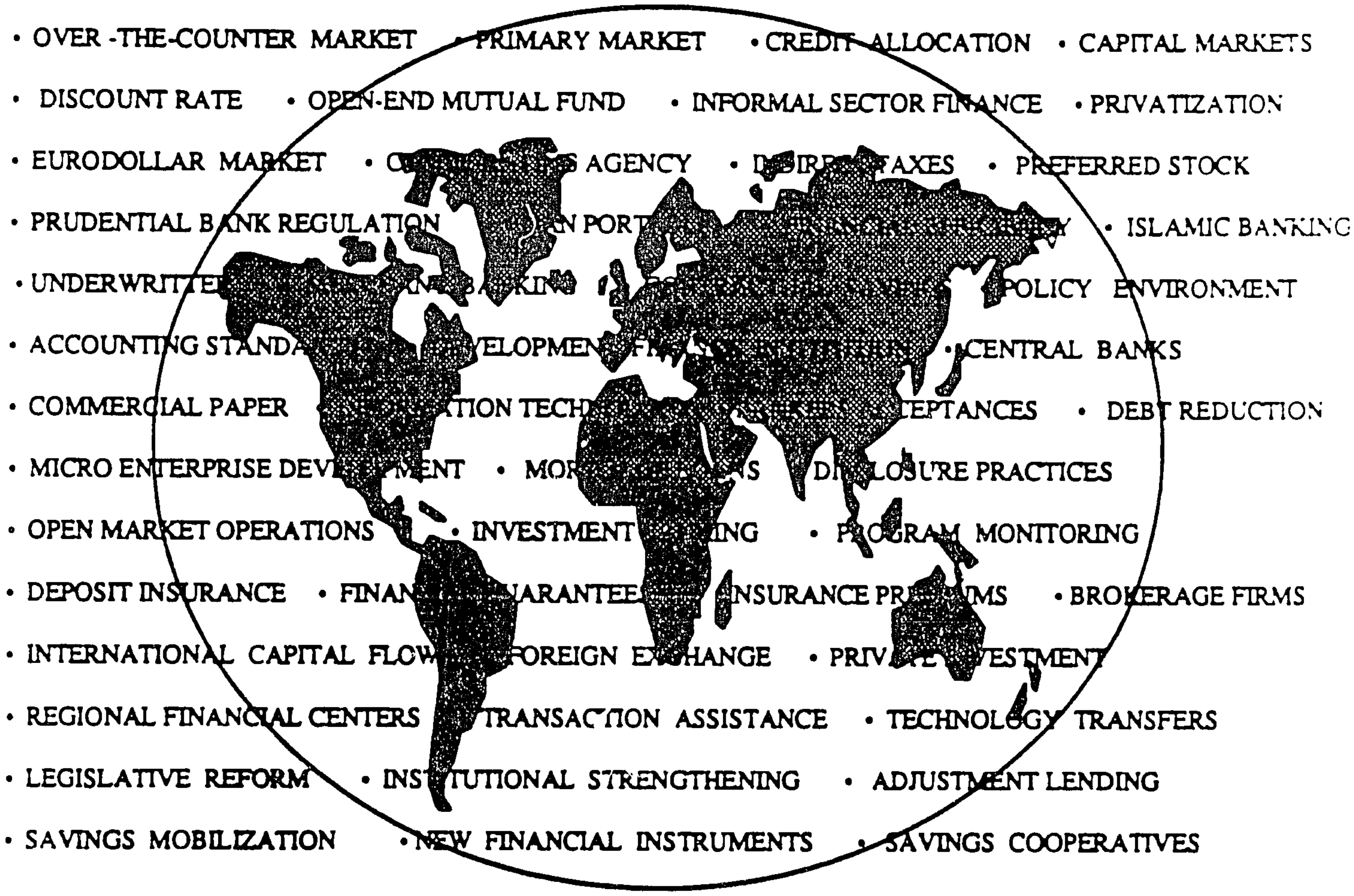
LEADING ISSUES IN THE FINANCING OF DEVELOPMENT

Excerpts from Supporting Documents

Excerpt from:

AGENCY FOR
INTERNATIONAL DEVELOPMENT

REGIONAL FINANCIAL MARKETS GUIDEBOOK



BUREAU FOR EUROPE AND NEAR EAST

AUGUST 1991

PREFACE

The primary purpose of this guidebook is to provide guidelines and ideas on potential areas to explore in financial markets development to project officers in the Agency for International Development. The guidebook also provides a summary of the policy context for financial markets programming within A.I.D., as well as a summary of our experience in financial markets development to date.

The need for this type of guidebook was first discussed during the Asia, Near East, and Europe Bureau's private sector officers' workshops held in Thailand and Jordan in May 1990. Workshop participants agreed that a comprehensive, step-by-step guidebook was needed if Missions were to expand their financial markets development programs. This guidebook attempts to address that need; it also complements a previous Guidebook on Trade and Investment produced by ENE/PSD in July 1990 and reviewed in draft at the May field workshop. Our intention was to develop a "user-friendly" guidebook that would be of use to project officers in designing, implementing and evaluating activities in financial markets development. We have tried to keep technical and bureaucratic jargon to a minimum, and where special terminology or acronyms are necessary, they are explained in the text or defined in the glossary in Annex A.

What this guidebook does not do is prescribe areas for financial markets development. Given the diversity of political, economic and social conditions in which A.I.D. operates, there is no one approach to financial markets development that is suitable for all countries. Rather, the guidebook intends to provide some practical programmatic suggestions for project officers. In the process, we hope to encourage 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 business community.

In this connection, it is also useful to observe up front that this guidebook has been written largely, but not exclusively, with the organization of the U.S. financial markets in mind. This, however, should not be meant to imply that the systems currently in use in the U.S. financial markets are the only models appropriate to all developing country situations. This is manifestly not the case, and project officers should be alert to the potential applicability of models used in other advanced financial markets to the local situation. Future editions of this guidebook will provide more information about financial models used in other countries.

As you read through this guidebook, I urge you to keep in mind the general principles which guide all of our efforts in designing development programs. The ENE Bureau's broad programmatic strategy of "Open Markets - Open Societies" lies at the core of everything we aim for. It expresses a linkage between the human desire for freedom, and the kind of economic system that most effectively promotes development. This broad aim has its counterpart in more specific principles which apply directly to the development of financial markets. The following paraphrase from the 1988 Financial Market Development policy paper bears repeating as the most succinct expression of these principles:

> A.I.D. should promote a system of financial markets that is integrated and relatively undistorted, one that relies heavily on competitive private financial institutions, and

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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.

Organization of the Guidebook

The Guidebook is structured in four parts. Part One explores what we mean by "financial markets development." It includes a discussion of the international evolution of financial markets in order to provide historical context for A.I.D.'s financial markets programs, as well as a brief summary of financial markets in the Near East and Asia. The heart of the Guidebook -- Chapter III of Part One -- examines potential areas for activities in financial markets development. The areas examined include:

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

Part Two of the guidebook examines policies and programs in financial markets development including those of A.I.D. and other major multilateral donors and U.S. Government agencies. We begin by looking at the policy framework of financial markets development in the U.S. Government and A.I.D. and then examine the types of interventions A.I.D. Missions have undertaken over the past decade. A key theme of this part of the guidebook is how A.I.D.'s financial markets' policy and programs have evolved over time. Based on our review of A.I.D.'s financial markets activities, we have identified some of the key trends and directions for future programming. Areas for collaboration between A.I.D. and other institutions are highlighted at the conclusion of this part of the guidebook.

Part Three of the guidebook explores the "how-to's" of financial markets programming. It describes how to conduct a financial sector assessment, a critical first step toward defining options for financial markets programming. This part also provides some general guidelines for the design of financial markets programs, as well as guidance on how to evaluate such programs.

Part Four of the guidebook describes resources for financial markets development that may be useful. It provides an illustrative list of technical assistance and training resources, a calendar of up-coming events focusing on financial markets, and an annotated bibliography of sources of information on financial markets development. We hope that this guidebook will be a valuable resource to project officers in furthering their understanding of financial markets and will stimulate their interest in obtaining additional information or training.

We welcome your comments on the guidebook. In order to provide Missions with relevant and up-to-date information, we plan to issue a supplement to this guidebook in the fall of 1991. The supplement will include the proceedings of the Agency-wide Workshop on "Leading Issues for the

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Financing of Development" to be held in August 1991, as well as a compendium of your comments on the guidebook. Please submit your comments to Gary Vaughan, ENE/DR/PE/FTI, Room ~~4440~~ NS, U.S. Agency for International Development, Washington, D.C. 20523. In the interim, we hope that the guidebook is of assistance in your efforts to promote financial markets development.

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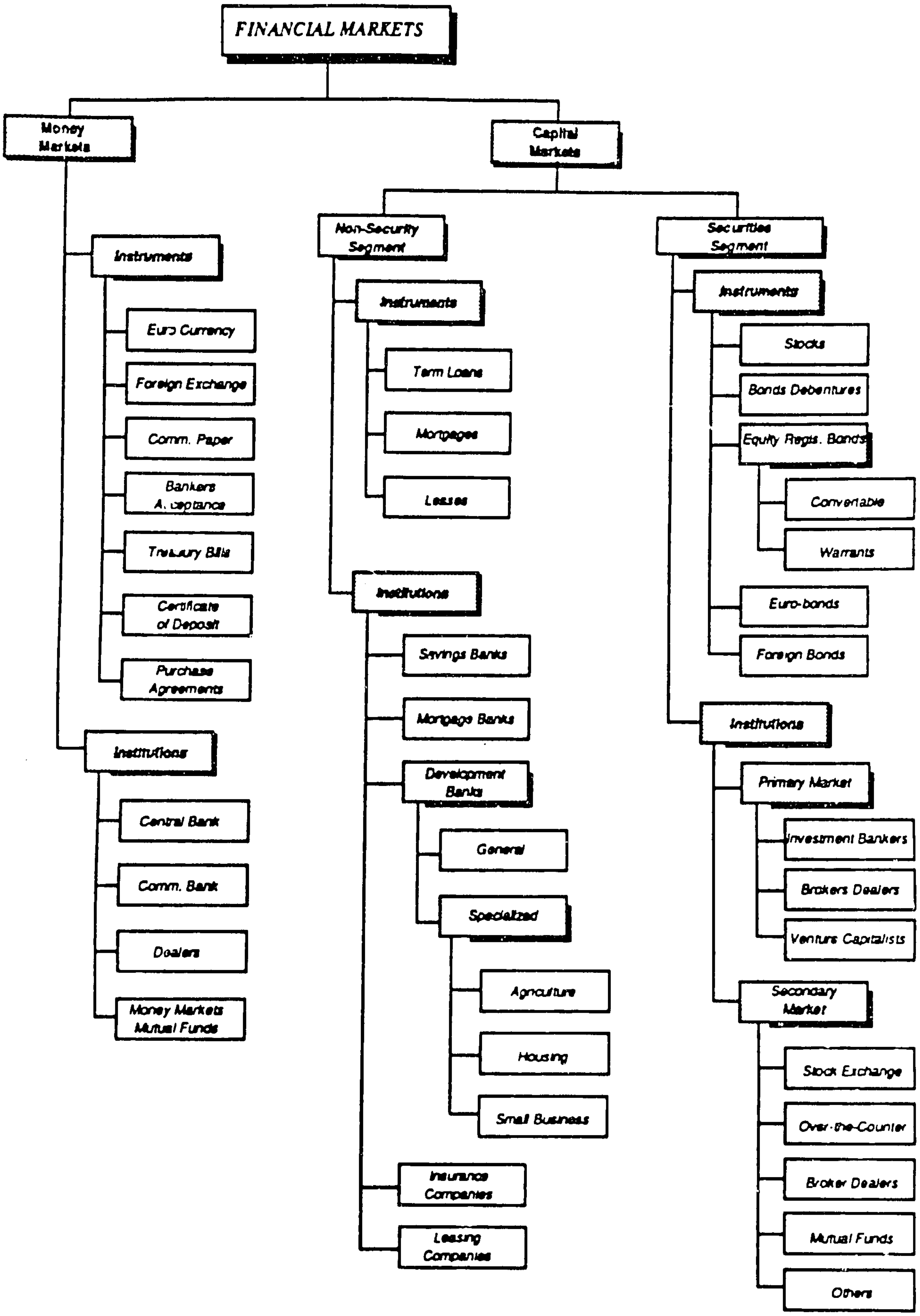
An Overview of Financial Markets



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CLASSIFICATION OF A.I.D. INTERVENTIONS

TASKS	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		

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		

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.

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 polic· ·r technical assistance requirements; A.I.D. often best assists by focusing on a small part of the r. .rm 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 will 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 will 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.

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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.

The Costa Rica Credit Union Strengthening Project funded by USAID was designed to strengthen the capacity of the Costa Rica National Federation of Savings and Loan Cooperatives (FEDERCREDITO) to serve rural cooperatives and to initiate efforts toward self-sufficiency. Project components include: (1) production loans to cooperatives to finance activities in rural areas; (2) a rotating fund to help rural cooperatives upgrade their administrative and financial procedures; and (3) the establishment of a reserve fund as the basis for a cooperative mutual assistance program.

6. <u>Privatization</u>

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.

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.

A.I.D. Policy Paper

Financial Markets Development

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.

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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 inves[illegible]ents 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.

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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.

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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 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 is 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 suggests 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 very 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; artifically 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 credit-worthiness, 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

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*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

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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

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*The informal sector refers to those business entities that operate outside formal economic and governmental structures and range in size from the small and labour-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 — [illegible] 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.

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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 c[illegible] 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 enterprepreneurs.

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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.

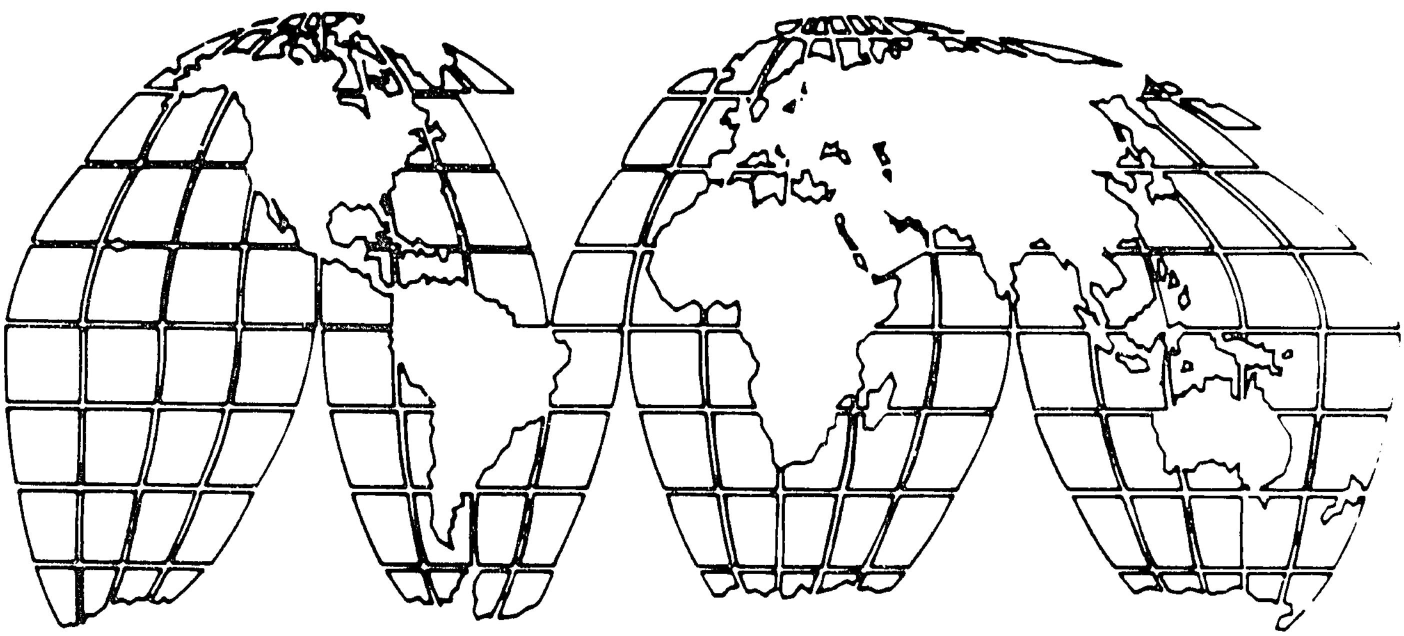
Venture capital—Capital to provide funds for start-up situations ("seed capital") or for existing high-risk small businesses suffering from capital deficiencies but having high profit potential as emerging growth companies.

Yield—The rate of return from one's investment in a specific security or specific piece of property.

Excerpts from:

A.I.D. Program Evaluation Discussion Paper No. 31

Development Finance Institutions
A Discussion of Donor Experience



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FOREWORD

In 1982, the Development Assistance Committee of the Organization for Economic Cooperation and Development (DAC/OECD) established an Expert Group on Aid Evaluation to improve donor evaluation methods and practices; to strengthen donor coordination, standardization, and joint efforts in evaluation; to promote and support the evaluation capabilities of developing countries; and to contribute to aid effectiveness by synthesizing from donor evaluation experiences operational lessons for improving project and program design and implementation.

With regard to the last objective, the DAC Expert Group on Aid Evaluation has in recent years produced various reviews of the effectiveness of donor approaches in the priority areas of health care, program sustainability, and technical cooperation, asking the fundamental question, What, in the conduct of development interventions, works, what does not work, and why? A.I.D.'s Center for Development Information and Evaluation (CDIE) has found such syntheses of mutual donor experiences to be valuable in providing a broader basis for assessing development intervention than that provided by a review of A.I.D. experience alone. Insights from such studies can contribute to improving the quality of development assistance and to promoting greater harmony among donor operations and practices.

Recently, CDIE staff prepared two reviews of donor experiences for the DAC meetings in February 1990: The Development Impacts of Program Food Aid: A Synthesis of Donor Findings and Current Trends and Strategies and Development Finance Institutions: A Discussion of Donor Experience. The reports are syntheses based on evaluations of program food aid and of development finance institutions carried out by donors, including A.I.D., and on assessments by other development professionals. Because the reports present a compendium of donor experiences in these areas and highlight common donor findings and lessons, they have relevance to a broad audience of program and project managers in both A.I.D. and the wider donor community.

To broaden the awareness of the development community on the valuable lessons learned from these reviews, CDIE is publishing the DAC papers under its Program Evaluation Discussion Paper series. CDIE wishes to express its sincere thanks to all members of the DAC who supplied evaluation reports for the reviews.

This paper examines key issues with respect to the decision of continued donor support for development finance institutions (DFIs) based on a review of donor experience to date. Donors have supported DFIs in developing countries as intermediaries for

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providing credit to targeted beneficiary groups, such as small businesses. The issues raised in the paper include the effectiveness of DFIs as intermediaries for targeting credit to priority sectors, the long-term viability of DFIs in developing countries, and the contribution of DFIs to the development of financial markets. The paper aims to stimulate discussion on donor strategies for developing financial systems that are able to mobilize local resources and supply long-term credit to priority groups in developing countries.

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Bureau for Program and Policy Coordination
Agency for International Development
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SUMMARY

Development finance institutions (DFIs) have for several decades been important intermediaries for donors aiming to channel financial resources to priority groups and to fill the long-term credit gap. The 1989 Development Assistance Committee (DAC) agenda report recommends continued support for these institutions, contending that DFIs are indispensable for reaching small- and medium-sized enterprises. This review of donor evaluation reports of DFI projects aims to stimulate needed discussion on key issues concerning continued donor support to DFIs. The paper focuses on three questions: (1) How effective have 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?

Two different objectives leading to two different orientations have characterized donor support of DFIs during the 1970s and 1980s. Some donors looked to DFIs as instruments of financial market development, expecting DFIs to fill the long-term credit gap in the private sector, to mobilize domestic savings, and, ultimately, to be financially viable institutions. Other donors conceived of DFIs primarily as vehicles for targeting long-term credit to predominantly disadvantaged groups, intending loans to improve income distribution and increase production and employment. Thus, these institutions were expected to fulfill roles both as promoters of development objectives and as self-sustaining financial intermediaries. The findings from the review of the evaluation reports suggest that DFIs have had and may continue to have considerable difficulty achieving either of these objectives.

Recent evaluations and studies of DFI programs have found that in some developing countries, DFI programs have helped expand the supply of long- and short-term credit to the private sector, thus stimulating growth in that sector. However, donor evaluations have become increasingly pessimistic about the capacity of DFIs to reach target beneficiaries. The high collateral requirement for credit, significant transaction costs of loans, and subsidized interest rates charged to subborrowers have typically resulted in tremendous concentration of resources in a few large subborrowers located in particular areas. Furthermore, donors have often operated at cross purposes. They have supported a multiplicity of DFIs targeting a range of economic sectors, creating confusion and sometimes excess of funds. Adding to the complexity, donors have set different terms for their assistance. They established different interest rates and loan criteria for subborrowers in each of the DFIs assisted, often

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leading to further confusion among subborrowers, underutilization of donor loan funds, and instability of the lending institution.

In addition, recent research on the informal sector has pointed to this sector's continued lack of access to formal sources of credit, including loans from DFIs. In fact, donors are increasingly acknowledging the inability of DFIs to reach the informal sector and marginal farmers, and are instead giving priority to developing alternative programs for reaching these target beneficiaries.

Many donors have operated under the assumption that DFIs will become sustainable financial intermediaries; however, a review of a wide spectrum of donor evaluation reports reveals that poor financial performance is typical of most donor-supported DFIs. Many DFIs suffer from high levels of arrears on their loan portfolios, and some even have difficulty covering their operating expenses and are dependent on government and donor resources for their sustainability.

A serious constraint to achieving sustainability has been the inability of DFIs to mobilize domestic savings and to operate as full-fledged financial institutions. As a result, DFIs have not been able to diversify risk or compete effectively with commercial banks and other sources of long-term credit operating in developing countries. Furthermore, the cost associated with providing a wide range of services aimed at reaching development objectives has added to the financial burden of these institutions. This leads to the question, When does financial self-sufficiency become the overriding objective to the exclusion of development aims? Another major constraint to sustainability of DFIs is the limited management capacity of the institutions, which has hindered their ability to compete in the increasingly complex economic environment.

Finally, DFIs have not been able to contribute effectively to strengthening financial markets in developing countries. First, the assumption of donors that DFIs would have a virtual monopoly over long-term finance has proven false in face of increasing competition from commercial banks, leasing companies, and other sources of long-term credit. Second, financial policy in many developing countries controls interest rates and credit allocations, limits short-term lending and commercial paper operations, restricts competition among financial intermediaries, and constrains financial diversification. Such policy measures have placed severe limits on the ability of DFIs to offer new financial services, raise substantial local resources, and help develop local capital markets. Given the increased competition, diversification of financial services is an important option for DFIs in many countries. However, with regard to developing financial markets, financial policy reform may be more critical than reliance on DFIs.

In summary several lessons emerged from the review of donor evaluation reports of DFI programs:

1. Donors have operated at cross purposes in supporting DFIs. The result has been confusion among subborrowers and inefficient use of loan funds. To increase the efficiency of existing and future sources of long-term credit, donors may need to adopt more coordinated responses to promoting DFIs.

2. DFIs have had limited success in reaching target beneficiaries. To expand supply of long-term credit to these beneficiaries, donors need to assist DFIs in lowering the administrative cost of the loans, encourage DFIs to charge real positive interest rates, rely more on established financial institutions with extensive branch networks, and direct DFIs toward credit and financial market development to ensure more efficient use of available credit.

3. Few DFIs have achieved sustainability. The most successful tend to be financial institutions capable of mobilizing domestic savings and offering a variety of services and a strong management capacity. Donors may need to reassess their goals for DFIs: Should DFIs be self-sustaining institutions to the exclusion of some of their development goals or should they pursue development objectives, even if this requires continuing subsidy to DFIs?

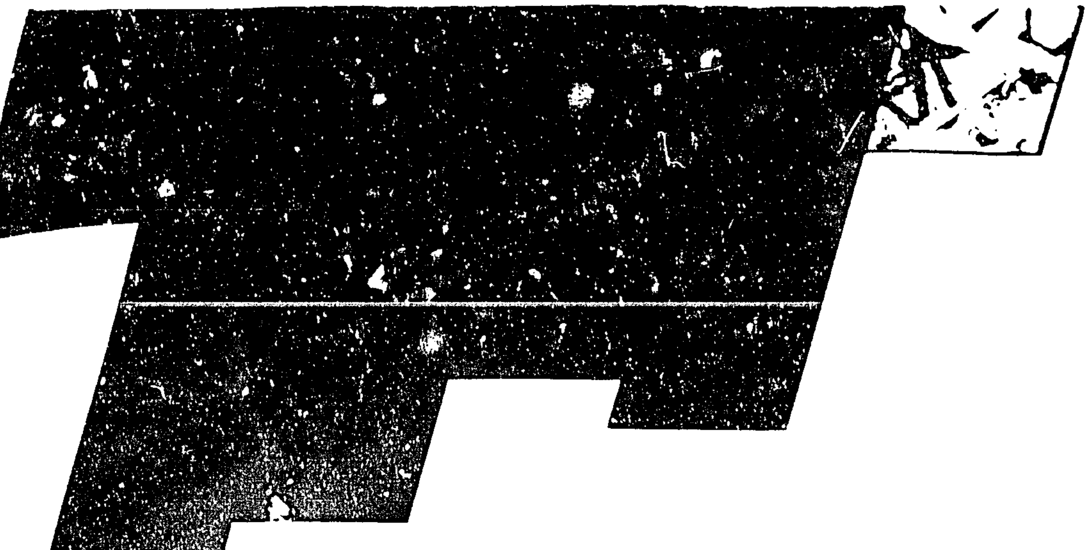
4. DFIs have not been particularly effective in contributing to financial market development; instead policy reform appears to be the critical factor in the development of such markets. In this context, increased competition among DFIs and diversification of financial services are important for promoting capital markets in developing countries.

Excerpt from:

World Development Report 1989

Financial Systems and Development
World Development Indicators

Source: The following excerpt is the Chapter One taken from the World Bank's "World Development Report 1989" published in June 1989 by the Oxford University Press. Copies of the entire booklet were distributed to all participants at the August 1981 workshop. A reference copy should be obtainable from the Program Economist at each U.S.A.I.D. mission.



Financial systems and development: an overview

The experiences of the 1980s have led many developing countries to reconsider their approach to development. Although countries differ in the scale of government intervention and in the extent to which they have already stabilized and restructured their economies, most have decided to rely more upon the private sector and market signals to direct the allocation of resources. To obtain all the benefits of greater reliance on voluntary, market-based decisionmaking, they need efficient financial systems.

A financial system provides services that are essential in a modern economy. The use of a stable, widely accepted medium of exchange reduces the costs of transactions. It facilitates trade and, therefore, specialization in production. Financial assets with attractive yield, liquidity, and risk characteristics encourage saving in financial form. By evaluating alternative investments and monitoring the activities of borrowers, financial intermediaries increase the efficiency of resource use. Access to a variety of financial instruments enables economic agents to pool, price, and exchange risk. 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 their own activities have undermined financial development. In recent years financial systems came under further stress when, as a result of the economic shocks of the 1980s, many borrowers were unable to service their loans. In more than twenty-five developing countries, governments have been forced to assist troubled intermediaries. The restructuring of insolvent intermediaries provides governments with an opportunity to rethink and reshape their financial systems.

Conditions that support the development of a more robust and balanced financial structure will improve the ability of domestic financial systems to contribute to growth. By restoring macroeconomic stability, building better legal, accounting, and regulatory systems, specifying rules for fuller disclosure of information, and levying taxes that do not fall excessively on finance, governments can lay the foundations for smoothly functioning financial systems. This Report reviews the lessons of experience in both high-income and developing countries and tries to identify the measures that will enable domestic financial systems to provide the services needed in the 1990s.

The economic background

In 1988 conditions were generally favorable for economic growth in the developing countries. High-income countries enjoyed steady growth with low inflation for the sixth consecutive year and grew even faster in 1988 than in 1987. Interest and exchange rates were less volatile than during earlier phases of the recovery from the worldwide recession of 1982, and prices of the principal commodities exported by developing countries rose by an average of 20 percent.

Some developing countries have taken advantage of the favorable world environment. Most countries in Asia did well; in several the gross national product (GNP) grew at an estimated annual rate of 10 percent. Some countries, however, continued to suffer from misdirected domestic policies, excessive indebtedness, and the economic shocks of the 1980s. The growth rates of many African nations remained near zero. The heavily indebted economies also continued to stagnate. The governments of creditor countries agreed at the Toronto summit to grant debt relief to the poorest and most heavily indebted countries, such as the countries of Sub-Saharan Africa, and early in 1989 took the first official steps to sanction debt relief for the middle-income countries. But despite a rise in the disbursement of funds to the highly indebted countries in 1988, net transfers to these countries continued to be negative.

Future growth in the developing countries will depend in part on the policies of high-income countries. By ensuring the success of the Uruguay Round of trade negotiations, the high-income countries can create a favorable environment for the exports of developing countries. Tighter fiscal but easier monetary policy in high-income countries would bring international interest rates down, which would ease the burden of debt. This would benefit developing and high-income countries alike. But far more important will be the policies pursued by the developing countries themselves. They can improve their growth prospects by continuing to seek fiscal balance and trade reforms. The decline in foreign capital flows has placed a premium on policies that encourage domestic saving and investment and direct the flow of resources to profitable activities—in other words, on policies that will improve the performance of domestic financial systems.

Origins of financial distress

When the developing countries set out to modernize their economies in the 1950s and 1960s, their financial systems comprised mainly foreign-owned commercial banks. These provided short-term commercial and trade credit. Governments decided to remodel their financial systems to ensure that resources were allocated in accordance with their development strategies. Toward this end, they created new financial institutions to provide funding at low interest rates to the sectors that were to be at the forefront of industrial development, or they directed existing institutions to do so. The governments themselves borrowed heavily, both from the domestic financial system and from abroad, to finance budget deficits and the needs of state-owned enterprises. In many countries banks were also directed to open rural branches in order to mobilize deposits and provide credit to widely dispersed smallholders.

During the 1960s this development strategy seemed to be working: many developing countries grew rapidly. But economic performance during the 1970s was more mixed. Despite favorable terms of trade and an ample supply of cheap foreign financing, growth in some countries began to slow. Except in Asia, only a few developing countries have grown rapidly in the 1980s.

The interventionist approach was much less successful in promoting financial development. Under government pressure, banks did lend to state enterprises and priority sectors at below-market interest rates, but spreads were often too small to cover the banks' costs. Many of the directed loans were not repaid. Interest rate controls discouraged savers from holding domestic financial assets and discouraged institutions from lending longer term or to riskier borrowers. In some countries public borrowing from commercial banks displaced lending to the private sector; in others, public borrowing financed by money creation led to rapid inflation. Many countries developed a market for short-term debt, but only a few have more than a rudimentary system for long-term finance. In sum, the financial systems of all but a few developing countries remain small and undeveloped.

In recent years the inability or unwillingness of borrowers to repay their loans has become a serious problem. Its roots lie in the shocks of the early 1980s and in the industrial and financial policies pursued over the past thirty years. Many countries depended on commodity exports and foreign borrowing to pay for the imported inputs essential to their industrialization programs. For the highly indebted countries in particular, foreign borrowing became expensive as interest rates rose in the late 1970s; it became virtually impossible as foreign commercial banks ceased voluntary lending after 1982. Deteriorating terms of trade and international recession in the early 1980s further reduced countries' ability to pay for imports. Many countries were forced to reduce their trade deficits. To promote exports, they devalued their currencies

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and lowered their tariffs and other trade barriers. Firms in developing countries therefore had to face abrupt changes in relative prices, often alongside recession at home. Many became unprofitable and thus were unable to service their loans.

Instead of foreclosing on bad debts, many bankers chose to accrue unpaid interest and roll over unpaid loans. In some cases this was because the borrowers were linked to the banks through ownership, in others because taking provisions for loan losses would have made the banks insolvent. Collateral was often inadequate, and foreclosure procedures were slow and biased in favor of debtors. So in many countries it was not thought feasible to start bankruptcy proceedings. The practice of rolling over unpaid loans and making new loans to cover unpaid interest has undermined the adjustment process: instead of financing new ventures made profitable by changed relative prices, much new lending has gone to prop up firms that are no longer viable.

Financial institutions in many developing countries have suffered large losses: many are insolvent, and some have actually failed. Bank insolvency is nothing new, but the scale of the problem—the number of insolvent institutions, the size of their losses, and the number of countries affected—is without precedent. Although more than twenty-five developing countries took action during the 1980s to restructure financial institutions, many of them dealt with only the largest or most seriously affected ones; others remain severely impaired. Restructuring banks is politically difficult, particularly when the banks are public or the principal defaulters are public enterprises, but experience shows that delay is costly and that losses mount with time.

Reform needs to go beyond recapitalizing insolvent banks. It must address the underlying causes of bank insolvency as well. Governments can strive to provide macroeconomic stability, which generally means reducing their spending. They can also undertake the structural adjustments that will lead to a more productive use of resources. Restructuring or closing insolvent firms must be part of this process; otherwise the recapitalized intermediaries that continue to lend to them will once again become insolvent.

Prerequisites for financial development

Countries with stable economies and fairly well-developed and competitive financial markets would benefit from giving market forces more influence over interest rates. Where these conditions are not satisfied, governments may choose to control interest rates, but unless that control is flexible enough to take account of inflation and market pressures, it will impede financial development. Proper alignment of interest rates is particularly important for economies that have open capital markets.

In the past, governments have allocated credit extensively. In a world of rapidly changing relative prices, complex economic structures, and increasingly sophisticated financial markets, the risk of mismanaging such controls has increased. Many countries could allocate resources better by reducing the number of directed credit programs, the proportion of total credit affected, and the degree of interest rate subsidization. Governments that continue to direct credit should specify priorities narrowly. An emphasis on credit availability is preferable to interest rate subsidies, which undermine the financial process.

Liberating financial institutions from interest rate or credit controls cannot, by itself, ensure that financial systems will develop as intended. The legal and accounting systems of most developing countries cannot adequately support modern financial processes. Legal systems are often outdated, and laws concerning collateral and foreclosure are poorly enforced. Because collecting debts can be difficult, and because borrowers are hard to monitor and control, lenders have been unwilling to enter into certain types of financial contract. If governments overcome such reluctance by directing banks to make loans that the banks consider too risky, losses can result. Governments can increase the supply of long-term loans and other types of financing by reducing the risks to lenders—for instance, by requiring fuller disclosure of financial information and defining and enforcing the lenders' rights. To ensure the stability of the financial system and discourage lenders from fraud, it is equally important for governments to supervise financial markets and institutions. In the past, supervisors have spent too much time checking banks' compliance with directives on credit allocation and too little time inspecting the quality of their loans and the adequacy of their capital.

Institutions and markets

Commercial banks are likely to remain the dominant institutions for some time. Banks can be made more efficient by improving their management systems and increasing the competition they face. Better management requires new lending policies.

better loan recovery procedures, more sophisticated information systems, and better-trained staff. The entry of new banks, domestic or foreign, can stimulate competition.

Countries also need to develop other financial institutions, whose services compete with and complement those of commercial banks. Nonbank financial intermediaries, such as development finance institutions, insurance companies, and pension funds, are potentially important sources of long-term finance. Most of the existing development banks are insolvent, however. Where they are to be restructured, rather than closed or merged with commercial banks, thought must be given to their future role and viability. Any diversification should build on the experience of their staffs and on their existing client relationships. As more of the population becomes able to and desires to make provision for retirement, contractual savings institutions will grow in size. Permitting pension funds and insurance companies to invest in financial instruments other than low-interest government bonds can greatly increase the supply of long-term finance to the private sector.

Many developing countries have benefited from the creation of money and capital markets. Money markets can provide competition for banks, a flexible means for managing liquidity, a benchmark for market-based interest rates, and an instrument of monetary policy. Capital markets can be a source of long-term finance—both debt and equity—and can help to foster sounder corporate capital structures.

Most developing countries have a long-established informal financial sector that provides services to the noncorporate sector—households, small farmers, and small businesses. Although family and friends are usually the most important source of credit, pawnbrokers provide a substantial amount of credit to those with marketable collateral, and moneylenders to those without. Merchants provide financing to their customers, and purchasing agents advance funds to their suppliers. Rotating savings and credit associations are ubiquitous in the developing world.

Financial institutions have often been weakened by being forced to channel credit to small-scale borrowers. Because such borrowers do not maintain financial accounts, formal lenders find it difficult to predict who is likely to repay. Moreover, if the borrower is in a group favored by government, formal intermediaries may find it difficult to collect. The informal sector, in contrast, has been able to serve such borrowers. Informal lending has severe drawbacks, however. The scale of lending is small, the range of services is limited, markets are fragmented, and interest rates are sometimes usurious. Nevertheless, these institutions help clients that formal institutions often find too costly or risky to serve. Some countries have recognized this and have established programs to link informal markets more closely with formal markets. The most successful formal programs for the noncorporate sector utilize rather than suppress indigenous systems, take deposits as well as lend, and levy charges that cover costs.

As the developing countries move toward more sophisticated financial systems, they can draw on the experience of the high-income countries in the design of instruments and institutions. Some of the lessons are cautionary. One lesson is that competitive financial markets, although efficient at mobilizing and allocating funds and managing risk, can still make mistakes—witness the excessive lending to developing countries that took place in the 1970s and the current savings and loan crisis in the United States. Another is that market-based financial systems can be unstable and susceptible to fraud. This underlines the importance of adequate regulation and supervision. Because finance evolves rapidly, regulators must continually strive for the right balance between stimulating competition and growth and limiting fraud and instability.

The path to reform

Many developing countries have taken steps toward financial liberalization during the past decade. In perhaps a dozen countries, interest rates have been fully liberalized; in many more, interest rates are managed more flexibly than before. Many countries have curtailed their directed credit programs, although few have eliminated them entirely. Competition among financial institutions has been promoted by opening the domestic market to foreign banks and by authorizing charters for new banks and nonbank financial intermediaries. Several centrally planned economies aim to stimulate competition by extensively restructuring their banking systems.

In a few countries financial liberalization has been quite comprehensive. Argentina, Chile, and Uruguay, for example, carried out extensive reforms in the mid-1970s, including the elimination of directed credit programs, interest rate controls, and exchange controls. Several Asian countries have also moved toward deregulation, but the reforms were introduced more gradually and were less comprehensive. Financial liberalization has sometimes proved difficult. In the Southern Cone countries—Argentina, Chile, and Uruguay—liberalization ended in disarray: the government of Argentina had to reimpose controls, and all three governments had to deal with widespread bank failures. Turkey's government had to restore interest rate controls when real rates rose too high. But in Asia, where macroeconomic conditions were more stable and reforms were implemented more gradually, there has been no need to reintroduce controls.

Experience suggests that financial liberalization needs to be undertaken alongside macroeconomic reform. Countries that attempted financial liberalization before undertaking other reforms suffered destabilizing capital flows, high interest rates, and corporate distress. Although certain measures should be taken at an early stage, such as the alignment of interest rates with market forces, overall liberalization cannot succeed unless it is accompanied by the restructuring of insolvent banks and firms and by adequate regulation and supervision. Domestic financial markets need to be competitive to ensure that intermediaries are efficiently run. And to avoid the destabilizing capital flows that proved so difficult to manage in several countries attempting deregulation, care must be taken in opening the capital account.

The change in many countries' approach to development implies important changes in their financial sectors. Countries that wish to rely more upon private decisionmaking need financial systems that operate on a more consensual basis. For that, confidence is needed—confidence that the value of financial contracts will not be eroded by inflation and that contracts will be honored. Getting the prices—interest rates—right is important for financial development, but this must be complemented by other policies as well. Countries also need to create appropriate financial institutions, develop better systems of prudential regulation and supervision, improve the flow of financial information, develop human skills for managing complex financial operations, and promote good financial habits. None of these changes will be easily or quickly accomplished.

Outline of the Report

Chapter 1 describes the global macroeconomic environment that has confronted developing countries in recent years and discusses two scenarios for prospects to the end of the century. Even under the more optimistic of these, the developing countries face serious economic challenges.

Chapter 2 introduces the main body of the Report and examines the role of finance in development. It argues that finance matters in more ways than might be immediately apparent. Efficient financial systems help to allocate resources to their best uses and are indispensable in complex, modern economies. In many developing countries, as some of their governments have begun to realize, the financial sector is in urgent need of reform.

Reform will not be easy, but the difficulties faced by developing countries as they seek to improve their financial systems are not new. Chapter 3 charts the history of financial institutions in the industrial countries. It shows an often unsatisfactory mixture: innovation in response to the needs of growing economies, but many disruptive episodes of financial instability. Failures and fraud in their financial systems have led governments to intervene extensively.

Chapter 4 shows that for several decades after World War II, regulation of the financial systems in developing countries was designed to control the economy rather than foster the safety and soundness of banks. More than in the high-income countries, governments used the financial system to pursue their development objectives. This left their financial institutions weak, and as a result many were unable to withstand the worldwide economic shocks of the 1970s and early 1980s. Chapter 5 describes the difficulties of financial institutions in many countries and the steps taken by some governments to address the problems of their financial sectors.

This experience has led the developing countries to reassess their financial policies. A search is under way for policies that will strengthen the financial sector so that it can make its full contribution to the efficient use of resources, while keeping its tendency toward instability in check. Chapter 6 examines the legal and institutional changes that should be part of this reappraisal. Chapters 7 and 8 report in more detail on the current provision of financial services to the corporate and noncorporate sectors and explore ways in which these services might be improved. Chapter 9 discusses the lessons that can be learned from the developing countries that have already begun to liberalize their financial sectors.

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FSDP Update

News from the Financial Sector Development Project

Global Integration Essential to Developing Country Growth

by Dr. Stanley Fischer, M.I.T.

The politicians and economists who created the post-World War II economy aimed to reconstruct and restore the global economy which had been destroyed by two world wars and the Great Depression. They created a framework for international integration to stimulate economic growth and they succeeded beyond any sober expectation. Throughout the post-World War II period, international trade grew at a faster rate than overall gross national product. Major national money, bond and stock markets are now as integrated as they were prior to World War I.

The trend of increasing financial and economic integration will likely continue throughout the last decade of the century as Eastern Europe and the Soviet Union rejoin the international economy, European integration proceeds rapidly and the Uruguay Round creates possibilities for expanded trade in services, agriculture and textiles.

Both industrialized and developing countries have benefited enormously from economic and financial integration. The lessons are apparent: economies that grow are those that are linked to the global commerical and financial community. Nonetheless, continued progress in increased global integration faces formidable barriers. U. S. financial institutions are in distress, the structural transformation of Eastern Europe and the Soviet Union will be lengthy and difficult, and the outcome of the Uruguay Round negotiations is uncertain. Given the critical importance of trade, the potential failure of the Uruguay Round raises concerns that trade expansion could cease to be an engine of growth, and that trade restrictions could become engines of destruction. If the Round fails we can expect increasing non-tariff protection and the further development of regional trading blocs, although the development of three major exclusive trading blocks in the relevant future looks very unlikely. A two-bloc world (Europe and the rest of the world) is a possibility, one that would be costly for the developing countries that would have to choose sides and might be excluded from one or the other large market.

A failure in the Uruguay Round could also seriously dampen the current trend toward globalization in finance, since the integration of the real sectors of the world's economies is the background against which global financial integration is taking place.

We live in a global financial marketplace and the internationalization of these markets is reflected in the possibility of twenty-four hour-a-day trading and the essentially instantaneous transmission of shocks among major markets. Speculators, investors, and financial economists have all gone international. These advancements in the international marketplace owe much to the trends in financial deregulation in the industrialized economies and the lifting of capital controls in Great Britian, Japan and other European countries.

Investors in the United States, Europe and Japan directly and indirectly (through pension funds) have larger shares of foreign securities - often in the form of mutual fund shares - in their portfolios than they did a decade ago. Foreign direct investment and the internationalization of production are also results of the mobility of long term capital.

These benefits of internationalization also bring with them some risks. The two most apparent examples are the worldwide shock experienced among major markets following the Stock Market crash of 1987 and the international debt crisis of the 1980's. Both events provide lessons for the future. As a result of the debt crisis, moderation and innovation are now in vogue, and it has become clear

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Dr. Fischer is a professor at the M.I.T. Sloan School of Management. This article is a summary of a 40 page paper written for the "Leading Issues in Development Finance Conference."

Inside

Developing Country Securities Markets: The Need for Balanced Regulation

by Jan Aalbregtse

As the world privatizes and turns toward free market capitalism, securities markets will play a key role in mobilizing the requisite capital for the change. There is a tendency to assume that, because a free market approach is being adopted in lieu of a controlled economy, regulation of a securities market is inappropriate. On the contrary, new forms of regulation become necessary to achieve efficient and fair securities markets that retain investors confidence. The secret is to achieve the appropriate balance between regulation and a dynamic and competitive free market.

Present Approaches to Regulation

Developing country securities markets have suffered from both underregulation and overregulation. Those countries that have opted for the former approach have found that a free market has limitations. The unregulated and unrestrained free market approach is ineffective primarily because it leaves all market participants exposed to those who choose to engage in corrupt practices which mislead and abuse persons with a lesser degree of knowledge or sophistication.

As a result, many developing countries that have adopted this approach suffer from both the perception and the reality of an unfair market. Reliable financial information, an essential ingredient in a fair marketplace, is often unavailable in emerging markets.

In most cases this failure is the direct result of a lack of strong regulation which enforces fair and full disclosure of material financial information. Tax systems, on the other hand, provide an incentive to underreport results of operations. Information about material developments affecting public companies usually becomes available to "insiders" long before the general public. The lack of any effort to control fraudulent practices leaves all investors at risk to lose their invested capital. Unfortunately, the strength of human greed has proved to be too strong to enable markets to be guided only by their participants. Customers usually come last in that system.

Some developing countries have reacted to these problems with a paternalistic approach, which provides a degree of overregulation. For example, in Thailand, the government and the stock exchange conduct "due diligence" reviews of companies to assure they are sound. Companies may not be listed on the exchange unless "the company is sound and appropriate to the type of business, its operations are satisfactory, and its main business is economically and socially beneficial to the nation." In an attempt to protect customers from securities companies, Thailand gives its central bank board regulatory power to order securities companies to rectify any problems in operations deemed to be causing damage to the pub-

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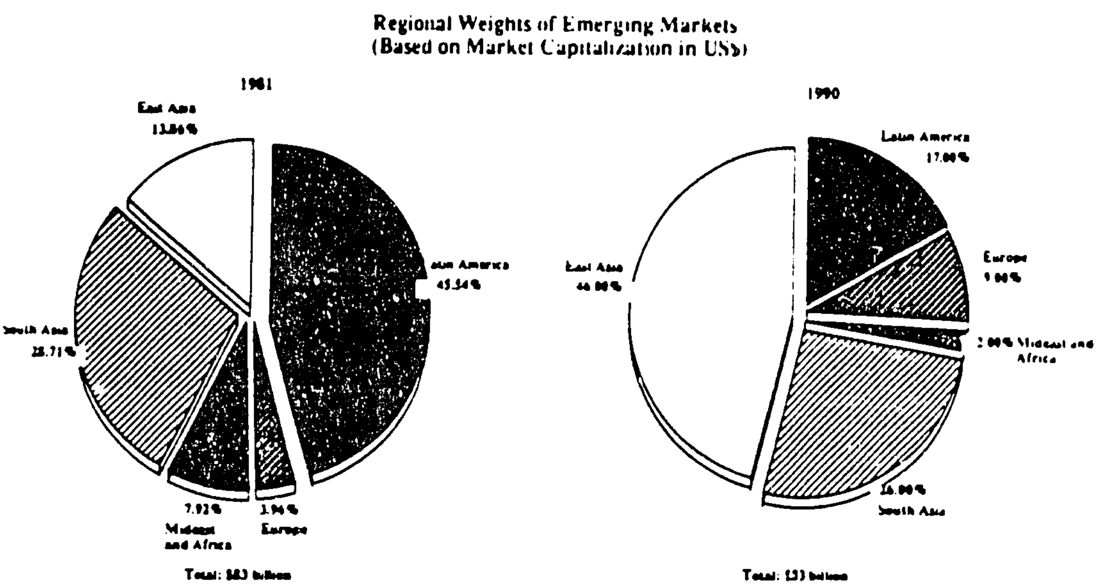

**From Emerging Stock Markets Factbook, 1991. Published by the IFC.

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CALENDAR OF EVENTS

Upcoming Conferences and Training Courses

DATES	EVENT, SPONSOR & LOCATION
Dec., 1991 Jan, 1992 (Exact dates to be determined)	**Financial Analysis** (2 week course) **U.S. Agency for International Development** Washington, D.C.

CONTACT: Jean F. Stevens
Bureau for Personnel and Financial Management
Office of Personnel Management, Training Div.
Room 314, SA-2, Washington, D.C. 20523
Telephone: **202-663-2283**

DATES	EVENT, SPONSOR & LOCATION
February 10-21	**Privatization Management and Implementation** (in English & French) ***INTRADCS/ International Management Group** Washington, D.C.

CONTACT: Margaret Ghadar
INTRADOS/IMG, 2020 Connecticut Ave., N.W.
Washington, D.C. 20008
Telephone: **202-667-8270**, Fax: **202-223-8791**

DATES	EVENT, SPONSOR & LOCATION
	Regional Conference on Microenterprise Finance
Feb. 10-12	Swaziland
March 9-10	Jakarta, Indonesia

CONTACT: Beth Rhyne
APRE/SMIE
Room 3214, NS
Washington, D.C. 20523

Telephone: **202-647-2727**
FAX: **202-647-1805**

*** These organizations offer various courses throughout the year. For information on other courses, please notify the appropriate contact person.**

Leading Issues in Development Finance: A.I.D. Conference Discusses Key Developments

With the global economic environment in the developing world drastically changing, a group of development experts convened this August to discuss and unveil the key changes and initiatives surfacing in development finance. Sponsored jointly by the Bureaus for Asia/Private Enterprise, Europe/Near East, Africa and Latin America, the Leading Issues in Development Finance conference was a collaborative effort across A.I.D. bureaus and included perspectives from field missions and the central offices, private sector and project officers, policy analysts and economists. The conference took place on August 19-21, 1991, and was designed and organized by Dr. Donald Lessard, Professor of International Management at M.I.T., Mr. J. Richard Breen, FSDP Project Director at Price Waterhouse, and a working group from the A.I.D. bureaus.

Dr. Donald Lessard opened the three-day seminar stressing the main theme: "the financial system is the nervous system of a market economy; it signals resource availability and requirements and creates incentives, monitors performance and imposes sanctions in the case of non-performance". This theme was reiterated by Antoine van Agtmael, Emerging Markets Investors Corp., who stated that "capital markets are a necessary tool for democracy; they change and broaden ownership, and fill economic and social roles. John Mullen, Assistant Administrator for the Bureau for Private Enterprise, explained that most developing countries now recognize that free and open markets are the best engine for growth. The challenge that remains ahead is ensuring that markets are allowed to work.

The experts examined the main characteristics of today's financial markets as determinants for the future in development finance methods. First and foremost, financial markets are global and highly integrated. Secondly, there has been tremendous growth in the number of new and innovative financial instruments and financing techniques. Dr. Lessard explained that financial innovations are contributing greatly to the development of capital markets in developing countries, and through these markets, to the

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Introducing a Forward Foreign Exchange Market in Egypt

An FSDP team is currently working with USAID/Cairo to analyze Egypt's new foreign exchange system and to design a framework for developing a forward market.

The FSDP team's objective in this assignment is to provide the participants in Egypt's foreign exchange market with an overview and outline of how forward contracts can be introduced and made an integral part of the system, with a view to enhancing the efficiency of the free foreign exchange market.

The team found that, before an active forward market could develop, there was no reason why banks could not begin to offer their customers forward contracts if the following steps were undertaken: (1) development of a spot interbank market; (2) changes made in the Central Bank regulations regarding bank foreign exchange exposure limitations; and (3) an educational process targeted at Central Bank officials, bank managers, and traders. Furthermore, the Central bank will need to ensure that banks have the proper controls and reports regarding interest rate and foreign exchange risk in place prior to engaging in forward transactions.

Investigating Options for an Automated Warsaw Stock Exchange

An FSDP consultant is on a two-phased project to advise the President of the Warsaw Stock Exchange and USAID/Warsaw on automating trading, clearance and settlement operations of the newly-opened exchange. The scope of this project, a joint effort between the Department of Treasury and A.I.D., is to advise on a feasible and practical level of computerization needed by the exchange to operate effectively; and to review proposals to the WSE from software and hardware vendors. The consultant completed Phase I by recommending the short-term and long-term designs of the computerization of clearance and settlement mechanisms for the exchange. In Phase II the consultant analyzed hardware and software requirement definitions for project transactions based on the potential growth of listed companies and the shared transactions, comparing them to proposals from vendors to recommend the right package for the exchange.

Appraising Credit Subsidies in Sri Lanka

FSDP was engaged by USAID/Colombo to conduct a preliminary appraisal of the extent and incidence of credit subsidies in Sri Lankan financial markets. The team determined that the high cost of subsidized credit in Sri Lanka is directly related to failure of the commercial banks to price their loans in a way that reflects the full cost of financial intermediation. Most borrowers in Sri Lanka are being subsidized by banks (including the state-owned commercial banks and the National Savings Bank) charging unrealistically low interest rates. This distortion in interest rate structures, as well as other market imperfections, results in inhibited competition, the near-insolvency of many financial institutions, and sluggish money and capital markets. Based on a great deal of research and extensive interviews, the FSDP team concluded that the indirect costs of subsidized credit are much more significant than the direct costs of Central Bank refinancing and credit guarantees.

The team discovered that, since the government has agreed to phase out the direct subsidy within a matter of two to three years, the NSB is in a very precarious position. The team recommended that the NSB learn how to manage a more diversified asset portfolio in order to operate independently; that mortgage-specialized institutions should begin to offer adjustable rate mortgages; and that the state bank should consider being sold to private investors after rehabilitation. The two in-country mortgage-specialized institutions are exposed to interest rate risks and must adjust more rapidly to changes in market conditions if they are to pay full competitive rates.

An impact of the FSDP final report is that USAID/Colombo will use the results of this study to design a project to support the liberalization of interest rate structures.

Studying the Reprivatization of Banks in Chile

The 1985 reprivatization of two major Banks in Chile was made successful with the aid of a new "popular capitalism law" which gave preferential loans to small investors in these banks. It is believed that this program contributed to the successful offer of 350 million shares (U.S. $ 9.0 million) by these banks on the local market.

An FSDP case writer went to Santiago to study and bring together detailed facts relating to the role that the popular capitalism program played in the offer.

The case writer explored the issues which were considered at the time, and how those issues were resolved. In addition, the case writer researched qualifying citizens' utilization of these loans, their experience with them, default rates, profitability of the shares to the investor, redemption rates and other information which would bear on the replicability of this method in other countries.

Global Integration

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that while countries, firms, banks and investors can make profitable use of the international capital markets, such activity should be tempered. The debt crisis has illustrated that developing countries should:

- Borrow only to finance productive investments,
- Limit access to foreign borrowing,
- Understand that real interest rates can change rapidly,
- Take advantage of risk-sharing forms of foreign investment.

Policy Implications for Developing Countries

What do the lessons learned mean for developing countries? Specifically, what domestic financial policies can an individual developing country undertake to assure integration into world financial markets?

First, a country can reap many benefits from longer-term inflows, particularly through portfolio investments and foreign direct investments. Countries do not need a fully open capital account to be able to bring in portfolio investments, to set up regulations that allow foreign investors to move their portfolios in and out, and set up arrangements for repatriation of profits. Countries should be focusing on getting these regulations straight rather than opening the capital accounts immediately.

Second, foreign direct investment brings with it not only the obvious benefit of foreign capital but also potential access to foreign management skills, technology, and markets. Countries that manage their economies well are likely to be able to attract increasing amounts of foreign capital in the form of direct investment.

There are also increasing opportunities for developing countries to hold reserves and invest in innovative commodity-price related hedging instruments. Hedging instruments are potentially very important for countries such as Mexico, Venezuela and Indonesia

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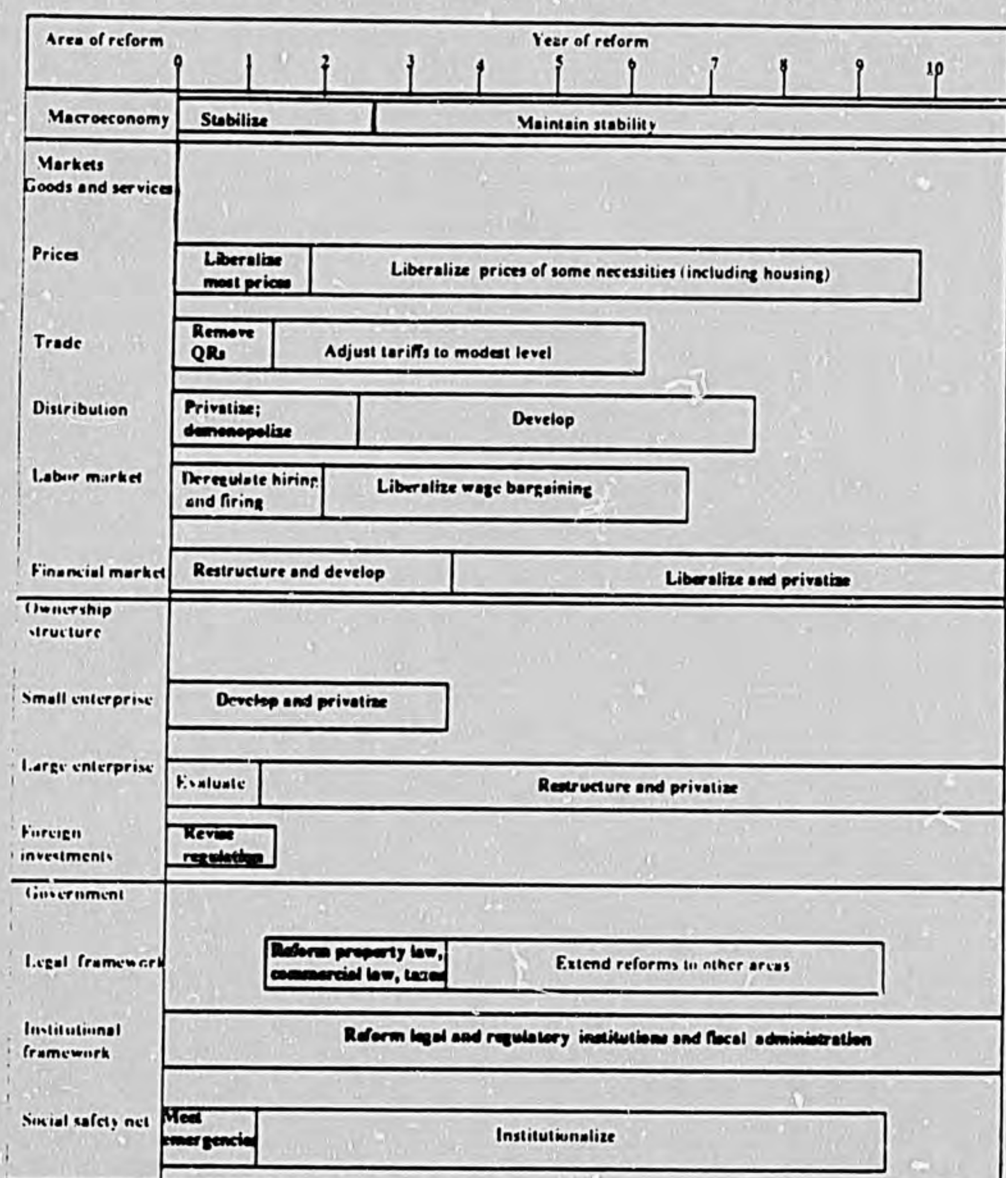
which depend on the export of a single commodity, since their economies get hit by massive shocks when the price of this commodity moves. Fortunately, we are now beginning to see practical financial instruments that countries can use to hedge these risks. Mexico and Algeria now have oil bonds, others have cocoa or copper bonds. Chile has a copper stabilization fund to control the impact of price fluctuation on the government budget. Those innovations will undoubtedly be exploited by the capital markets in the future as they are alternatives to the commodity-price stabilization schemes that LDCs have been trying to set up unsuccessfully for a long time.

At the same time as countries seek to encourage international flows of finance, they have to be sure to create sound domestic financial systems. Due to the nature of the financial system, the crucial roles of deferred payments, information and economies of scale, finance is not an industry where laissez faire works well. There is a strong need for a careful system of prudential regulation in financial intermediaries. The principal focus of regulation has to be the banking system where the objective of robustness is more important than sophistication. If the banking sector is not allowed to fail, it should be regulated so that it does not take speculative financial positions. The rest of the financial system can invest in whatever it chooses, so long as it is understood that it will not be bailed out.

Finally, the development of a stock market need not be an especially high priority for governments, but there is no reason to oppose the development of a stock market, provided that the appropriate prudential disclosure regulations are put in place. In general, stock markets are not an important source of financing in the early stages of development. Even in industrialized economies, the bulk of financing comes from retained earnings and from borrowing from banks or other financial institutions.

In short, a clear mixture of prudential regulation and the promotion of the debt and equity markets should be an integral component of domestic policy plans to spur economic growth and to foster global integration.

Eastern Europe and the Soviet Union, Latin America, Africa and Asia are all moving in the direction of a global economic order. Progress is not inevitable and current events in the areas of international trade and finance may cause rifts in economic integration. Nevertheless, recognizing the progess that has been made by countries that have participated fully in the international economy and the collapse of centrally planned economies, there is much about which to be optimistic.



Note: Darker shading indicates intensive action. QRs, quantitative restrictions.
*Graph taken from the *World Development Report 1991*. World Bank: Oxford University Press, pg. 146.

THE PHASING OF REFORM*

Securities Markets

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lic interest". The central bank must approve in advance the hiring of any director, manager or broker. The number of licenses that may be granted to securities companies is also strictly controlled, thereby indirectly encouraging monopolistic tendencies.

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. To accomplish this, securities must be placed in the hands of the general public. Unfortunately, developing country capital markets generally are not effcient enough to provide an incentive for the redistribution process to take place on its own.

To compensate, governments of some countries have decreed that companies of a certain size list their securities on local stock exchanges, or require that a certain percentage of a company's securities be sold to the public. Some even require that these sales be made at prices that are advantageous to the public. Others have dispensed with free market principles entirely, and require government officials to fix the price of the shares to be sold!

"The secret is to achieve a balance between regulation and a competitive free market"

For example, Pakistan uses all of the methods described above in an attempt to force the small group of families that owns most of its companies to divest a portion of their ownership, with the following results:

- The families repurchase the shares in the market in order to maintain control.
- The companies fail to report results of operations to the market or to minority shareholders.
- Profits are distributed to family shareholders in the form of compensation for services, instead of being distributed to all shareholders as dividends.
- There is no secondary trading market for the shares of many companies, leaving minority shareholders without a method to sell their shares.
- Fixed prices that are imposed by the government distort the market, and provide unfair advantages to the few who are entitled to purchase at the low price.

Thailand, which has a much more developed market than Pakistan, allows prices to be established freely and does not require that companies list their securities. Instead, it has attempted to achieve redistribution goals and to protect minority shareholders by enacting a law that purports to apply to any company that accesses public capital. That law requires a public company to distribute 50% of its shares to the public and provides significant protections for minority shareholders. Unfortunately, the law fails to appropriately balance protections for shareholders with realities of the marketplace, and the companies have found ways to avoid direct compliance.

In sum, attempts to force market compliance with direct government action have always failed to achieve the desired result. Worse, these actions have taken the focus off the real problems of capital market regulation, i.e., full and fair disclosure to all in the market.

A Balanced Regulatory Structure

Some developing countries have recently embarked on programs to achieve a balanced regulatory structure. Indonesia has been a pioneer both in using its securitites market to address social goals and in revising its laws to achieve a balanced regulatory structure. In January 1991, by Ministerial decree Indonesia enacted provisions govening securities markets that may become a model for other developing countries. Highlights of that decree are:

- A regulatory body, BAPEPAM, was created and given a significant degree of independence.

- Exchanges were established as self-regulatory organizations (SROs). As an SRO, an exchange makes its own rules, polices its members, and provides a surveillance function, subject to oversight by BAPEPAM. Exchanges are non-profit and are required to have a selection of persons on their board representing the private sector, investors, as well as members of the exchange.

- Public offerings are regulated through a system requiring full disclosure of material information. There is no system of "merit" review, whereby a governmental agency substitutes its judgement about securities for that of investors.

- Brokerage firms are required to be licensed and are regulated primarily through "net capital" requirements, which establish daily capital requirements based on assets and liabilities on that date. Individuals who perform any of these functions of a broker-dealer are required to obtain licenses.

- "Capital market supporting professionals" are required to register with BAPEPAM. This includes accountants, notaries, public appraisers and legal consultants who provide services in the capital markets that are regulated by BAPEPAM.

Indonesia is one example of how balanced regulation contributes to the proper development of an emerging securities markets, but growing markets in other Asian countries are quick to follow. With the adequate balance of free market management and clearly defined rules and regulations, emerging securities markets will be a significant factor in development country growth in the future

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to the economic development of those countries. Third, securitization is becoming increasingly fundamental to the financial industry. Finally, credit risk and country risk will be with us for the next decade. As such, much more finance will be collateralized and the result will be a "flight to quality, or a new conservatism."

This new conservatism will be characterized by increased risk sharing and managerial involvement. Examples of such financing include privatization, commodity linked financing, venture capital, swaps, options, guarantees and direct foreign investment. Dr. Roger Leeds of the PriceWaterhouse International Privatization Group and Mr. Aaron Tornell of the Mexican Ministry of Finance demonstrated the importance of privatization by expounding on the many options available to governments as they decide to privatize state-owned enterprises. Mr. John Blackton, Deputy Assistant Administrator for Policy concurred, and offered the A.I.D. experience as an example by stating that privatizing the private sector has been one of A.I.D.'s most challenging efforts over the past ten years.

Venture capital is another means of financing investment. As explained by Kenneth Locklin, Manager of the Africa Growth Fund, venture capital is high risk, but its potential for success is heightened due to the most important asset it brings to investment: management and entrepreneurial experience. Other innovations, such as swaps, options, futures, guarantees, hedging, pre-export financing and commodity reserve financing have been proven to help countries reduce the risks associated with volatile commodity prices and provide a firm basis for future international lending.

According to Dr. Stanley Fischer, Professor of Economics at M.I.T., foreign direct investment is the best form of investment as it brings with it the added benefits of potential access to foreign management skills, technology and markets. He explained that earlier hostility toward FDI has been replaced by international competition for its benefits.

Dr. Philip Wellons of Harvard Law School emphasized that prudential regulation and legal infrastructure are the underlying requirements of a financial system. Financial systems should be decontrolled to allow flexibility, but <u>prudential</u> regulation is required to ensure stability and to see that everyone plays by the rules. This point was reiterated by Fischer who noted that the financial sector has long been the source of the most spectacular examples of fraud and mismanagement in both industrialized and developing countries. He added, this is "not an industry where laissez faire works well. the need for a careful system of prudential regulation in financial intermediaries is widely recognized."

"The financial system is the nervous system of a market economy"

John Mullen, Assistant Administrator of PRE, underscored the importance of the demonstration effect. The successful turnarounds of Mexico and Chile, for example, provide lessons to other countries on both policy and transactional levels. The relevance of these success stories was reinforced by Douglas Tinsler, USAID San Jose, who explained that Costa Rica's policy makers and business leaders are working closely with Mexican and Chilean counterparts to derive lessons learned and apply them, as appropriate.

Workshop participants cited three areas in which A.I.D. can and should make an important contribution: enabling environment, transactions and *training*.

First, through policy dialogue, A.I.D. can and should work with host governments to ensure the enabling environment required for financial market development. Without appropriate policies, neither economic nor financial market development will take place. Secondly, policy reform alone will not guarantee financial system growth. Actual involvement in the use of new instruments and in strengthening the legal/enforcement infrastructure for prudent surveillance will also be required. Both John Mullen and Henrietta Holsman-Fore emphasized the importance of transactions to make things happen. Finally, A.I.D. can and should play a significant role in training its own staff as well as host country personnel.

Dr. Fischer summarized some of the key thoughts expressed at the workshop with the following, "recognizing the progress that has been made by countries that have participated fully in the international economy, and the collapse of centrally planned economies, we should be optimistic both about the potential gains from global integration of trade and finance, and the likelihood that many will realize them."

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UPCOMING ENGAGEMENTS

NO	LOCATION	TITLE
	Central America	Financial Sector Seminar
	Eastern/South Africa	Financial Sector Seminar
	Egypt	Bank/Insurance
	Egypt	Bond Market Development
	Egypt	Equity Finance
	Guatemala	Financial Sector Assessment, Studies
	Guatemala	Financial Sector Training
	Honduras	Bank Training
	Honduras	Capital Market Development
	Kenya	Financial Market Technical Assistance
	Nicaragua	Bank Association Strenghthening
	Nicaragua	Insurance & Pension Funds
	Nicaragua	Superintendency of Banks
	Philippines	Technical Assistance to the Exchanges & SEC in Developing a New Automated Securities Market System
	Tanzania	Commercial Bank Examination
	Tunisia	Stock Market Promotion

ACTIVE OR OPEN ENGAGEMENTS

NO	LOCATION	TITLE
8.	Egypt	Equity Finance Facility Feasibility Study
16.	Honduras	Bank Strengthening Program
30.	U.S.	Bank Analyses for PRE/I
41	Bolivia	Privatization Seminars and Conference
44.	ENE Bureau	Regional Financial Markets Guidebook
45.	Morocco	Secondary Debt Market
46.	Tunisia	Financial Sector Assessment
49.	Egypt	Government Bond Market Development
51.	Sri Lanka	Credit Subsidies Appraisal
52	Washington, DC	Financial Leadership Conference
53.	Indonesia	Advice on Clearing and Settlement Issues
54.	Cote D'Ivoire	La Financiere Financial Analysis II
55.	CFA	Regional Financial Markets
56.	Morocco	Stock & Secondary Debt Markets Follow-On Work
57.	Portugal	Housing Finance Study
58.	Poland	Warsaw Stock Exchange
59.	Chile	Popular Capitalism and Privatization: A Case Study
60.	Indonesia	Accountancy for Regulation
61.	Philippines	Capital Market Development Strategy
62.	Guinea-Bissau	Debt/Equity Swap
63.	Egypt	Foreign Exchange Forward Market
64.	Washington, DC	Newsletter IV, FSDP Update
	Honduras	Development Bank Feasibility Study
	Near East	Financial Sector Assessments: Turkey & Oman
	Africa	Financial Sector Development in the CFA Zone